

Amortized Cost for Operating Lease Assets

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SYNOPSIS:

A proposed accounting standard issued jointly by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) would require firms to recognize many more lease assets than are currently required and to amortize those assets on a straight-line basis. A number of respondents to the exposure draft argue that the “front-loading” of lease expense resulting from straight-line amortization would not reflect the economics of the lease assets. This study compares straight-line amortization with the most-often cited alternative, present value amortization. First, we illustrate by example that under stylized conditions, present value amortization provides information that more faithfully represents the future cash flows of lease assets than straight-line amortization. Second, for a large subset of firms that are more likely to conform to the stylized conditions in our example, we find that investors value those firms as though the lease assets are capitalized and amortized on a present value basis. Finally, we find that financial ratio comparability is substantially increased when operating leases are constructively capitalized and amortized using straight-line amortization, and further increased when using present value amortization. Taken together, these results provide no evidence for favoring straight-line amortization over present value amortization as the default method for amortizing capitalized operating leases.

Data Availability: Data used in this paper are publicly available.

Keywords: leasing, straight-line amortization, present value amortization, value-relevance

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