

Solutions Manual

to accompany

Understanding Australian Accounting Standards

Janice Loftus, Ken Leo, Ruth Picker,
Victoria Wise, Kerry Clark

By Janice Loftus

WILEY

John Wiley & Sons Australia, Ltd 2013

Comprehension Questions

1. Describe the four components of an accounting policy. Illustrate your answer with examples.

Accounting policies the following involve four components:

Definition – which element(s) of financial statements is recognised, e.g. recognising expenditure on building improvements as an asset;

Recognition – when the item is to be recognised, e.g., recognising cost of goods sold as an expense when goods are delivered to the customer;

Measurement: how should it be measured, e.g., whether to measure an asset at cost or fair value, how to measure depreciation; and

Disclosure: how information should be presented and disclosed, such as whether to disclose the useful life of an asset.

2. Differentiate normative accounting theory from positive accounting theory. Provide an example of each

A **normative theory** prescribes what should be done based on a specific goal or objective. The outcome of a normative theory is derived from logical development based upon a stated objective; e.g., the Conceptual Framework prescribes principles, such as recognition criteria for elements of financial statements, based upon an explicit objective of financial reporting. In contrast, the role of a positive theory is to describe, explain or predict. For example, agency theory is a positive theory because it is used to explain why managers prefer accounting policies that increase profit in certain situations, such as when there is a bonus plan linked to accounting profit.

3. What is the difference between the deductive and inductive processes of developing a theory?

Developing a theory using **inductive reasoning** commences with observing definable activities and actions, which form the basis for inferring the principles that conform to the observations. The theorist would then attempt to infer higher-level assumptions and objectives.

Developing a theory using **deductive reasoning** commences with setting objectives, which may be based on assumptions. For example, an objective of providing information that is useful for decision making involves assumptions about the users of financial statements and their information needs for decision making. Principles, (e.g., information should be faithfully represented) are derived logically from both the objectives and the assumptions. Definitions and observable actions are, in turn, derived from the principles.

Thus, under inductive reasoning, observations of practice lead to the development of principles. However, under deductive reasoning, the objectives and principles lead to the actions prescribed by the theory.

4. What is an agency relationship? Explain how monitoring costs, bonding costs and residual loss arise in agency relationships.

An agency relationship occurs when one party, who is referred to as the principal, employs another party, the agent, to undertake some activity on their behalf. Costs incurred by the principal to observe, evaluate and control the agent's behaviour are referred to as monitoring costs. Examples of monitoring activities incurred by shareholders to monitor management include having the financial statements audited. Bonding costs are those costs incurred by the agent to provide assurance to the principal that they are acting in the principal's best interests. The time and effort expended in producing and providing quarterly accounting reports to lenders is an example of bonding costs. Residual loss is the reduction in value of the firm that results from the separation of ownership of control, when the marginal cost exceeds the expected benefit of additional monitoring and bonding.

5. Why would managers' interests differ from those of shareholders?

Agency theory assumes that parties, such as manager and shareholders, will act in their own interests. Accordingly, given separation of ownership and control managers are expected to act in their own interests through excessive consumption of perquisites and avoidance of effort. The interests of managers and shareholders can also diverge because managers have shorter horizons in evaluating decisions, are more risk averse and prefer dividend retention.

6. Explain the following agency problems that can arise in the relationship between owners and managers

- a) the horizon problem**
- b) risk aversion**
- c) dividend retention**

- a) Shareholders are concerned with the long term growth and value of the firm, which reflects the market's expectations of the present value of the future cash flows. However, management's interest in the cash flow potential may be limited to the period over which they expect to be employed by the firm. This horizon problem is exacerbated by approaching retirement. Managers generally adopt a shorter horizon than shareholders when evaluating proposed actions or investments, e.g., delaying research and development expenditure may increase short-term profitability but have adverse long-term consequences.
- b) Managers are generally more risk averse than shareholders because managers are less able to diversify risk. Shareholders typically spread their investment (and hence, their risk) across a range of securities and other assets. Their liability is limited to the unpaid capital on their shares. Shareholders may also receive income from sources, such as employment, that are independent of the company. Managers, however, have less diversifiable 'human' capital invested in the company. Their management compensation (remuneration) is likely to be their primary source of income.
- c) Managers prefer to maintain a greater level of funds within the company through dividend retention. This helps managers to expand the size of the business they control (empire building) and to pay their own salaries and benefits. Shareholders, on the other hand, may have a preference for increased dividends.

7. Outline the four agency problems that can arise in the relationship between lenders and managers.

Four agency problems that can arise between lenders and managers include: excessive dividend payments to owners; asset substitution; claim dilution; and underinvestment.

Management may pay excessive dividend, which can leave the company with insufficient funds to service the debt. To reduce this problem managers and lenders agree to covenants that restrain dividend policy and restrict dividend payouts as a function of profits.

Asset substitution refers to management investing in riskier assets after the loan has been arranged, e.g., borrow money to invest in local production facilities but actually spending it on overseas investments with additional foreign currency risk. Managers may use the debt finance to invest in alternative, higher risk assets in the likelihood that it will lead to higher returns to shareholders. Lenders bear the risk of this strategy as they are subject to the increased risk of default, but do not share in any benefit in the form of higher returns if the investment project becomes more successful.

Claim dilution arises when firms take on debt of an equal or higher priority. For example, after obtaining an unsecured loan, management might obtain additional loan funds by offer floating charge over its working capital to another lender. This reduces the assets available to unsecured creditors in the event of default.

Lastly, underinvestment can arise if the borrower is struggling to repay the principal and interest components of debt. Extra cash flows that might be generated by additional projects would go to repaying the debt rather than increasing shareholder wealth because creditors rank above shareholders in order of payments. Thus any funds generated by these projects would go towards debt rather than equity if the company were liquidated. Managers, acting on behalf of owners, may lack incentive to undertake projects that could lead to increased funds being available to lenders.

8. What is a debt covenant and why are they used in lending agreements?

Debt covenants are restrictions or undertakings imposed in debt contracts. Debt covenants reduce the risk to the lender, resulting in lower interest costs being imposed on the borrower. Some debt covenants use accounting numbers. For example, a debt covenant may restrict leverage to 60 per cent of total assets. By agreeing to debt covenants, managers may be able to borrow funds at lower rates of interest.

Debt contracts will often restrict investment opportunities of the firm, including mergers and takeovers, to protect themselves against the additional risk arising from asset substitution. Establishing a minimum ratio of debt to tangible assets can also mitigate asset substitution by restricting investment in intangible assets. Restricting higher priority debt is a common method of reducing the risk of claim dilution.

9. Why would managers agree to enter into lending agreements that incorporate covenants?

Lenders expect to be compensated for risk. Debt covenants reduce the risk to the lender and thus result in lower interest costs being imposed on the borrower. As a result of agreeing to debt covenants, managers may also be able to borrow more funds and/or for longer periods.

10. How does accounting information reduce agency problems in relationships between management and shareholders?

Accounting information is used in contracts that are designed to agency problems in the relationship between shareholders and management. For example, a bonus may be calculated as a percentage of profit. Accounting information is also used to monitor performance. For example, performance indicators, such as return on shareholders' equity, are used in determining whether a manager has met performance targets.

11. How does accounting information reduce agency problems in relationships between management and debtholders?

Accounting information is used in debt covenants to reduce the risk to the lender. For example, a debt covenant may restrict leverage to 60 per cent of total assets, thus reducing the lender's risk of claim dilution. Debt covenants may also restrict dividend payouts as a function of profits, again using accounting information.

12. What are the factors a manager might consider in making various expensing-capitalisation choices?

While accounting standards play a very important role in determining accounting treatment, this does not remove the need for professional judgement in the application of accounting principles. According to agency theory, the application of judgement in accounting policy choice may be influenced by incentives arising from the economic consequences, particularly in relation to the outcomes for contracting parties. In deciding whether to account for an item expenditure (e.g., cost of maintenance which also enhances the efficiency of the asset) as an asset or an expense, management may consider the effect of the alternative accounting treatments on their remuneration, the firm's proximity to debt covenants, and the political visibility of the firm.

13. Linking managerial remuneration to firm performance motivates managers to act in the interests of shareholders. However, it also burdens managers with greater risks than they may like. How do organisations balance these two considerations in management remuneration plans?

Management compensation packages typically comprise fixed salary and at-risk components. The at-risk remuneration refers to that part of a manager's income which is subject to meeting or maintaining performance targets. Also, some remuneration schemes link at-risk remuneration to performance over a longer period, which reduces the risk borne by management for intermittent fluctuations in performance over a period of several years. Benchmarking against other firms or the industry can also be used in compensation arrangements to reduce the manager's exposure to industry-wide risks.

14. Bonus plans are used to reduce agency problems between managers and shareholders. Discuss two (2) of these problems specific to the relationship between shareholders and managers and identify how bonus plans can be used to reduce the agency problems you have identified. In your answer you should provide examples of specific components that may be included in a bonus plan to address the issues identified.

While all three problems that can arise in the shareholder-manager agency relation are considered in this solution, students need only address two of them in answering the question.

Managers generally adopt a shorter horizon than that of shareholders in making decisions about various courses of action the company may take. The horizon problem can be reduced by linking management rewards to the company's performance over a longer period, for example, through share-based remuneration, such as shares or executive share options. Paying a portion of managerial remuneration as shares provides management with an incentive to focus on long-term performance because it is likely to affect their own wealth.

Managers prefer to maintain a greater level of funds within the company, thus increasing their power and prestige, whereas shareholders may have a preference for increased dividends. The dividend retention problem can be mitigated by aligning the interest of managers with those of the firm through the use of incentive-based

payment. Both bonuses linked to profit and share-based remuneration can discourage managers from accumulating funds in excess of available investment opportunities that would enhance the value of the firm.

Managers, who have undiversified human capital, may be more risk averse than shareholders who can readily diversify their risk through portfolio management. Managerial remuneration contracts can include incentives to encourage managers to invest in more risky projects. For instance, linking a bonus to profits can encourage managers to consider more risky projects that have the potential to increase profits. However, share-based compensation, such as executive shares and share option schemes, can be less effective in encouraging managers to invest in more risky projects because the cost to the manager of diversifying risk increases with managerial share ownership.

15. What are political costs? How might political sensitivity influence accounting policy choice?

Political contracts are implicit and refer to the expectations of government and society in relation to how companies' exercise power over resources. Political costs refer to the effects on the firm of political actions such as lobbying and increased regulation. Political action is more likely to be taken against larger, more profitable companies, which control more resources and have power to affect more people. Accordingly, managers of companies with high political sensitivity may prefer accounting policies that result in lower profits to reduce political visibility.

16. Distinguish between the three forms of market efficiency? Which form is more relevant for financial reporting? Justify your answer.

Market efficiency is the rapid and unbiased adjustment of prices in response to information. Different forms of market efficiency can be distinguished in terms of the information set impounded in share prices, that is, the information set to which the market is efficient.

The weak form of market efficiency is the rapid and unbiased adjustment of prices in response to information in past prices. The semi-strong form of market efficiency is the rapid and unbiased adjustment of prices in response to all publicly available information. This form is most important for financial reporting because it forms part of the set of publicly available information. Further, sophisticated capital markets are considered to be better categorised by semi-strong efficiency than other forms. The strong form of market efficiency is the rapid and unbiased adjustment of prices in response to all information, including private information.

Exercises

Exercise 2.1

DEBT COVENANTS AND ACCOUNTING INFORMATION

Required

Prepare a report outlining what agency problems the bank should be concerned with, how covenants in debt agreements can be used to reduce those problems, and how accounting information can be used to assist in this process.

The bank should consider three agency problems of debt that may arise when lending to companies: excessive dividend payments to owners; asset substitution; claim dilution; and underinvestment. Each of these problems is considered in turn, followed by some suggestions as to how debt covenants may be used to mitigate them. Some of the debt covenants rely on accounting information.

Excessive dividends payments may result increase the risk of the company being unable to service the debt. This problem may be reduced if managers agree to debt covenants that restrain dividend policy. Accounting information may form the basis of the dividend restriction, such as a maximum dividend payout expressed as a percentage of profit.

Asset substitution refers to management investing in riskier assets after the loan has been arranged. This generates a problem of adverse selection. If the lender had known that the managers would invest in riskier assets, a different decision option would have been selected, such as not granting the loan, or granting the loan but charging a higher interest rate to compensate for the higher level of risk. Debt covenants can restrict the investment opportunity set of the firm by establishing a minimum ratio of debt to tangible assets. This discourages investment in intangible asset which may be less liquid than some tangible assets and thus be less useful to creditors in the event of the company defaulting on the loan.

Claim dilution arises when firms take on debt of an equal or higher priority. This reduces the assets available to unsecured creditors in the event of default. Lenders can mitigate the risk of *claim dilution* by restricting higher priority debt. Another debt covenant employed in many debt contracts is a maximum leverage ratio. This accounting-based debt covenant can also reduce the risk of claim dilution by limiting further borrowing when the firm approaches the maximum.

Lastly, there is the risk of underinvestment which may occur if the borrower is struggling to service the loan. Extra cash flows that might be generated by additional projects would go to repaying the debt rather than increasing shareholder wealth because creditors rank above shareholders in order of payments. Thus any funds generated by these projects would go towards debt rather than equity if the company were liquidated. It is very difficult for lenders to protect themselves against the risk of underinvestment because management has control over the use of resources unless the firm is facing severe financial difficulties such that management loses control (for example, if control of the company is placed in the hands of an administrator).

Exercise 2.2

MECHANISTIC HYPOTHESIS AND EFFICIENT MARKET HYPOTHESIS

Required

- (a) **Describe the mechanistic hypothesis. What does the mechanistic hypothesis predict about how investors, and therefore, share prices, will respond to information about the profit reported in Adele Ltd's 2013 financial statements?**
- (b) **Describe the semi-strong form of market efficiency. What does the efficient market hypothesis predict about how investors, and therefore, share prices, will respond to information about the profit reported in Adele Ltd's 2013 financial statements?**

a) The mechanistic hypothesis suggests that investors respond mechanistically changes in accounting numbers when analysing financial statements. This hypothesis is based on an assumption that investors ignore differences in the way that those numbers are calculated. In other words, investors fixate on accounting numbers, such as profit, ignoring the implications of any differences or changes in accounting policies.

Ceteris paribus (other matters being equal), according to the mechanistic hypothesis, the share price will increase in response to Adele Ltd's increase in profit. The disclosure of the decline in fair value will not affect the share price because it does not affect reported profit.

b) The semi-strong form of market efficiency suggests that the share price makes a rapid and unbiased response to all publicly available information. With reference to the semi-strong form of market efficiency, the efficient market hypothesis suggests that the share price would impound all information disclosed about the change in fair value of the financial instruments, irrespective of whether it is in the financial statements or in the notes. It is reasonable to anticipate that the release of information about a decline in the value of assets would result in a drop in the share price, unless the market had already predicted the occurrence and its impact on the firm's capacity to generate future cash flows.

Exercise 2.3

MANAGEMENT REMUNERATION PLANS AND PERFORMANCE

Required

- (a) **Explain how the use of a bonus plan linked to performance and the deferral of part of the bonus can reduce the agency problems of the owner–manager relationship.**
- (b) **How does the senior executive equity ownership plan reduce agency problems beyond that which is achieved by the bonus plan?**

a) Agency problems that arise in the owner-manager relationship include the horizon problem, dividend retention and risk aversion.

The horizon problem refers to management's tendency to adopt a shorter horizon in decision making than that preferred by shareholders. A bonus plan linked to firm performance can help to align management's interests with those of shareholders because shareholders prefer more profit. However, the use of performance hurdles could potentially encourage management to focus on the short term in order to meet performance hurdles. UBS' deferral of equity-based remuneration can encourage a longer term focus by providing an incentive to maintain or improve the share price over a longer period, such as five years. Making vesting contingent upon meeting performance targets in subsequent periods provides additional incentive for management to adopt a longer horizon so that previous equity-based rewards vest.

Dividend retention may result in overinvestment (investment in negative present value projects), with consequential adverse effects on share price. Similarly, risk aversion has an adverse effect on share price through under investment (rejection of positive net present value projects). Equity-based remuneration linked to firm performance can mitigate these agency problem by providing an incentive to invest in (only) positive net present value projects that increase share price. Deferral of the equity based remuneration further discourages dividend retention and risk aversion by providing management with incentives to take actions that maintain or increase the share prices, in order to increase the value of the remuneration. Conditional provisions, such as those introduced by UBS further discourage dividend retention and risk aversion as managers attempt to continue to maintain performance targets, so that previously granted awards vest.

b) While the cash bonus is partly deferred, all of the equity-based senior executive remuneration is deferred, with shares vesting proportionately over time. Further, the vesting of the deferred cash bonus is conditional upon the executives not committing harmful acts, whereas the equity bonus plan imposes additional conditions for vesting, including that the maintenance of profit targets. Thus the equity ownership plan provides further reduction in agency problems through the greater incentive to meet ongoing performance targets. Additionally, the value of the cash bonus is the amount of the cash received. Managers can use the cash bonus as they please. However, the equity bonus plan can increase the manager's shareholding in the firm and thus align their interests with that of other shareholders.

Exercise 2.4 AGENCY THEORY AND MANAGEMENT REMUNERATION

Answers to this exercise will vary over time and with the student's choice of company. For illustrative purposes, the Commonwealth Bank's 2012 remuneration report has been selected, refer www.commbank.com.au. Details of the compensation contract and remuneration for the CEO can be found in the "Directors' Report – Remuneration Report" on pages 69-88 of the *Annual Report 2012*.

- a) For the year ended 30 June 2012 the remuneration of Ian Narev, Managing Director and CEO of the Commonwealth Bank, included salary (including superannuation) of \$1,964,281 (\$943,236 in 2011) and cash bonus (short term-incentive payment at risk) of \$1,999,088 (\$976,500 in 2011). Note, accrual-based accounting numbers are used (refer page 83). Accordingly, both the 50% of STI paid in cash and the 50% of STI deferred are included.
- b) Other forms of remuneration include non-monetary fixed remuneration in the form of car parking, interest accrued on short term incentive awards that have been deferred, superannuation, long service leave, and share-based payments (page 83).
- c) The fixed proportion of the CEO's remuneration is 38% [$(\$1,964,281 + \$5,763 + \$27,989 + \$25,000 + \$133,353) / \$5,676,046$]; 62% [$(\$1,999,088 + \$1,520,572) / \$5,676,046$] is performance based (at risk).
- d) Total shareholder return forms a hurdle for long-term incentives. Short-term performance incentives are based on measures of financial performance that include "cash net profit after tax" and "profit after capital charge". The capital charge refers to an adjustment for the level of risk, such that a larger charge against profit is applied if more risk was involved in generating the profit.
- (e) The reliance on profit may provide an incentive to select accounting policies that temporarily increase profit, particularly in periods in which the reported profit would otherwise fall below the hurdle. For example, a policy of straight-line depreciation increases profit in the earlier periods of the asset's useful life, compared with the reducing-balance method. Estimating a longer useful life for an asset would similarly delay the recognition of depreciation expenses, resulting in more reported profit in the short term. Another example of an accounting policy choice that affects profit is in relation to the timing of the recognition of income arising from bank fees charged to customers, particularly large fees associated with granting loans. Specifically, the accounting policy decision is whether to recognise bank fees as income immediately, or to spread them across the term of the loan. However, the use of a cash-based profit measure means that some accrual accounting adjustments are ignored in the profit measure used in determining short-term incentive payments.
- (f) Agency theory assumes that managers, acting in self-interest, will prefer investments that maximise returns over a shorter horizon than that preferred by shareholders. The use of a four-year performance period for long-term incentives and the deferral of the incentive award payments may be considered as an attempt to motivate the managers to consider a longer horizon.
Linking management remuneration to risk-adjusted profit measures can also be viewed as an attempt to align the interests of managers with those of shareholders, both in terms of achieving shareholder returns and avoiding use of excessive risk in the process. Further, the payment of awards in shares rather than in cash can also be viewed as seeking to align the managers' interests with those of shareholders by linking their wealth to the value of the bank's shares.
Lastly, the use of cash-based profit may reflect concerns that management may use its control over accounting policy choice to select accounting methods that maximise their incentive payments without reflecting any real increase in the earning capacity of the bank.

Exercise 2.5 DEBT COVENANTS AND AGENCY RELATIONSHIPS

Required

- (a) Debt covenants or restrictions are commonly used in Australian lending agreements. Discuss how they are used to reduce agency problems that exist in the relationship between management and lenders.**

Debt covenants reduce the risk to the lender by restricting investment opportunities of the firm, including mergers and takeovers, to protect creditors from the additional risk arising from asset substitution. Establishing a minimum ratio of debt to tangible assets can mitigate claim dilution by reducing further borrowing, (or it can mitigate asset substitution by restricting investment in intangible assets). Restricting higher priority debt is a common method of reducing the risk of claim dilution.

- (b) Why would management choose to enter into a lending agreement that contains a covenant that restricts the company's leverage?**

A debt covenant may restrict leverage, for example, to a maximum of 60 per cent of total assets. By agreeing to debt covenants, managers can reduce the creditors' risk of claim dilution, so that the company is able to borrow funds at lower rates of interest.

- (c) How might asset impairment increase the risk of breaching debt contracts?**

Asset impairment reduces assets and increases expenses, with consequential effects on profit and equity. To the assets, profit and equity numbers are used in debt covenants in debt contracts, the recognition of an impairment loss may increase the likelihood of breaching a debt covenant, even though the entity may still be servicing the debt. For example, assume an entity has a debt covenant that restricts leverage to 65% of total assets. If the entity's total liabilities and total assets are \$6 000 000 and \$10 000 000, respectively, it would have a leverage ratio of 60%, in compliance with its debt covenant. However, if an asset or cash generating unit were to become impaired, such that an impairment loss of \$1 000 000 were recognised, the assets would be reduced to \$9 000 000, resulting in a leverage ratio of 66.7%, which would place the company in breach of its debt covenant. These effects are in addition to any difficulties in servicing debt that may arise from the reduced capacity to generate cash flows from the impaired assets.

- (d) If a company is close to breaching its leverage covenant what actions might it take?**

Aside from operating and financing considerations, such as deferring actual expenditures or restructuring finance, or renegotiating the leverage covenant, the company, through its managers, may choose accounting policies that reduce the proximity to restrictive debt covenants. Such accounting policy choices might involve earlier recognition of revenue. For example, some complex contracts with customers may involve multiple components, some of which may be delivered immediately while others involve ongoing service. Allocating more of the consideration paid or payable by the customer to delivered components can result in earlier recognition of revenue. Other techniques involve deferring the recognition of expenses, which may be achieved by allocating expenditure to assets, such as leasehold improvements, rather than expenses, such as repairs and maintenance, or spreading costs over more accounting periods through long useful life or straight-line rather than accelerated depreciation techniques. Another approach is to use off-balance sheet forms of financing, such as leases that are classified as operating leases, rather than those which require an asset and liability to be recognised on the balance sheet (statement of financial position).

Exercise 2.6 LEASES AND EFFICIENT MARKET HYPOTHESIS

Required

Critically evaluate this statement.

The evaluation of this statement first explains the claim made, and then considers both its strengths and weaknesses. This evaluation argues that there is some merit in the statement but it reflects a misunderstanding of the implications of an efficient market and ignores other reasons why management might prefer to classify a lease as a finance lease.

The author (of the statement) asserts that managers would have no preference for classifying a lease as either operating or financing if the market is efficient. The classification of a lease as either operating or financing has implications for its effect on financial statements. Specifically, a lease is classified as a finance lease, the leased asset and a corresponding lease liability for the present value of the minimum lease payments are recognised in the statement of financial position. Conversely, if a lease is classified as an operating lease, lease rental is expensed as incurred and the leased asset and corresponding liability are not recognised on the balance sheet.

Market efficiency suggests that the share price would impound all information disclosed about the lease, irrespective of whether it is in the financial statements or in the notes. Although the statement is not specific, the implied form of market efficiency is the semi-strong form in which share prices respond in a rapid and unbiased manner to new publicly available information. Information included in general purpose financial reporting is publicly available, irrespective of whether disclosure is in the financial statement, or the notes to the financial statements. Thus, if the effect on the share price is the same irrespective of whether the lease is classified as a finance lease or an operating lease, management might be expected to be indifferent between the alternative lease classifications and their implications for financial statements.

The claim in the statement and the above argument contain some assumptions, including that managers believe the market to be efficient and act on that belief. Market efficiency does not rely on market participants believing in it. Management might still make choices on a mistaken belief in inefficiency; that some managers act as if the market is not efficient, does not mean it is not efficient. Indeed, market efficiency may be promoted by this disbelief as it acts as an incentive to search out and act upon more information – the so-called paradox of the efficient market hypothesis.

Another limitation of the statement is that it ignores other reasons why managers may prefer one accounting treatment over another. For example, debt constraints may give rise to for using off-balance sheet finance to keep the firm within a maximum leverage ratio permitted by a debt covenant. Managers may be more concerned about the relative consequences of breaching debt covenants than the market's reactions to leasing.

More generally, the efficient market hypothesis only considers the relationship between the release of information and market reaction, which reflects only one user group (investors). It does not attempt to explain the reactions or financial information literacy of credit analysts, which may influence management's preference for alternative lease classifications.

Thus the statement is partially correct that if the market is efficient, share price reactions would be robust to alternative lease classifications. However, this assumes the classification has no other economic consequences. The extension of the efficient market implications to management's indifference to alternative lease classifications relies on an invalid assumption that market efficiency relies on management believing in it. The claim is also incorrect to the extent that other factors may influence managers' preference for lease classifications, and their effect on financial statement numbers.