



Economics Working Paper 90

**Management's Response to Finance Lease
Capitalization in Spain**

John Blake*

and

Oriol Amat†

and

Julia Clarke‡

September 1994

Keywords: Leasing, Spain, Management, Finance.

Journal of Economic Literature classification: G21, G39, M41.

* University of Central Lancashire.

† Universitat Pompeu Fabra.

‡ University of Central Lancashire.

Abstract

In December 1990 a new 'Plan General de Contabilidad' (PGC -the general accounting plan) was issued in Spain. This implemented the European Community 4th. and 7th. Directives in Spanish accounting law. The new PGC also covered one matter not addressed in the EC directives, the accounting treatment of lease agreements, requiring capitalization of finance leases. This requirement is of particular interest for two reasons:

- 1) The 'substance over form' convention, which underlies capitalization of finance leases, is alien to the Spanish accounting and legal tradition.
- 2) Finance lease capitalization gives rise to a number of questions over 'economic consequences' issues, of a kind which have been extensively debated and researched in the USA and the UK but have attracted little attention in Spain.

This paper reports the results of research involving a questionnaire survey of Spanish managers on the subject of accounting for leases by lessees. The objective is both to contribute to the debate over lease accounting and to stimulate awareness of the nature and significance of 'economic consequences' issues.

Management's response to finance lease capitalisation in Spain.

Introduction.

In December 1990 a new 'Plan General de Contabilidad' (PGC - the general accounting plan) was issued in Spain. This implemented the European Community 4th and 7th Directives in Spanish accounting law. The new PGC also covered one matter not addressed in the EC directives, the accounting treatment of lease agreements, requiring capitalisation of finance leases. This requirement is of particular interest for two reasons:

- 1) The 'substance over form' convention, which underlies capitalisation of finance leases, is alien to the Spanish accounting and legal tradition.
- 2) Finance lease capitalisation gives rise to a number of questions over 'economic consequences' issues, of a kind which have been extensively debated and researched in the USA and the UK but have attracted little attention in Spain.

This paper reports the results of research involving a questionnaire survey of Spanish managers on the subject of accounting for leases by lessees. The objective is both to contribute to the debate over lease accounting and to stimulate awareness of the nature and significance of 'economic consequences' issues.

The emergence of regulation on lease accounting in Spain.

Before 1973 Spain had no general provision for accounting regulation, although detailed regulations for accounting in specific sectors, particularly financial, can be found from 1922 onwards. (1) In 1973 Spain's first 'Plan General de Contabilidad' (PGC), being the 'General Accounting Plan', was published. This was based on the French Plan of 1959, providing detailed guidance on accounting presentation and principles.

In 1976 a government body under the treasury, the 'Instituto de Planificación Contable' (IPC) was formed with responsibility for overseeing and amending accounting regulation. One of the first amendments made to the PGC was concerned with accounting for leasing. Legislation in 1977 provided special rules on accounting for finance leases by lessors. The definition of a finance lease is more restrictive than in the USA or the UK. In particular it was provided that:

"The lease conditions must include a purchase option in favour of the user at the end of the lease" (2) Subsequently IPC permitted, but did not require, finance lease capitalisation by lessees.

In 1979 a private sector body, the 'Asociación Española de Contabilidad y Administracion de Empresas, (AECA), was formed. AECA currently has some 3500 individual and 500 corporate members (3) drawn from academics, accountants in industry, and public practitioners.

AECA issues recommendations on accounting principles which are not mandatory but are highly influential because:

- i) Their high technical quality commands general respect in Spain, resulting in widespread adoption by Spanish accountants.
- ii) AECA recommendations have proved influential in the subsequent formulation of government regulations on accounting.

AECA, in a recommendation issued in 1981, suggested a broader definition which would have recognised a finance lease as arising if one of two conditions had been provided for at the end of the primary lease period:

- a) "To enter into a new finance lease at much reduced payments".

or

- b) "To acquire the leased asset at its residual value" (4).

In 1988 IPC was replaced by a new body, the 'Instituto de Contabilidad y Auditoria de Cuentas' (ICAC). The main difference between IPC and the new body, ICAC, is that the latter has responsibility for the oversight of auditing as well as accounting in Spain. In 1990 a new PGC was issued, responding to Spain's obligation as a member of the European Union to implement the audit and accounting requirements of the fourth, seventh and eighth directives on company law. Spain entered wholeheartedly into the spirit of these directives, introducing the 'true and fair view' overriding requirement ('imagen fiel' in Spanish), and breaking the traditional tie between tax and accounting rules. Although lease accounting is not covered in any EC directive a requirement to capitalise finance leases was included in the new PGC. Since few companies had previously exercised the option to capitalise finance leases allowed under the 1977 legislation, the 1990 PGC marks the commencement of finance lease capitalisation for most Spanish companies.

The PGC of 1990 defines a finance lease somewhat more narrowly than the 1977 legislation, stipulating that a finance lease must include a purchase option and that "there must not be any reasonable doubt that the purchase option is going to be exercised" (5). The accounting rules for finance leases indicate some reluctance to go fully down the road of 'substance over form'. A capitalised finance lease is shown as an intangible rather than as a tangible asset, although the corresponding obligation appears as part of liabilities. A transfer from intangible to tangible assets is then made when the purchase option is exercised. A subsequent AECA recommendation issued in 1991 argues against the classification of assets held under finance leases as intangible.

The decision of ICAC to classify leased assets as intangible is described by two Spanish academics in these terms:

"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". (6).

The tone of this observation, and the AECA opinion, both indicate some distaste for the classification of leased assets as intangible rather than tangible. One reason for the approach by ICAC may have been to respond to a point made by the Asociación Española de Leasing (AEL), the Spanish Leasing Association. AEL were concerned 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. (7).

This concern to ensure that the accounts form a reliable basis for macro economic planning is characteristic of the 'Plan' based system which Spain has adopted from France. It is interesting to contrast this with a comment in the USA that 'For every lease that is capitalised on the books of a lessee, there should be a sale or a direct financing, recorded by a lessor'. (8). That observation introduced a warning on the dangers of premature recognition of income and consequent misleading of the markets.

Economic consequences

The Spanish leasing association has observed that:

"From 1991, the change in the accounting treatment of the lessee also removes the off-balance-sheet advantage of leasing" (9).

Table 1 shows the annual growth or decline of the Spanish leasing market (10). It appears that the particularly striking growth in 1987 was to take advantage of some tax incentives withdrawn at the end of that year. The loss of the off balance sheet benefits of leasing, therefore, coincides with a time when the Spanish leasing industry is already suffering from both the loss of some tax benefits and a downturn in the Spanish economy.

Table 1

Annual growth or decline of the Spanish leasing market

	%
1986 growth	53
1987 growth	165
1988 growth	20
1989 growth	16
1990 decline	(5)
1991 decline	(2)
1992 decline	(24)
1993 decline	(38)

Studies in the USA (11) the UK, (12) and India (13) have indicated that managers, when confronted with a requirement to capitalise finance leases, have tended to respond by moving away from finance leases.

Indeed, this reaction is one of the most widely cited examples of how a change in accounting rules can give rise to 'economic consequences'. (14).

This information inductance (15) effect depends on management's perception of how users will react to accounting data. That is:

"For a management response to an accounting change to arise it is not necessary that change should have an actual economic impact on management, it is only necessary that management believe that there will be a change in the behaviour of users of the accounts and that this will have a negative effect". (16).

In order to assess the likely economic impact of a requirement to capitalise finance leases in Spain we therefore addressed a questionnaire to financial managers in Spanish companies.

The questionnaire was completed by 82 managers of Spanish companies 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 approaching managers was chosen because Spanish managers 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. (17).

The questionnaire contained the following elements:

- a) Identification of data about the respondents and their companies. Respondents were asked for their company's size on the criteria laid down in the PGC, whether the share capital is owned in whole or in part domestically or by foreigners, (18) whether the company is quoted on a stock exchange, and the order of importance attached to the five user groups listed in the PGC.
- b) An enquiry as to whether the company uses leasing and, if so, what importance attaches to various factors in that decision.
- c) Two questions then address the question as to how managers expect companies and managers to react to the requirement to capitalise finance leases. The question is formed so as to ask how managers think business in general, rather than just their own specific company, will react, because evidence in the UK suggests that managers regard the off balance sheet finance benefits of leasing as 'OK for the other guy' but 'too much of questionable financial practice to claim it for oneself'. (19) In discussions with Spanish accountants when formulating the questionnaire we found that capitalisation of finance leases frequently improves reported profit in the early years of the lease because depreciation can be spread over a longer period than that of the lease

rentals, so we included questions to ascertain whether this reported profit improvement would make lease capitalisation positively attractive to Spanish managers. This issue has not been addressed in comparable studies in other countries. An Australian study explicitly observes "lease capitalisation usually results in shifting net income from earlier to later years" (20).

- d) Managers' views on their preferred accounting treatment for leases are explored from two perspectives:
- i) Would they prefer the lease capitalisation requirements in the PGC, a more comprehensive definition of a finance lease, or abolition of lease capitalisation.
 - ii) Would they prefer to show assets held under finance leases as tangible, as preferred by AECA, or intangible, as provided in the PGC.

Data on the respondents

Data on the size, ownership, listing status, and attitudes of respondents to the order of importance of users of accounts, are summarised in tables 1-4.

Table 1
Size of business on the basis of the criteria laid down in the General Accounting Plan

	Number	%
Small	44	53.7
Medium	13	15.9
Large	24	29.3
Not answered	1	1.2
Total	<hr style="width: 100%;"/> 82 <hr style="width: 100%;"/>	<hr style="width: 100%;"/> 100.00 <hr style="width: 100%;"/>

Table 2
Ownership of business

	Number	%
100% Spanish owned	56	68.3
Spanish majority - foreign minority	10	12.2
Foreign majority - Spanish minority	4	4.9
100% foreign owned	11	13.4
Not answered	1	1.2
	<hr/> 82	<hr/> 100.0
	<hr/>	<hr/>

Table 3
Stock exchange listing

	Number	%
YES	9	11.0
NO	73	89.0
	<hr/> 82	<hr/> 100.0
	<hr/>	<hr/>

Table 4
Order of importance of users of accounts

	1	2	3	4	5
Shareholders	61	13	4	0	1
Creditors	3	22	16	12	7
Employees	10	11	6	4	16
Government	6	21	25	6	6
Competitors	1	4	9	20	10

Motives for leasing

Tables 5 and 6 report the characteristics of businesses where managers say leasing is used. Foreign owned companies were rather more likely to employ leasing than Spanish owned companies, while small companies were slightly more likely to use leasing than other companies.

Table 7 shows the relative importance of various factors in the decision to use leasing. Tax, not surprisingly, comes out way ahead as the most important. The two other factors that attract over 50% responses as 'very important' or 'important' relate to the ability to finance 100% of asset costs and the flexibility of lease payments.

Table 8 shows a comparison of the results of this survey with two studies of UK managers response to similar questions, one published in 1976 (21) and one in 1990 (22). This confirms that Spanish managers are particularly concerned with the tax benefits, the ability to finance 100% of assets, and the flexibility of payments, offered by leasing.

Table 5
Comparison of usage of leasing with size

	<u>Do you use leasing with finance investment?</u>	
	<u>YES</u>	<u>NO</u>
<u>Small</u>		
- number	30	14
- %	68.2%	31.8%
<u>Medium</u>		
- number	9	4
- %	69.2%	30.8%
<u>Large</u>		
- number	14	10
- %	58%	42%
<u>Unspecified size</u>		
- number	1	-
<u>Total</u>		
- number	54	28
- %	65.9%	34.1%

Table 6
Comparison of usage of leasing with foreign ownership.
Do you use leasing to finance investment?

	<u>YES</u>	<u>NO</u>
100% Spanish owned		
- Number	35	21
- %	62.5%	37.5%
Part or wholly Foreign owned		
- Number	18	7
- %	72%	28%
No answer on ownership	1	-
Total		
- Number	54	28
- %	66%	34%

Table 7

If your business uses leasing, show the importance of each of the following factors in deciding whether to enter a financial lease.

	Very important	Important	Moderate importance	Little importance	No importance
<u>Tax advantages</u>					
Number	45	4	2	2	3
% answering	80.4	7.1	3.6	3.6	5.4
<u>Finance cost</u>					
Number	3	8	12	4	20
% answering	6.4	17.0	25.5	8.5	42.6
<u>Conserving liquidity</u>					
Number	4	10	18	4	13
% answering	8.2	20.4	36.7	8.2	26.5
<u>Leasing can include other services</u>					
Number	7	8	8	12	14
% answering	14.3	16.3	16.3	24.5	28.6
<u>Protects against asset obsolescence</u>					
Number	9	9	11	8	12
% answering	18.4	18.4	22.4	16.3	24.5
<u>Finance 100% of asset costs</u>					
Number	17	7	8	5	10
% answering	36.2	14.9	17.0	10.6	21.3
<u>Timing and amounts of lease payments are flexible and can be negotiated</u>					
Number	22	5	10	6	6
% answering	44.9	10.2	20.4	12.2	12.2

%age of respondents showing factors as 'very important' or 'important'.

Table 8

<u>Factor</u>	<u>Spain</u> <u>study</u>	<u>UK</u> <u>study</u> <u>1976</u>	<u>UK</u> <u>study</u> <u>1990</u>
Tax advantages	87.5%	*	67%
Leasing can include other services	30.6%	*	10.5%
Conservation of working capital	28.6%	76%	25.2%
Permits 100% financing	51.1%	37%	15%
Flexibility of payments	55.1%	30%	8.4%
Protects against asset obsolescence	36.8%	21%	*

*Question not asked in comparable form.

Managers' reactions

Table 9 shows managers reactions to the requirement to capitalise finance leases. Interestingly, a substantial majority (61% to 18%) see that this requirement will promote a preference for operating leases to avoid the impact of gearing while a smaller majority (45% to 32%) see the requirement promoting a preference for operating leases to improve profitability. When it comes to predicting how companies will react overall there are a substantial number predicting a reduction in finance leases leading to use of other sources of finance (54%) or reduced investment (30%). By contrast considerably fewer managers saw leasing becoming more attractive leading to replacement of other sources of finance (11%) or increased investment (10%). Table 10 and 11 relate managers expectations as to these key 'economic consequences' to their ranking of creditors as users of accounts. Table 10 shows that the prediction of a negative impact of lease capitalisation is similar whether creditors are ranked high (1-2) or low (3-5) as users. By contrast Table 11 shows that prediction of a positive impact of lease capitalisation is more likely where creditors are ranked low as users.

These 'information inductance' effects depend, as we have discussed above, on how managers expect analysts to perceive lease capitalisation in the accounts. Table 12 shows that managers' expectations of analyst's reaction, showing 72% expecting a perception of higher gearing compared with 45% expecting the perception of higher profit, is consistent with the overall tendency of managers to take a negative perception of the impact of lease capitalisation. Their 74% expectation that analysts will not understand lease capitalisation is also consistent with an anticipated naive response.

Table 9

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?

	<u>YES</u>	<u>NO</u>	<u>DON'T KNOW OR NO ANSWER</u>
Companies will prefer operating leasing, so as not to have to capitalise leases.	50 61%	15 18%	17 21%
Companies will prefer finance to operating leases to improve profitability	37 45%	26 32%	19 23%
Leasing will lose some of its attractions, in favour of other forms of finance	44 54%	16 20%	22 26%
Leasing will be less attractive, so that some investments will not be made	25 30%	29 35%	28 34%
Leasing will be more attractive, and so will replace other forms of finance	9 11%	40 49%	33 40%
Leasing will be more attractive, so that investment will increase	8 10%	41 50%	33 40%
The accounting complications of lease finance will make operating leases more attractive	45 55%	18 22%	19 23%

Table 10

	Creditors ranked 1-2		Creditors ranked 3-5	
Leasing will lose some of its attractions in favour of other forms of finance	<u>YES</u>	<u>NO</u>	<u>YES</u>	<u>NO</u>
	14	7	19	8
	67%	33%	70%	30%
Leasing will be less attractive, so that some investments will not be made.	8	12	9	15
	40%	60%	37.5%	62.5%

Table 11

	Creditors ranked 1-2		Creditors ranked 3-5	
Leasing will be more attractive, and so will replace other forms of finance	<u>YES</u>	<u>NO</u>	<u>YES</u>	<u>NO</u>
	1	17	8	14
	6%	94%	36%	64%
Leasing will be more attractive so that investment will increase	1	15	7	17
	6%	94%	29%	71%

Table 12

How do you think analysts will react to accounts when finance lease agreements are capitalised on the Balance Sheet?

	Yes	No	Don't know or no answer
They will perceive the company as being higher geared	59 (72%)	17 (20.7%)	6 (7.3%)
They will perceive the company as having a lower asset base than if assets had been financed in another way	31 (37.8%)	42 (51.2%)	9 (11%)
They will perceive the business as more profitable than if operating leasing had been used	37 (45.1%)	30 (36.6%)	15 (18.3%)
They will not understand the nature of a finance lease because the legal and accounting aspects are not easy to understand	61 (74.4%)	10 (12.2%)	11 (13.4%)

Managers' preferences

Table 13 shows managers' preferences on lease accounting rules. In view of their expectations as to analysts' response, it is not surprising that they tend to oppose lease capitalisation. The strong opposition to the classification of leased assets as intangible, as shown in table 14, seems in line with the general distaste of the Spanish accounting profession for this approach.

Table 13

Which of the following bases for accounting for leases do you think is most appropriate?

	<u>Number</u>	<u>%</u>
All leases should be accounted for as rental agreements.	40	48.8
The definition of a finance lease should be expanded to include some agreements currently classified as operating.	11	13.4
The rules currently laid down in the General Accounting Plan.	12	14.6
Don't know or not answered	19	23.2
	<u>82</u>	<u>100.0</u>

Table 14

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

	<u>Number</u>	<u>%</u>
YES	61	74.4
NO	18	22.0
Don't know	3	36.6
Total	<u>82</u>	<u>100.0</u>

Conclusion

Spanish managers appear to anticipate negative economic impact arising from the requirement to capitalise finance leases. Only a small number of managers, mainly those who give creditors low importance as users of accounts, expect a positive economic impact. Thus the Spanish leasing industry appear to have judged rightly in expressing their concerns that the new accounting rules on lease capitalisation will reduce both the use of leasing and investment levels. However, AEL, the Spanish leasing association, may have exacerbated this effect in their successful lobbying for leased assets to be shown as intangible.

Further research might usefully explore analysts' reactions to finance lease capitalisation in order to ascertain whether the pessimism of Spanish managers is justified.

References

- (1) E. Fernandez Peña "La Contabilidad en el Siglo XX" in J. A. Gonzalo Angulo "Contabilidad en España 1992".
Madrid: Instituto de Contabilidad y Auditoria de Cuentas. pp 51-74. 1992.
- (2) S. Antolinez Collet. "Problemática contable de las operaciones de leasing financiero" Revista Española de Financiación y Contabilidad January-April 1985 p 111.
- (3) L. Cañibano Calvo "Regulación profesional: principios contables AECA" in J. A. Gonzalo Angulo "Contabilidad en España 1992" Madrid: Instituto de Contabilidad y Auditoria de Cuentas, pp 109-127. 1992.
- (4) Asociación Española de Contabilidad y Administración de Empresas, "Principios Contables: inmovilizado material" Documento 2, (Madrid: AECA, 1989) p58.
- (5) See O. Amat "El leasing: Modalidades, funcionamiento y comparación con otras opciones" Bilbao: Ediciones Deusto (1989) p 74.
- (6) R. Herranz and A. Socias "A comparative study of Italian and Spanish annual accounts after the implementation of the Fourth Directive", 17th Annual Congress of the European Accounting Association, Venice, April 1994, p 14.
- (7) See E.T. Castello Taliani "Estudio Económico de los contratos de leasing y su captación en los informes contables". Madrid: Instituto de Contabilidad y Auditoria de Cuentas, 1989) p 255.
- (8) C. R. Barker "Leasing and the setting of accounting standards: Mapping the Labyrinth" Journal of Accounting Auditing and Finance. (Spring 1980) p 204.
- (9) Leaseurope and Arthur Andersen. Leasing in Europe. London: McGraw-Hill.
- (10) See P. Fernandez "La inversión en leasing gana más atractivo fiscal" La Vanguardia, 9 April 1994, p8.
- (11) A. R. Abdel-khalik. The Economic Effects on Lessees of FASB Statement No 13 Accounting for Leases. Connecticut: Financial Accounting Standards Board 1981.

- (12) See:
 P Taylor and S Turley "The views of management on accounting for leases" Accounting and Business Research, (Winter 1985) pp 59-67.
- C. Drury and S. Braund "The Leasing Decision: A Comparison of Theory and Practice" Accounting and Business Research. (Summer 1990) pp 179-191.
- (13) R. Narayanaswamy "Accounting for leases by lessees in India. Some evidence of Economic Impact" International Journal of Accounting (1992) pp 255-261).
- (14) For the UK example see J Blake "Economic Consequence issues in the emergence of SSAP21: Accounting for leases and hire purchase contracts" Managerial Finance (1/2 1989) pp 21-25.
- (15) See P. Prakash and R. Rappaport "Information Inductance and its significance for Accounting" Accounting Organisations and Society (Vol 2, No 1, 1977).
- (16) V. Pina Martinez. "Efectos Económicos de las normas contables" Madrid: Asociación Española de Contabilidad y Administración de Empresas (1988) p 20.
- (17) M. A. Garcia Benau, C. Humphrey, P Moizer, and S. Turley "Auditing expectations and performance in Spain and Britain: A comparative analysis" International Journal of Accounting, 28, p 284.
- (18) The view that leasing is particularly appropriate to small and foreign owned companies is put forward by M. Gutierrez Viguera "Estudio sobre el leasing desde la vertiente del arrendatario". Técnica Contable (July 1988), p 353.
- (19) R. A. Fawthrop and B. Terry "Debt Management and the use of leasing finance in UK Corporate Financing Strategies" Journal of Business Finance and Accounting (Autumn 1975) p 305.
- (20) M. Bazley, P. Brown, and H Y Izan "An analysis of lease disclosures by Australian Companies" Abacus, (March 1985), p47.
- (21) A. Sykes, The lease-buy decision - a survey of Current Practice in 202 Companies, London: British Institute of Management, (1976).
- (22) C Drury and S Braund. "The Leasing Decision: A Comparison of Theory and Practice" Accounting and Business Research, (Summer 1990), pp 179-191.