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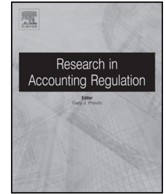

Research Report

Comment letter activity: A response to proposed changes in lease accounting

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ABSTRACT

This study examines the motivations that lead some firms to lobby, via comment letters, against the changes in accounting for leases proposed by FASB/IASB. There are at least three distinct motivations for a company to lobby against the proposed changes: a high perceived cost of implementation/operation, a belief that the changes will increase the cost of capital, and a desire on the part of management to avoid any administrative burden associated with the changes. Our research suggests that companies that engage in lobbying are concerned with the costs of such changes (renegotiation of debt covenants, auditor fees, change in IT systems, etc.), but they also seem to be motivated by their accounting manager's desire to avoid any additional effort that the changes will require.

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1 Introduction

At the suggestion of the SEC in 2005, the FASB undertook a controversial joint project with the IASB aimed at converging lease accounting standards. More than a decade later on February 25, 2016, Accounting Standards Update (ASU) No. 2016-02 Leases was issued and will be effective for most companies after December 18, 2018.[1]

This report provides an analysis of the more than 1400 comment letters sent to the FASB/IASB in response to accounting changes proposed via ASC 840 and 842 *Leases*. Although the economic impact of the changes proposed by the FASB/IASB was not clear, they generated strong opposition from companies. Our analysis reveals that approximately 80% of the comment letter lobbying firms were against the proposed changes. While there is a substantial body of empirical research devoted to understanding the implications of lease accounting, little primary research has been conducted in this area. This paper provides an analysis of the entities that engaged in comment letter lobbying around this issue, the tone of the comment letters they sent, and a summary of the specific reasons they gave in opposition to the changes. We also provide some related empirical findings. The reasons for, and potential motivations behind, lobbying against what is arguably one of the most contentious issues in contemporary accounting, should be of interest to practitioners, regulators and academics alike. Consistent with prior studies (e.g. Anantharaman, 2015; Francis, 1987; Fried, 2012; Ramanna, 2008) we use the term lobbying in a narrow context, referring specifically to comment letter lobbying.

The purpose of the joint project was to address concerns that the current standard (SFAS 13) does not meet the needs of investors. More specifically, the existing accounting model has been criticized, among other reasons, because it represents one of the largest forms of off-balance sheet accounting and fails to provide a faithful representation of leasing transactions [www.fasb.org]. The main effect of the new standard will be to end the use of operating leases and instead require capitalization of all leases. The FASB's objective was to increase financial statement comparability by preventing similar transactions from being reported differently, as currently happens due to the bright-line rules of

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[1] The effective date of the ASU for public companies is for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For private companies, it is effective for fiscal years beginning after December 15, 2019 and interim periods beginning the following year. Early adoption is permitted. (http://www.fasb.org/jsp/FASB/Page/BridgePage&cid=1351027207574).

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SFAS 13[2] that differentiate between operating and capital leases.

Ex-ante, it is not clear why firms would lobby for or against the proposed changes. If stakeholders understand the implications of off-balance sheet leases, the changes should have minimal effect. However, if a group of stakeholders is not correctly adjusting for operating leases, it is possible that the proposed changes could increase their risk assessment for companies. It is evident from the comment letters that most companies are against the proposed change. This study examines whether companies are opposed to the proposed lease changes because they wish to obfuscate their perceived risk, or because they perceive that the new rules will increase their operational costs or their cost of capital.

This paper contributes to the current literature on lobbying by analyzing the specific objections to the proposed changes from the comment letters and by investigating whether lobbying firms have unique characteristics that could raise red flags for investors. This study also complements the current literature by analyzing the behavior of firms when management compensation is not expected to be negatively affected.

2 Literature review

The Boards' primary concern that current lease accounting does not always faithfully represent leasing transactions and, as such, may disadvantage some investors, is borne out by extant academic research but not conclusively. A number of papers present evidence that companies structure their leases in order to keep them off-balance sheet (OBS), and that some market participants do not fully adjust for information available in the footnotes. Imhoff and Thomas (1988) show that capital leases decreased after SFAS 13, and provide evidence that firms want to keep leases OBS. Cornaggia, Franzen, and Simin (2012) corroborate this view by documenting high levels of excessive operating leases among firms investigated by the SEC (or Department of Justice) for accounting misrepresentation (or fraud). Ge (2006) presents evidence that OBS leases are negatively related to future earnings and stock performance and that investors seem to value them as if they were positively related to future performance.

Research investigating whether market participants react differently to recognition than to disclosure on financial statements also supports the FASB/IASB view that leases ought to be capitalized. A number of papers (e.g. Aboody, 1996; Ahmed, Emre, & Lobo, 2006; Callahan, Smith, & Spencer, 2013; Davis-Friday et al., 2004) find that investors react more strongly to recognition than disclosure in footnotes.

There is however no consensus regarding how well market participants adjust for operating leases. While Dhaliwal, Lee, and Neamtiu (2011) find that investors do adjust for operating leases, their results imply that they do so less than for capital leases. On the other hand, Altamuro, Johnston, Pandit, and Zhang (2014) provide evidence consistent with bond investors using OBS information to determine spreads in the absence of a Standard and Poor credit rating. Krische, Sanders, and Smith (2012) find that, relative to other forms of earnings management, analysts attach less importance to lease structuring. Finally, Bratten, Choudhary, and Schipper (2013) find that there is no statistical difference between recognition of capital leases and the disclosure of operating leases. The authors conclude that this is evidence that capitalizing leases is not necessary since the markets already adjust for these.

One of the main arguments against the Boards' proposal relates to the costs that the changes would engender at both macro and micro levels. A 2012 report published by Chang and Adams Consulting claimed that, best-case scenario, the proposed changes would cost the U.S. economy 190,000 jobs and reduce the U.S. Gross Domestic Product (GDP) by $27.5 billion annually.[3,4] Current academic literature (e.g. Cornaggia, Franzen, & Simin, 2013; Singh, 2012; Wicker & Young, 2011) supports the notion that the proposed changes in accounting for leases would significantly, and adversely, impact the financial ratios of leasing firms. Regarding more specific leasing issues, Hales, Venkataraman, and Wilks (2012) argue that the inclusion of a renewal period could make it harder for firms to raise capital unless they disclose the minimum obligation period and the renewal period separately. Finally, anecdotal evidence from the media and comment letters implies that of larger concern to firms is the high costs of implementing the rule changes (e.g., increases in auditor fees, changes in IT systems to track leases) and the economic effects associated with the proposed changes (e.g., higher borrowing costs). The media however has been silent about the differential effects for firms with different incentives.

This study also complements the current lobbying literature by analyzing the behavior of firms even when management compensation is not expected to be strongly negatively affected. Previous research on lobbying behavior (e.g. Beatty & Weber, 2006; Dechow, Hutton, & Sloan, 1996; Ramanna, 2008) has shown that firms are more likely to engage in lobbying with the FASB when proposed changes are likely to affect management's self-interest (e.g., compensation). Leasing presents an interesting complement to the extant lobbying literature given that the balance sheet rather than the income statement is primarily expected to be affected.

[2] The FASB has ruled that a lease should be treated as a capital lease if it meets any one of the following four conditions: (a) the lease life exceeds 75% of the life of the asset; (b) there is a transfer of ownership to the lessee at the end of the lease term; (c) there is an option to purchase the asset at a "bargain price" at the end of the lease term; (d) the present value of the lease payments, discounted at an appropriate discount rate, exceeds the fair market value of the asset.

[3] These results were based on the assumption that historical data would still be valid under the new rules and that companies would forgo projects, rather than renegotiate debt covenants and adjust to the new leverage ratios.

[4] A counter-study commissioned by the Financial Accounting Foundation concluded that the Chang & Adams Consulting report "significantly overstated the macro-economic effects of the proposed accounting changes."

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