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**Bank Financial Analyst's Response to
Lease Capitalization in Spain**

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Abstract

The 'Plan General de Contabilidad' (PGC) or General Accounting Plan, issued in Spain in December 1990, implemented the European Community fourth, seventh, and eighth directives. The PGC also introduced into Spain a requirement for lessees to capitalize finance lease. This paper reports the result of research involving a questionnaire survey of Spanish financial analysts on the subject of accounting for leases by lessees. They survey enquired into opinions on the most useful form of lease disclosure and the expected reaction of managers of Spanish business to the new rules. The survey also included a request to evaluate two economically identical companies that differed only in the method of accounting for leases.

Studies in both the USA and Singapore suggest that bank financial analysts tend to identify the gearing implications of leases, whether they are capitalized or not, but show some confusion over the impact of finance lease capitalization on return on capital employed.

This survey indicates that Spanish bank analysts support the move to finance lease capitalization, favour its development, and do not anticipate negative economic impact. However, at this early stage analysts appear to take a crude approach to the use of accounting information on leases.

BANK FINANCIAL ANALYST'S RESPONSE TO LEASE CAPITALISATION IN SPAIN

Introduction

The 'Plan General de Contabilidad' (PGC), or General Accounting Plan, issued in Spain in December 1990, implemented the European Community fourth, seventh, and eighth directives. The PGC also introduced into Spain a requirement for lessees to capitalise finance lease. This paper reports the result of research involving a questionnaire survey of Spanish financial analysts on the subject of accounting for leases by lessees. The survey enquired into opinions on the most useful form of lease disclosure and the expected reaction of managers of Spanish business to the new rules. The survey also included a request to evaluate two economically identical companies that differed only in the method of accounting for leases.

Lease Capitalisation in Spain

Spain has a relatively short history of regulating company published accounts. Until 1973 there was no general provision for accounting regulation although accounting requirements for certain specific sectors, mainly financial, had existed for a period of some 50 years (Fernandez Peña 1992). In 1973 the first PGC was published, based on the French Plan of 1959. Compliance with this Plan was voluntary although, in an interesting use of incentives to promote good accounting, in 1978 a tax amnesty was granted on condition that companies complied thereafter with the PGC. In 1976 a government body under the treasury, the 'Instituto de Planificación Contable' (IPC) was formed. This body was given responsibility for developing accounting regulation. One of the first statements of the IPC, produced in 1977, addressed the question of accounting by lessors. The definition of a finance lease was more restrictive than that in the USA, including a provision that:

"The lease conditions must include a purchase option in favour of the user at the end of the lease". (Antolinez Collet 1985:111 - translation).

The issue of leasing was also addressed by a private sector body, the 'Asociación Española de Contabilidad y Administración de Empresas' (AECA), the Spanish Association for accounting and business administration. AECA seem to have been prepared for a broader concept of a finance lease, referring in 1981 to the situation where an option existed at the end of the primary lease period 'to enter into new finance lease at much reduced payments' (AECA 1989 p58).

In 1988 a new governmental body, the 'Instituto de Contabilidad y Auditoria de Cuentas', (ICAC), replaced IPC. ICAC has responsibility for the oversight of both accounting and auditing.

In 1990 a new PGC was issued, implementing the EC fourth and seventh directives. The opportunity was taken to go beyond the basic requirements of the directives in a thorough review of accounting regulation. One issued addressed was that of leasing. A new definition of a finance lease continued the purchase option requirement of the 1977 rules and added "there must not be any reasonable doubt that the purchase option is going to be exercised" (Amat 1989:74. translation).

Lessees are required to show a capitalised finance lease as an intangible asset with the corresponding obligation shown as a liability. A transfer from intangible to tangible assets is then made when the purchase option is exercised. The decision of ICAC to classify leased assets as intangible has been controversial. Two Spanish academics describe this approach:

"because certain groups of people, influential in the drawing up of accounting standards, were unwilling for (leased assets) to be entered (as tangible) a somewhat strange formula was agreed upon in which they were to be considered intangible fixed assets and an item was created specially, called rights on leased property". (Herranz & Socias 1994 p14).

A subsequent AECA recommendation issued in 1991 argues against the classification of assets held under finance leases as intangible.

A factor which ICAC may have had in mind in taking this approach is a concern expressed by the Asociación Española de Leasing (AEL), the Spanish leasing association. AEL argued that any ambiguity in the definition of a finance lease might give rise to 'double counting' in the compilation of national economic statistics, with the same fixed asset appearing in the accounts of both lessor and lessee (Castello Taliani 1989 p255).

Economic Consequences

As in other countries, concerns have been expressed in Spain that the loss of the 'off balance sheet finance' aspect of leasing will lead to a reduction in leasing activity in favour of other forms of finance or a reduction in investment. One survey, predicting contraction in the Spanish leasing market, lists as a contributory factor:

"From 1991, the change in the accounting treatment of the lessee also removes the off-balance-sheet advantage of leasing" (Lease-Europe and Arthur Andersen 1992 p102).

Although a recent discussion of the advantages of leasing does refer to the opportunity to structure a lease so as to avoid capitalisation requirements (Marcos Rodriguez 1994 p73) this carries economic costs in Spain because the tax treatment of operating leases is less favourable than for finance leases.

On the other hand, some companies in Spain have welcomed the new requirements as an opportunity to boost profits in the early years of a lease. This is because depreciation on a capitalised leased asset can be spread over the whole asset life, beyond the end of the lease term.

Whether or not lease capitalisation will have an economic impact on Spanish business is dependent in large measure on the attitude of bank financial analysts, given:

"the limited role played by the Stock Exchange as a source of funds and the fundamental role of the banking system" (Giner Inchausti 1993 p385).

Accordingly, a survey of bank financial analysts' attitudes to finance lease capitalisation has been undertaken.

The Questionnaire Survey

A questionnaire was completed by 46 bank financial analysts who participated in management development programmes in various Spanish academic institutions in early 1994. Completion of the questionnaire was voluntary; in practice, almost all those approached did respond. This method of approach was chosen because the Spanish managers business community are noted for their reluctance to complete questionnaires received through the mail. A recent study reports a response rate from Spanish accountants of 15.3% and cites evidence that this is in line with general Spanish practice. (Garcia Benau et al 1993 : 284).

The questionnaire investigated:

- a) What factors were believed to influence business in deciding to use leasing.
- b) How companies were expected to react to the new requirements to capitalise finance leases in the PGC.
- c) Which method of accounting for leases was preferred by respondents.

In addition, participants were asked to analyse two sets of accounts and then answer questions on how they would respond to these. The two sets of accounts were identical except for the accounting treatment of a finance lease, with capitalisation in one set of accounts but not the other.

Participants were divided into two batches:

- a) Batch 1 received accounts where both capitalisation and non capitalisation showed similar profit levels.
- b) Batch 2 received accounts where capitalisation gave a profit level some 50% higher than non capitalisation.

Details of the accounts used for the two batches, together with details of the underlying assumptions used, are shown in an appendix to this paper.

Studies in the USA tend to show that markets do not need lease capitalisation in the accounts to identify the financial impact of leasing (see for example, Elam 1975, Bowman 1980, and Cheung 1982). However, studies in the USA (Abdel Khalik 1981) and Singapore (Wilkins et al & Zimmer 1983 a) & b)) suggest that bank financial analysts faced with accounts to compare show some confusion over the treatment of leases, particularly in respect of the treatment of profit.

The Analysts' Views

Table 1 shows the factors that the analysts believed influenced the decision to use leasing. Not surprisingly, tax considerations were perceived as the most important factor, seen as very important or important by all but 1 of the respondents. The ability to negotiate the timing of lease payments and the conservation of liquidity were also seen as being of particular importance. By contrast the off balance sheet finance aspect of leasing was seen as being of little or not importance. This view is consistent with a substantial majority of analysts predicting that the finance lease capitalisation rule would not cause a reduction in the usage of finance leasing; indeed, a majority anticipated a positive increase in the use of leasing, as shown in table 2.

Overall respondents were supportive of lease capitalisation, with as many as 32% wishing to make the definition of an operating lease wider, as shown in table 3. Although Spanish accountants seem to dislike the classification of leased assets as intangible, table 4 shows the bank analysts equally divided on the issue.

Table 1

How important do you think each of the following factors is when business uses leasing?

	Very Important	Important	Moderate Importance	Little Importance	No Important
Tax advantages	30 (67%)	14 (30%)		1 (3%)	
Finance Costs	6 (13%)	20 (44%)	10 (22%)	5 (11%)	4 (10%)
Conserving Liquidity	3 (7%)	22 (51%)	15 (35%)	2 (5%)	1 (2%)
Because before the new accounting plan leases were off balance sheet	3 (10%)	3 (10%)	9 (29%)	6 (19%)	10 (32%)
Leasing can include other services	1 (2%)	3 (7%)	15 (35%)	13 (30%)	11 (26%)
Means and preventing obsolescence of assets	6 (13%)	14 (31%)	12 (27%)	11 (24%)	2 (5%)
Finances 100% of asset costs	9 (20%)	9 (20%)	9 (20%)	8 (18%)	9 (20%)
Timing and amounts of lease payments are flexible and can be negotiated	13 (28%)	13 (28%)	9 (20%)	9 (20%)	2 (4%)

Table 2

The General Accounting Plan requires that a finance lease should be shown as an intangible fixed asset and as a liability. How do you think companies will react to this situation?

	YES	NO	DON'T KNOW
Leasing will lose some of its attraction, leading either to other forms of finance or to a reduction in investment	10 (21.7%)	28 (60.9%)	8 (17.4%)
Leasing will be more attractive, leading to its use in place of other forms of finance or to an increase in investment	21 (45.7%)	15 (32.6%)	10 (21.7%)
The complications of accounting for finance leases will make operating leases more attractive	3 (6.5%)	9 (19.6%)	34 (73.9%)

Table 3

Which of the following approaches to accounting for leases do you prefer?:

All leases should be accounted for as rental agreements	7 (15.2%)
The definition of a finance lease should be expanded to include some agreements currently classified as operating	15 (32.6%)
The rules laid down in the General Accounting Plan	12 (26.1%)
Don't Know	12 (26.1%)

Table 4

Do you think that assets held under a finance lease should be shown as tangible rather than as intangible?

Yes	22 (47.8%)
No	23 (50%)
Don't Know	1 (2.2%)

The Analyst's Response to Accounts

Table 5 shows the analysts' response to two sets of accounts where the only difference between the two companies is in the accounting treatment of the lease. Company A capitalises the lease, Company B does not.

In Batch 1 the circumstances underlying the lease were designed to give Company A a very slightly (3%) lower profit figure.

The relationship between these figures is similar to those used in a study in the USA, where the capitalising company showed a 10% lower profit figure. (Abdel Khalik et al 1981).

In Batch 2 the circumstances underlying the lease were designed to given Company A a 50% higher profit figure.

In both cases the respondents were advised that the accounting treatment of the lease was the only difference between the two companies, and were given data by way of note to appreciate the broad cash flow effect of the lease agreement. Therefore, in the case of questions 1, 2, 4 and 5, all of which ask questions that compare performance and financial stability, the 'correct' answer is that the companies are 'equal', and a material difference between A and B indicates a tendency for the accounting treatment to bias analysts in one direction.

Table 5 shows the responses. Question 3, in which both batches show a preference of the information given by lease capitalisation, is consistent with the responses given earlier on views on appropriate accounting rules.

Comparing the answers given by Batch A to the survey by Abdel Khalik et al, (1981) in the USA, in every case Abdel-Khalik found a materially higher proportion of companies giving the 'correct' answer 'equal'. This is not surprising, given that at the time of the US survey bank analysts had had the benefit of an extensive discussion of issues relating to leasing in the literature.

In answering questions relating to profitability, financial security, and investment prospects, analysts in both countries show a bias towards the non capitalising company, with the Spanish analysts showing the greater bias. However, when asked to recommend a company for a loan, US analysts were biased to the non capitalising, Spanish analysts to the capitalising company. This seems strange given the high bias of Spanish analysts towards Company B in answer to questions 1 and 2.

There is an interesting contrast between batches 1 and 2. Batch 2 identify Company A as more profitable by a majority of 64% to 8%, in contrast with the reverse view taken by batch 1, and similarly prefer company A as an investment prospect in contrast with the opposite view taken by batch 1. Batch 2 do show a majority regarding B as more financially secure, but by a narrower majority, than batch 1. However, when it comes to deciding which company should have a loan, there is no material difference between the two batches.

Overall Spanish bank financial analysts appear to be strongly influenced by the raw figures in the accounts, despite being offered evidence in the notes indicating the underlying pattern of cash flows. Although, perceiving the non-capitalising company as 'more financially secure' nevertheless they show a marginal preference to recommend a loan to the capitalising company, perhaps out of regard for its compliance with an accounting rule they respect.

Conclusion

The move to require finance lease capitalisation has been a break with tradition in Spain, a country which has, indeed, only recently legislated requirements for comprehensive, audited, company accounts. Our survey indicates that bank analysts support this move, favour its development, and do not anticipate negative economic impact. However, at this early stage analysts appear to take a crude approach to the use of accounting information on leases.

Table 5

		A	B	Equal	Missing Response	Sample Difference Between A and B	A-K Difference Between A and B	A-K 'Equal'
Which of the two companies is more profitable?	Batch 1	14.3% (3)	47.6% (10)	33.3% (7)	4.8% (1)	B 33.3%	B 29.6%	51.9%
	Batch 2	64% (16)	8 % (2)	24% (6)	4% (1)	A 56%		
	Overall	41.3% (19)	26.1% (12)	28.3% (13)	4.4% (2)	A 15.2%		
Which of the two companies is more financially secure?	Batch 1	14.3% (3)	57.1% (12)	23.8% (5)	4.8% (1)	B 42.8%	B 16.7%	64.8%
	Batch 2	36% (9)	40% (10)	20% (5)	4.1% (1)	B 4%		
	Overall	26.1%	47.8% (22)	21.71% (10)	4.4% (2)	B 21.7%		
Which accounts give the more useful information on the lease contract?	Batch 1	66.7% (14)	19.0% (4)	14.3% (3)				
	Batch 2	80% (20)	12% (3)	14% (1)	4% (1)			
	Overall	73.9% (34)	15.2% (7)	8.7% (4)	2.2% (1)			
Which company would you recommend for a loan?	Batch 1	38.1% (8)	33.3% (7)	28.6% (6)		A 4.8%	B 14.8%	61.1%
	Batch 2	40% (10)	36% (9)	20% (5)	4% (1)	A 4%		
	Overall	39.1% (18)	34.8% (16)	23.9% (11)	2.2% (1)	A 4.3%		
Which of the two companies is the better investment?	Batch 1	19% (4)	28.6% (6)	42.9% (9)	9.5% (2)	B 9.6%	B 9.5%	65.9%
	Batch 2	48% (12)	12% (3)	36% (9)	4% (1)	A 36%		
	Overall	34.8% (16)	19.6% (9)	39.1% (18)	6.5% (3)	A 15.2%		

Appendix A

Constructing Financial Statements for the Experiment

Analysts were divided into two batches. Each batch was asked to compare accounts for two companies, 'A' and 'B'. Questions asked were introduced with the observation:

"The accounts are almost identical except for the way in which the lease commitment has been accounted for".

Company A capitalised the lease. Company B wrote off lease payments as an expense in the profit and loss account.

Batch 1 was presented with a four year lease of an asset with a life of $4\frac{1}{2}$ years. The effect was to give similar profit figures in the two sets of accounts.

Batch 2 was presented with a three year lease and an asset with an expected life of 6 years. The effect was to give company A, capitalising the lease, a profit 50% higher than company B.

BATCH 1

Company A

(in millions of pesetas)

Balance Sheet 31 December 1993

Fixed Assets:	
- Intangible (leased assets)	587
- Tangible	1000
Current Assets	250
	<hr/>
	1837
	<hr/>
Equity	621
Loans	500
Lease Obligations	591
Current Liabilities	125
	<hr/>
	1837
	<hr/>

Note: The leasing obligation consists of six equal payments which are spread over the next three years.

Company A

(in millions of pesetas)

Profit and loss account for the year ended 31 December 1993

Sales		1277
Cost of Sales		512
		<hr/>
		765
Interest	54	
Depreciation	166	
Other Expenses	409	
	<hr/>	
		629
Profit Before Tax		<hr/>
		136
		<hr/>

Company B

(in millions of pesetas)

Balance Sheet 31 December 1993

Fixed Assets:	
- Tangible	1000
Current Assets	250
	<hr/>
	1250
	<hr/>
Equity	625
Loans	500
Current Liabilities	125
	<hr/>
	1250
	<hr/>

Note: The company has entered into an operating lease agreement. This runs for three years and has a present value of 591 million pesetas.

Company B

(in millions of pesetas)

Profit and loss account for the year ended 31 December 1993

Sales		1277
Cost of Sales		512
		<hr/>
		765
Lease Payments	216	
Other Expenses	409	
	<hr/>	
		625
Profit Before Tax		<hr/>
		140
		<hr/> <hr/>

BATCH 2**Company A**

(in millions of pesetas)

Balance Sheet 31 December 1993

Fixed Assets:	
- Tangible	1000
Current Assets	250
	<hr/>
	1250
	<hr/> <hr/>
Equity	625
Loans	500
Current Liabilities	125
	<hr/>
	1250
	<hr/> <hr/>

Note: The leasing obligation consists of 8 equal instalments payable over the next 2 years.

Company A

(in millions of pesetas)

Profit and loss account for the year ended 31 December 1993

Sales		1277
Cost of Sales		512
		<hr/>
		765
Interest	53	
Depreciation	92	
Other Expenses	409	
	<hr/>	
		554
Profit Before Tax		<hr/>
		211
		<hr/>

Company B

(in millions of pesetas)

Balance Sheet 31 December 1993

Fixed Assets:		
- Tangible	1000	
Current Assets	250	
	<hr/>	
	1250	
	<hr/>	
Equity	625	
Lease Finance	500	
Current Liabilities	125	
	<hr/>	
	1250	
	<hr/>	

Note: The company has entered into an operating lease that has two years to run and a present value of 391 million pesetas.

Company B

(in millions of pesetas)

Profit and loss account for the year ended 31 December 1993

Sales		1277
Cost of Sales		512
		<hr/>
		765
Lease Payments Interest	216	
Other Expenses	409	
	<hr/>	
		625
Profit Before Tax		<hr/>
		140
		<hr/>

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