Accounting for Lease Renewal Options: The Tradeoff between Transaction Structuring and Informational Effects

Jeffrey Hales

Prof. Jeffrey Hales (Accounting) will present his research this coming Thursday, October 7th at 11 am in room 312.

Jeff Hales’ research is of particular interest to those involved and interested in behavioral decision making, behavioral economics, experimental research, accounting/finance, and policy implications.

Abstract: The purpose of this study is to examine how a newly proposed standard on lease accounting is likely to affect lending decisions. U.S. and international standard setters have tentatively decided that all leases in excess of one year should be recognized as assets and liabilities on a lessee’s balance sheet, including optional lease periods even though the lessee can choose not to renew the lease. We argue that this approach lacks representational faithfulness and creates an informational problem for users. Using an experiment, we show that the proposed “look-through” approach for renewal options has a negative effect on lenders’ willingness to lend to a firm with renewal options. However, we also show that disaggregating the capitalized optional renewal periods from the capitalized non-optional periods of the lease mitigates some of the negative effects of the proposed look-through approach. The results of this study should be of interest to standard setters as they deliberate the proposed changes to both lease accounting and financial statement presentation.