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Capital Structure and the Changing Role of Off-Balance-Sheet Lease Financing

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Laurel Franzen (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=83912)

Loyola Marymount University

Kimberly Cornaggia (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=300559)

Pennsylvania State University - Department of Finance

Timothy T. Simin (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=243018)

Pennsylvania State University

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Abstract

Using trend regression analysis, we demonstrate the remarkable increase in off-balance-sheet (OBS) lease financing and simultaneous decrease in capital (on-balance-sheet) leases over the last 27 years. This trend is consistent with the contentions of regulators and popular press that firms intentionally structure leases to qualify for OBS accounting treatment. Moreover, we find that firms rely heavily on this OBS financing in addition to, not merely in lieu of, conventional debt. We include a proxy for the benefits of the OBS accounting treatment as an additional explanatory variable in a traditional capital structure model and find a significantly negative relationship: as abnormal OBS lease activity increases, conventional debt ratios fall. Our results suggest common financial risk metrics underestimate the risk of such firms as the lower debt ratios may be associated with higher OBS debt financing. Our results should be of interest to a host of market participants as the US considers changes in accounting treatment of lease financing.

Keywords: Capital structure, Operating leases, Off-Balance-Sheet financing

JEL Classification: G32, M41, M48

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