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# Market Evaluation of Off-Balance Sheet Financing: You Can Run But You Can't Hide

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## Abstract


A commonly cited motivation for off-balance sheet financing is a reduction in reported book (balance sheet) leverage. Operating leases, the most common form of off-balance sheet financing, are required to be disclosed in financial statement footnotes, but limited disclosure complicates external evaluation of the effective amount of off-balance sheet debt. In this paper we investigate the market evaluation of operating leases. We compare the impact of operating leases on debt ratings and the yield of new debt issues to that of balance sheet debt. We document three central findings. First, operating leases are significantly less important than balance sheet debt for firm debt ratings. Second, operating leases have the same impact as balance sheet debt on the yields of new bond issues. Combined, these findings indicate that while moving debt off-balance sheet may be useful in maintaining higher debt ratings, it does not fool the market, because bond yields reflect off-balance sheet obligations, despite their limited disclosure, in the same manner as balance sheet debt. Finally, the simple perpetuity approach to estimating operating lease debt appears to be most consistent with the market evidence. Using the perpetuity method, we estimate operating lease debt to be of comparable magnitude to balance sheet debt.

**Keywords:** Operating leases, Off-balance sheet financing, Bond yield, Debt policy

**JEL Classification:** G32, M41, G12

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