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Reporting of leases in financial statements; Accounting research study no. 04

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AN ACCOUNTING RESEARCH STUDY

REPORTING OF LEASES IN FINANCIAL STATEMENTS

By John H. Myers, Ph.D., CPA

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REPORTING OF LEASES IN FINANCIAL STATEMENTS

ACCOUNTING
RESEARCH
STUDY NO. 4

REPORTING OF LEASES IN FINANCIAL STATEMENTS

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AMERICAN
INSTITUTE
OF CPAs

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Director's Preface

One of the striking developments of the post-war period is the rapid expansion in the extent of leasing and the various forms it has taken. The importance of this development was first highlighted by the Securities and Exchange Commission in its Fifteenth Annual Report, for the year ended June 30, 1949. In that report the Commission pointed to the emergence of the sale and leaseback as a major financing device and to the accounting problems it created. Since that time, others have discussed the subject in one or more of its manifold aspects.

This study by Professor John H. Myers of Northwestern University is a thorough and timely analysis of the accounting issues in this complex and controversial area. He was asked to study leases, not the whole area of commitments, so the absence of any systematic discussion of this broader question is no reflection on him or his efforts. He has made a dispassionate analysis of the topic assigned to him and has recommended a set of accounting principles which are in the best tradition of adequate disclosure in financial reports.

On one point in his recommendations there is no dissent—disclosure of commitments under lease contracts has been inadequate in the past and should be improved by one means or another. He also finds no disagreement on another point—some leases should be reflected in the balance sheet as an asset, with the related obligations shown as a liability. Disagreement does exist as to the extent to which the rights and obligations of the lease contract should be reported in the balance sheet itself. Some may assert that Myers goes too far, others that he does not go far enough, in his recommendations as to the formal recognition in the financial statements themselves of the property rights involved and their related obligations. Each reader can judge for himself whether the evidence Myers has marshaled and the analysis he has made sustain the conclusions reached and the recommendations offered.

The study is mainly descriptive and analytical and deals only incidentally with the practical problems of implementation or of a transition period. All of Myers's recommendations are practical in the sense that they can be put into effect if businessmen and their accountants wish to do so. If they will in fact wish to do so, and under what conditions, involves, however, issues of accounting and business *policy* that a research staff concerned mainly with analysis should not deal with.

A small project advisory committee, consisting of John B. Inglis as chairman, Robert N. Anthony, Donald R. Gant, Ira A. Schur, and Walter R. Staub, were most helpful in advising John H. Myers and me. (Two members of the committee, Ira A. Schur and Walter R. Staub do not agree with the major conclusion of the study. Their comments appear on page 68-70.) The members of this committee reviewed the plan of research in its early stages, suggested sources of information, and acted as a sounding board for the conclusions reached. The responsibility for this study, however, rests upon John H. Myers and me.

New York, N. Y., May, 1962

MAURICE MOONITZ
Director of Accounting Research

Author's Preface

This study is essentially a complete re-examination of the facts about leasing as it has developed in the post-war period and its financial and accounting aspects. The research study consisted of two phases. One phase involved the reading and analysis of about three hundred different items on the practice of leasing and its uses by lessees. A search of the literature was made for the views of users of financial statements, both of lessees and of lessors, but with little success. As a result, the second phase of the research consisted of interviews in the field and of correspondence with persons interested in leasing. These persons represented three different points of view: that of the lessee, the lessor, and the "third party" who analyzes financial statements primarily in order to reach a decision about investing in securities of a lessee or lessor.

In reporting the results of my research and the conclusions reached, I have presented in the first chapter a summary of the problem, my analysis and my conclusions. The reader who wants merely a brief synopsis thus can find it quickly. The reader who wants to make a more thorough study of the topic will find that the second chapter summarizes the background of leasing as obtained in the course of this study. In the third chapter I discuss accounting as currently practiced by lessees and lessors. The following two chapters, one for the lessee and one for the lessor, state my analysis and conclusions on the presentation of lease transactions in the financial statements. Appendixes follow which spell out in considerable detail the background of leasing. They are intended for the person who has not been in close touch with the subject. After the appendixes, there is a highly selected bibliography, presenting what I judged to be the most significant statements relating to lease presentation. A few items are also included representative of the many giving a description of leasing, its advantages and disadvantages.

I wish to express my appreciation to all those who have helped to

bring this project to its successful conclusion. Members of the profession, too numerous to mention by name, have given me new ideas and have clarified those with which I was wrestling. Outside the profession, Messrs. J. E. Hellier of the Chemical Bank New York Trust Company, Arthur L. Nash of the Robert Morris Associates, Ralph G. Starke of the Berkshire Life Insurance Company, and Alvin Zises of the Bankers Leasing Corporation have been most generous in giving me facts, new points of view, and critical readings of drafts of this report. Miss Cecilia Tierney of the Institute's Research Staff has assisted greatly, particularly in my work with the annual reports of lessees and lessors. The members of a project advisory committee provided me with contacts, facts, and helpful criticism. The chairman of that committee, John B. Inglis, has been particularly helpful not only in the ways already mentioned but also in his constant interest in keeping the study moving to its conclusion.

May, 1962 JOHN H. MYERS

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Statement of the Problem
Summary and Conclusions

The Problem: Lessee

The lease is a type of contract that dates back at least to our emergence from the feudal system. It is thus not something new to the economic environment in which our accounting structure has developed. During the last two decades, however, this ancient form of contract has been used more widely and for reasons which differ from those prevailing in earlier periods.

Of special interest are those cases in which the lease has been used primarily as a financing device. Probably one major reason for the growth of this use is that the lessee has felt it wise to take advantage of the traditional accounting treatment of a lease under which rental payments are recognized only at the scheduled payment date or by accrual between dates. By not showing the liabilities on his balance sheet, the lessee has conformed to a supposed standard of financial circles—the lower the liabilities on the balance sheet, the higher the quality of the company. The sale and leaseback is an outstanding example of the use of the lease as a financing device.

This new use of the lease was officially recognized by the accounting profession in 1949 when the committee on accounting procedure of the American Institute of Certified Public Accountants issued *Accounting Research Bulletin No. 38* (reissued in 1953 with almost identical wording as Chapter 14 of *Bulletin No. 43,* reproduced in Appendix D). *Bulletin No. 38* states the problem in these words:

> 1. The growth in recent years of the practice of using long-term leases as a method of financing has created problems of disclosure in financial statements. . . .
>
> 3. It has not been the usual practice for companies renting property to disclose in financial statements either the existence of leases or the annual rentals thereunder. One of the effects of the long-term lease as a substitute for ownership and mortgage borrowing is that neither the asset nor any indebtedness in connection with it is shown on the balance sheet. . . .

The committee preparing *Bulletin No. 38* stated that in its opinion

> (a) disclosure should be made in financial statements or in notes thereto of:
>
> (1) the amounts of annual rentals to be paid under such leases with some indication of the periods for which they are payable, and
>
> (2) any other important obligation assumed . . . ;
>
> (b) the above information should be given not only in the year in which the transaction originates, but also as long thereafter as the amounts involved are material; and
>
> (c) in addition, in the year in which the transaction originates, there should be disclosure of the principal details of any important sale-and-lease transaction.

After several sentences of discussion, the committee went on to state that in its opinion

> . . . where it is clearly evident that the transaction involved is in substance a purchase, then the "leased" property should be included among the assets of the lessee with suitable accounting for the corresponding liabilities and for the related charges in the income statement.

For at least a year or two before the issuance of *Bulletin No. 38,* a number of articles appeared in the journals calling attention to the growing importance of leases. Some of the writers went much further than the committee in advocating that leased assets and the related liability be placed upon the balance sheet. A major argument was that the accountant should look through the form of the transaction to its substance and should record the transaction as a financed purchase, if such it was.

In the years subsequent to the issuance of *Bulletin No. 38,* the following four developments have been observed:

1. Leasing has grown in importance and in multiplicity of forms.
2. Disclosure in notes to the financial statements has become a matter of course on a basis equal to or, in a great many cases, less than the minimum recommended in the *Bulletin.*
3. The financial analysts have sought more information than is recommended in the *Bulletin.*
4. The balance-sheet presentation of leases which were "in substance a purchase" has been almost nonexistent.

The experience of the last ten years calls for a serious review of lease presentation in order to determine what, if any, changes must be made if accounting statements are to give full and fair disclosure. The problem seems to resolve itself into two questions: (1) What information should be given? (2) Should the property rights under lease and the obligation therefor be shown on the balance sheet? The first question gives rise to subsidiary questions relating to the manner of giving that information. If the answer to the second question is affirmative, two further questions arise with respect to it; namely, what leases should be so set up, and what description should be used?

In order to consider these questions, this study has been made. It covers leases for real and personal property but, because of distinctly different problems involved, omits consideration of leases for wasting natural resources such as timber and minerals. This omission indicates merely that some practical limit had to be placed on this study to keep it manageable. Whether the conclusions appropriate to the leases analyzed in this study are also appropriate to those for wasting natural resources is a matter for separate consideration and is not resolved here.

Current accounting thought has been focused on long-term leases because the aggregate property right and related liability under one of these is greater than under a short-term lease. Furthermore, since equipment typically has a shorter life than does real estate, the problem is often thought of as being restricted to long-term leases of real estate. However, the fundamental nature of the property rights and liabilities is the same regardless of term of lease or type of asset, and the discussion will proceed on this premise.

Summary and Conclusions: Lessee

More information. More information is desirable in the financial statements either in the body of the statement or in a note. The user of financial statements of the lessee should be able to determine the extent of the obligation under leases. With respect to debt obligations, financial statements as now prepared typically give enough information to enable the reader to determine the amount to be paid and the dates payable. In most cases, the reader also can determine the type of property, whether or not the obligation is subject to call, and any restrictions placed upon the company by the creditor. Comparable information on leases should be given.

Balance-sheet presentation recommended. As in the case of any kind of information, lease data could be given in a note to the financial statements. The function of notes, however, should be to supplement (namely, to give elaborative details on) the items already presented in the statements rather than to complement (complete) the statements themselves. If notes are used only to supplement, the balance sheet itself will give a complete summary of the financial position. To the extent then that leases give rise to property rights, those rights and related liabilities should be measured and incorporated in the balance sheet.

The major question then is what leases, or parts of leases, give rise to property rights. The entire amount of rentals is probably a payment for property rights in the case of a lease containing all of the following provisions:

1. Length—The lease covers substantially the entire useful life of the leased property.
2. Option at termination—The lessee may buy the property at the termination of the lease for a nominal price.
3. Cancellation provisions—The contract is noncancellable.
4. Rent—The lessee pays fixed amounts (as distinguished from variable) sufficient to return to the lessor his investment in the property under lease plus a fair return.
5. Taxes, insurance, maintenance—These and other similar costs are to be paid by the lessee.

On the other hand, only a trifling portion of the rentals would constitute payment for property rights in a case such as the following:

1. Length—The lease covers a very short period of time.
2. Option at termination—The lessee has no options at termination specifically open to him under the contract.

3. Cancellation provisions—The contract may or may not contain a provision for cancellation.
4. Rent—The lease provides that rents shall be set at a level which is competitive with the rents on comparable property and service.
5. Taxes, insurance, maintenance—These and other similar items are to be paid by the lessor.
6. Other services—These are to be supplied by the lessor.

In this case, payment of maintenance cost, insurance, taxes and the other services supplied by the lessor would clearly constitute a major portion of the rentals.

To the extent, then, that the rental payments represent a means of financing the acquisition of property rights which the lessee has in his possession and under his control, the transaction constitutes the acquisition of an asset with a related obligation to pay for it. To the extent, however, that the rental payments are for services such as maintenance, insurance, property taxes, heat, light, and elevator service, no asset has been acquired, and none should be recorded. To that extent, the transaction involves an agreement to make payments, period by period, for services to be rendered. This distinction between performed and unperformed services has long been present in accounting practice and was clearly set forth as early as 1929 by John B. Canning in his *Economics of Accountancy.*

The measurement of the asset value and the related liability involves two steps: (1) the determination of the part of the rentals which constitutes payment for property rights, and (2) the discounting of those rentals at an appropriate rate of interest. These two steps are discussed at length in Chapter 4.

On the balance sheet the property rights acquired under lease should be grouped with the other property accounts, but probably separately classified in order to disclose the existence of the lease arrangement. The liability should be divided into its current and long-term portions and shown in the appropriate classifications. A note to the financial statements probably will be necessary to give supporting data, such as the payment schedule for rentals, and other pertinent factors.

Effect of balance-sheet disclosure upon income statement. Since the property rights acquired under a lease have a limited useful life, the cost or other initial basis should be amortized by charges to operations. Over the entire life of the lease, the total charges for interest plus amortization will equal the total rentals paid. If the schedule of amortization of the property right coincides with the extinguishment of the related liability, the total *annual* charge to income will equal the current payment for lease rental. If the property right is amortized on a straight-line or accelerated basis, the total annual charge to income will be higher than the annual rent payments in the early years and lower in the later years. Unless the tax return is filed on the same basis, the problem of tax deferral will arise.

In effect, the proposed balance-sheet treatment removes the charge for "rent" in the accounts as an occupancy cost and instead treats it simply as a payment of an obligation and interest thereon. In its place is put "amortization of property right acquired under lease" (an occupancy cost) and "interest" (a financial expense). In the case of manufacturing concerns there probably would be a related effect on the valuation of work in process and of finished goods.

Sale and leaseback. When the lease contract arises as part of a sale and leaseback transaction, the facts seem to point clearly to the conclusions (a) that the sale and the lease are not independent transac-

tions, (b) that the price of the one is integrally related to the price of the other, and (c) that the transaction is a secured borrowing. Accounting treatment as a secured borrowing is therefore in order. By the very nature of the transaction, the amount of other property received (probably cash) is the present value of the future rentals. Gain or loss does not arise merely because the cash received is different from the accounting basis of the property given as "security." If, however, an adjustment of property values would be in order regardless of the sale and leaseback transaction, the sale and leaseback may precipitate recognition of the change. Furthermore, if gain or loss is recognized for tax purposes but not in the books, a problem of tax anticipation or deferral arises.

The typical leases under a sale and leaseback transaction do not differ in essence from the types of leases which are suggested as ones which should be disclosed on the balance sheet. For example, when property to be leased is bought or constructed by the lessor to the specifications of the lessee under an agreement to enter into a lease contract, treatment as a secured borrowing is in order. The only difference between this contract and the usual sale and leaseback is prior ownership of the property—really an irrelevant fact.

Objections to balance-sheet presentation. Objections to balance-sheet presentation seem to be based upon five points. The first objection is that the rights to leased property are not the same as ownership and, hence, are not assets. An examination of "assets" on the balance sheet, reported at greater length in Chapter 4, reveals that assets are rights acquired irrevocably, as differentiated from services yet to be rendered which may not be performed. As an illustration of nonowned assets, consider property held under conditional sale contracts and property commonly known as leasehold improvements.

The second objection states that so many subjective judgments are required that the statements will be meaningless or dangerously misleading. Since objectivity is a *desideratum* in accounting determination, the word "subjective" may divert attention from the need for disclosure to the possible inaccuracies of an estimate. Estimates are widely used in accounting today. Consider, for example, the use of estimates in connection with depreciation of plant and equipment. Estimates of this type are closely related to those associated with balance-sheet disclosure of rights to leased assets and the obligation for them. The problem of dividing future lease rentals between payments for property rights and services is a specific example of the familiar, but troublesome, joint-cost problem. The basis for estimating the relevant interest rate is discussed in Chapter 4. It also contains a discussion of the effect of a difference in rates upon present value.

The third objection seems to be a technical accounting one. It takes the form of saying that balance-sheet treatment of lease commitments should be deferred until we have investigated all other commitments to see if and to what extent they should be disclosed on the balance sheet. On the contrary, however, improvements must be made as recognized if progress and evolution are to take place. Commitments under bond contracts have long been recognized as ones which should be shown on the balance sheet at their present (discounted) value—a value which on date of issue is equal to cash proceeds received. The finance element of lease contracts is but little different from a bond contract to the going concern. Other commitments such as those under purchase, service, and employment contracts have not been investigated to any great extent, but they appear to be different in certain essentials from lease contracts.

The fourth objection is to the economic consequences that would ensue. Analysis of the objections seems to indicate that conventions such as standard ratios in financial analysis, required ratios in credit contracts, utility rate-making ratios, and state tax allocation factors are based in part upon present accounting practices. Change in accounting practices would disrupt those conventions. Yet, the fact that these conventions grew in one environment indicates that they are subject to change with changes in that environment. Therefore, although such objections may be based on real problems, they are transitory. In addition, if an economic advantage to some parties is based upon present accounting methods, it appears likely that a removal of that advantage would react to the advantage of others. Since the purpose of accounting is to report in a manner fair to all parties, such objections might be construed as evidence that a change is necessary.

The fifth objection is that many of the economic advantages of leasing would be lost if the recommended treatment is required. This reason suggests that the advantages are based upon the illusion created by the method of reporting rather than upon substance. Advantages resting upon a basis of "illusion" are bound to disappear in time as the true nature of a lease is recognized, regardless of the accounting methods in use.

The Problem: Lessor

The problem of proper presentation of lease information for lessors has attracted much less attention than has the problem of the lessee. Only in the case of those few companies whose primary business is the owning, leasing, and possibly operating of assets, are leased assets large enough to form a significant balance-sheet item. Other than those held by real estate or equipment-operating companies, most leases are held by organizations with large investment portfolios, such as insurance companies, trusts, and manufacturers' financing subsidiaries. For these investing organizations, leased assets form but a minor part of their total assets. Even though the leased assets are minor today, the question is whether they are in the nature of investments or of operating property.

There is also a major problem in income recognition. If (a) the rent revenue is level, (b) the depreciation on the leased property is also level, and (c) the lessee pays maintenance, insurance, and taxes, then the lessor's annual net income from a single unit of property is level. However, the level dollar income, when compared to a decreasing book value of the property, produces an increasing rate of return. If many units are leased, the lower rate of return on those in the early stages will tend to offset the high rate of return on those leases approaching termination, but the fundamental accounting method is still in question.

Summary and Conclusions: Lessor

Two basic methods of recording leases are in use. The "rental" method recognizes each rental receipt as revenue of the period. Costs of depreciation, interest on money borrowed to finance the asset, and service are, or should be, matched.

The "finance" method treats the lease much like a credit sale. A receivable is established for the present value of the contracted payments. Mechanical details vary; sometimes a receivable is recorded for the total value of rentals to be received and a credit for unearned finance charges is made, but sometimes the receivable is shown as a single net figure. The appropriate asset account is credited for the asset "sold." If the lessor has valuable rights to the asset at the expiration of the lease term, these should be recognized by leaving an appropriate amount in the asset account. Revenue under the finance method is recognized over the term of the lease as to the interest element of the lease contract. Gain or loss may also be realized at the date of the "sale" if the amount removed from the asset account is different from the amount of the receivable set up. How the gain should be recognized (e.g., sale or installment basis) is a problem in accounting not unique to lessors and should be so considered. Gain or loss would be expected to arise unless the lessor purchased the asset, either from the lessee or another, directly in connection with the lease transaction.

As in the case of the lessee, certain leases or parts of leases should be considered a financing transaction. For this portion of the transaction, the finance method of accounting is appropriate. When the lessor still has service to perform, the portion of the contract representing these services should be recorded by the rental method. The rental method is appropriate for the entire lease payments only when no property rights are given to the lessee, as would be the case of a day-to-day or month-to-month lease without renewal or purchase option.

2

Background of Leasing

Typical Provisions

10 Since a lease is a type of contract, the provisions agreed upon by the contracting parties may vary widely. Typical provisions are outlined briefly in the following tabulation and are discussed more fully in Appendix A.

Duration—The lease may run for any term, from a few moments to the entire expected economic life of the asset.

Alternatives at termination—The option open to the lessee may range from none, through the right to purchase at the fair value, to the right to renew or buy at nominal prices.

Rental payments—In many cases rents are set to enable the lessor to recover the cost of his asset plus a fair return over the life of the lease. The rents may be level, increasing, or decreasing. The rents may be predetermined or may vary with sales or some other factor, but usually a minimum amount is specified.

Duties of parties as to taxes, insurance, maintenance—Either the lessee or the lessor may bear these obligations, or they may be divided between lessee and lessor.

Lessor's duties as to services (e.g., heat, elevator)—These duties may be numerous or nil.

Restrictions on lessee's activities—The contract may restrict dividends and/or further leasing and debt.

Early termination—The contract may grant the right to terminate on payment of a set scale of prices (prices often representing the lessor's unrecovered cost) plus a penalty.

Default—The contract may state liquidated damages in terms such that the lessee is liable for all future payments at once and, when paid, the lessee is to receive title to property. Alternatively, the contract may state that the lessor is to sell and that lessor and lessee are to adjust any difference between the sale price and lessor's unrecovered cost.

In any individual case, of course, any combination of provisions on these different points may be used. However, certain combinations of the various provisions are typical. Some common ones are as follows:

1. The term is for the entire expected useful life, and the rentals are set so that the lessor recovers cost of asset plus a fair return. Also, the lessee can buy the property at a nominal price at termination. Lessee must pay taxes, insurance, and maintenance. Lessee may terminate early by paying the discounted value of future rents, in exchange for which he will receive title to the property.

2. Same as (1) except that the lessee has no special rights on termination. (Since asset life presumably will have expired, these rights would usually have little value. However, subsequent economic changes may make them valuable.)

3. Same as (1) except that the life of the lease is shorter than the economic life of the assets (say, 50 per cent) but the rent scale is accelerated to the point that lessor recovers full cost plus a fair return over the shorter life.

4. Same as (3) except that no termination rights are granted and the rent scale is lower than in (3). Provisions for early termination are probably absent.

5. Same as (4) but the lessor pays taxes, insurance, and maintenance. Rent is higher than in (4) in order to cover lessor's extra costs.

6. Same as (5) except that the term is considerably shorter (say, 5 per cent of the life of the assets).

7. Same as (6) except that the lessor furnishes considerable services such as heat, elevator service, gas and oil for trucks, perhaps even drivers for the trucks.

Economics of Leasing: Lessee

There are many reasons for leasing:

1. To acquire use of asset not otherwise available
2. To meet a temporary need
3. To shift risks of ownership
4. To farm out an operation
5. To obtain clear-cut or allowable costs
6. To circumvent restrictions on acquisition of fixed assets
7. To eliminate real estate taxes by leasing from a tax-favored lessor
8. To obtain buying or servicing advantages
9. To obtain income tax savings or deferment
10. To obtain other financial advantages

All of these are discussed in Appendix B. Two that have been most discussed are the income tax and financial advantages.

Income tax advantages. Three income tax advantages of leasing have been advanced. One is that rental payments are fully tax-deductible expenses whereas equally large tax deductions would not be available to an owner. If, however, cash outlay under leasing and under ownership are the same as to amount and if the assets have no residual value to the user at the end of the period (either because the lease has expired or the owned assets have become entirely worthless), the total tax deductions must be identical in amount, assuming no change in the applicable tax rate or base. Since an owner has certain economic advantages over a lessee, such as the right to salvage or land values and possibly greater use before abandonment, his tax deductions will, of course, be smaller or at least deferred.

A possible tax advantage concerns the timing of deductions for rent as contrasted with those for depreciation. The accelerated depreciation provisions enacted in 1954, however, have reduced this advantage if, indeed, they have not removed it altogether.

A second possible tax saving which has been suggested arises in cases where assets are leased to replace selected assets sold from a group on which a composite depreciation rate is used. To the extent that the assets sold from the pool are short-lived and the composite rate is not adjusted, there is a larger total deduction in the short run for leasing and depreciation, as explained in Appendix B.

The third tax advantage which has been advanced lies in the sale of property at a profit and then its leaseback for the remainder of its useful life. Since the gain on sale might be taxed at capital-gains rates and the future lease rentals (repaying the purchaser-lessor his cost plus a fair return) are fully deductible from income taxed at regular rates, there may be a tax advantage. However, the Internal Revenue Service may look through the form of the transaction, and tax the lessee as if he had borrowed the money.

Financial advantages. Financial advantages of leasing seem to be centered around the fact that the lessee can obtain the use of more assets than he could were he to borrow to buy. First, a specific asset usually cannot be purchased entirely on credit. Second, though it hardly appears plausible, more credit seems to be available to an organization using a combination of leases and borrowing than to an organization using borrowing alone. Third, in terms of cash flow, leasing may have advantages over borrowing to buy. Whether or not such an advantage exists depends upon a comparison of interest cost, down payment, repayment schedule, and tax deductions including depreciation. Separate computations must be made for the individual case. These considerations are more fully discussed in Appendix B.

Economics of Leasing: Lessor

There are four types of lessor, each with a different economic point of view regarding leasing. These are the operator of assets leased to others, the financial institution using the leased property as an investment, the leasing company, and the manufacturer using the lease in his sales program.

Owner-operator. The owner-operator of leased assets typically leases his property for less than the economic life of the property, and he typically renders substantial services beyond making the property available. His business is largely one of property management and operation. A real estate operator or an automotive fleet operator is an example of such a lessor. His revenue is in the form of rent, and his expenses are not only interest and depreciation but also taxes, maintenance and all of the other costs of rendering the services.

The owner-operator's annual net profit is probably largely a function of rent revenue as related to service costs, as opposed to rent revenue as related to asset costs, as in the case of a financial institution. In addition, the owner-operator is more likely to be interested in the amount of profit as a measure of success or failure than he is in the rate of return. Alternatives to leasing are not available; leasing is the heart of the business.

Financial institution. The financial institution, such as a life insurance company or a pension trust, is engaged primarily in some business other than leasing *per se.* The point of view connected with leasing is that of selecting among alternative investments (including, in subsequent periods, the choice of retaining the assets now owned), and collecting the periodic receipts. A major factor in selecting the investment is the rate of return to be realized over the life of the investment.

Ordinary depreciation methods, such as straight-line and sum-of-years digits, when applied to such a leased asset give a rising pretax rate of return. Consider the pretax rates of return on a $100,000 asset with a ten-year life, leased for its full term and expected to have no salvage value. Rents are assumed to be $12,950 payable at the end of each year. These are sufficient to repay the lessor the cost of the asset plus a 5 per cent per annum return on his investment. The following table shows that the rate of return rises to unrealistic heights in the final year, except when compound interest depreciation is used.

Effect of Depreciation Method Upon Reported Rate of Return

Year	*Unamortized cost of investment at first of year*	*Rent income*	*Depreciation expense*	*Net profit*	*Rate of return*
		Straight-line depreciation			
1	$100,000	$12,950	$10,000	$2,950	2.9%
6	50,000	12,950	10,000	2,950	5.9
10	10,000	12,950	10,000	2,950	29.5
		Sum-of-years-digits depreciation			
1	$100,000	$12,950	$18,182	$(5,231)	(5.2%)
6	27,273	12,950	9,091	3,860	14.2
10	1,818	12,950	1,818	11,132	612.2
		Compound interest depreciation			
1	$100,000	$12,950	$ 7,951	$5,000	5.0%
6	56,069	12,950	10,147	2,803	5.0
10	12,334	12,950	12,334	617	5.0

The compound-interest method of depreciation provides a level rate of return because, by definition, the depreciation is the difference between the rent income and 5 per cent of the first-of-period investment in the asset. The sum of the annual depreciation figures exactly amortizes the initial value, because the 5 per cent rate is the one used in determining the annual rental. This compound-interest method of depreciation is seldom used today when the tendency is to use depreciation faster than straight-line rather than less rapid depreciation. When companies use different methods of depreciation on the tax return than they do for corporate reporting, the pattern of rate of return is likely to be radically different from those just presented unless the tax deferrals are accounted for.

Because lessors today typically use straight-line or accelerated methods of depreciation, they must depend on having a group of assets, balanced as to expected life and point of time in life, if their financial statements are to reflect the rate of return actually being earned by their investment decisions. Since investors typically have but a small part of their investment in property under lease, this problem of depreciation and a level rate of return has not become a material one in over-all financial reporting for these companies, even when the asset groups are not "balanced."

Leasing company. The leasing company may have the same objective as the owner-operator or the financial institution just discussed. In fact, the term "leasing company" may be applied to either an owner-operator or a financial company if leasing constitutes a major part of the business. The services rendered in addition to making the asset available are a key distinction. Of course, some leasing companies participate in purely financing leases, in full service leases, and in the many gradations of lease between these two extremes.

Manufacturer. Manufacturers who lease their own product may have the same objective as the operator of real estate or of the auto fleet cited previously. These lessors may have entered manufacturing in order to provide the assets for their leasing business. On the other hand, the manufacturer's objective may be to finance the "purchasers" of their product. This financing objective is probably the case when the leasing operation is carried out by a financing subsidiary. A manufacturer may very well change his objective from time to time. One prominent company today is manufacturing and selling an expensive new product. Many of the "buyers" are financing their purchase by lease. The manufacturer plans, after meeting the initial demand, to make the product available generally on short-term leases. Thus the manufacturer's objective in leasing may be that of an operator, a financier, or both at the same or at different times.

Viewpoint of Investors in Lessees

Investors in lessees, as the term is used here, include not only the owners of the stocks and bonds of lessees but also the bankers, trade creditors, other lessors, and all others to whom the lessee has contracted to pay. The prime concern of these investors, except possibly the investor in the capital stock of the company, is the ability of the lessee to pay. Most investors appear to have less concern about the financial reporting of lessors, and they do not seem to have crystallized their opinions on the lessor's financial reporting to the same extent as on the lessee's financial reporting. Therefore, this section is confined to a discussion of their views on lessees.

Over the years investors have developed "techniques" for predicting ability to pay. One group of techniques is based upon balance-sheet comparisons of fixed obligations to various other factors. Another group of techniques is based upon analysis of required cash outflows as compared to the ability to generate funds to meet the outflow.[1] If the corporation has spaced its maturities appropriately, the analysis becomes one of determining if there is an adequate margin of safety.

One of the most commonly used measures of a safety margin for meeting debt-service requirements is the ratio, "times interest earned." (The "interest" may be interest, or interest and bond discount amortization.) The ratio is computed by dividing the amount available to meet such interest by the amount of the interest; the higher the ratio, the greater the safety margin. Over the years the investment analysts have developed a set of standards for various types of companies.

If a company (1) leases part of its assets instead of borrowing to buy and (2) shows lease rentals as an operating expense instead of as a financial expense, then the amount available for interest and the interest itself are both lower by identical amounts than they would

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[1] These methods of analysis are discussed in many books on investment and corporation finance. A most recent study is that reported by Gordon Donaldson in his *Corporate Debt Capacity*, Harvard University, 1961, and in "New Framework for Corporate Debt Policy," *Harvard Business Review*, March-April 1962, pp. 117-31.

have been under borrowing. However, the "times—interest—earned" ratio is substantially higher. For example, let us assume that a company could lease a large portion of its assets at a rental exactly equal to the depreciation cost and the interest that would be paid were those assets purchased with borrowed money.

	No Leasing	*Leasing*
Amount available for interest (after depreciation and lease rentals)	$100,000	$75,000
Interest	50,000	25,000
Net profit	$ 50,000	$50,000
Times interest earned	2	3

Even though net profit has not changed, the times-earned ratio is substantially higher if leasing is used.

In their *Security Analysis*[2] Messrs. Graham and Dodd suggest that, in computing this times—interest—earned ratio, one third of rentals be included in interest instead of in operating expenses. The Securities and Exchange Commission in its revised paragraph (c) (2) of General Instruction A for filing form S-9 states, "The term 'fixed charges' shall mean . . . (ii) one-third of all rentals reported in Schedule XVI, or such other portion as can be demonstrated as representative of the interest factor in the circumstances of a particular case. . . ." Moody's Investors Service in its *Bond Survey* of September 26, 1960, computed the interest protection on a new issue of Associated Dry Goods Corporation both on the traditional basis and "... based on combined total of actual rentals paid ... plus estimated annual interest charges. ..." The Standard Oil Company (Ohio), in its 1961 annual report, gives a ten-year summary which includes a "times fixed charges" figure; a footnote to the figure says that it includes "... the portion of rentals charged to income which constitutes the estimated return to lessors on their investment in all premises covered by long-term leases." The effect of leasing upon this traditionally important ratio is thus recognized. In cases where the figures are not available, approximations are being made to prevent errors in judgment induced by substitution of lease financing for conventional borrowing.

Some other commonly used ratios are debt to total capitalization, debt to equity, debt to net plant, working capital to plant, and plant to sales. Since plant and related debt are removed from the balance sheet by leasing, the traditional interpretation of the related ratios is invalid

[2] 3rd ed., pp. 381-84.

unless the reader is to determine the present value of the lease rentals and add the resulting figure both to the assets and to the liabilities.

Although many professional analysts are content to handle the ratio analysis and the related lease problems in an informal way, there is not a single one with whom I have had contact, whether by interview, by correspondence, or by his publications, who has not felt a strong need to include lease obligations in a cash-flow analysis. These analysts want to know (on a year-by-year basis for at least the next few years) the amount of the cash outlay required under existing contracts, be they bond, lease, or other.

Other factors which analysts have indicated, with varying degrees of forcefulness, that they want to know are:

Current annual rental, fixed and variable—What is the total annual lease obligation at the present level of business?

Type of property leased—Is it essential to business? Does it have alternative uses?

Cost of property—If the lease were terminated, what would it cost the company to acquire similar property?

Options at maturity—Does the lessee have an option to buy at a nominal price?

Options for early termination—What would it cost the lessee to terminate the lease before maturity?

Lessee's responsibility for taxes, insurance, maintenance—Is his responsibility that of an owner?

Default provisions—Are they equivalent to the default provisions found in conventional debt contracts?

Restrictions against further leasing or debt—What are these restrictions, if any?

Interest rate implicit in rentals, after providing for lessor's recovery of cost—Is the lessee a good negotiator?

3

Disclosure of Lease Information in Present Financial Statements

Lessees

There are four main sources of financial information open to the person outside the corporation. These are the annual report, the Securities and Exchange Commission filings, the financial services, and the direct inquiry either of the company itself or of its commercial and investment bankers. Since the financial services themselves are outsiders, they must rely upon the other three sources. Useful though direct inquiry may at first appear, it is almost always limited by the confidential nature of much that may be requested. Analysis of the annual report and the Securities and Exchange Commission material almost always precedes direct inquiry. In fact, some people feel that direct inquiry should not be necessary if accounting reporting is adequate.

The corporation has freedom in what to show and how to show it in the annual report subject to the influence of its independent public accountant, the Securities and Exchange Commission and the various stock exchanges in persuading better presentation and in withholding an unqualified opinion or necessary permissions if minimum standards are not met. This section is devoted to an analysis of corporate annual reports. Reference to the Securities and Exchange Commission filings is made only to point out either additional data that might have been presented or an alternative method of presentation.

Accounting Trends and Techniques (1961 edition) gives the following summary of lease reporting for the year 1960:

	Details set forth in:			
	Footnotes	*Letter to Stockholders*	*1960 Total*	*1951 Total*
Disclosures by Lessees				
Annual rental amount	133	3	136	59
Aggregate rental amount	10	1	11	2
Lease expiration date	27	1	28	14
Number of leases	57	2	59	37
Renewal option	15	1	16	13
Sell-leaseback feature	19	3	22	3
Term of leases	85	2	87	12
Total	346	13	359	140

	1960 Total	1951 Total
Number of Companies		
Setting forth details of long-term leases	117	61
Mentioning long-term leases but omitting details thereof	69	
Indicating long-term leases (without mention thereof) by reference to leaseholds or leasehold improvements	37	139
	223	200
Neither referring to nor indicating long-term leases	377	400
Total	600	600

No reference to leases. The fact that so many of the six hundred companies make no reference to leases at all or give no details may be because of any of three factors: the company has no leases, the leases are judged as not material, or the companies fail to disclose. A leading electronics company is an example of a company having leases but making no mention of them in its annual report. The Form 10K filed with the Securities and Exchange Commission discloses rentals for 1960 of $484,000, which figure "excludes rentals for office and other equipment under leases generally terminable at the Company's option." Criticism for failure to disclose may or may not be proper; such annual rentals may well be judged material when compared to debt of $28 million, and interest thereon of $1.2 million. The only clue to leasing in the annual report to stockholders is in the name of the smallest component of fixed assets: dies, tools and leasehold improvements. In the 1959 annual report of another company there was an extended discussion of the activities of each of the six divisions of the company. In the discussion of one of the divisions this sentence appeared: "This Division occupies a leased, modern 36,000 square foot facility . . . where complete facilities exist for. . . ." There is no other reference to leases in the statements, notes, or text of the report. As the company is not listed on a securities exchange, regular Securities and Exchange Commission filings are not available. The investor might assume that leases are negligible; the assumption might be erroneous.

Lease rental obligations on balance sheet. Only a very few companies have shown as part of their balance-sheet totals the aggregate (total or discounted) rentals due under some or all of their leases. Some are Allied Paper Corporation, Continental Air Lines, Inc., Lenkurt Electric Co., and Mohasco Industries, Inc. The Fairbanks-Whitney Corporation showed such a value on its balance sheet, but did not include the figures in the total.

Allied Paper Corporation in its 1960 annual report carries the mill which it leases in Property, Plant, and Equipment. The rentals payable under the lease are carried as Long-Term Debt (as disclosed in its Note D, reproduced in our Appendix C) at the full amount to be paid. This is a change from the procedure followed in prior years, as explained in the second paragraph of its Note G (reproduced in full in our Appendix C) as follows:

> In recognition of circumstances indicating the probability that the option to purchase the Bryant Mill will be exercised in 1966, management believes that it is more realistic and appropriate for accounting purposes to treat the transactions arising from the 1956 agreement as a purchase.

Continental Air Lines has a note to the 1960 financial statements giving details of its $46 million of debt. The last item is "other obligations $1,204,616." A note explains this as follows:

> Under terms of a sale and leaseback agreement executed in 1958, the Company sold its maintenance base, located on leased ground at the Los Angeles airport, for $750,000 and leased back the buildings at $12,450 a month for eighty-four months, with an option to repurchase at the end of the term for $20,000. The Company considers this to be essentially a loan arrangement and is so treating it in its accounts. An amount of $430,959 is included in "other obligations," above, as the long-term portion of the unpaid obligation.
>
> Also included in "other obligations" above are amounts relating to certain fueling and other ground equipment being acquired under lease-purchase agreements or conditional sales contracts in the amount of $666,595, and a mortgage note payable secured by office building and land in the amount of $107,062.

Certain other leases, however, are not handled in this manner, as described in another note.

Prior to its acquisition by General Telephone and Electronics, Lenkurt Electric Company planned to include its lease obligations in its published balance sheet. Although never released, the statements are described in an article by one of its officers.[1] His sample statements under the name Zed Corporation are reproduced in our Appendix C.

Mohasco Industries sold and leased back certain of its properties in 1958. On the balance sheet as a liability is the aggregate of all future rentals, net of tax effect, on these properties. Certain other data pertinent to the sale aspects of the property are given (reproduced in our Appendix C) and will be discussed later. The same presentation is used on the Form 10K filed with the Securities and Exchange Commission.

Current year rentals. In a specific examination of the annual reports of a number of companies both within and without the six hundred analyzed for *Accounting Trends and Techniques,* we find that a very small proportion of the companies disclose in their annual reports the amount of lease rentals charged during the current year. Some of these few companies disclosing current lease rentals (for example, Marshall Field & Co. and Montgomery Ward & Co., Inc.) give it as a separate item in the income statement. Others give it in a note. This variation in rent disclosure is comparable to that of depreciation disclosure. Since rents may be incurred both for manufacturing and for selling facilities, the showing of rent as a separate item on the income statement precludes sharp division along functional lines. The Securities and Exchange Commission solves this problem by requiring that rents be set out in the schedule of Supplementary Profit and Loss Information which provides for allocation of rents to manufacturing, selling, and other costs.

Some of the companies giving current year rentals give no indication as to the length of the lease. For example, one company states in a note, "Annual rental commitments under long-term leases amounted to $XX at December 31, 1960." No more information was given in the Form 10K filed with the Securities and Exchange Commission. In cases such as this the lease may be an annual one for a relatively small amount of space. On the other hand, if the company had been a

[1] Kenneth R. Rickey, "Including All Leases in the Balance Sheet—A First," *NAA Bulletin,* December 1959, pp. 51-60.

one-location retailer, the lease might have been one for the land underlying its only store.

Several major oil companies show the excess of rent expense over rent income. For example, Union Oil Company of California in its 1961 report says:

> Rentals paid during 1961, less rentals received, amounted to approximately $12,124,000. The rentals paid relate primarily to marketing facilities, chemical plants. . . . In the aggregate, rentals paid on service station properties are approximately offset by rentals received from service stations subleased to others.

Gulf Oil Corporation on the other hand shows estimates for the coming year of both rentals payable, $84 million, and rental income, $32 million, in its 1961 report.

Future rentals. Most companies that give lease data in their annual reports give information about future rentals. The amount of information varies widely. Typically, the companies give minimum annual rentals. Actual rentals may exceed the minimum under percentage leases. The information given about minimum annual rentals varies considerably. For example, J. C. Penney Company in its 1960 annual report says:

> . . . the total minimum annual rentals payable under leases expiring after five years was approximately $11,700,000. Leases covering about 79% of this amount will expire on various dates during the next twenty years.

Other companies have selected two, three, and ten years as the dividing line between short-term and long-term leases. Three years is the most common one stated, possibly because that is the criterion suggested in a note to Chapter 14 of *Bulletin No. 43* and formerly in Regulation S-X. Other companies just say "long-term" without further definition.

A few companies give data on all rentals, short and long term. The Great Atlantic & Pacific Tea Company is one. It states in its report for the year ended February 27, 1960:

> . . . The leases are for varying periods (generally for 3 to 10 years). . . . At February 27, 1960, the companies were lessees under approximately 4,600 leases . . . with an annual rental of approximately $56,500,000.

Safeway Stores, Incorporated, in its 1960 annual report somewhat similarly states that the "minimum annual rental for 1961 under all . . .

is approximately $43,000,000; this amount decreases annually until the year 2008 as leases expire." Arden Farms Co. has an unusual presentation of minimum annual rentals. As a separate item on its 1961 balance sheet, after liabilities and capital but before the total, it has

Long Term Lease Commitments:	
Minimum annual rentals of approximately	$6,200,000.00

The amount is not extended into the columns which are totaled.

A few companies have gone considerably further than those cited in the previous paragraphs and have been specific about the future periods. Several cases are ones where but few leases are involved. Indian Head Mills, Inc. in its 1959 annual report refers only to one lease and states, "Annual rentals on these properties aggregate $464,040 through 1964 and $40,020 thereafter." Tishman Realty & Construction Co. has twelve leases. Tishman's note, reproduced in Appendix C, shows expiration date and annual rental of each lease. The same note appears in the Form 10K filed with the Securities and Exchange Commission. Notes to certain leases specify a different rental after

a given date. Loblaw Groceterias Co., Limited (a Canadian company) gives a schedule in its report for the year ending June 3, 1961, showing the aggregate (not annual) minimum rentals payable during each five-year period for the next twenty-five years and the aggregate payable after twenty-five years (the amount of this aggregate is very small, being less than 10 per cent of that payable 1962-66). The note is reproduced in Appendix C. Similar treatment is given in the separate statements of Loblaw's United States subsidiaries. Allied Stores Corporation in a note in its 1960 report (for the year ended 1/31/61) states:

> The aforementioned minimum annual rental grouped by lease expiration dates is as follows: $3,042,431 prior to 1980; $2,674,734 in 1981-1985; $3,058,116 in 1986-1990; $1,966,100 in 1991-2000; and $3,454,060 in 2001-2059.

Except for a few cases such as those cited in the preceding paragraph, the investor generally does not receive from the annual reports the information he needs in order to compute the discounted future rentals, or even to make a good approximation of them. Without such an approximation to add to the balance sheet, his analysis of balance-sheet ratios as discussed earlier will be distorted.

Neither the data given in the typical annual report to stockholders nor included in the Supplementary Profit and Loss schedule required by the Securities and Exchange Commission is sufficient to compute the discounted future rentals.

In a few cases the information necessary to compute the discounted rentals is included in the Securities and Exchange Commission Form 10K. For example, Montgomery Ward, in its Form 10K for the year ended February 1, 1961, included a schedule of minimum annual rentals due in 1961, 1962, 1963, 1964, 1965 and the aggregate rental due in each five-year period through the year 2000. The aggregate of all rentals due after 2000 is also given, and is quite small, being less than 12 per cent of the rentals due in the year 1961 alone. The note is reproduced in Appendix C. Prior to 1960 Allied Stores used a more abbreviated footnote in its annual report, but had a schedule in its Form 10K somewhat comparable to that of Montgomery Ward. The 10K schedule of Allied Stores for 1960 (year ended 1/31/61) shows minimum annual rentals of leases expiring in 1964, 1965, 1966 and then in five-year intervals to 1996 and in two groupings for later years. Note that, in contrast to the Montgomery Ward statement, in order to find minimum rentals payable in any given year, it was necessary to add rentals under leases expiring in each subsequent year. The rentals were divided between those payable to an unconsolidated subsidiary and those payable to outsiders. The note is reproduced in Appendix C.

The information about leases by Tishman, Loblaw, Montgomery Ward, and Allied Stores is but little different from the data given in the typical bond schedule. In contrast there are several examples of notes in Appendix C giving many bond details but meager lease details. Data given in Moody's *Industrial Manual* and Standard and Poor's *Corporation Records* are comparable in almost all cases to those in the annual report.

Other lease provisions. Chapter 14 of *Accounting Research Bulletin No. 43* calls for disclosure of "any other important obligation assumed or guarantee made in connection therewith. . . ." The F. W. Woolworth Co. and Sears, Roebuck and Co. are two of the few companies that have indicated the obligation to pay real estate taxes and other expenses in connection with at least some of the leases. The lease notes of both of these companies are reproduced in Appendix C. The wording in the Sears report for the year ended January 31, 1961, is "Minimum annual fixed rentals, exclusive of taxes, insurance and other expenses paid directly by the Company under long-term leases. . . ." The Gimbel Bros. note in its 1960 annual report is one of the few that states that the taxes on leased property were "included with taxes" in the income statement.

A growing practice is for the lessor to restrict the lessee in some measure with regard to working capital, dividends, future leasing, and/or debt. Only one case, the 1959 annual report of the Ritter Company, Inc., has been found stating such a restriction among the lease data. The note states a restriction on dividends and on working capital, and it applies only to a subsidiary. It is reproduced in Appendix C and contains information comparable to that so often disclosed in the case of bonds. If both the lease and the bond contract have restricted the use of retained earnings, the note on bond restrictions or the note on retained earnings presumably discloses the total or most stringent restrictions and, therefore, the restrictions need not be repeated in the lease note.

Options in leases are now common. They may be (1) at termination to buy or to renew or (2) before termination to buy or to cancel. Only about 10 per cent of recent annual reports of lessees give any indication of these options. About such options the financial reporting services, in isolated instances, have given data not included in the annual reports. Some examples of the option disclosure in annual reports are given below. Basically the same information is in the Form 10K filed with the Securities and Exchange Commission.

Options at termination:

> . . . with an option to repurchase at the end of the term for $20,000. (Continental Air Lines, Inc., 1960.)
>
> . . . The leases contain options to purchase the [transportation] equipment at prices declining in proportion to rentals paid. (Penn Fruit Co., Inc., 1960.)
>
> . . . The leases [on automatic sprinklers] are subject to renewal at the option of the Company at nominal rentals. (Penn Fruit Co., Inc., 1961.)
>
> . . . Options that provide for renewal privileges exist under the terms of many of the retail store leases now in force. (Montgomery Ward & Co., Inc., 1959; sentence not repeated in 1960.)
>
> A subsidiary occupies a manufacturing plant under a 20-year lease. . . . The lease, which expires June 30, 1977, is renewable at the lessee's option for eight five-year periods at substantially reduced rentals. (Keystone Steel and Wire Co., 1960.)

Options before termination:

> . . . an option to purchase . . . at a price equal to the lessor's then unamortized cost. . . . (Libby, McNeill & Libby, 1961.)

> Property Leases in effect number 2,904, of which 2,376 contain options to cancel. Should the Company exercise these options, it could be required to purchase 1,893 properties. . . . (Safeway Stores, Incorporated, 1960.)

Sears, Roebuck and Co., in its report for the year ended January 31, 1961, takes an interestingly different view of the life of leases. Instead of saying that the leases are renewable, Sears reveals the total term including the renewal periods and states that, at certain times during the lease period, it has the option "to terminate or continue at reduced rentals." The report also states "The Company can, after the initial period of years, purchase the property at the then fair value of the land alone." From Sears' point of view these appear to be options before termination, but to most companies these options would be options to renew at the termination of a shorter lease. Sears states another option that would also be considered an option before termination by other companies.

> The Company can, on various specified dates (usually within the first 25 to 35 years), make a rejectable offer to purchase the property at specified prices and, in the event the lessor does not accept the offer, can either terminate or continue the lease.

An unusual option before termination is that of a lessor rather than the lessee. Lerner Stores Corporation has a note in its report for the year ended January 31, 1961, that reads as follows:

> . . . The leases . . . include 7 leases under which the companies may be required to purchase the premises under lease for a total of $1,576,210 at the option of the landlords. . . .

Sale and leaseback. Chapter 14 of *Accounting Research Bulletin No. 43* states that in the year the transaction originates "there should be disclosure of the principal details of any important sale-and-lease transaction." When such transactions are deemed important enough to be reported, the notes usually give considerable detail. Although most sale and leaseback transactions involve new property, there are a few cases in which older property is sold and leased back. The disposition of gain or loss poses a theoretical problem which will be discussed later. The disclosure given in six cases of sale and leaseback follows.

The Scott Paper Company in 1960 had a footnote telling of certain properties being constructed to be sold and leased back. By December

31, 1961, the transaction had been consummated and the following footnote appeared:

> The company has under long-term lease . . . constructed at a cost of approximately $24,000,000. The leases extend for periods up to forty years with annual rentals totaling approximately $1,600,000 for each of the first fifteen years and reduced amounts thereafter. The company has options to purchase the properties under specified conditions.

The gain on sale and leaseback was deferred in the case of the Comptometer Corporation as disclosed in its 1960 annual report. The note reads as follows:

> Certain of these leases cover properties originally owned by the company which were sold and leased back. The excess of net sales prices over the company's undepreciated cost of the properties sold in these transactions has been deferred, and is being amortized over fifteen years, the period of the leases.

On the balance sheet the profit deferred is shown between Notes Payable and Capital Stock. The item is labeled "Deferred Credits, arising from sale and leaseback of properties, being amortized over lease periods." Neither cost nor selling price appears. The same treatment is given in the Form 10K for 1959 filed with the Securities and Exchange Commission.

The gain on sale and leaseback was shown in the Statement of Income and Retained Earnings by S. H. Kress & Co. in its 1959 report. The gain of $1,132,137 (after deducting $378,000 for Federal taxes) is shown as a separate item after Net Income of $1,892,071. A note states that the properties were leased back for twenty-five years with renewal options for an additional fifty years. The note also states the annual rental payable during the initial period and the fact that the company must pay "real estate taxes, insurance, and certain other charges." No information is given as to the cost or selling price of the properties.

A loss on sale and leaseback was incurred by Indian Head Mills during its fiscal year ended November 28, 1959. The loss is shown on the income statement among several items labeled "nonrecurring income or (loss)." Some gains on sale of property are netted against the loss incurred on the sale and leaseback, so that the loss on the income statement is about half as large as the loss on the transaction as reported in the note. The note is as follows:

> In October 1959, the Company sold for $2,000,000 the land, buildings, machinery and equipment comprising the Whitney

> and Glendale mills and leased them back for an initial period of five years with renewal options for an additional fifteen years. Annual rentals on these properties aggregate $464,040 through 1964 and $40,020 thereafter.
>
> The loss on the sale amounted to $981,880 and is included in the loss on disposal of property, plant and equipment in the income statement.

The buyer-lessor in the case of the Essex Universal Corporation's sale and leaseback in 1959 is a group of stockholders. The note reads:

> On March 21, 1959, Wm. Gluckin and Co., Inc. and its subsidiary Pittston Apparel Company sold a major portion of their Fixed Assets to former Gluckin stockholders who are now Stockholders of Essex Universal Corporation.
>
> Wm. Gluckin and Co., Inc. has leased these assets for ten years at an annual rental of $50,000.00 for the first five years with an option to purchase at the end of that period for $415,000.00. The rental for the second five-year period, if the option is not exercised, will aggregate $465,000.00.

No gain or loss on these properties appears in the Essex Universal statements if for no reason other than that the consolidated statements include only those transactions of the subsidiaries since acquisition, and the sale and leaseback took place before acquisition.

The gain on sale and leaseback is shown in the income statement of Mohasco Industries, Inc. for the year 1958 as a special item. Also shown as a special item is a "Special charge—provision for long-term rentals on Amsterdam properties" which is 83 per cent as large as the gain credited. The credit side of the entry setting up this special charge appears on the balance sheet as "Long-term rentals on Amsterdam properties." The amount on the balance sheet is slightly less than the amount in the income statement; it is presumed that the difference is current rental due and is shown among the current liabilities. The complete note and the statements appear in Appendix C.

Another unusual case of leaseback is that reported by Corning Glass Works in its 1959 report. The company transferred to its pension fund the entire capital stock of the subsidiary owning its New York office building (presumably mortgaged). The note to the Corning statements says that "cost and expenses" on the income statement were charged with $1,600,000, the cost of the stock, but that the pension trustee credited the company with the fair value, $4,347,959. Corning Glass Works then leased the building back and the terms are set out in the note. One of the terms is that "The Trustee . . . has the option to sell the stock . . . to Corning Glass Works at a price of $4,347,959 . . . at any time prior to June 30, 1984 or ninety days after any sale or disposition . . . of its interest in the building." The same note appears in its Form 10K filed with the Securities and Exchange Commission. In the 1960 and 1961 reports the note has been shortened substantially, as in the subsequent year there is no need to describe the transaction. The note refers to the amount of the lease rentals and to the commitment to repurchase the stock of the building corporation.

These several cases of sale and leaseback transactions indicate the wide variety of treatment the subject is receiving and the wide variety of information that is given the investor. In at least some of the cases set forth here, an investor would be unable to reconstruct the transaction and thus include on the balance sheet the present value of future lease rentals and related asset as some wish to do.

Leasing from subsidiaries. A number of companies, particularly retail department stores, lease a substantial part of their operating properties from their real estate subsidiaries. When the subsidiary is consolidated, there is no problem of lease disclosure. When the subsidiary is not consolidated, however, the problem of disclosure becomes important because the two entities involved are so closely related. Allied Stores Corporation is one that leases from its nonconsolidated subsidiary. On the 1960 Allied Stores statement of earnings, rents are set forth as a separate item with a parenthetical statement showing the amount paid to Alstores Realty Corporation (the unconsolidated, 100 per cent owned subsidiary). Financial statements of Alstores are also presented in the Allied Stores annual report. The rental income line of the Alstores earnings statement parenthetically shows the amount earned from the parent (about three-quarters of the total). A note to the Alstores statement states

> A substantial part of the property and equipment is under long-term leases to Allied Stores Corporation or to its subsidiaries guaranteed by Allied Stores Corporation. Such leases applicable to mortgaged property are pledged as collateral for the indebtedness.

In the 1959, but not the 1960, annual report there was also a note about Alstores' position as lessee of property which in turn is leased out to Allied Stores. It stated that Allied Stores was required to make rent payments directly to the underlying lessors.

Lessors

Many companies which we know are lessors of assets give no clue on their balance sheets or in the notes to the fact that certain of the assets are leased, and they give no clue on their income statements that part of their gross income is from leased assets. In some cases this information may be significant to the user of the statements. Typically, however, the leasing of assets forms but a minor part of the company's total business.

In some cases companies do not disclose how much of their fixed assets and how much of their income is from leasing, but they do acknowledge the fact of leasing on the financial statements. International Business Machines Corporation in the 1961 annual report shows as its largest asset "Factory and office equipment, rental machines and parts." The first item in IBM's income statement is "Gross Income from Sales, Service and Rentals in U. S." Union Tank Car Company in its 1961 annual report handles its income statement in a manner comparable to IBM and calls the item "Income from Sales and Services." The balance sheet has a heading titled "Property, at Cost." Under this heading the company lists both "Tank Cars" and "Land, Buildings and Equipment." General American Transportation Corporation in its 1961 annual report goes one step further and not only separates the property accounts, but also divides the major component of "Gross Income" into two parts, "From manufacturing" and "From services." Ex-Cell-O Corporation in its 1961 statement has a slight variation from the General American Transportation pattern. On the balance sheet the "Rental Machines, at Cost" are in a separate major section distinct from "Plant and Equipment, at Cost." On the income statement, "Sales, and gross income from leased machines" is a single item, but a note gives the amount of the gross income from leased machines.

As distinct from the above companies which use the leased asset as a part of their operations there are manufacturers whose leasing is incidental to sales. Among the receivables on the Motorola, Inc. 1961 balance sheet is the subheading "Notes and contracts" which has as a subdivision "Lease and conditional sales contracts." Clark Equipment Company is one that carries the leased assets in its wholly owned finance subsidiary. The major asset of this subsidiary is "Lease contracts and notes receivable from customers and dealers." This treatment seems to reflect clearly the points of view both of the manufacturing company and of the finance subsidiary. In the Clark Equipment case, the manufacturer has sold to a dealer who, in turn, has leased the assets to the user. The dealer then has discounted the lease with the finance subsidiary. Many finance subsidiaries of other manufacturers undoubtedly have handled the lease form of financing, but the fact is not apparent in most such financial statements. Perhaps the amount is among the miscellaneous assets, but more likely it is among the receivables and the heading is not sufficiently detailed to spell out what may be a minor component.

Life insurance companies also own assets leased to others. Although treatment of the asset in a manner comparable to other investments might be indicated, insurance regulations require that the leased assets be carried in the property accounts and depreciated in a comparable manner. Since assets leased to others are but a minor portion of total assets of these companies, the problem has not yet become significant.

To the real estate operating company, renting may be only one of several activities. On the income statement the rent revenues and the expenses connected with renting are usually placed so that income from renting can be determined. All property expenses including depreciation, interest on mortgages and lease rentals paid typically are deducted. On the balance sheet real estate owned typically is in a separate section from other assets.

Leasing companies, as distinct from all others discussed so far, have leasing as their major business. Two distinct forms of accounting are used by these. The Hertz Corporation in 1961, for example, carries "Revenue Earning Assets" separately from "Property, Equipment, and Intangibles," and records rent as revenue and depreciation on the leased assets as an expense. For sake of convenience, this might be called the "rental" method. The Hertz statements are presented in Appendix C.

In contrast, both as to method of doing business and as to method of accounting, Boothe Leasing Corporation and United States Leasing Corporation use what might be called the "finance company" method. Although the details differ, both of these companies carry the rents receivable from lessees as an asset without defining it either as current or fixed. Both have a separate account representing the estimated "residual" value (cost less depreciation) of the assets at termination of the lease. Both have an account for the "unearned income" in the lease contracts, although Boothe deducts the "unearned income" from the receivable while U. S. carries it among the liabilities. The balance sheets and certain notes of both of these companies are presented in Appendix C.

As to recognition of revenue, United States Leasing explains in its Note 3 in 1960 that enough revenue is recognized upon negotiation of the contract to offset the expenses of putting it on the books. No information is given as to the schedule for recognizing the revenue that is deferred. Boothe explains that the "unearned income" is recognized on a

> . . . sum-of-the-months-digits basis. This method has the effect of recording earned rental income on a declining basis over the life of the lease in proportion to rental installments outstanding.

Both companies give recognition to income taxes deferred.

4

Proposed Lease Presentation—Lessees

There appear to be but two basic methods of handling lease transactions in the accounting statements. The method presently in greatest use is to report the cash outlay as an expense in the period to which it pertains and to ignore, in the accounting, any commitments to make future payments. The second method is to consider the lease transaction as a financial transaction in which an asset is acquired and an obligation is created. The asset and related liability are recognized by inclusion among the items and in the totals on the balance sheet. Although there seems to be common agreement that present accounting presentation of leases is inadequate, there is disagreement over (a) whether the needed improvement can or should be accomplished through more adequate notes or (b) whether the present value of future payments should be computed and included on the balance sheet.

This chapter will be devoted first to a discussion of the accounting method to be followed: balance-sheet recognition of future rentals at the inception of the lease vs. recording rental expense as the payments are made. As balance-sheet recognition is the method seldom used today, the discussion will take the form of stating the case for this balance-sheet treatment and the case against it. Second, the methods of presenting lease information will be considered.

The Case for Balance-Sheet Disclosure

Let us consider a hypothetical lease in which the lease terms are as follows:

Life—Fixed term for the entire estimated useful life of property

Property costs (taxes, insurance, and maintenance)—Obligation of lessee

Rights at termination—Title to lessee at nominal price

Rent—Single payment at beginning of term approximating fair value of property

There probably would be no question as to the proper accounting for such a lease. Cash would be credited and another asset debited. There might be some question as to whether the debit would be classified among the property accounts or among the prepayments. Most accountants probably would classify the asset as "plant," in recognition of the property rights acquired.

Let us modify the preceding case slightly and assume that the lessee had adopted a different alternative available in the negotiations. Instead of paying in a lump sum, he agreed to pay in installments. The total sum agreed upon was larger, but the present value of that sum, discounted at 5 per cent per annum, was identical with the lump sum he might have paid. The fact of the installment payments should modify the recording only to substitute a credit to a liability account for part of the former credit to cash. The property right created is no different from the previous case.

If the schedule of installments were to call for two large payments near the beginning of the term and no subsequent payments, the common practice today probably would call for the treatment just discussed. The mere stretch-out of the installment schedule, however, is hardly sufficient to warrant a completely different accounting treatment in which the property right and the liability are ignored.

Let us modify the case in one further respect, that of rights at termination. The new terms are then:

Life—Fixed term, estimated to be the entire useful life of property

Property costs—Obligation of lessee

Rights at termination—Option of lessee to renew for nominal price

Rent—Installment payments, present discounted value of which approximates fair value of property

If the lessee should find the property does have value at the expiration of the lease, the fact that he must make nominal payments to renew and continue his enjoyment of the property can have no effect on the initial recording. The parties merely have agreed, many years in advance, to a price to be paid if the "rights" are to be "bought." Furthermore, if the original agreement had called for large payments for the renewal term (perhaps in consideration of lower payments for the original term) the method of recording the payments for the original term would not be affected. The payments during the original term are to discharge, in full, the obligation created.

These terms are common ones in cases in which the lessor purchased the asset just prior to the beginning of the lease term, after the agreement to lease had been made. The asset may have been constructed or purchased new to meet the lessee's specifications, or the asset may have been purchased from the lessee in a sale and leaseback transaction.

If the lessee had no contractual rights whatever at the end of the lease term, that fact probably would have affected the original negotiations but little. Since the asset was leased for the entire expected useful life, any expected residual value at that future time probably would be small. Discounted to the date of the negotiation of the lease contract, the present value of the residual would be even smaller. To be sure, those future residuals have a speculative value; price inflation or scarcity of the item may have changed the economic environment. Such speculative values are not recorded today in the case of owned assets; the possibility of their presence, however, is indicated by the fact of ownership of fixed assets. When the obligation of future lease rentals and the related property rights are to be shown on the balance sheet, some method of indicating the presence or absence of such speculative residuals should, perhaps, be devised. Discussion of this point is deferred to page 57.

Now let us modify the hypothetical lease with respect to its life. The new terms are:

Life—A fixed term for a major part, say 60 per cent, of useful life of property (as contrasted to 100 per cent in the previous cases)

Property costs—Obligation of lessee

Rights at termination—Option of lessee to renew at a nominal price to end of useful life

Rent—Installment payments. Over the original term, the present discounted value of the payments approximates fair value of property

In this case, where the life of the lease is shorter than in the preceding cases, the right to renew is more valuable. Since the present value of the lease payments is enough to pay for the property over the shorter term, each periodic installment will have to be larger. In spite of the different payment schedule, the lessee effectively is purchasing the right to the property for its entire useful life for the same cost as that in the preceding case. No difference in original recording is in order. The liability will be extinguished more rapidly, but, since the asset will not become worthless any more rapidly, it should be amortized over its useful life which presumably is the same as in the preceding cases. Had the termination option been to buy at a nominal price, the consequences would be the same as when the options to renew at a nominal rental continue to the end of useful life.

In all of the cases discussed so far the lessee has acquired the right to the asset for its entire useful life for a price equal to the fair value of the asset at inception of the lease. In these cases, recording the lease almost in the same manner as the acquisition of property by purchase has been in order.

Now let us change the case materially to the point where the lessee buys the right to use the asset for only 60 per cent of its life. The price now should, of course, be smaller. Since the lessee is purchasing the right to use the asset in its early years, the price may be different from 60 per cent; let us assume 75 per cent of fair value at the inception of the lease.

The terms of the new case are:

Life—Fixed term, at 60 per cent of estimated useful life

Property costs—Obligation of lessee

Rights at termination—None

Rent—Installment payments, present discounted value of which approximates 75 per cent of fair value.

In this case, the right to use the asset has not been purchased for its full useful life. It would be incorrect to set up the asset and the liability for the same amounts as before, but it is not incorrect to record, in the same manner, the smaller asset being purchased for a smaller price. An asset has been acquired as before; this time the asset is a right to use for a shorter period. The fact that the right expires before the asset becomes useless to anyone in the economic sense can hardly make a significant difference; it is useless to the lessee at the expiration of the lease. The present value of the payment, therefore, should be recorded, and, over the life of the lease, both the asset and liability should be extinguished.

Even if the lease were for a minor fraction of the life of an asset, say 5 per cent, the basic philosophy is unchanged. Perhaps the present value of the rentals would be small enough to be judged "not material," and on such a basis would not be recognized on the balance sheet. "Not material" merely indicates that an "error" in handling will be tolerated because it can do no harm.

Throughout the cases previously discussed the one fact that has not been varied has been the lessee's obligation to pay for taxes, insurance, and maintenance, in addition to the rentals. These additional costs are the same as he would be paying if he owned the property. No property owner by today's accounting standards, or by any that I have ever heard proposed, sets up a liability for taxes, insurance, and maintenance to be incurred in future years.

Expenses of taxes, insurance, and maintenance are recognized by a property owner as they accrue. Comparable recording of the same costs is in order in the case of leasing. Whether the lessee pays these costs directly or whether the lessor pays them from higher rental payments makes no fundamental difference. A practical difference does arise in determining what portion of a lease rental is for these property costs as distinct from the portion paid for the right to use the property on a fully paid or installment-payment basis. As discussed in Chapter 2, and more fully in Appendix A, the lessor may assume the payment of the costs incurred to provide heat and elevator service in a building or gasoline and oil for trucks. Rentals can be set to cover these operating costs as well as the cost of availability and of financing. These other operating costs should be handled like taxes, insurance, and maintenance.

In summary, then, the present value of contracted lease payments should be placed among the assets and liabilities on a balance sheet *to the extent* that they represent the acquisition of the right to use property. The portion representing periodic services to be performed by the lessor should not be capitalized.

Balance-Sheet Treatment and Accounting Theory

The function of accounting as set forth by Maurice Moonitz in "The Basic Postulates of Accounting" (American Institute of Certified Public Accountants, 1961, p. 23) is

> (1) to measure the resources held by specific entities; (2) to reflect the claims against and the interests in those entities; (3) to measure the changes in those resources, claims, and interests; (4) to assign the changes to specifiable periods of time; and (5) to express the foregoing in terms of money as a common denominator.

Among the "resources" of a business is the right to use certain assets, and among the "claims against" the business are the obligations to make payments already contracted for.

From the same source (p. 52) we find

> **Postulate B-2. Market prices.** Accounting data are based on prices generated by past, present or future exchanges which have actually taken place or are expected to.

In the case of the lease contract, has an exchange taken place? The previous discussion in this monograph has indicated that it has. The balance-sheet treatment of leases is then compatible with the "basic postulates" of accounting. Some further discussion is necessary, however, to relate the lease contract more specifically to the concept of "asset" and of "liability."

"Resources" as used by Moonitz, is synonymous with "asset." The definition of "asset" given by Kohler in his *Dictionary for Accountants* (Second Edition) is pertinent.

> Any owned physical object (tangible) or right (intangible) having a money value; . . . any cost benefiting a future period.
>
> . . . The accounting meaning of "ownership" as applied to an asset is usually legal ownership, but there are exceptions; an equity in an item of property, coupled with possession and use, is . . . an asset to the owner of the equity . . . [example, an auto on conditional sales contract].[1]

Although Kohler defines an asset in terms of ownership, he recognizes that, in certain cases, an asset may be represented by rights less than ownership in the common sense of the term. A further example of an asset on the balance sheet which is not owned in the legal sense of the term is a leasehold improvement. Though installed and paid for by

[1] This definition and the one of Canning's cited below are in line with the discussion of assets in Robert T. Sprouse and Maurice Moonitz, "A Tentative Set of Broad Accounting Principles for Business Enterprises," *Accounting Research Study No. 3,* American Institute of CPAs. 1962. In the Sprouse-Moonitz study, "assets represent expected future economic benefits, rights to which have been acquired by the enterprise as a result of some current or past transaction."

the lessee for his use during the term of the lease, the lessor is the legal owner. A still further example of a nonowned asset on the balance sheet is the rolling stock of a railroad, acquired under an equipment trust obligation.

In his *Economics of Accountancy* (1929), Canning discussed the nature of assets at some length before arriving at the following definition:

> . . . An asset is any future service in money or any future service convertible into money (except those services arising from contracts the two sides of which are proportionately unperformed) the beneficial interest in which is legally or equitably secured to some person or set of persons. Such a service is an asset only to that person or set of persons to whom it runs. (p. 22)

The "service receivable" in the present case of leases is the right to the use of the property. The lessor has performed his full obligation; the property has been made available. The lessor's only further duties are to receive and account for the periodic installments and to permit the lessee quiet enjoyment.

Canning's parenthetical expression, "except those services arising from contracts the two sides of which are proportionately unperformed," is applicable to a lessor's possible responsibility to furnish heat, elevator service, or other services. Here the service to be performed by the lessor is offset by rent to be paid by the lessee. Sprague, in 1909, recognized the fact that the equally unperformed services were not recorded when he made the following statement in his *Philosophy of Accounts*.

> . . . An individual receiving a salary for his skill . . . and expending it exactly as fast as it is received, needs no balance sheet. . . . If he does "get ahead" or "get behind" to a slight extent he will have assets and liabilities which will give rise to a balance sheet. . . . (p. 37 of the 1913 reprinting)

The concept proposed in this present monograph is thus merely an application of long-standing practice to an area which recently has grown in importance. The asset, right to use leased property, is truly an asset even though not owned. The lessee has a service receivable from the leased asset. To the extent the lessor has performed his full duties, the asset should be recognized. This is the common case in the net lease. To the extent the lessor still must perform certain services which have not been paid for, the asset should not be set up.

"Claims against" the business to which Moonitz refers in "The Basic Postulates of Accounting" are liabilities in the typical accounting lan-

guage. The definition of liability set out by Canning is comparable to his statement that an asset cannot exist if the right to receive services is exactly offset by an equal duty to render service. His definition of liability is as follows:

> . . . A liability is a service, valuable in money, which a proprietor is under an existing legal (or equitable) duty to render to a second person (or set of persons) and which is not unconditionally an agreed set-off to its full amount against specific services of equal or greater money value due from this second person to the proprietor. (p. 55)

A contract of employment at its inception (or on the morning after pay day) is the type to which Canning refers as one in which the liability is unconditionally an agreed set-off against the services—no work, no pay. The asset of "work to be received" is likewise an unconditional set-off and would not be shown. Since compensation is paid periodically instead of continuously, assets and liabilities arise in the form of prepaid or accrued wages. In the case of some leases, although the covenants are independent, certain aspects of the contract are somewhat comparable to an employment contract in that there appears to be a right of set-off of the unpaid money against unrendered services such as maintenance, taxes, heat and elevator service. In leases, however, there is an element of completed service by the lessor in that he has made the property available. The property-available element is the sole element of many leases. The liability under this property-available element of the lease is, in Canning's words, "a service . . . which a proprietor is under an existing legal obligation to pay" without any set-off against specific services due to the proprietor.

The appropriate valuation of a short-term liability is the amount to be paid. Long-term liabilities are, however, valued at their present (discounted) value or the equivalent. A liability under a bond issue, for example, cannot be valued at the sum of all of the amounts to be paid, including both principal and interest. Thus a certain $1,000,000, 5 per cent, thirty-year bond issue requires the issuer to make sixty semiannual payments of $25,000 each, plus a lump sum payment of $1 million at maturity, making a total of $2,500,000. Instead of showing the liability on the balance sheet at $2,500,000, it is shown at the present value of all future principal and interest payments. The interest (discount) factor is the one negotiated in the sale of the bonds. If the bonds are issued to yield 5 per cent, the proceeds received equal par. If, however, the interest factor negotiated had been 4.9 per cent, the bonds would have been sold for $1,015,600. A rate of 5.1 per cent would have brought $984,700. These amounts are, of course, the present value of the payments to be made when discounting is done at the rate specified. For convenience of recording when the proceeds are not equal to par, the liability is usually shown in two accounts—one for par and the other for the difference between par and cash proceeds. Periodic adjustments typically are made to bring the balance to par at maturity. If the periodic adjustment is made on the compound interest basis, the total liability will then be kept equal to the present value of future payments at the interest rate negotiated at the inception of the contract. The straight-line adjustment and accrual of interest coupons so widely used in practice are approximations of the results achieved by use of the more accurate compound interest methods.

In the preceding brief discussion of the nature of long-term debt, no recognition is given either to the penalty premium that may be payable to close out the loan prior to maturity, or to the possible smaller payment paid in bankruptcy to discharge the obligation. No recognition is given to the fact that the economic burden of meeting the obligation is altered by price-level change. The nonrecognition of these two factors coincides with the usual assumptions of going concern and measurement in terms of the dollar. The going concern concept assumes that the enterprise will continue at least for the foreseeable future; this assumption makes irrelevant the showing of assets at possible sale value and of liabilities at possible discharge amount, unless in fact the concern clearly is headed toward dissolution and liquidation. The same considerations about penalty for early payment, total payment in bankruptcy, and changing value of the dollar are equally appropriate in the case of a lease. Because amounts paid in case of financial trouble are likely to differ between a mortgage bond, a debenture, and a lease, the nature of the contract should be pointed out briefly, but certainly no evaluation of this liquidation amount is pertinent to the going concern.

Portion of Rentals to be Shown on Balance Sheet

One problem in disclosing lease rentals on the balance sheet is to decide what portion of the rentals should be so shown and what portion should not. The problem hinges upon a decision as to the property rights created in which the lessor has rendered his full service as distinct from those services which the lessor still must perform.

To the extent that property rights are conveyed, their cost should be recorded on the balance sheet under the theory just pointed out. There are, however, many gradations of property rights conferred. At one extreme, the rights conferred are readily identifiable and their cost easily established. At the other extreme, no rights (other than those between payment dates) are conferred. To illustrate, some types of leases are listed below and are arranged in the probable order of extent of property rights held by the lessee:

1. Full payment for a term of years made at inception of lease

2. Rentals large in early years, nominal in later years

3. Level rents during term; lessee has right to acquire title to property for a nominal amount at end of lease (These are the terms in many sale and leaseback contracts.)

4. Level rents during term; lessee has no right to renew or buy at end of term.

(In all four of the above types, the lessee is to pay taxes, insurance, and maintenance.)

⋮

n. Level rents for a long term of years, but lessor provides taxes, insurance, and maintenance.

⋮

n+k. Medium term lease; lessor provides taxes, insurance, maintenance, and operators.

⋮

z. Month-to-month lease, as of office space; lessor provides taxes, maintenace, heat, elevator, etc.

Many property rights – equal to the value of the total payment – are created in the first case. No property rights – other than those between due dates of the rent – are created in the zth case. In the fourth case there is little question that property rights are created at inception of the lease, but all have expired at the end of the term. In the first case there is no obligation to be shown among the liabilities. In the *z*th case there is no obligation to be shown; none exists except for the one between due dates of the rent. In the fourth case, as in the third case, obligation for the entire rental has been created. In the *n*th case the amount of obligation must be determined by reference to the amount which is not set off against services to be rendered.

The existence of property rights and obligations for those rights is a matter to be decided in the individual case. This decision is easy only near the extremes. Several criteria have been suggested, however, that may help in the determination. None is definitive in determining the unperformed vs. performed nature on part of the contract. Some may give conflicting answers in individual cases.

1. Does the lease use up part of the lessee's total pool of credit? If the lease in question has reduced the lessee's ability to borrow or to enter into further leasing, part of his total pool of credit has been used up. For example, assume that an existing bond contract requires certain ratios, such as times-charges-earned, to be maintained. If the lease in question reduces those ratios, it is likely to have used up part of the total pool of credit.

2. Who bears the incidents of ownership? If the lessee bears such incidents, he has obtained a property right and the obligation to pay for it. One of the rewards of ownership is to be able to keep use of the property for a set price even though the price of acquiring that property may be considerably higher. A risk might be that of financial loss should the property no longer serve its purpose.

3. Is the lessee's decision to lease based upon financial factors? To the extent the decision is based on financial factors as opposed to operating ones, the lessee has acquired a property right and the obligation to pay for it. A decision based on a financial factor would be one in which the decision was made to lease instead of to buy because the discounted cash outflow under leasing was lower than under buying. A decision to lease trucks under a contract allowing the number of trucks leased to vary from time to time and from location to location would be one based, at least in part, upon an operating factor.

4. Is the lessor's decision to lease to the specific lessee on the specific terms based primarily upon the general credit of the lessee or

primarily upon the value of the specific assets? If the lessor's decision is based primarily upon the general credit of the lessee, the lessor is assuming a position more like that of a creditor than like that of a landlord who contemplates only a nominal loss should the property have to be leased to another.

5. Is the lessor a major financial institution? Such institutions (and others in whole or in part) are in the business of investing money rather than owning and operating assets. Their use of the lease form instead of direct lending probably rests on legal considerations. In addition, this type of lessor is hardly likely to default (because of overextended use of credit, tax obligations, or other reasons) in his pledge to permit quiet enjoyment to the end of the lease term.

The Internal Revenue Service and the courts in tax cases have used criteria similar to at least some of these in determining whether a transaction was a lease or a conditional sales contract. The Service states in Rev. Rul. 55-540, 1955-2 CB 39, "... Whether an agreement, which in form is a lease, is in substance a conditional sales contract depends upon the intent of the parties...." The Ruling, after stating some specific circumstances in which there may be said to be an intent warranting treatment as a sale, says

> The fact that the agreement makes no provision for the transfer of title or specifically precludes the transfer of title does not, of itself, prevent the contract from being held to be a sale of an equitable interest in the property.

The concept of equitable interest has been the basis of other rulings (for example, Rev. Rul. 55-541, 1955-2 CB 19) and is close to the criterion suggested above of who bears the incidents of ownership.

Some contracts will be partly performed and partly unperformed. The lessor may have performed a substantial part of his service at the inception of the contract and still have some service to provide in later periods. Separation of the two elements of a lease contract is necessary if the property rights and the liability for them are to be set up without also setting up the amount for services yet to be received. This is a specific case of the general problem of allocating common or joint costs, a troublesome problem in many phases of accounting. As an example, office machines are sometimes leased on the basis that the machine becomes the property of the lessee at the end of the term, yet, during the term, the lessor must provide full maintenance. The problem of separating the performed from the unperformed portions of the contract is probably easier in this case than in others, because the office machine could have been purchased outright and a service contract could have been bought for a separate price. Also a rental contract without service, if available, could have been used.

Interest Rate and Compounding Period

Another problem connected with balance-sheet presentation of leases is the selection of the interest rate and compounding period to use in determining present value. The interest rate to be used in discounting the future rentals is that used in setting the rentals. This rate will be apparent in many of the cases in which balance-sheet disclosure of property rights and the related obligation is in order. For example, when the property is acquired by the lessor for the particular lessee and when either the lease runs for the entire useful life or lessee has the option to buy the property for $1 at the end of the lease, the interest rate should be available readily. It may have been the specific point of negotiation or, at least, may be computed from knowledge of the cost of the asset and the rental schedule. In case of a sale and leaseback, all of these factors will be available readily. In other cases where the interest factor in the transaction itself is not available, an appropriate factor may be selected, within a small margin of error from (a) the prime rate adjusted for the company's creditworthiness, (b) the rate the company is paying for loans recently negotiated, plus ½ to 1 percentage point because of the lease, or (c) the price on the bond market of similar credit (again raised a point or less because the instrument is a lease rather than conventional debt).

To use an interest rate different from that used in setting the rentals is to place a value other than cost upon the assets and hence to misstate the liability. For example, assume that property costing $1 million could be leased for twenty years (with title to the lessee at that time) for an annual rental of $83,679 payable at the end of each year. The interest rate involved in these figures is 5½ per cent. However, if the annual rentals of $83,679 are discounted at 6 per cent, the present value of the payments is $959,795. This illustration not only shows that any difference in the interest rate used creates a different present value, but it also shows that differences in present value caused by use of a slightly inaccurate interest rate are not material. The following table illustrates the effect of larger errors in interest rate for several periods of time.

Present value of rentals at various interest rates

	Rental	*4%*	*5%*	*5½%*	*6%*	*7%*
5 years	$234,176	$1,042,512	$1,013,861	$1,000,000	$986,436	$960,170
20 years	83,679	1,137,229	1,042,829	1,000,000	959,795	886,469
50 years	59,061	1,268,769	1,078,221	1,000,000	930,918	815,092

The compounding period probably should equal the time between dates the rentals are due. Even if in a given case a different period is called for from a theoretical standpoint, use of a compounding period equal to the rent payment period is recommended for practical purposes. Discussion of the theory is omitted because the arithmetic becomes elaborate when compounding periods do not equal payment periods, but the difference in present values is hardly material, as indicated in the two representative illustrations below:

Present value of rentals at various compounding periods

Rental				
Amount	*Period*	*Monthly Compounding*	*Annual Compounding*	*Difference*
$120,000	annually—20 yrs.	$1,480,465	$1,495,465	$14,624
10,000	monthly—20 yrs.	1,515,253	1,529,434	14,181

(Assumes payments at end of period, and an annual rate of 5 per cent.)

Transition Period

A third problem of disclosing leases on the balance sheet is the transition from one method to the other. Several proposals for a transition period have been advanced and are discussed later, but let us assume that the decision is made to disclose on the balance sheet a lease formerly disclosed only by notes. One method of handling the transition would be to compute the present value of the remaining rentals, at the interest rate pertinent at the inception of the lease, and to include this amount among the assets and liabilities just as a new lease on this date would be handled. Amortization (as discussed under the next paragraph heading) would be based upon this value, determined on the transition date.

An alternative method would be to determine the present value of rentals at the date of the execution of the lease. This amount would be set up as the initial value of the asset and of the liability. Each would be amortized according to the considerations set forth under the next paragraph heading. If amortization of the asset and liability is at unequal rates, an adjustment of prior year earnings would be necessary. The method of handling the adjustment, whether it be through retained earnings or through income (perhaps as a special item), would be decided on the same basis as used on other adjustments of prior year earnings. Unless there is a change in management intent, however, as in the Allied Paper case cited in Appendix C, it does not seem proper to make an adjustment of prior year earnings. Such adjustments could be avoided, even with the use of this retroactive method, by the assumption of appropriate depreciation schedules, as will be discussed presently.

Amortization of Property Rights and Lease Liability

The asset of lease rights should be amortized for the same reasons that apply to any other item of property, plant, and equipment with limited life. If the assets become the property of the lessee at termination, the useful life of the leased assets may be longer than the life of the lease. If all rights at the end of the lease revert to the lessor, useful life to the lessee is the life of the lease, and "salvage" value is zero. If there are renewal options, the useful life and value at end of the term of a lease are less clear. The problem, however, appears no greater than that of predicting useful life and salvage value of any other item of property, plant, and equipment.

Two different points of view as to life of leases with renewal options are apparent in the footnotes in recent corporate annual reports. The first point of view is evident in the type of disclosure used by most companies. It indicates, for example, that the leases run for twenty-five years with two options to renew for ten years each at nominal rentals. The second point of view is apparent in the pattern illustrated by Sears Roebuck (see Appendix C), which states that the leases run for forty-five years with option to terminate or to pay reduced rentals at the end of twenty-five and thirty-five years. In the first case the company presumably would amortize over a life of twenty-five years to a salvage value; in the second it would amortize over forty-five years and have no salvage.

Amortization schedules for rights to leased assets would be chosen in the same manner as are the depreciation schedules for other items of property, plant, and equipment. Straight-line, the more rapid schedules, and those based on activity are examples of methods which would have the same propriety if the assets are leased as they do when the assets are owned outright. Some people have presumed that the unamortized cost of the asset should be kept at the level of the discounted rentals year by year. The operating history of the asset, however, and the rate of reduction of the liability are independent facts. They may proceed at the same rate, of course, but not necessarily and probably not usually. To achieve year-by-year equality of the net asset and the liability would involve the use of a depreciation method in which the annual charge increases year by year. The practice of crediting depreciation to a separate account rather than the cost-of-asset account probably also should be followed in the amortization of rights to leased assets.

If the lease payment schedule is level, the liability for rentals due under the lease will be extinguished slowly at first and more rapidly later, because each lease payment will be considered first as payment of interest on the unpaid balance and second as extinguishment of the liability. The schedule is exactly like the typical home mortgage repayment schedule so common today.

Income Statement When Leases Disclosed on Balance Sheet

When leased assets are carried on the balance sheet at the present value of the obligations, there will be a periodic charge to income both for the interest element of each rental payment and for the periodic amortization of the asset value. The sum of the periodic charges (though not the timing) must be the same as the sum of the rentals paid. The interest element of each payment will be recorded as expense when paid. The liability element of the rents equals the amount set up as the asset. Over the whole life of the asset, its whole initial value must be amortized.

If a residual value is to be recognized, as might be the case, for example, if the lessee has the option to purchase the leased property at the end of the lease for $1, this value will be recognized by amortizing less than the full amount of the property rights originally set up. When, as is typically the case today, balance-sheet treatment is not given to lease liabilities, this residual value should be recognized by periodic credits to income. Although theoretically proper, such recognition is given seldom, if at all. Two probable reasons are the conjectural value of the residual and the general prohibition against writing up assets. However, if consistent treatment under the two methods of accounting is given to the residual values which may exist at the termination of a lease, the total charges to income are the same over the life of the lease.

Lease rentals, when charged to expense as the amounts are paid, are distributed to cost of sales and to selling or other expense. Balance-sheet treatment of lease rentals will provide two figures for the income statement: amortization and interest. The amortization figure should be divided among cost of sales and selling or other expense according to the usual considerations. The interest figure should be handled in the same way as other interest. Since, under this procedure, total manufacturing overhead will not include the interest element now concealed in the total rental charges, the total overhead will be lower. If, under the existing cost accounting system, total manufacturing overhead is charged to product, and if any product remains unsold at the end of the year, then inventory values and net profit will be affected by the method of handling leases. Over the life of the leased asset the total charges to income would be the same, except for the relatively insignificant effect on inventory in the final year. During the life of the lease, there would be apt to be small year-to-year differences.

Although total charges for amortization plus interest over the life of the lease will equal total rental payments as explained above, there may well be a significant difference in any given year between (a) the rentals paid and (b) the sum of interest plus amortization to be charged to income. If amortization is computed each year at such an amount as will keep the asset value equal to the present value of the future rents, the amortization plus the interest will equal the total rental payment in that year. Amortization computed by such a method would increase each year. This might be termed "decelerated depreciation" and would hardly be consistent with depreciation on other assets which today typically is straight-line or accelerated. If, then, the asset of lease services is also amortized on a straight-line or accelerated basis, net profit in the early years of a lease would be less (and greater in the later years) than the net profit reported when current rentals are charged to expense as paid. Furthermore, if the tax returns are filed on a "rental paid" basis while the books reflect the asset and its amortization, the problem of tax deferral arises.

Sale and Leaseback

The term "sale and leaseback," as generally used, describes a transaction in which all of the following conditions are present:

The property is sold at a price equal to or less than current market value.

The property is leased back for a term approximating its remaining useful life, for rentals sufficient to repay the buyer for the cash he has disbursed plus a reasonable return on his investment, and the lessee is to pay all maintenance, insurance, and taxes, just as he did when an owner.

Two additional terms are sometimes present:

The lessee may have the right to buy the property back during the lease term at a set scale of prices designed to repay the lessor his unrecovered cost, plus a premium.

The lessee may have rights, limited or unlimited, at the termination of the lease.

The sale and leaseback transaction seems to be but a single economic transaction. The level of rents and the sale price are not independently determined. Economic gain or loss (apart from income tax considerations) cannot arise from such a transaction merely because the money received is different from the undepreciated cost of the property transferred to secure payment. Such a transaction may, however, reveal a hitherto unrecognized gain or loss.

Since the sale and leaseback seems to be but a single economic transaction and since its major (or sole) purpose is to raise money with certain property given as security, the transaction should be recorded as a single, financing transaction. The debit would be to cash and the credit to an appropriately designated liability. The property accounts would remain on the books to be depreciated in the usual manner. Periodic rental payments would be charged in part against income (the interest element of the payment) and the remainder against the liability. The question of how to handle a gain or loss on the sale and leaseback would not arise, because no property has been removed from the balance sheet in exchange for cash. Appropriate recognition should be given to the changed legal status of the property in subsequent balance sheets. Appropriate recognition should also be given to the consequences of any gain or loss that may have been reported for tax purposes.

The single-transaction method of recording a sale and leaseback is directly in harmony with the concept of showing the present value of lease rentals as a liability and a related property right. In the previous discussion it was stated that this present value was the cost of the property right acquired. In the case of the sale and leaseback, the basic rights to the property had been acquired in a preceding transaction. The cost, as determined in the preceding transaction, is the one at which property rights in a sale and leaseback are carried under the single-transaction method. The original amount paid for the property is the proper carrying value under the generally accepted "cost" principle of accounting even though "market" may be different. If, however, the economic value of the property is substantially below undepreciated cost, the objective recognition given to that fact in the sale and leaseback may well serve to precipitate recognition of that fact by a write-down which would have been appropriate in the absence of a sale and leaseback transaction.

Economic and Legal Consequences of Disclosing Leases on Balance Sheet

The most important economic consequence of disclosing future lease rentals on the balance sheet is that the balance sheet will represent a more complete accounting of financial position. "Financial position" as shown by the balance sheet and the various ratios typically computed from it will be a function of the economic position of the business and not of the legal forms used to acquire the use of property.

Decisions on financial position will not have to rely upon the validity of adjustments made by the user of the balance sheet to overcome an accounting deficiency. Consider, for example, the statements of the Great Atlantic & Pacific Tea Company for the year ended February 27, 1960, reproduced in Appendix C. The company has no long-term liabilities on its balance sheet, but, if the present value of future lease rentals is placed on the balance sheet, a different picture emerges. In his *Fortune* article titled "The Auditors Have Arrived (Part II)" (December 1960, p. 144), T. A. Wise suggests that the amount might be about $560 million "arbitrarily capitalized at ten times current lease payments." If this figure were included in the balance sheet, long-term liabilities would then equal 55 per cent of total long-term liabilities and capital stock and surplus. Although the "ten times" figure which Mr. Wise "arbitrarily" has used is often suggested as a lease-capitalization figure, I would suggest that the proper figure in this case would probably be considerably smaller because of two factors; first, the note to the A&P financial statements says that most leases cover three to ten years, and second, the present value of the leases, even if all were ten years, would be less than ten times the current rental. Balance-sheet presentation by the company of the lease liabilities would do much to prevent misconceptions about the financial position—both (a) on the part of the unsophisticated users of the statements whose misconceptions stem from the generally accepted accounting practice followed by A&P of showing nothing on the face of the balance sheet and (b) on the part of the more sophisticated users who must make the "rough and ready" adjustment necessitated under today's typical practice, which does not even provide the needed data by note to the statements.

A large number of other economic and legal consequences have been cited as reasons why the present value of leases should not be shown on the balance sheet. None of them bear on the subject of disclosure and accounting design. Instead, they seem to bear upon perpetuation of a vested interest, upon adjustments of standards during a transition period, or upon the extension of the lease-disclosure technique to other items. Those persons opposing balance-sheet treatment of leases for the reasons above point out that all lease facts relevant to a financial appraisal can be given in notes and that analysts place less importance on balance-sheet analysis than on cash flow analysis, as discussed on page 16.

Perhaps the consequence most worrisome to lessees is an expected adverse effect upon their credit standing. The lessees believe, and with considerable reason, both that the financial community does not like to see "too much" debt on a balance sheet and that the financial community overlooks the obligations created in leasing. This, then, is an argument to continue inadequate disclosure because it gives an advantage. The magnitude of the supposed advantage is diminishing as is evidenced both by the restrictive clauses in bond indentures requiring recognition of lease obligations and by such discussions in nontechnical publications as the *Fortune* article just cited.

A number of other "disadvantages" of balance-sheet disclosure were cited by Alvin Zises in his *Journal of Accountancy* article (Feb. 1961). His major points can be paraphrased as follows:

1. The Department of Defense specifically refuses to recognize the cost of debt (or equity) as a component of expense. On the other hand, rental costs are allowable if reasonable. Discounting rent invites the Defense Department to disallow such factor.

2. Where a local governmental entity levies taxes on total capital rather than on capital stock or net income, the lessee may be taxed on the leased assets.

3. All term debt indentures have restrictions on incurring of additional debt. Many have a flat restriction on the borrower, preventing the incurrence of any additional term debt. Counsel has informed me [Zises] that such accounting treatment would precipitate default under such indentures. Where a borrower has issued long-term debt at rates substantially lower than the present going rates, there is likelihood in many cases that some institutional investors will use the default under the indenture to effect refunding of the outstanding indebtedness at higher prevailing rates. Also there is a problem with the current ratio when the current portion of capitalized lease rentals are included in the current liabilities.

4. Practically all states have statutes regulating the issuance by public utilities of stocks, bonds, notes, or other evidences of indebtedness. In some states the statutes provide that an unauthorized issue is void. Leases might be considered such an unauthorized issue.

5. The supposed advantages under income taxation (as discussed earlier in this study and in Appendix B) will be lost.

There is no question that, if the consequences which the author points out are true, they would be disadvantageous to the lessee. However, what is a disadvantage to one person is likely to be an advantage to another. For example, perhaps the Department of Defense has been allowing too large an expense deduction, and local governments have been assessing taxes too lightly against lessees. If this has been the case, other taxpayers have been carrying a disproportionate burden.

Perhaps, to assume an extreme case, the bond issues under point 3 would be declared in default on the basis that, through erroneous reporting, the term-debt holders have been deprived of their rights. On the other hand, and more likely, default was not contemplated in the contract if leasing subsequently were used. In *Home Building and Loan Association* vs. *Blaisdell,* 290 U. S. 398 (1934), the United States Supreme Court said:

> The obligation of a contract is the law which binds the parties to perform their agreement. . . . This court has said that "The laws which subsist at the time and place of the making of a contract, and where it is to be performed, enter into and form a part of it, as if they were expressly referred to or incorporated in its terms. This principle embraces alike those which affect its validity, construction, discharge, and enforcement. . . ." *Von Hoffman* v. *City of Quincy,* 4 Wall. 535. . . .

If the principles of the Court stated regarding "the laws that subsist at the time" are equally applicable to the accounting principles that subsist at the time, then default would not occur. And if this or a comparable rule of law were not to hold, a "decent" creditor, quoting an officer of a large life insurance company, would not call a loan on such a technicality in order to force the borrower to negotiate a new loan at a higher rate of interest. The problem of potential default, however, is essentially a legal matter and cannot be resolved in this study.

To mitigate the burden of these alleged disadvantages, which Mr. Zises lists, there have been several suggestions for a transition period in which there could be adjustment of the standards whether they be legal, contractual, or less formal. An extreme suggestion is that each company begin disclosing leases on the balance sheet when it is ready to do so. A second suggestion is that each new lease be placed on the balance sheet when it becomes effective, but that existing leases be handled as they have been. A third suggestion is that after a specific date the remaining payments on all leases be handled in the new way without recasting figures for prior years or making adjustments to retained earnings for differences arising from the pattern followed in the past. The first two suggestions do not seem appropriate; during the long-lasting transition period as the older leases were expiring, users would find the basis of financial statements noncomparable as between companies, between years, and even within a company in any one year. The third suggestion contains the problem of the timing of the specific date. Suggestions have been made that the date should be "at once," and other suggestions have been made that the date be set at some date in the near future after an educational period. The widespread interest and discussion of the leasing topic indicate that the educational period is moving along rapidly and the "at once" and "after an educational period" are rapidly becoming equals. Some evidences of the progress of the transitional-educational period are:

1. Bond indenture covenants now taking cognizance of leasing

2. Securities and Exchange Commission rulings requiring that a portion of lease rentals be included in "fixed charges" for certain calculations

3. New York insurance law requiring treatment similar to that of the Securities and Exchange Commission for certain ratios

4. Various states' requirements that leased assets be included in factors for allocating income for the purpose of state taxation.

If future rentals under leases are to be shown on the balance sheet, at present value, it may be that other commitments should be handled in a similar fashion. Some critics suggest that balance-sheet treatment of lease commitments also implies, to be consistent, similar treatment of other commitments such as purchase and labor. Although detailed consideration of these commitments is beyond the scope of this paper, it does not seem that purchase and labor commitments meet the criteria set forth for determining that a lease commitment should be shown on the balance sheet. Nevertheless, some people feel that a decision on leasing should be postponed until these other matters can be considered too. Recognition at the present time of property rights and liabilities under leases can be a step forward and might well serve as a precedent for similar treatment of other commitments, if they meet the same criteria as those suggested for leases.

A further "consequence" of showing lease rights and obligations on the balance sheet is not directly economic or legal in the sense the words have been used so far. However, the consequence may be both economic and legal to accountants if one critic is right when he states

> I do not agree that it is possible to "capitalize" rights and duties under a lease and include such amounts as balance-sheet items without making so many subjective assumptions and forecasts that the result is either meaningless or misleading.

His "subjective judgments" seem to fall into two categories. First is the interest rate. This is discussed on pages 46 and following. Second is the division of lease rentals among those which should be shown on the balance sheet and those which should not. This topic was discussed at length in the early part of this chapter. To be sure, both of these items do require the use of estimates, but that is not unique in accounting. For example, depreciation calculations require estimates as to useful life and salvage value. Estimates and judgment are required in the allocation of joint costs whether it be the traditional example of the meat and the hide, the common one of burden application, or the division of a lease rental between its two components. Accountants do make judgments; they try to do so on a reasonable basis.

Form of Balance Sheet With Lease Items

In cases where the present value of lease obligations is set out among the liabilities and the corresponding property rights are recognized, there is a problem as to the proper designation of these items on the balance sheet.

The assets leased are usually ones which would be recorded among the property, plant, and equipment. The items typically included under this heading include a mixture of those owned "free and clear," those mortgaged, those acquired on a conditional sales contract, and those installed on leased premises. There is no question but that rights under a lease are different from these others, but the difference is little if any greater than the difference already existing among the items now carried as property, plant, and equipment. That leased assets probably would not be available in case of bankruptcy to satisfy general creditors is no reason to state the leased assets separately from mortgaged assets which likewise are not available in bankruptcy.

However, leased assets probably should be separated from owned assets at least during a transition period when users are becoming accustomed to their inclusion on the balance sheet. Such a separation would enable the reader to see the financial position on the basis to which he is accustomed, as well as on the revised basis. The separation of the rights to leased assets can be set out within the fixed asset section of the balance sheet somewhat as follows:

Property, plant and equipment:		
Land	x	
Buildings	x	
Equipment	x	
Leasehold interest in:		
Buildings	x	
Equipment	x	xx

The Allowance for Depreciation should include an allowance for amortization of lease rights and may be handled in the balance sheet as is currently done.

An important difference between owned and leased assets is the right to whatever value the property may have at the end of its useful life. Salvage value of owned assets may turn out to be far higher than the nominal amount anticipated. The same may be true of the value of leased assets at the termination of a lease. If these values can be purchased by the lessee for the payment of the amounts specified in the lease options, the lessee reaps any rewards of the changed economic environment just as would an owner. On the other hand, if the lessce has no contractual claim to these rights, the rights belong to the lessor for whatever speculative value they may have. Separation of the assets as suggested in the previous paragraph is not sufficient to distinguish ownership of the speculative rights if, indeed, they should be distinguished. If the rights belong to the lessee, the leased assets may be merged with those in which the lessee has "ownership rights" in the usual sense of the term. If the lessor retains the termination rights, the separation suggested above with a brief explanatory note will disclose the facts fully.

The obligation for lease rentals due will be shown on the liability side of the balance sheet. As is the case with a bond issue, the current portion should be among the current liabilities. The long-term portion probably would be shown in the same section as bonds. The lease obligation, however, should be distinguished from the bond obligation because of the different status in case of financial difficulty. In the case of a bond issue, interest rate, maturity date, type and priority of lien, callability, and serial maturity are given in a few words. Similar data could be given on leases as in the following example for a 1960 statement (in which the bond descriptions are copied from two actual cases):

Long Term Obligations

3½% subordinated notes payable to banks—payable \$750,000 in each of the years 1962 to 1966 inclusive, and \$2,250,000 in 1967. Not subject to prior repayment.	\$ 6,000,000
Promissory notes, 3¾% due semiannually 1981 to 1990.	\$50,000,000
Lease rentals for property rights acquired discounted at 5%, payable in equal annual installments of \$481,456 for principal and interest to 1980. Subject to prepayment without penalty.	\$ 6,000,000

This example of lease disclosure does not meet all of the investor's requests, but probably his major ones have been satisfied. The \$481,456 need not have been given; the determination of the equal annual payment could be computed with the aid of compound interest tables. A possible complication of showing the \$481,456 is that "equal annual payments" to a bond investor is likely to mean equal annual payments of principal. For a \$6,000,000, 5 per cent, twenty-year debt, "equal annual payments" probably would imply a \$300,000 payment on principal each year plus a gradually diminishing interest payment starting at \$300,000 in the first year. Although sufficient data are stated, the investor may need help in using compound interest tables to determine that $6 million is the present value of a series of twenty annual payments of $481,456 discounted at 5 per cent. Even the trained mathematician would be frustrated if neither the interest rate nor the rental schedule were given.

Notes to Statements With Leased Items on the Balance Sheet

If the present value of the obligations under a number of leases is to be shown on the balance sheet, it will not be feasible to list the suggested details on the face of the statement. A supporting schedule comparable to that often used for bond issues may be used to support a single figure on the balance sheet. However, when thousands of leases are involved, as in the case of a chain grocer, further condensation will be necessary. The following schedule for a hypothetical chain grocer is suggested:

Green Grocers, Incorporated
Summary of Leases
December 31, 1961

	Store Properties	*Warehousing*	*Vehicles*
Rentals paid in 1961			
Minimum annual rentals due:			
1962			
1963			
1964			
1965-9 average			
1970-4 "			
1975-9 "			
1980-2000 average			
2000-2028 "			
Present value of rentals at rates in effect when leases negotiated			
Number of properties			

If portions of some leases are not to be shown on the balance sheet, data on them will have to be shown in separate columns.

In Chapter 2 it was pointed out that professional analysts have a considerable list of items they want to know. The following schedule lists those items and indicates which "wants" are fulfilled by the suggested treatment on the liability side of the balance sheet:

	Disclosed by suggested	
Factors analysts want to know	*Direct balance-sheet listing*	*Schedule of numerous leases*
Cash outlay, amount and time	yes	yes
Current annual rental		yes
Type of property leased		yes
Cost of property leased		
Options at maturity		
Options for early termination		
Lessee's responsibility for insurance, taxes, and maintenance		
Default provisions		
Restrictions on dividends, further debt or leasing		
Interest rate implicit in rentals	yes	

Certain facts about the assets are shown in the property section of the balance sheet as discussed earlier. Perhaps all the items the analyst wants to know are pertinent to financial position and operating results in any given situation. When they are pertinent, these "open" items in the list will have to be disclosed by notes comparable to at least the best disclosure today. If the notes are not given, the reader must presume. Presumptions would probably be as follows:

Item	*Presumed to be*
Type and cost of property	As implied by the usual balance-sheet descriptions.
Options at maturity	Valued among assets. The amortization schedule should be set to take account of options at maturity just as depreciation schedules are set to take account of salvage at the end of useful life. A note would be necessary to disclose whether or not lessee had rights to the speculative value of those future property rights.
Options for early termination	No presumption possible.
Lessee's obligations as to taxes, insurance, and maintenance	Like an owner's.
Default provisions	Not material in a going-concern statement.

Item	*Presumed to be*
Restrictions on dividends, further debt, or leasing	No presumption possible. The data if significant to financial position would have to be given by note as in the case for bonds.

However, management should not expect readers to presume answers; management should disclose. When a regular pattern of reporting develops, listing of the details by note might not be necessary. Until that time, however, disclosure within the balance sheet probably will have to be supplemented with notes which may be only slightly less extensive than those suggested in the next section for use in cases where lease rights and obligations are not shown on the balance sheet.

Notes Recommended Until Balance-Sheet Treatment Adopted

Until the adoption of the balance-sheet presentation of lease rights and liabilities, lessee companies can and should give substantially more disclosure than is common today. All of the items for which analysts profess a need can be given in the notes.

The method of disclosure of the data is dependent, in part, upon the number of leases involved. If the lessee has only one or a few leases, a note comparable to that of Tishman Realty and Construction Co., reproduced in Appendix C, might well be appropriate. For each lease this note gives annual rental and expiration date. Notes to the list tell of rent changes in the future and of renewal clauses. The basic table in this example could have been extended by the use of additional columns to give the following information for each lease:

Type of property leased
Renewal time and rental
Cost of property
Interest rate
Lessee's obligations
Unqualified obligation-to-pay clauses

In fact, any of the items on the investor's list of wants could be included. Certain explanations applicable to all leases (for example, that the lessee is obligated for taxes, insurance, and maintenance) might be given in text. As is done in the case of notes about bond issues, only the most restrictive of the prohibitions against dividends, further debt, and further leasing need be given.

If the lessee has a large number of leases on different types of property, the leases probably will be grouped. Since the rents called for by the various leases are hardly likely to be level and to expire at the same time, a schedule probably will have to be used. The one suggested on page 59 for Green Grocers, Incorporated is pertinent whether or not the present value of rentals is placed on the balance sheet. The line for "present value of rentals," however, might not be pertinent. Additional explanatory notes will be necessary, as in the case where lease items are included on the balance sheet, to disclose such other items as type and cost of property, options, obligations with respect to taxes, insurance, and maintenance, default provisions, and restrictions.

5

Proposed Lease Presentation—Lessors

Two Basic Accounting Methods

As is the case with accounting for lessees, the lessor seems to have but two basic methods of accounting for leased assets. The "rental" method records each receipt as rent on the use of an item carried as a fixed asset. The fixed asset is depreciated in the normal manner. Depreciation as a cost is matched against the rental revenue.

The second method is the "finance" method. On the date the lease becomes effective a receivable is set up, and the fixed asset account is reduced. The difference is revenue. Problems in the "finance" method arise as to the size of the receivable to set up, the amount of reduction in the fixed asset account, and the timing of the recognition of revenue. Two problems which arise with the "rental" method are (a) the separate classification of assets out on lease or available for lease and other assets and (b) separation of rental revenue, and accompanying expenses, from sales revenue and the cost of goods sold.

Comment and criticism of financial statements of lessors has been meager, especially when compared to the discussion of the statements of lessees. Without widespread public interest, the needs of investors and the fundamental issues have not been crystallized to the extent that they have been in the case of lessees. Nevertheless, the same basic issue is present. Is the transaction a transfer of property rights in return for a promise to pay?

Finance Method

The question of transfer of property rights is the same one that is critical in deciding whether or not a lessee should capitalize his future lease payments. In the case of the lessee, it appears appropriate to determine the present value of the future lease payments and to recognize the asset and liability in cases where there has been a transfer of property rights, as distinct from a contract for future services to be rendered. The same criterion, when applied to the lessor, indicates when he should transfer an asset out of the "fixed asset" section to the "receivable" area of the balance sheet. If the lessee recognizes that he has a fixed asset and an obligation to pay for it, the lessor, then, by the same reasoning the lessee used, does not have that same fixed asset but instead has a receivable which is the counterpart of the lessee's payable. The lessor is in the position of a creditor, and the "finance" method is appropriate.

In the use of the "finance company method" perhaps the easiest problem is determining the credit to the property account. When the lessor's value is nil at the termination of the lease, the entire cost should be removed from the property account at the time the lease receivable is set up. This absence of value of the property account would arise in a case when the lessee has the right to buy or renew at a nominal amount. In cases where the lessee has the right to buy or renew at a larger but specified amount, the lessor's value at termination hardly can be greater than that amount, because, if the property were worth more, the lessee would exercise his option. Therefore, the expected residual value of the leased property would have to be estimated in the range between the lessee's option price and zero. When the lessee has no options, the lessor will have to estimate the residual value at the end of the lease as he would estimate the residual value for depreciation purposes. In the present case he has sold all rights to the property for the first years. All of the depreciation he normally would record during those first years is an expense of the sale to be matched against the sale price. Whether the difference between the expense and the sale price is recognized now or deferred will be discussed after discussion of the valuation of the receivables.

The valuation to put upon the receivable theoretically should be the same as that which the lessee puts upon his payable. In many cases the amounts will be apparent such as in the case where the lessee has the alternative of a cash price. However, in many cases communication about an internal accounting matter would not be a fit subject after the intense, arm's-length bargaining preceding the signing of the contract. The valuation should be the present value of the rental payments, excluding any rentals to be paid for service to be rendered by the lessor. It seems to make little difference whether the present value is shown on the statements as a single figure or is shown as the difference between the total rents to be received and an unearned finance charge.

In many cases the debit to the receivable and the credit to property are likely to be equal. Such cases will arise when the lessor's sole function has been that of purchaser-lessor. The leasing company, the pension trust, and the life insurance company are probably in such a position, even though the life insurance company may be precluded by regulatory authority from this type of accounting. However, a manufacturer of products for sale would hope to have a profit from manufacturing and selling as well as revenue from financing the asset. When such a profit is earned, the cost of the asset will be less than the present value of the rental payments. Whether this profit should be recognized at the time of sale or over the lease period depends upon whether the manufacturer uses the sale basis or the installment basis of recognizing revenue. Consideration of the relative merits of the two bases is beyond the scope of this study.

Recognition of the income from financing should be spread over the life of the lease. Use of the compound interest methods set forth in Chapter 4 (discussing the expense to the lessee) is equally appropriate here in discussing the income of the lessor. This method gives a level rate of return upon the declining receivable balance, and is, at present, in use by at least one large life insurance company. The sum-of-digits method used by many finance companies and by Boothe Leasing, as revealed in its note reproduced in Appendix C, is an approximation of the compound interest method.

Income for tax purposes is likely to be recognized at different times from those suggested in the preceding two paragraphs. Appropriate allocation should therefore be made of the related income taxes.

Rental Method

The "rental" method is appropriate in cases where the receipts from the lessee are for something other than property rights. As with the case of lessees, there undoubtedly are cases where part of a transaction should be handled on the "finance" basis and part on the "rental" basis. The "rental" basis is certainly appropriate in the case of short-term full-service leases, such as the rental of autos on a daily basis, with all expenses borne by the lessor. Any property rights acquired by the lessee are negligible, or, if not, have certainly expired by the end of the day.

If the sole business of a company is leasing assets, there is no problem in classifying leased assets on the balance sheet. If, on the other hand, a manufacturer produces assets for sale or for lease, he will have to separate those in inventory held for sale from those out on lease. The problem becomes acute when the assets are not considered in two separate pools, but any asset on hand may be sold or leased depending on the desire of the customer. Division of the assets into inventory and operating assets to conform to "generally accepted accounting principles" will have to be made in the individual case based on the facts.

When a company manufactures goods for sale as well as for lease, there is a question if the two businesses – manufacturing and selling on the one hand, and leasing on the other – should be separated in the income account. In cases where the "finance" method is appropriate and is used, no problem arises. However, when the "rental" method is used, the separation may be highly important. Let us assume, as an example, that a company has been making its product available only on a lease basis and that it now offers the option to buy or to lease. If it uses the "rental" method, the shift of some of the current year's production from leasing to sales will increase the revenue of an otherwise stable company. Expenses for the year would be correspondingly increased, because the amount charged off would be the entire cost of the assets sold instead of merely the depreciation on those assets. No problem would arise if the proportion of sales and lease revenues were to remain stable over the years, but proportions do in fact shift. Unless the analyst knows of shifting between leases and sales, he will find it difficult to make an intelligent analysis of the company's operation. A number of companies now give the division of revenues between sales and lease, but it is not customary to divide the expenses. Perhaps to do so would reveal profit margins by line of activity, a secret apparently jealously guarded today by most companies and eagerly wanted by the analyst.

When the "rental" method is used, the problem of fairly matching revenues and costs arises. In Chapter 2, page 14, illustrative figures showed that a compound-interest method of depreciation is necessary if a level rate of return on the investment (net, after depreciation, but before taxes) were to be recorded.

If the lessor borrows all of the money to buy the assets to be leased, the lessor's objective may not be return on investment in assets bought with borrowed money; instead the objective may be earnings from his position as middleman. A proper matching of cost and revenue might well be one which would provide the lessor a level amount of return; there is no *rate* of return for he has none of his own money invested in the assets. If the lessor-middleman makes level payments to cover principal plus interest on the money borrowed to buy the assets to lease, his interest cost will decline year by year. In order to achieve a level total cost to match with level rent revenue, it is necessary to have a rising annual amount of depreciation computed by the compound-interest method demonstrated previously. Since depreciation for tax purposes is not likely to be computed by the same method, allocation of taxes probably will be necessary.

Comments of Ira A. Schur

Although I do not object to publication of the study for the purposes, indicated in the "Statement of Policy," of promoting discussion and exchange of views in accounting and business circles, at this stage of the evolution of accounting theory I do not subscribe to the major conclusion of the study that leases generally should be accounted for by capitalization and inclusion in the balance sheets of lessees.

My reservations are based in part on theoretical and in part on practical considerations. As a matter of theory, I question whether any such departure from established principles of balance-sheet preparation should be advocated without thoroughly considering (a) the theory of commitments in general, and (b) the basic functions of the balance sheet. These two problems are closely related to each other and are fundamental to the question of accounting for leases.

From a practical standpoint, I do not believe that the study has shown that footnote disclosure cannot adequately deal with the facts and effects of leasing. In addition, I believe that the many practical difficulties of implementing a principle of capitalization may have been passed over too lightly in the study.

Comments of Walter R. Staub

The extensive research and comprehensive consideration given by Dr. Myers to the problem of accounting for leases has resulted in a very worthwhile addition to accounting literature. However, I have considerable reservation as to the desirability of adopting, as required accounting, his conclusion that leaseholds should be capitalized.

A lessee's leasehold interest may in fact represent an economic resource, but I do not believe it necessarily follows that it must therefore be accounted for as an asset in a balance sheet, or that a related unmatured obligation need be there reflected. A balance sheet is essentially a technical accounting concept resulting from the application, to financial transactions, of accounting conventions deemed to be useful, and does not pretend to reflect all of the economic resources attaching to a business entity and, admittedly, does not include all of its obligations or commitments.

The final criterion which should decide inclusion or exclusion of an item in a balance sheet rests on a judgment as to whether or not, on balance, more meaningful financial statements result; the nature of a leasehold interest as an asset and of the related obligation as a liability is, of course, an important consideration in arriving at this decision, but is not determinative. Judgmental considerations leading to a decision as to the desirability of adoption of an accounting convention nearly always involve weighing offsetting advantages and disadvantages.

The principal advantage cited in favor of inclusion of the capitalized value of leasehold interests in balance sheets is that this will result in reflection of the lessee's obligation to pay future rents over the term of the lease. This information appears to possess significance for purpose of determining capitalization ratios of companies using leased property that will be comparable with those of companies owning property that is financed by debt. For many purposes of financial statement evaluation, however, disclosure of aggregate annual rental requirements for a period of years (say five) following the balance-sheet date may well be more significant, since it lends itself to evaluation in terms of the relationship of anticipated cash flow from operations to expected cash requirements.

A principal disadvantage that appears likely to result from extensive application of the principle of capitalization of *all* leases — to the extent that they are grants to use property — lies in the possibility that the determined capitalized present value may be arbitrary due to the difficulty of determining the portion of rents which should be attributed to bare property rights; certainly the amounts so determined would be largely influenced by subjective considerations. This problem arises, for instance, in cases where rentals include payments of taxes or rendering of services by the lessor, and may be expected to be especially vexatious where they are arrived at by negotiation and bear no discernible relation to cost of the leased property or are dependent to a large degree upon the lessee's revenues or profits.

I realize that problems having the capacity to impute arbitrariness to capitalized amounts may not be present in certain leases. However, I do not believe it desirable to recommend an accounting policy under which some leases would be capitalized and some not capitalized, solely on the criterion of feasibility, because of the internal inconsistency which this would introduce in financial statements.

On balance, I am far from convinced that capitalization of leasehold rights, or of related obligations, as a required accounting convention, will result in more meaningful or useful financial statements, especially when information of the same and possibly greater significance can be given by way of footnotes.

I am in accord with Dr. Myers' view that a sale-leaseback arrangement should be regarded as a single economic transaction and that, consequently, it should not give rise to removal of the related property from the accounts or to recognition of profit or to loss except such loss as may have been inherent in the property and simply recognized as an incident to the sale-leaseback.

Dr. Myers explicitly excluded questions regarding accounting for executory contracts other than leases from consideration in his study, since it was directed to research in a specific area. However, I do not believe that these other contracts can be ignored in deciding whether or not to adopt the conclusions in the study, since to do so may lead to differing accounting practices in situations where the same logical considerations appear to be applicable.

APPENDIX A

Lease Provisions

Life of Lease

The duration of leases varies widely. Some leases of land in urban centers and some leases of railroad property run for more than a century. Leases of improved real estate and of equipment seldom run more than, say, 90 per cent of the economic (not physical) life of the property. The remaining 10 per cent of life serves as a safety margin for the lessor. In those instances when the lease does run longer, the lessor is relying substantially more heavily on the general credit of the lessee than upon the value of the property as his security. On the other hand, a lease for automotive equipment may be written for a term of years longer than the expected life of any piece of equipment, and the lessor assumes the obligation of furnishing modern equipment (rather than individual vehicles) throughout the term of the lease. Under such a "blanket" lease the quantity of equipment under the lease may vary seasonally or otherwise in accord with the needs of the lessee. As compared to these long leases, many are for terms far shorter than the economic life of the property. Office space, residential dwellings, factory buildings, special equipment, automobiles, are likely to be rented for short periods. Special construction equipment may be leased by a contractor on a day-by-day basis.

Alternatives at Termination

At termination of a lease there are many provisions ranging from the lessor taking possession of the asset to the lessor's surrender of title to the lessee for one dollar. None can be classed as typical. The following is a list of provisions:

1. Lessee has no rights different from those of a stranger. The lessor is entitled to take possession.

2. Lessee has the right to purchase property at the then market value. Any outside offer to purchase must be deferred a limited time to give lessee an opportunity to consider if he will exercise his right to purchase the property at the offered price – the offer being considered evidence of market value.

3. Lessee has the right to renew the lease at market price in preference to outsiders.

4. Lessee has the right to renew the lease at a scale of rentals stipulated in the original lease. If the rentals are below the going rate at renewal date, this option may be very valuable. Often the stipulated rentals are nominal.

5. Lessee has the right to purchase the property for a price stipulated in the original lease. Often the stipulated price is nominal.

6. Lessor promises to release asset to lessee.

The lessee is likely to have major rights at the termination of a lease if his rental payments have approximated the sum of (1) the value of the asset at the beginning of the lease, plus (2) a fair return on the lessor's unrecovered cost. Such a high level of total rentals usually is confined to those leases that run for substantially the entire economic life of the asset.

The Internal Revenue Service is much interested in the rights at termination. Its ruling is that the lease is to be treated as a purchase if the lessee builds up an equity in the asset during its life.[1]

Rentals

Rentals under a lease are usually fixed in the lease contract. Most often they are level throughout the term of the lease. In some cases, however, they are at different levels at different times during the lease. There seem to be five different types of variation in required rentals:

1. High level for a period of time and then dropping to a lower or even nominal level for the remainder of the term (for example, a twenty-five-year building lease with rentals payable during only the first fifteen years).

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[1] See Rev. Rul. 55-540, 1955-2 CB39; and see Quartzite Stone Co. 30 TC 511.

2. Low rentals during an initial period and then a higher rent (to assist the tenant in years when the business is getting established).

3. A high rental for the first month and then lower rentals throughout (comparable to the down payment typical in installment sales).

4. Rentals stepping down at several times during the contract (used with real estate where lessee bears cost of maintenance which is likely to increase with the years, and used in the case of equipment likely to be subject to high obsolescence).

5. Rentals stepping up at several times during the contract (used in an effort to protect lessor against inflation).

Some rentals are variable by terms of the lease contract. The most common is the lease of store space with the rental set at a percentage of sales. Other bases for variable rentals are deposits in the case of a branch bank, mileage in the case of automotive vehicles, units of use as in the case of many machinery leases, and shifts during which the asset is used as in the case of certain office equipment rentals. In some cases, particularly of office space, there may be an escalation clause requiring that the rental be adjusted according to a predetermined formula as certain maintenance and service costs vary. In rare cases the lease rental is tied to the price level as measured by government indexes. Almost always there is a minimum below which the variable rental cannot go.

The minimum rental is usually set to protect the lessor against any decline in sales (or other basis of calculation) from that which he sees at the inception of the lease. If this minimum level is that on which he bases his calculations on recovery of costs plus a fair return, the variable element then gives the lessor a bonus. This bonus in most cases is considered either to give him a reward for taking a larger than usual risk or to protect him against inflation.

Where the lessor purchased the asset (other than in a sale and leaseback) for the specific lease, the lease rental usually is related directly to the cost of an asset being leased. Typically, the lease price is set to return to the lessor his full cost, plus a fair return on his investment, plus a fee for any services to be rendered. A "fair return" on a straight-financial lease appears from readings and field work to be about one percentage point higher than would be obtained on a straight loan to the same class of risk. Because the value of the property at the end of a long-term lease is problematical, the lease rental is apt to include interest plus full recovery of cost with little if any adjustment for the residual. In equipment rentals where the lease term is short, the provisions for ownership of the property are apt to be apparent in the lease cost. The price scale of one company offering its equipment for sale on several different plans is as follows. (Only the three-year plans are shown, but other periods have comparable figures.)

	Cash Sale	*Install-ment sale*	*Lease with option to buy for $1*	*Lease with no options*
List price	$10,000	$10,000	$10,000	$10,000
Add-on	—	1,200	1,200	700
Total price	$10,000	$11,200	$11,200	$10,700
Percent of total price:				
a. To be paid at once	100%	17.8%*		
b. To be paid in equal monthly installments				
First year		27.4%	50%	50%
Second year		27.4%	30%	30%
Third year		27.4%	20%	20%

* The contract states that the down payment shall be 20 per cent of list price and that the add-on shall be 15 per cent of the remainder.

In another case the lease contract calls for payments which are the sum of (1) an equal part of the cash cost of the asset, plus (2) interest on the unpaid balance at two percentage points above the prime rate in effect at the time the rent payment falls due. The identity with a financed purchase is obvious both in the case of the lease in this paragraph and in the case of the lease with option to purchase in the previous paragraph. In fact the lessor in one of these cases stated in an interview that, when a default had occurred under the lease, he had been unable to collect in the courts because of failure to record the "conditional sale."

Types of Lessors

Anyone with capital or access to capital may become a lessor. Insurance companies, pension and profit-sharing trusts, and educational institutions usually are involved with leases in which the lessee takes care of all taxes, insurance, and maintenance. Although regulatory measures often prohibit financial institutions from owning some or all types of property as a substantial investment, these institutions become lessors in effect through the use of nominees or intermediate corporations. Life insurance companies, profit-sharing and pension trusts, and educational institutions usually confine their direct investing to real estate but use intermediaries in their investing in personal property to lease. The intermediary is used not only in cases where legal requirements prohibit direct ownership but also in instances where several organizations are brought together to finance a single, large lease.

Individuals have been lessors of store and residential property for years. About thirty years ago they began to be involved with sale and leasebacks of stores. Now, through such leasing middlemen as the trust department of a bank, individuals are beginning to be lessors of larger pieces of real estate and of equipment.

Subsidiaries of corporate lessees are often created for the sole purpose of owning and financing the property used by their parent. This type of lessor is found frequently in the retail field. Both real estate and equipment are involved. Frequently, the leasing subsidiary is not included in the consolidated financial statements.

Leasing companies purchase pieces of equipment for specific leases. The lease is often on the basis that the lessee is to pay all costs of taxes, insurance, and maintenance but that the lessor will perform a buying service. Through frequent purchases for various lessees, the lessor may develop an ability to buy wisely and at quantity prices. Other leasing companies render substantial services in addition to making the asset available. Banks are the major source of capital of these companies. The loans may be secured either by a pledge of the leased assets, by a pledge of the rentals, or by both.

Manufacturers or their subsidiaries have been lessors of their products for many years. United Shoe Machinery Corporation is an old example of a company leasing its major product, shoe machinery. American Can Company is an example of a company primarily selling an expendable product but leasing the equipment (can-closing machinery) necessary to make use of the product (metal cans after filling). For many years these and other companies made their product available only on a lease basis. Now they offer their product for sale or lease with varying degrees of service. Sometimes the service goes so far as to include (a) replacement in the event of loss even by improper use, and (b) substitution of current models for obsolete ones. Occasionally, a manufacturer will purchase assets manufactured by someone else, so that the manufacturer can offer the lessee all of his needed equipment in a single lease. Frequently the manufacturer pledges the lease rentals to secure a loan of funds needed to finance the leases.

The lessee may also be lessor of the same property. This situation arises sometimes in the case of oil company service station leases. A future operator buys a vacant piece of property and leases it to the oil company. The oil company then builds the service station and leases it back to the property owner who becomes the operator. The lease to the oil company is usually a long enough term to enable the company to amortize the cost of the improvement, but the lease to the operator is usually terminable if a certain volume of business is not maintained or if other covenants are violated.

The term "dummy" is applied to a lessor used for the purpose of holding title. Circumstances sometimes require that the dummy buy and lease the assets and be primarily liable on the debt if it is to hold title effectively. There are several different circumstances when the device of a dummy is used. One is the case of a bank wishing to become lessor but being unable to do so because of legal restrictions. A separate corporation will be created to buy, own, and lease an asset. The bank or its nominee may own the stock, or the lessee may own the stock. The dummy borrows from the bank, buys the asset and then pledges the asset and lease rentals to the bank. The dummy also arranges for the lessee to pay rentals directly to the bank and for the bank or lessee to pay any expenses of the dummy.

Another case of the use of a "dummy" is that of a trust acting as middleman between a lessee and a number of lessors. The dummy holds title, but rent receipts and expense disbursements are made by the trust company.

The trust under a railroad equipment trust obligation almost might be called a "dummy." It acquires the equipment, leases it to the railroad, collects and disburses the rental payments, and eventually gives title to the equipment to the railroad. The idea behind the equipment trust has been used in another way as described by Gant.[2] The lessee causes the "dummy" to be created, to buy and lease the assets and to raise the money by debt securities. The lessee pays rents to the dummy (or a trustee) which in turn meets the payments required by the debt obligation. The lease, unlike the railroad equipment lease, carries no right for the lessee to acquire the assets at the end of the lease term. Title will continue to vest in the dummy and its owners. The lessee makes some sort of arrangement not to own or control the dummy until the expiration of the lease and then to capture title to the dummy and its assets. One such device is for the dummy to issue one share of common stock to a charity and to issue many shares of nonvoting con-

[2] Gant, Donald R., "Illusion in Lease Financing," *Harvard Business Review*, March-April 1959, p. 125.

vertible preferred stock to the lessee. The preferred stock will be converted to common at the termination of the lease; the lessee, then, will own the assets except for the trifling share given to the charity for its "services."

Lessor's Service to Lessee

The services rendered by the lessor vary from rendering none, except making the asset available for a fee, to what amounts to performing a whole operation for the lessee which he might well have performed with his own organization. The following list illustrates the type of services that may be involved in the lease of an automotive fleet. One or all of the services may be included:

Provide the asset for a fee. (The lessee often selects and makes purchase arrangements for the asset.)
Provide insurance.
Pay taxes on the property.
Supply spare parts.
Perform road service.
Perform maintenance.
Supply substitute vehicles when one is out of order.
Provide additional vehicles for peak periods.
Provide gasoline and oil.
Provide driver.

Services in connection with the rental of office space are similarly varied ranging from (a) rental of a whole building with the lessee to pay taxes, insurance, and maintenance (commonly known as a net lease) to (b) the type of space a salesman might rent when first engaging in business for his own account. Assistance in operating methods is sometimes offered by manufacturers to lessees of their products.

When service is to be rendered by the lessor, two contracts sometimes are used. One is for the service, and the other is for the asset itself. Although the leases in which the lessor provides personnel are not usual, those in which the lessor provides all other services are common. Also common is the net lease described above in which the lessor's only obligation is to receive the rents and permit the lessee to have quiet possession. In special cases the lessee may even guarantee to pay the lessor's Federal income taxes arising from the leasing operation.

The full service lease with personnel provided has been compared to the "farm-out" of an operation. In the case of a full service lease of trucks, the services may be so large as to approximate the services available from a common carrier. In cases of lease of a plant with a highly mechanized operation, such as a power plant, the lease has been said to approximate a long-term purchase commitment.

Options to Lessee During Term of Lease

During the term of a lease the lessee may find it disadvantageous to continue the contract. Although a party to a contract may determine to default on the contract and be held liable for damages, this is not a right conferred by the contract. Many leases, however, give the lessee the right to relieve himself of the unwanted obligation. Some typical rights, one or more of which may be included in a lease contract are as follows:

1. To sublet or assign. This right is common in leases of real estate, but in cases of equipment the right often is specifically denied.

2. To buy the property at a set scale of prices. After the lessee buys the property he, of course, has the right to sell it.

3. To return the property to the lessor coupled with the obligation to hold him harmless for any loss. This arrangement may be set up in either of two ways. One is that the lessor is to sell the property. If the proceeds are less than his unamortized cost, the lessee is to pay the difference. The other arrangement is to have the lessee pay to the lessor the present value of all future rents and then to recover some portion of the salvage value which the lessor obtains from sale. If the lessee, instead, rents a new asset from the same lessor, the lessee may be entitled to 100 per cent of the salvage of the old asset.

4. To make an offer for the property at a set scale of prices. If the offer is rejected, the lessee then has the right to cancel the lease without penalty (common in Safeway Store leases).

5. To cancel lease if a new or larger asset is rented in its place from the same lessor.

6. To cancel lease with no penalty. This is found in cases where a franchised dealer leases his store from the manufacturer. The lease is canceled if the franchise is canceled.

Some of these various rights shade gradually from one to the other and hence are hardly specifically different rights.

Restrictions Against Lessee Incurring Further Obligations

Until recently no restrictions were placed against the incurring of further obligations by the lessee. As the financial community has grown to recognize the similarity of certain leases to conventional debt, the lessors have begun to require restrictions against further obligations somewhat comparable to those in bond indentures. These usually only appear in large, net leases which are very close to, if not in fact, methods of financing assets. Therefore, similar restrictions seem in order. The most stringent restriction is the prohibition of all further debt and lease obligation without permission of the lessor. He often mitigates this restriction by guaranteeing that, if permission is denied, the lessee may repay the lessor's unrecovered costs without penalty with funds provided from another lessor or creditor.

Other types of restrictions may be divided into two classes, and the lessor may require a restriction from each class. The first type is based upon a balance-sheet approach. The present value of future lease rentals is to be added to funded debt. New obligations may not be created or dividends may not be paid if the total of funded debt and lease liabilities will exceed some specified percentage of equity or of assets (after adding in the leased assets valued at the same amount as the lease liabilities). The second type of restriction is based upon a funds flow approach. Lease rentals, or some portion of them, are added to interest charges. The ratio of this sum to profits before "fixed charges," is computed and compared to some minimum standard. (In financial circles, "fixed charges" usually means bond interest cost, but in railroad analysis the term includes rents for leased lines.) An illustration of the use of the funds flow approach is in the standard set by the Securities and Exchange Commission to determine when a company is eligible to use the abbreviated form of registration statement, S-9. According to General Instruction A, this form is allowed if certain conditions are met, one of which is that earnings be at least a prescribed multiple (varying with certain other factors) of fixed charges.

Paragraph (C) (2) says that the term fixed charges shall include "one-third of all rentals reported in Schedule XVI, or such other portion as can be demonstrated as representative of the interest factor in the circumstances of a particular case. . . ."

Comparable restrictions are now being placed in bond indentures restricting further incurrence of obligations either by bonds or by lease.

Lessor's Acquisition of Asset to be Leased

In the "old-fashioned" leasing arrangements, the lessor had owned the asset prior to the time a particular lease was under consideration. This was true particularly in the case of land and building rentals. In many leasing arrangements now being made, the asset is acquired in contemplation of a particular lease. Perhaps the earliest use of this acquisition for a particular lease was in the railroad equipment trust field. The trust acquires the asset from the manufacturer only at a closing session at which the lease is simultaneously executed with a railroad. Previously, the parties had agreed on what was to be purchased. More recently, buildings have been built by financial institutions to the specifications of the intended lessee. Equipment likewise is purchased by a leasing company specifically at the request of the intended lessee.

A variation of this acquisition for the specific lessee is the sale and leaseback. In these transactions, the lessor acquires the asset from the lessee. The asset may be a new one about to be put into service (as is the case with Safeway Stores' store-leases), or the asset may be one which has been used for many years (as in the cases of Comptometer Corp., S. H. Kress & Co., Melville Shoe Corporation and Mohasco Industries, Inc. as described in notes to their financial statements reproduced in Appendix C). When the sale and lease transactions are between the same two parties, the question arises as to whether the sale price is near the price that would have been reached had the transaction been at arm's length. It is possible that, in consideration of a different rental, the "sale" price might have been different. It is probable that the "sale" price is never above market; if it were, the lessor would, in effect, be making an unsecured loan to the lessee to the extent of the excess of sale price over market to be repaid by "excessive rents." If undepreciated cost of the asset is below market, it is possible that the price might equal undepreciated cost; the lesseeseller would thus sacrifice some of his credit potential to avoid a possible tax on the capital gain.

Default Provisions

The basic rule upon default is that the lessor may bring legal proceedings to obtain possession of the property and that he can sue the lessee for damages. In bankruptcy or Chapter X reorganization, the damages may be limited to one or three years' rentals if the lease is disavowed. Because of the uncertainty as to damages that will be allowed and the possible inadequacy of those that will be allowed under bankruptcy and reorganization, various provisions have been designed in an effort to make certain the amount that will be payable.

Perhaps the strongest provision is that found in railroad equipment trust obligations. The railroad unconditionally guarantees that if the trustee does not pay the obligation, the railroad will pay it. This unconditional guarantee by the user to the financier has been brought into leasing of other equipment through the clause colloquially known as the "hell-and-high-water" clause.

In the case where a bank is assignee under a lease, the lessee guarantees, both in the lease and in the consent to the assignment, that he will pay the lessor's loan. Wording of one such clause is as follows:

> For the purpose of inducing such assignee to advance moneys to lessor in connection with such assignment, lessee expressly covenants that
>
> (a) it will have an unconditional obligation to pay such assignee . . .
> (b) cancellation or termination of this lease . . . will not be a defense by lessee to . . . make such payments to such assignee
> (c) it will not assert against such assignee any defense, set-off or counterclaim . . .
> (d) it will not modify or consent to any modification hereof without the written consent of such assignee.

There is a remote possibility that the lessee might have to pay and yet not have the asset because of attachments by the lessor's other creditors.

As between the lessor and the lessee, this "hell-and-high-water" clause may take the form of stating that in case of default, all future rents become due and payable at once. If such payment is made, the property would then belong to the lessee. More commonly, however, the lessor has the right to sell, to recover his costs, and to divide the remainder with the lessee. Some lessors feel that these clauses have not been thoroughly tried in court and that, therefore, their effect is uncertain.

Many equipment lessors have found that their leases in which the lessee acquired the property at termination were interpreted by the courts as conditional sale agreements. As pointed out on page 74, one manufacturer has stated that he has been unable to collect in case of default because of failure to record the contract. He further stated that rather than going to the expense of complying with the filing requirements of the many states in which he does business, he has chosen to carry insurance against such losses.

Rights of Lessor During Lease

The lessor, of course, has a number of rights under the lease associated with protection of his investment. These consist of such things as inspection of property, financial reporting, and holding of insurance policies. An unusual right of a lessor is to require the lessee to buy the property at a value determined under rules set forth in the lease contract. (An example is reported in the 1959 annual report of Corning Glass Works to which reference is made on page 29.) This arose in the case of a pension trust buying a building from and leasing it back to the company whose employees were the beneficiaries. Another special right of a lessor is to assign the lease and to require the lessee to give the assignee a "hell-and-high-water" clause.

APPENDIX B

Economics of Leasing

Reasons for Leasing

The basic reason for leasing is to acquire the right to use an asset. In almost all cases the alternative of buying the asset is available; in many cases the alternative is not only available but also feasible. In the following list are many of the economic reasons why a lessee would choose to lease an asset. Each is described briefly; little attempt has been made to classify or to evaluate the reasons, except for those related to financing and to income tax.

Only basis available. In certain cases property may not be available on any basis other than leasing. Space for hangar, office, and passengers at major airport terminals may be owned by the municipality solely for lease to airlines. Downtown office space is likely to be available only on a lease basis except to certain firms large enough to own a whole unit of property. At one time United Shoe Machinery Corp. and International Business Machines made much of their equipment available only on a lease basis.

Temporary need. When the need for assets is temporary, leasing is the only feasible basis on which to acquire property. For example, the moderate-sized contractor who, on rare occasions, needs a piece of specialized equipment will choose to lease on those occasions rather than to own. Similar considerations lead to leasing of autos in the various cities to which a traveling salesman flies.

Shift risks of ownership. Users particularly wish to shift the risks of ownership when acquiring new and untried equipment. It may not be suitable for the job, or even if suitable it may be outmoded quickly. In many cases, a modest-sized piece of equipment is acquired in preference to a larger, more automatic model. The user may realize that when he gets to know the capabilities of the new machinery, he may wish he had acquired the larger model. Proper lease arrangements make the shift possible. Manufacturers often become lessors of their product to enable the user to avoid the risks of ownership discussed above, and thus remove a sales resistance point.

Farm-out of an operation. Leasing may be used to shift ("farm-out") the burdens of running a certain operation. An example is the moderate-sized company that leases trucks on a full-service basis including drivers. The company has shifted all scheduling, maintenance, personnel and other operations to another (whose operations may approach those of a common carrier). A moderate-sized company may not have sufficient operations to warrant the employment of a full-time manager of the trucking operation. By shifting the operation to a specialized organization, the small company buys the management talent which it could not afford by itself on a full-time basis.

Clear-cut and allowable costs. If assets are leased for use on a single contract, there is no problem of allocation as might be the case if the assets were owned. When contract reimbursement is based on cost, the problem of allocation may be avoided by leasing assets for use on the particular contract. In addition, there are problems of determining allowable costs on certain government contracts. Alvin Zises[1] commented on this point as follows:

> The Defense Department has refused to recognize the cost of debt or equity as a component of expense in pricing equipment produced by manufacturers of military hardware. Rent, however, has generally been allowed as a fully recoverable expense, including the unsegregated portion of the rent attributable to the lessor's financing costs.

Circumvent restrictions on acquisition of fixed assets. Regulatory bodies and managements of nonregulated companies frequently restrict the purchase of fixed assets. The sole restriction may be that authorization must be received before purchase can be made. Managements of regulated companies and lower management levels of other types of companies can circumvent controls by leasing fixed assets and thereby acquire the use of assets which would otherwise be denied to them.

[1] In an address before the Boston Control of the Controllers Institute of America, February 10, 1960.

In addition, certain bond indentures contain an "after acquired" clause which places all owned assets under the indenture even though acquired after the indenture was signed. Leasing enables management to give a "first" lien to the financier of such new assets, because title to the new assets would pass directly from the manufacturer of those assets to the lessor.

Eliminate real estate tax. Real estate taxes may be eliminated by leasing if the lessor is a tax-free organization such as a municipality or eleemosynary institution. Since these organizations typically do not pay real estate taxes, they often charge less rent than would a taxable organization. To the extent this is done, these organizations are, in effect, selling their tax exemption.

There are, however, two major exceptions to the statement that real estate taxes can be eliminated by leasing from municipality or eleemosynary institutions. A municipality which is not using the lease as a device to induce new industry to locate in its community is likely not only to set the rent high enough to recover its capital plus a fair return on the investment, but also to cover what would likely be payable in real estate taxes. In the case of eleemosynary institutions, there is a growing tendency for them to lose their tax exemption on property used for noneleemosynary purposes.

Obtain the buying advantage of a leasing corporation. Leasing corporations state that they are able to buy certain items of equipment more reasonably than could the lessee. They give two reasons for this. First, the leasing corporation has more skill in buying equipment because it is buying for many different lessees and has the advantage of large scale. Second, manufacturers resist selling at less than list price because of potential damage to their pricing and marketing structure. To the extent that the manufacturer regards the leasing company as a member of its distributing organization and gives it the discounts appropriate to such a middleman, the leasing company is able to buy for less than could the intended lessee. If the leasing company passes on some of this discount through reduced rentals, the lessee does receive a buying advantage.

Obtain manufacturer's servicing facilities. Users of equipment often feel that the lessor of the equipment will give better service than would be obtainable by hiring an outside repair service when needed. On the other hand, many manufacturers offer a service contract at the time of sale of the equipment. Presumably, the same quality of service would be rendered.

Federal income tax advantages. Financing advantages. Many people refer to advantages of leasing through Federal income tax reduction or deferment and to advantages of financing through leases instead of through customary debt. These factors are discussed in the succeeding paragraphs on the income tax considerations and the financial considerations of leasing.

Income Tax and Leasing

In computing income subject to tax the lease rentals paid are generally deductible as being ordinary and necessary business expenses. Likewise, if the asset had been purchased and the necessary funds raised by borrowing, the depreciation and interest expense would be deductible. Any tax advantage or disadvantage from leasing must then be the result of the combined force of two factors: total amount of deductions over the life of the asset and timing of the deductions.

Advocates of leasing state that under leasing the lessee is allowed to deduct the full cost of the asset over its life, whereas, if he had bought the asset instead, he would be able to deduct only depreciation. Since depreciation must not include either the salvage or land values, total depreciation must be less than full cost. Although the facts are true, the implication is hardly valid that there are tax benefits from these facts which make leasing less costly than ownership. To make the implication valid, it is necessary to assume two factors. First, one must assume that the lessee rents the asset for its whole economically useful life for amounts which reimburse the lessor for his entire cost plus a fair return on his investment. Under such assumption, the lessee does deduct, as rent, the entire cost of the property, including land. Second, one must assume that the lessor has the right to any residual values that may remain at the end of the lease term to prevent the lessee from being taxed as if the transaction were a financed purchase. Under this second assumption, the lessee has no property or rights at the termination of the lease, but, if he had purchased the asset, he would have both the land and the worn-out asset for whatever they might be worth. The tax basis of these two, in the hands of an owner, would be equal to the cost not deducted as depreciation. If these residuals have value equal to "basis," the owner can sell them without incurring tax. However, under the lease arrangement, the lessee would have lost the residuals and received tax deductions. As long as the tax rate is less than 100 per cent, his benefits from reduced taxes are less than his proceeds of sale (disregarding the time value of money). If the purchaser disposes of the assets by abandonment because they have no value, he has an abandonment loss equal to his basis and hence is in the same total tax position as he would have been as the lessee. The difference would then be one of timing.

Prior to the passage of the Internal Revenue Code of 1954, there was substance to the argument that the lessee's deductions were made earlier than those of the counterpart-purchaser. This was true because of (1) the likelihood that depreciation deductions would have been spread over a longer life than that of the lease; and (2) prior to 1954, depreciation typically was taken on a straight-line basis.

Since 1954, depreciation frequently has been claimed and allowed on a basis faster than straight-line. Unless lease payments are likewise accelerated, depreciation deductions are likely to come earlier than lease payments and deductions. The early depreciation deductions are likely to be greater than early lease deductions even though (1) the total amount allowed to be depreciated is less than the full cost of the asset; and (2) the depreciation period may be longer than the life of the lease. There is thus no clear-cut tax advantage today from this set of circumstances.

Lease contracts are sometimes drawn in such a way that the lessee obtains title to the assets at the end of the lease term. If lease rentals are deducted in full during the life of the lease, then the lessee has assets with a zero base at the end of the lease term. To the extent that this is allowed by the Internal Revenue Service, the lessee is in a more favorable position as to total deductions than is the purchaser of such assets. However, an Internal Revenue Service ruling[2] says, in essence, that such leases shall be treated as purchases.

Another tax advantage claimed by the advocates of leasing is in the case of companies using composite rate depreciation. If a company uses a single composite rate of depreciation, the rate is an average of those on both short- and long-lived assets. If the company then disposes of its short-lived assets, such as automobiles, and instead leases its autos, theoretically the composite depreciation rate should be changed. However, if the short-lived assets converted to leasing were a minor part of the total assets (as opposed to having a minor effect on the

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[2] Rev. Rul. 55-5540, 1955-2 CB 39.

depreciation rate), the Internal Revenue Service apparently would not call for an adjustment of the composite rate. The maintenance of the same rate for depreciation of remaining assets plus the effective higher depreciation rate in a lease rental might cause a material reduction in taxable net income as illustrated by the following example:

Depreciation deduction under ownership:

30-year assets of	$3,000,000	$100,000
3-year assets of	100,000	33,333
	$3,100,000	$133,333

At a composite rate of 4.3 per cent.

Assume all three-year assets sold for $100,000 and leased back:

Depreciation on $3,000,000 remaining assets at 4.3 per cent	$129,000
Portion of rent to enable lessor to recover his cost	33,333
	$162,333
Increased tax deductions	$ 29,000

In this example the sale and leaseback of approximately 3 per cent of the assets increased the tax deductions nearly 22 per cent, thus, at a 52 per cent tax rate, retaining $15,080 more cash. To the extent the Internal Revenue Service permits such a shift of assets without requiring a change in the composite depreciation rate, there is an important tax advantage to leasing. However, a real disadvantage of such a transaction is that it might precipitate an Internal Revenue Service examination of the whole composite rate structure of the company.

In the case of a sale and leaseback if the sale is made at a gain, apparently the gain would be taxed as the gain on sale of "Section 1231 asset" at, in the case of a corporation, 25 per cent (unless the Internal Revenue Service were to challenge successfully prior depreciation deductions, thereby increasing prior year taxes by a full 52 per cent and reducing or eliminating the gain). Lease rentals in the future would be deductible in full and thus reduce tax of a corporation by 52 per cent. Had the new money been obtained by borrowing, there would have been no gain now, but the annual deductions for depreciation in the future would have been smaller than the lease deductions. Presumably, the difference between the lease deductions and the depreciation deductions (except for the finance charge in the lease) is equal to the gain. The question is one of weighing the disadvantage of a 25 per cent tax now against the disadvantage of a 52 per cent tax which is delayed. One company selling property at a substantial gain and leasing it back has some operating loss carryforwards about to expire (Mohasco Industries, 1958. See financial statements and note in Appendix C). To the extent that the gain was offset by these carryforwards which could not otherwise be used, the company appears to have a real tax saving.

If the sale in a sale and leaseback transaction were made at a loss, it would appear that the loss would be deductible in full now and that annual deductions for lease rentals in the future would be smaller than the depreciation deductions that would have been taken. However, the allowance of the deduction for such a loss is not clear in view of conflicting court decisions in cases which, of course, involve different sets of facts.[3] In one case the court held the transactions to be a tax-free exchange of like properties; in the other, the court held the transaction to be a bona fide sale.

As a result of the various rulings, decisions, and other factors (assuming adequate enforcement by the Internal Revenue Service), it seems that income taxes can hardly be an important consideration in the decision of whether to lease or to buy with borrowed money. The only instance where a clear-cut advantage might arise in leasing seems to be that, if the lease is regarded as such by the Internal Revenue Service, there is no room for a difference of opinion about estimated life.

Financial Considerations in Leasing

In many situations, the financial considerations are major ones in determining whether to lease or to buy an asset. Assets acquired must be paid for, and so the costs of funds obtained from alternative sources must be considered. The pertinent comparisons are those made to the least costly (most likely to be used) alternative sources. Because interest on borrowed money is tax deductible and dividends on stock are not tax deductible, borrowing is almost always the least costly alternative. Sometimes, however, the alternative of borrowing is precluded either by contracts with previous lenders, by traditional debt-equity and other ratios for the industry, or by regulatory authorities. When borrowing is precluded, leasing may not be similarly precluded. Present debt contracts limiting future debt often have not included contracted lease payments as debt, and present accounting practice

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[3] Century Electric Co. 192 F.2d 155, and Jordan Marsh Co. 269 F.2d 453.

does not include lease liabilities on the balance sheet, thus leaving the apparent debt-equity ratio unchanged.

In one respect, at least, the cost of leasing is generally believed to be higher than that of borrowing. In the net lease, one in which the rental payments are set to cover only the cost of the asset plus a fair return to the investor, the interest factor is generally set one half of 1 per cent to 1 per cent higher than would be set on a loan to the same borrower. A statement of this fact by Gant in the *Harvard Business Review*[4] was challenged in some of the letters to the editor which were published in subsequent issues. However, Vancil and Anthony asked questions as to the reason for this differential in preparing their survey for a subsequent article, "The Financial Community Looks at Leasing,"[5] and, of the people contacted, only a few commented that this higher rate was unrealistic. (My field work substantiates this statement.) The major reasons for this higher cost, as found by Vancil and Anthony,[6] are (1) that the financial institution has a greater risk of loss; (2) that it has higher administrative, legal, and clerical cost; (3) that the lessee is willing to pay more to secure the other advantages of leasing; and (4) the financial institution finds the leasing contract less marketable than debentures.

Other costs of leasing, however, may well be less than the corresponding costs of borrowing. The cost of negotiating and setting up a lease may be less than the initial costs with a bond issue. A master lease may be drawn and various assets obtained under this lease from time to time by amendment. This piecemeal acquisition of money avoids the cost of idle money which may exist in the initial periods of a bond issue. It is also claimed that under leasing it is easier, and hence less expensive, to substitute new assets and a revised rental schedule than it is to get assets out from under a mortgage and substitute new ones with a corresponding alteration of the loan. Conflicting statements are found as to the ease of terminating or refunding a lease contract as compared to a bond contract.

In spite of many reasons offered to the contrary, leasing does seem to increase the total pool of credit available to a company. Many writers have stated this to be a fact, and my field work substantiates

[4] Gant, Donald R., "Illusion in Lease Financing," *Harvard Business Review*, March-April 1959, p. 126.

[5] Vancil, Richard F., and Robert N. Anthony, *Harvard Business Review*, November-December 1959, pp. 127-8.

[6] *Ibid.*, pp. 128-29.

the conclusion. Vancil and Anthony[7] present statistics from their survey of opinions of corporations and analysts. They report that 65 per cent of the corporations and 90 per cent of the analysts believed that the total pool of credit was enlarged. The explanation most commonly cited for this fact in the Vancil and Anthony survey was that:

> ...This permission may be granted implicitly (as when the financial analyst does not recognize lease obligations as being equivalent to debt), explicitly (by not restricting lease obligations in debt agreements), or simply by ignoring lease obligations when the amounts involved are small....
>
> A similar reason is that more credit would be available to a lessee because lease commitments do not appear on the balance sheet....[8]

Another explanation given is that, in leasing, 100 per cent of the asset is financed, whereas a lender usually requires that the user have some equity in the asset.

An important factor leading to leasing instead of borrowing is the comparative cash flow. The cash outflow in the early years may be less rapid under leasing than under debt incurred on the basis of a specific asset. There are several reasons, namely:

1. Lease payments are apt to be level throughout the life of the contract. A level repayment schedule is also typical in the case of debt, but level principal repayment coupled with interest on the unpaid balance makes a declining cash outflow. "Balloon" payments at the end of a debt schedule are common under certain circumstances, but not to those in which the credit rests largely on a single asset or group of assets.

2. Leasing represents 100 per cent of the value of the asset, for large initial payments are rare. On the other hand, debt financing of a specific asset might be only for 80 per cent of the value, thus requiring a large outflow in the first year for the down payment.

3. Income tax outflows may be less rapid under leasing, particularly if the lessee has no residual value in the asset so that the whole cost,

[7] *Ibid.*, pp. 129-30.
[8] *Ibid.*, pp. 129-30.

including salvage and land, is written off over the term of the lease. Under ownership and debt, the depreciation for the smaller amount might well be required to be spread over a longer period. Contrariwise, the larger deductions allowed in early years under accelerated depreciation methods may offset the shorter total time period.

4. Some of the underwriting costs may be shifted to the lessor and recovered by him over the life of the lease instead of being borne by the borrower out of his own funds in the year the loan is obtained.

As pointed out earlier, the total cash outlay for leasing may be greater than the total cash outlay in borrowing because of (1) a higher interest rate in leasing, and (2) a larger total amount financed. Nevertheless, even in such cases, the present value of the cash outflows may be less under leasing than under borrowing. No generalization can be made as to combinations of circumstances giving such lower costs. Computations are necessary in the individual case taking into account (1) payment schedule of leasing and of borrowing including down payment, (2) interest rate in leasing and in borrowing, (3) tax deductions including depreciation schedule, and (4) residual values of land and salvage.

One set of variables that gives a higher cash outlay but a lower present value of lease costs is as follows:

Twenty-year lease with 5½ per cent interest factor, rentals payable annually in advance

Twenty-year borrowing of 80 per cent of cost of asset at 5 per cent, with equal annual payments of principal and annual payments of interest

Depreciation on owned asset to 10 per cent of salvage value over twenty years by straight-line method, and sale at that value and time

Income tax rate 52 per cent

Five per cent discounting factor on all payments (annual compounding)

With these variables the present value of the after-tax cost of buying a $1 million asset is $513,909 and the present value of leasing that asset is $498,186. These calculations include the $200,000 down payment required if the asset is purchased rather than leased, but exclude any capital cost of that $200,000. A slight change in any one of the variables would change the relationship of the present values which are only 3 per cent apart. The details of the calculations are as follows:

	Cash outlay	*Present value of cash outlay at 5%*
Lease		
Rent of \$79,317[a] annually, 20 years, first payment due at once	\$1,586,340	\$1,037,888[b]
Less tax deductions at 52%	(824,897)	(539,702)
Total cost of leasing	\$ 761,443	\$ 498,186
Purchase—Borrow		
Down payment	\$ 200,000	\$ 200,000
Principal payments of \$40,000 annually, 20 years, first payment due at end of first year	800,000	498,488[c]
Interest on unpaid principal at 5%, first payment at end of first year and annually thereafter	420,000	301,512[d]
Less tax deductions at 52% due to interest	(218,400)	(156,786)
Less tax deductions at 52% due to depreciation of \$45,000 annually (20-year life, straight-line to 10% salvage)	(468,000)	(291,616)[e]
Less proceeds of sale at salvage value at end of 20-year life	(100,000)	(37,689)[f]
Total cost of purchase—borrow	\$ 633,600	\$ 513,909

Notes:

[a] $\$79{,}317 = \dfrac{\$1{,}000{,}000}{1 + a_{\overline{19}|5\frac{1}{2}\%}}$

Where $a_{\overline{n}|i}$ is the present value of an annuity of \$1 for n periods at i rate of interest with payments at the end of the period

[b] $\$1{,}037{,}888 = \$79{,}317 \left(1 + a_{\overline{19}|5\%}\right)$

[c] $\$498{,}488 = \$40{,}000\ a_{\overline{20}|5\%}$

[d] $\$301{,}512 = \$2{,}000 \sum_{n=1}^{n=20} a_{\overline{n}|5\%}$

\$2,000 is the annual interest on each \$40,000 of principal, the amount coming due each year

[c] + [d] = \$800,000, the amount borrowed

[e] $\$291{,}616 = 52\%$ of $\$45{,}000\ a_{\overline{20}|5\%}$

[f] $\$37{,}689 = \$100{,}000\ (1.05)^{-20}$

Other Economic Factors

State and local taxes may be influenced by the choice of financing by lease or by borrowing. In some localities taxes are based on total assets or on total capital as shown on financial statements. To the extent that leased items are not on the financial statements, the tax would be reduced.

States which impose an income tax require that companies allocate their income to the various states in which they operate. Amount of assets or debt is a factor used by some states, and, to the extent that leased assets are not reflected among assets or debt, the decision to lease instead of to buy influences the taxes payable to the various states. Because state tax bases and rates vary, leasing may influence not only the distribution of the tax among the states but also the total tax payable by the lessee.

Whether assets are owned or leased may affect the rates a public utility will be allowed to charge. The price charged customers in turn affects the rate of return upon stockholders' equity. To determine the effect of the alternative financing methods requires computation in the individual case under the rules set forth by the rate making commission involved. Electric and gas utility companies have used leases sparingly and have generally confined their use to short-lived assets.

Cost and availability of insurance may be a factor in determining whether to lease or to buy. Where the landlord is responsible for destruction by fire, he may have a claim (which, if he carried fire insurance, would be subrogated to the insurance company) against his tenant for loss from fire due to negligence. The tenant, in order to protect himself against the consequence of such a claim, may wish to purchase liability insurance in addition to paying enough in the lease rentals to reimburse the landlord for his fire insurance premium. Many tenants are unaware of this risk, and in some cases their plight has made headlines in the daily papers. For example, in the *Chicago Journal of Commerce*, November 10, 1949, an article discussed such a loss by General Mills and stated that insurance policies to cover such losses normally were not available.

APPENDIX C

Examples of Lease Disclosure in Financial Statements

Allied Paper Corporation[1]

Note D—Long-term debt. Long-term debt at December 31, 1960, consisted of the following:

5% note payable to bank, due \$400,000 in 1961 and \$2,400,000 in 1962	\$2,800,000
6% convertible debentures, \$103,968 payable annually to 1965	519,842
Remaining purchase price of subsidiary, \$469,346 payable in 1961 and in 1962, with interest at 5%	938,693
5½% notes, \$100,000 payable in 1962 and in 1963	200,000
Remaining rentals (\$400,000 payable annually to 1966) and purchase option price (\$675,000) under lease of Bryant Mill (See Note G)	2,875,000
Other notes, \$148,272 payable in 1961 with diminishing annual amounts in subsequent years	413,460
	\$7,746,995
Less amount classified as current liability	1,521,586
	\$6,225,409

The loan agreement relating to the 5 per cent note payable to bank sets forth certain minimum requirements as to working capital and places restrictions on payment of cash dividends and purchases or redemptions of the Corporation's capital stock. After giving effect to the "spin-off" distribution described in Note B . . . , retained earnings were wholly restricted under provisions of the loan agreement.

The 6 per cent convertible debentures outstanding provide for their conversion at the option of the holders into shares of common stock of the Corporation. The conversion prices per share in effect as of December 31, 1960, increase annually from \$15 in 1961 to \$23 in 1964 with respect to \$385,257 of the debentures outstanding, and from \$17 in 1961 to \$25 in 1965 with respect to the balance.

The common stock of The Egry Register Company purchased by the Corporation, which represented approximately \$2,450,000 of consolidated net assets at December 31, 1960, has been deposited in escrow as collateral for the remaining balance of the purchase price amounting to \$938,693.

Note G — Changes in accounting practices. In 1956, the Bryant Mill was leased to the Corporation until 1969 at an annual rental of

[1] Taken from 1960 Annual Report.

$480,000 (including $80,000 amortization of prepaid rent) with an option, exercisable in 1966, to purchase the facility for $675,000. The Corporation made improvements to the Mill at a cost of $1,600,000 prior to January 1, 1960, which were treated in the accounts as capital additions.

In recognition of circumstances indicating the probability that the option to purchase the Bryant Mill will be exercised in 1966, management believes that it is more realistic and appropriate for accounting purposes to treat the transactions arising from the 1956 agreement as a purchase.

Accordingly, the payments required under the agreement for the ten-year period 1956 to 1966 ($4,800,000) plus the option price were recorded on the books as of January 1, 1960, as the cost of the Mill. Amounts remaining unpaid to 1966 ($2,200,000 at December 31, 1960) and the option price were recorded as long-term debt. These adjustments resulted in a net credit of $909,563 to retained earnings as of January 1, 1960, representing amounts previously recorded as rent expense ($1,680,000) less additional accrued depreciation ($770,437).

Certain costs incurred in 1958 ($142,106) and 1959 ($198,991) which were attributable to the Corporation's plant improvement and process development programs were considered to be applicable to subsequent years and were to be amortized generally over three-year periods beginning in 1960. However, as of January 1, 1960, the Corporation adopted the practice of charging costs of this type to income in the periods in which they are incurred, and accordingly the prior year costs were charged to retained earnings.

The above-described changes had the effect of increasing net income of the Corporation for the year ended December 31, 1960, by approximately $350,000 ($400,000 in connection with the Bryant Mill less $50,000 with respect to costs of the type referred to in the preceding paragraph).

(Ed. Note: The Bryant Mill properties discussed in Note G above are included in the Property, Plant, and Equipment section of the balance sheet without separate designation other than the reference to Note G.)

Allied Stores Corporation

[2](R) *Long-term lease commitments.* The Corporation and its subsidiaries (except Alstores Realty Corporation and subsidiaries) have real estate lease commitments with terms expiring more than three years after January 31, 1961, which call for present fixed or minimum annual rentals (exclusive of taxes and other expenses payable under the terms of some of the leases) as follows:

	Leases from Alstores		*Leases from outside interests*	
Year of lease expiration	*No. of leases*	*Minimum annual rentals*	*No. of leases*	*Minimum annual rentals*
1964	–	$ –	5	$ 63,718
1965	–	–	3	29,629
1966	–	27,000	2	50,000
1967 to 1971	2	65,000	12	293,143
1972 to 1976	3	40,000	22	735,995
1977 to 1981	14	978,426	22	1,755,647
1982 to 1986	17	1,475,700	16	379,307
1987 to 1991	19	2,099,900	15	855,316
1992 to 1996	4	1,300,000	3	25,400
1997 to 2015	13	3,145,460	12	188,300
2016 to 2059	–	–	22	687,500
	72	$9,131,486	134	$5,063,955

The number of leases above includes sixty-two conditional leases based upon percentage of sales and sixty-seven leases renewable at the option of the Corporation and its subsidiaries (except Alstores Realty Corporation and subsidiaries).

[2] Taken from Form 10K filed with the Securities and Exchange Commission, January 31, 1961.

[3](I) At January 31, 1961, the Corporation and its consolidated subsidiaries were lessees under 206 leases having terms of more than three years from that date. The rentals under these leases for the year ending January 31, 1962, amount to a minimum of $14,195,441 (of which $9,131,486 is payable to Alstores Realty Corporation and subsidiaries), plus, in most cases, real estate taxes and other expenses and, in certain instances, increased amounts based on percentage of sales. The aforementioned minimum annual rental grouped by lease expiration dates is as follows: $3,042,431 prior to 1980; $2,674,734 in 1981-1985; $3,058,116 in 1986-1990; $1,966,100 in 1991-2000; and $3,454,060 in 2001-2059.

American Airlines, Inc.[4]

Note 1. At December 31, 1961, the Company had outstanding commitments for the purchase of forty-five aircraft (scheduled for delivery during the next four years) and other equipment and modifications, totaling approximately $194 million. Of this amount, $31,302,-329 had been deposited with the manufacturers at December 31, 1961, and an estimated $30 million will be expended during 1962.

Annual rental payments under long-term leases in effect at December 31, 1961, approximate $10,900,000 for airport, office facilities and equipment and, in addition, $7,600,000 for engines. As additional facilities are completed and engines delivered, annual rentals will increase to approximately $25 million in 1963 and decrease thereafter.

[3] Taken from January 31, 1961 Annual Report
[4] Taken from 1961 Annual Report.

Boothe Leasing Corporation[5]

CONSOLIDATED BALANCE SHEETS

DECEMBER 31, 1961 AND 1960

ASSETS

	1961	1960
CASH:		
Unrestricted funds	$ 1,166,331	$ 1,402,672
Restricted funds	150,000	–
Certificates of deposit, assigned as collateral to senior secured notes payable	350,000	–
	$ 1,666,331	$ 1,402,672
U. S. TREASURY BILLS, face value $1,300,000, maturing January 18, 1962, assigned as collateral to senior secured notes payable	$ 1,297,664	$ –
CONTRACTS RECEIVABLE FOR EQUIPMENT RENTALS, due in installments to 1976 ($33,558,861 in 1961 and $27,536,095 in 1960 assigned as collateral to notes payable—Note 4):		
Total amounts receivable	$43,160,752	$31,320,516
Less—		
Unearned rental income (Note 3)	(11,431,937)	(8,609,984)
Allowance for possible losses	(217,315)	(156,602)
	$31,511,500	$22,553,930
PURCHASES OF EQUIPMENT ON RENTAL CONTRACTS IN PROCESS (Note 6)	$ 1,136,244	$ 926,830
RENTAL EQUIPMENT, at estimated residual values (Note 6)	$ 6,064,083	$ 6,089,667
OTHER ASSETS:		
Deferred loan costs, in process of amortization over the lives of related loans	$ 354,107	$ 208,734
Office furniture and fixtures, and leasehold improvements—at cost less accumulated depreciation and amortization of $44,718 in 1961 and $25,209 in 1960	139,630	82,262
Prepayments, deposits and other assets	136,636	113,270
	$ 630,373	$ 404,266
	$42,306,195	$31,377,365

[5] Taken from 1961 Annual Report.

Boothe Leasing Corporation

CONSOLIDATED BALANCE SHEETS

DECEMBER 31, 1961 AND 1960

LIABILITIES

	1961	1960
ACCOUNTS PAYABLE AND ACCRUED LIABILITIES	$ 1,308,976	$ 316,541
ACCRUED FEDERAL INCOME TAXES (Note 3):		
Current portion	150,000	28,846
Deferred portion	1,144,074	852,000
UNSECURED NOTES PAYABLE, representing interim financing of rental equipment (Note 4)	6,765,000	2,000,000
INSTALLMENT NOTES PAYABLE, secured by assignment of contracts receivable for equipment rentals and mortgages of certain rental equipment (Note 4)	12,236,443	19,635,593
SENIOR SECURED NOTES PAYABLE, secured by assignment of contracts receivable for equipment rentals, U. S. Treasury Bills and certificates of deposit—		
Due in quarterly installments beginning July 1, 1965	1,000,000	–
Due in semiannual installments beginning October 1, 1966	10,000,000	–
LEASE RENTAL DEPOSITS	1,463,108	984,932
6% SUBORDINATED NOTES, due April 30, 1969 (Note 5)	3,500,000	3,500,000
Total liabilities	$37,567,601	$27,317,912
CAPITAL STOCK AND SURPLUS:		
Common stock, no par value (Notes 2 and 5)— Authorized—750,000 shares Issued and outstanding—354,671 shares in 1961 and 347,671 shares in 1960	$ 3,338,307	$ 3,086,307
Earned surplus	1,400,287	973,146
Total capital stock and surplus	$ 4,738,594	$ 4,059,453
	$42,306,195	$31,377,365

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Boothe Leasing Corporation

STATEMENT OF CONSOLIDATED INCOME

For the Years Ended December 31, 1961 and 1960

	1961	1960
INCOME:		
Rental income earned (Note 3)	$3,598,123	$2,752,732
Other income	96,023	39,275
	$3,694,146	$2,792,007
EXPENSES:		
Interest	$1,877,501	$1,421,510
General and administrative expenses	949,504	780,420
	$2,827,005	$2,201,930
Net income before provision for Federal income taxes	$ 867,141	$ 590,077
PROVISION FOR FEDERAL INCOME TAXES (Note 3):		
Current portion	$ 150,000	$ 27,000
Deferred portion	290,000	275,000
	$ 440,000	$ 302,000
Net income for the year	$ 427,141	$ 288,077

Notes to Consolidated Financial Statements

(3) *Accounting for leases.* Under the company's method of accounting for lease rental income, unearned rentals (representing the difference between total rentals receivable under lease contracts and the cost of related rental equipment less estimated residual values) are taken into income each month as earned on the sum-of-the-months-digits basis. This method has the effect of recording earned rental income on a declining basis over the life of the lease in proportion to rental installments outstanding.

For Federal income tax purposes lease rental payments are taxable in the year received, and the amortization of rental equipment for tax purposes is related to the rentals reported. In addition, there are certain other differences between book and tax accounting, with the result that book income to December 31, 1961, has exceeded taxable income. Federal income taxes applicable to this excess amounted to $1,144,074 to December 31, 1961; these taxes will be payable in subsequent years when this income is reported for tax purposes.

(4) *Contracts receivable and installment notes payable.* Total contracts receivable at December 31, 1961, amounting to $43,160,752, are due in installments to 1976; the amount due within one year from December 31, 1961, is approximately $10,800,000.

Total installment notes payable at December 31, 1961, amounted to $12,236,443; of this amount approximately $4,200,000 is due within one year. The unsecured notes payable of $6,765,000 representing interim financing of rental equipment are also due within one year; however, it is intended that these notes will be converted to term obligations.

(5) *6 per cent subordinated notes.* The 6 per cent subordinated notes payable are subordinated to all secured indebtedness and unsecured current indebtedness of the company. The related note agreements provide certain limitations on incurring additional subordinated debt and restrict the purchase or redemption of the company's capital stock.

In connection with the issuance of the 6 per cent subordinated notes, the company issued registered warrants which entitled the noteholders to subscribe to a maximum of 20,000 shares of the company's common stock, in proportion to the face amount of the notes held, at the prices per share and within the periods stated below:

On or before March 1, 1963	$36
March 2, 1963 to March 1, 1966, inclusive	39
March 2, 1966 to April 30, 1969, inclusive	42

During the year 1961, warrants were exercised with respect to 7,000 shares. The company has reserved 13,000 shares of its authorized common stock for issuance upon the exercise of the balance of the warrants.

(6) *Cost of rental equipment.* The cost of rental equipment at December 31, 1961, amounted to $54,035,775. In addition, at December 31, 1961, the company had commitments for the purchase of rental equipment having a cost of approximately $12,200,000, including equipment on rental contracts in process at that date.

The Borden Co.[6]

Depreciation and rentals. Provision for depreciation charged to operations was $17,448,830 for 1961 and $15,494,438 for 1960. Rentals amounted to approximately $12,100,000 for 1961, of which $9,300,000 was related to long-term leases.

Comptometer Corporation[7]

(4) Long-term leases. Substantially all of the land and buildings of the company and subsidiaries, and a major part of the machinery and equipment in the Chicago plant, are held under long-term leases which expire at various dates from 1964 to 1979. Total annual rentals under these leases are approximately $300,000 and the remaining lease commitments as of December 31, 1960, are approximately $4,150,000.

Certain of these leases cover properties originally owned by the company which were sold and leased back. The excess of net sales prices over the company's undepreciated cost of the properties sold in these transactions has been deferred, and is being amortized over fifteen years, the period of the leases.

Operations have been substantially discontinued at one of the Chicago plants of the company which is leased under a sale and leaseback agreement. The company has the right to repurchase the leased land, buildings and equipment at this Chicago plant for approximately $1,100,000. In the opinion of management, the cost of canceling the lease and repurchasing the plant and equipment, or the future rental payable if not repurchased, net of the deferred credit on the sale and leaseback, will be recovered by future sale or other utilization of the property.

In connection with the sale of the net assets of Comptometer Limited (Great Britain), the company is required to repurchase the land and buildings formerly occupied by Comptometer Limited (Great Britain) under a sale and leaseback agreement on or before May 31, 1961, for approximately $200,000. The property is leased to the purchasers of the net assets of Comptometer Limited (Great Britain) at a net rental sufficient to recover the repurchase price and interest costs over the term of the lease.

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[6] Taken from 1961 Annual Report.

[7] Taken from 1960 Annual Report.

Continental Air Lines, Inc.[8]

1. Long-term debt	*Long-term portion at December 31* 1960	1959
Note payable to bank, 5½%, secured by flight equipment, payable in quarterly installments of $1,275,000. Final payment due September 30, 1965 (Note A)	$19,125,000	$ —
Notes payable to insurance companies and other institutional lenders, 6½%, secured by flight equipment, payable in varying semiannual installments from June 30, 1964, to December 31, 1972 (Note A)	12,500,000	—
Notes payable, 6½% and 7%, subordinated, principal due in amounts equal to two-thirds of the Company's annual net earnings, before special item	2,996,490	—
Long-term debt at December 31, 1959, retired with proceeds from refinancing in September, 1960	—	27,672,900
Notes payable, 5% subordinated, due June 1, 1962	1,000,000	1,000,000
4¾% convertible subordinated debentures due November 1, 1970. Convertible into common stock at $7.96, on which basis 398,241 shares of common stock were reserved at December 31, 1959 (Note B)	3,170,000	3,220,000
5¾% convertible subordinated debentures due June 1, 1973. Convertible into common stock at $6.50, on which basis 948,307 shares of common stock were reserved at December 31, 1960 (Note C)	6,164,000	6,176,000
Other obligations (Note D)	1,204,616	1,549,911
	$46,160,106	$39,618,811

[8] Taken from 1960 Annual Report.

Note A. The loan agreement relating to bank and institutional loans provides, among other things, that (1) working capital (as defined) shall currently be maintained at the greater of $8 million or 19 per cent of operating expenses (exclusive of depreciation and amortization) for the twelve months ending one month prior to the balance-sheet date; (2) the lending bank will hold as cash collateral proceeds of $2,550,000 from the sale of two aircraft; (3) net worth, plus outstanding convertible debentures and subordinated indebtedness, will be maintained at not less than $27 million; and (4) dividends will not be declared or paid (other than in stock of the company) or stock purchased or redeemed, except out of 75 per cent of net earnings before special item subsequent to December 31, 1959, such 75 per cent to be calculated after deducting from net earnings amounts required to be paid on the 6½ per cent and 7 per cent subordinated notes, and after deduction from the 75 per cent of net earnings thus calculated the payments required pursuant to Notes B and C below. Under the foregoing provision relating to dividends, retained earnings at December 31, 1960, are restricted to the extent of $6,746,906. Provisions of the other long-term debt agreements are less restrictive.

Note B. The Company is required to purchase $100,000 face amount of debentures during each of the five years beginning June 1, 1960, at a cost not to exceed the initial offering price. Payments of $300,000 annually into a sinking fund are required beginning October 31, 1964.

Note C. Payments of $1 million annually into a sinking fund are required beginning May 31, 1967.

Note D. Under terms of a sale and leaseback agreement executed in 1958, the Company sold its maintenance base, located on leased ground at the Los Angeles airport, for $750,000 and leased back the buildings at $12,450 a month for eighty-four months, with an option to repurchase at the end of the term for $20,000. The Company considers this to be essentially a loan arrangement and is so treating it in its accounts. An amount of $430,959 is included in "other obligations," above, as the long-term portion of the unpaid obligation.

Also included in "other obligations" above are amounts relating to certain fueling and other ground equipment being acquired under lease-purchase agreements or conditional sales contracts in the amount of $666,595, and a mortgage note payable secured by office building and land in the amount of $107,062.

Fairbanks Whitney Corporation and Subsidiaries[9]

CONSOLIDATED BALANCE SHEET DECEMBER 31, 1960 AND 1959

ASSETS

		1960	*1959*
Current assets:			
Cash		$ 12,037,665	$ 14,400,609
Government securities, at cost		179,586	1,182,516
Receivables, less reserve of $551,331 and $535,755, respectively		28,053,149	24,825,856
Inventories, at lower of cost (first-in-first-out basis) or market—			
Raw materials and supplies		8,491,477	9,415,445
Work in process and finished parts		35,928,147	37,329,683
Finished goods		7,917,651	10,164,379
Total inventories		$ 52,337,275	$ 56,909,507
Prepaid expenses		1,330,354	1,077,880
Total current assets		$ 93,938,029	$ 98,396,368
Property, plant and equipment, at cost		$ 91,301,072	$ 91,144,470
Less—Reserves for depreciation, depletion and amortization		47,250,548	45,459,699
		$44,050,524	$45,684,771
Rights to use of leased facilities, at December 31, 1960, at discounted amount of related long-term rental obligations—see contra	$12,700,000		
Other assets:			
Mortgages and notes receivable		$ 2,729,248	$ 2,879,411
Investments in joint ventures		1,509,278	830,620
Government securities, pledged as security		125,972	340,608
Debt discount and other deferred charges		840,901	835,236
		$ 5,205,399	$ 4,885,875
		$143,193,952	$148,967,014

The accompanying notes to the financial statements are an integral part of this statement.

[9] Taken from 1960 Annual Report.

Fairbanks Whitney

LIABILITIES

Current liabilities:	1960	1959
Loans payable, less $400,000 cash collateral, secured by 40,000 shares of Fairbanks, Morse & Co. common stock, and notes payable	$ 7,015,817	$ 2,900,000
Accounts payable	8,728,974	8,129,375
Accrued expenses	6,245,465	7,205,825
Current maturities of long-term debt	2,125,999	2,184,200
Reserve for Federal and foreign income taxes	2,599,667	3,284,212
Total current liabilities	$ 26,715,922	$ 23,703,612
Reserves and deferred credits:		
Deferred Federal income taxes	$ 2,050,120	$ 1,755,144
Reserves for losses on long-term leases, etc.	4,795,087	5,461,307
Minority interest in subsidiary companies	7,905,795	8,688,779
	$ 14,751,002	$ 15,905,230
Long-term debt, excluding amounts due within one year (Note 2)	$ 31,793,125	$ 39,115,480
Rental obligations under long-term leases, at December 31, 1960, discounted over period of leases, (including $808,000 due within one year) see contra $12,700,000		
Capital stock (Notes 3 and 4) and surplus (Note 1):		
Cumulative preferred stock, par value $40 per share, authorized 369,672 shares, outstanding 369,372 shares, after deducting 300 shares in treasury, at December 31, 1960	$ 14,774,880	$ 14,787,040
Common stock, par value $1 per share, authorized 10,000,000 shares, outstanding 7,436,608 shares, after deducting 178,009 shares in treasury, at December 31, 1960	7,436,608	7,436,602
Capital surplus	47,683,225	66,312,468
Earned surplus (deficit)	39,190	(18,293,418)
	$ 69,933,903	$ 70,242,692
	$143,193,952	$148,967,014

(2) Long-term debt. Long-term debt at December 31, 1960, consisted of the following:

Twenty-year 2.75% sinking fund debentures of Fairbanks, Morse & Co. due May 1, 1967 ($500,000 minimum annual sinking fund payment)	$10,013,000
Fifteen-year 5.75% convertible subordinated debentures of Fairbanks, Morse & Co. due June 1, 1972 ($770,000 annual sinking fund payment)	12,690,000
4¾% notes payable to bank due in quarterly installments to April 30, 1964, secured by the outstanding common stock of Pratt & Whitney Company, Incorporated and Fairbanks Hartford Corp. and Subsidiary and 881,180 shares of Fairbanks, Morse & Co. common stock	4,726,000
6% purchase money first mortgage, due serially to December 18, 1972, secured by land and buildings of Pratt & Whitney Company, Incorporated	2,753,566
5% second mortgage bonds, due serially to May 18, 1986, secured by land and buildings of Pratt & Whitney Company, Incorporated	1,610,559
	$31,793,125

The agreement in connection with the notes payable to bank provides among other things that (1) consolidated working capital, as defined, shall not be less than $63 million and current assets shall not be less than 200 per cent of current liabilities, and (2) common stock dividends shall be limited to 70 per cent of consolidated net income since April 1, 1959, after payment of dividends on preferred stock. The Company was in compliance with these requirements during 1960.

Fruehauf Trailer Company and Consolidated Subsidiaries[10]

Note D — Long-term debt and restrictions on dividends on common stock. Long-term debt is summarized below:

	December 31 1960	December 31 1959
Amounts payable to Fruehauf Trailer Finance Company, less prepaid finance charges—secured by pledge of leased trailer rentals	$ 5,910,337	$ 4,242,395
3¾% Sinking Fund Debentures due June 1, 1974; redemption price to May 31, 1961, 103%, decreasing ¼ of 1% each year thereafter; annual sinking fund requirements of $1 million (no sinking fund payments required until 1963)	15,298,000	17,592,000
4% Sinking Fund Debentures due March 1, 1976; redemption price to February 28, 1962, 103¼%, decreasing ¼ of 1% each year thereafter; annual sinking fund requirements of $500,000 (no sinking fund payments required until 1967)	6,508,000	9,902,000
5¼% Sinking Fund Debentures, Series "A," of Fruehauf Trailer Company of Canada Limited due November 1, 1976, redemption price to November 1, 1961, 104%, decreasing ¼ of 1% each year thereafter; annual sinking fund requirements of $150,000 (1961 requirements included in current liabilities)	2,900,000	3,050,000
4% Convertible Subordinated Debentures due March 1, 1976; redemption price to February 28, 1962, 104½%, decreasing ¼ of 1% each year to February 28, 1965, and ⅜ of 1% each year thereafter; presently convertible into common stock at $26.24 a share; no sinking fund payments required until 1971	26,955,000	27,312,000
TOTAL	$57,571,337	$62,098,395

The indentures relating to the Sinking Fund Debentures and Convertible Subordinated Debentures and also the terms of the outstanding Preferred Stock, among other covenants, impose certain restrictions on the declaration or payment of cash dividends on common stock and purchase of shares of such stock. All of the earnings retained for use in the business at December 31, 1960, were free from these restrictions.

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[10] Taken from 1960 Annual Report.

Note E — Long-term leases. Fruehauf Trailer Company or Fruehauf Trailer Company of Canada Limited are lessees under sixty-seven long-term lease agreements expiring three years to twenty-seven years from December 31, 1960. Annual rental requirements of such leases will amount to approximately $1,425,000 in 1961, exclusive of taxes, insurance, maintenance, and repairs which are also payable by the companies.

Under the terms of forty-eight of the lease agreements, the companies have the right to purchase the properties after certain specified periods (generally five years from the date of the lease). The rental payments and purchase prices in most cases decline gradually over the terms of these leases. If all of the rights to purchase were presently exercisable, the aggregate purchase price would amount to approximately $10,450,000.

The Great Atlantic & Pacific Company, Inc. and Subsidiary Companies[11]

CONSOLIDATED BALANCE SHEET FEBRUARY 27, 1960 AND FEBRUARY 28, 1959

ASSETS

	February 27, 1960	*February 28, 1959*
CURRENT ASSETS:		
Cash	$159,596,563	$148,222,605
United States and Canadian Government obligations—at cost	15,941,969	36,733,451
Accounts receivable	10,161,318	10,089,205
Merchandise and supplies (at the lower of cost or market)	287,338,634	272,124,240
Total current assets	473,038,484	467,169,501
PROPERTY, EQUIPMENT, AND FIXTURES:		
Land, at cost	1,900,021	916,699
Buildings, at cost less accumulated depreciation—1960, $6,220,685; 1959, $6,091,624	2,256,908	2,448,691
Equipment, at cost less accumulated depreciation—1960, $99,740,267; 1959, $91,055,608	137,364,847	125,022,733
Store fixtures, at amortized cost	46,338,947	39,419,061
Property, equipment, and fixtures—net	187,860,723	167,807,184
DEFERRED CHARGES	13,717,803	12,211,679
TOTAL	$674,617,010	$647,188,364

[11] Taken from February 27, 1960 Annual Report.

Notes to Financial Statements of Great Atlantic and Pacific Tea Company

1. The activities of the companies are conducted in leased premises, except for a few manufacturing and warehousing operations. The leases are for varying periods (generally for three to ten years), renewable in most instances at the option of the companies. At February 27, 1960, the companies were lessees under approximately 4,600 leases (exclusive of premises where operations had not commenced), with an annual rental of approximately $56,500,000.

(continued on page 114)

The Great Atlantic and Pacific Tea Company, Inc. and Subsidiary Companies

CONSOLIDATED BALANCE SHEET
FEBRUARY 27, 1960 AND FEBRUARY 28, 1959

LIABILITIES

	February 27, 1960	*February 28, 1959*
CURRENT LIABILITIES:		
Accounts payable	$149,266,224	$135,910,886
Accrued accounts:		
United States and Canadian income taxes	32,536,319	53,154,671
Other taxes, salaries, etc.	33,836,541	32,453,063
Total current liabilities	215,639,084	221,518,620
RESERVES FOR SELF-INSURANCE, ETC.	5,547,882	5,845,549
CAPITAL STOCK AND SURPLUS:		
Common stock—$1 par value; authorized 28,000,000 shares; issued 1960, 22,284,983 shares; 1959, 21,635,906 shares	22,284,983	21,635,906
Capital surplus	273,924,978	250,000,000
Earned surplus	157,220,083	148,188,289
Total capital stock and surplus	453,430,044	419,824,195
TOTAL	$674,617,010	$647,188,364

Since February 27, 1960, the companies' modernization program has involved the customary substantial expenditure, made or to be made, for new store leases, equipment, and inventories.

2. Under the terms of a group annuity contract to provide non-contributory retirement benefits to eligible employees, contributions by the companies, including amounts for past service benefits, were $18,657,400 and $21,112,338 for the period ended February 27, 1960, and February 28, 1959, respectively. The estimated remaining past service contributions under the plan amounted to approximately $23,240,000 at February 27, 1960.

3. Cost and expenses include depreciation and amortization of $31,-800,832 and $28,655,799 for the period ended February 27, 1960, and February 28, 1959, respectively.

H. J. Heinz Company[12]

(2) Long-term notes. Details of long-term notes at April 27, 1960, are as follows:

	Interest per cent	*Maturity (fiscal year)*	*Portion Due* Noncurrent	*Portion Due* Current
Company:				
Promissory notes	2.90	1961-69	$ 9,750,000	$ 930,000
Serial notes	3½	1961-62	200,000	200,000
Promissory notes	4⅞	1965-84	20,000,000	—
Subsidiaries:				
Promissory notes (Australia)	4¼	1961-76	8,201,211	171,167
Debentures (British Isles)	6	1965-84	5,640,000	—
Debentures (British Isles)	5½	1966-85	2,810,000	—
Installment note (Holland)	2	1961-68	790,450	127,440
			$47,391,661	$ 1,428,607

Under note agreements, dated April 1, 1959, providing for the issue of $20 million of 4⅞ per cent twenty-five-year notes due April 1, 1984, fixed annual prepayments of principal of $1 million are

[12] Taken from April 27, 1960 Annual Report.

required to be made commencing April 1, 1965. Additional prepayments may be made at the option of the Company at specified premium rates or, under specified conditions, at no premium. In addition to restrictions relating to additional indebtedness, mortgages and liens, purchase and redemption of capital stock and other restrictions, the note agreements contain provisions against the payment of dividends by the Company upon its common stock (otherwise than in its own capital stock) if such dividends, together with purchases, payments to the sinking fund and dividends in respect of presently authorized cumulative preferred stock and amounts expended by the Company or any subsidiary for purchase or other acquisitions of any class of the Company's stock, since October 29, 1958, would exceed consolidated net income after October 29, 1958, plus the sum of $7,500,000 and, further, if the sum of consolidated funded debt and consolidated discounted lease rentals would exceed 50 per cent of consolidated capital and surplus after giving effect to such dividend payments. The portion of consolidated earned surplus at April 27, 1960, which was not thereby restricted was $19,082,927.

The 2.90 per cent notes, dated February 24, 1949, also contain various restrictions which are more than covered by the provisions of the 4⅞ per cent twenty-five-year notes.

The 6 per cent debentures, issued by the subsidiary located in the British Isles, contain provisions requiring annual sinking fund payments, commencing January 31, 1965, approximating $76,700 plus interest for one year. Prepayment of the entire indebtedness, or a portion thereof, may be made on January 31, 1975, with a 3½ per cent premium and at decreasing premium rates thereafter.

The 5½ per cent debentures, issued by the subsidiary located in the British Isles, contain provisions requiring annual sinking fund payments, commencing January 31, 1966, approximating $80,600 plus interest for one year. Prepayment of the entire indebtedness, or a portion thereof, may be made on January 31, 1976, with a 3½ per cent premium and at decreasing premium rates thereafter.

The Hertz Corporation and Subsidiaries[13]

CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 1961 AND 1960

ASSETS

	1961	*1960*
CURRENT ASSETS:		
Cash	$ 12,473,874	$ 7,879,257
Receivables, less reserve	13,248,732	13,274,375
Inventories, at cost or less	5,198,669	4,880,273
Prepayments and other assets	2,164,111	2,004,511
	$ 33,085,386	$ 28,038,416
REVENUE EARNING ASSETS, AT COST:		
Vehicles	$158,432,272	$147,628,191
Less—Reserve for depreciation	49,329,332	46,294,118
	$109,102,940	$101,334,073
Other equipment	$ 3,593,034	$ 642,426
Less—Reserve for depreciation	458,201	98,249
	$ 3,134,833	$ 544,177
	$112,237,773	$101,878,250
INVESTMENTS, AT COST:		
Subsidiaries not consolidated	$ 5,221,449	$ 5,221,449
Subordinated debenture of Gray Line Motor Tours, Inc., due September 1, 1966	587,967	650,500
	$ 5,809,416	$ 5,871,949
PROPERTY, EQUIPMENT AND INTANGIBLES, AT COST:		
Land, buildings and leaseholds	$ 7,053,327	$ 6,333,300
Service equipment	5,611,785	4,927,501
	$ 12,665,112	$ 11,260,801
Less—Reserve for depreciation	2,936,230	2,596,663
	$ 9,728,882	$ 8,664,138
Franchises and concessions, being amortized	2,503,379	2,364,112
Contract costs, being amortized	1,528,857	1,733,376
	$ 13,761,118	$ 12,761,626
	$164,893,693	$148,550,241

[13] Taken from 1961 Annual Report.

The Hertz Corporation and Subsidiaries

CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 1961 AND 1960

LIABILITIES

	1961	1960
CURRENT LIABILITIES:		
Accounts payable	$ 8,605,821	$ 9,054,543
Accrued liabilities	2,497,587	3,383,830
Dividend payable	1,038,602	1,034,642
Accrued taxes	4,551,787	5,230,218
Total	$ 16,693,797	$ 18,703,233
Vehicle equipment notes, due within one year	—	7,548,135
Other equipment notes, due within one year	925,706	111,884
Total—including equipment notes due within one year	$ 17,619,503	$ 26,363,252
LONG-TERM DEBT:		
Revolving credit notes	$ 51,000,000	$ 59,150,000
Promissory notes, due December 1, 1981 (prepayment requirements begin in 1972)	40,000,000	—
Vehicle equipment notes, due after one year	—	12,585,550
Other equipment notes, due after one year	2,507,484	265,147
Convertible subordinated note, due June 1, 1972 (convertible into 192,455 shares of common stock)	5,000,000	5,000,000
Convertible subordinated debentures, due July 1, 1970 (convertible into 12,960 and 20,333 shares, respectively, of common stock)	221,500	347,500
	$ 98,728,984	$ 77,348,197
RESERVES:		
Deferred Federal income taxes	$ 3,300,000	$ 3,000,000
Federal income taxes for years prior to 1959	5,200,000	5,200,000
Public liability and property damage	3,586,111	2,738,561
Other	816,333	510,592
	$ 12,902,444	$ 11,449,153
SHAREHOLDERS' EQUITY:		
Common stock of The Hertz Corporation—authorized 7,000,000 shares of $1 par value each—outstanding 3,462,043 and 3,448,805 shares, respectively	$ 3,541,686	$ 3,728,957
Additional capital paid in	21,390,838	21,055,912
Earnings retained in the business	10,710,238	8,604,770
Total shareholders' equity	$ 35,642,762	$ 33,389,639
	$164,893,693	$148,550,241

The Hertz Corporation and Subsidiaries

STATEMENTS OF CONSOLIDATED INCOME

Years Ended December 31, 1961 and 1960

	1961	*1960*
OPERATING REVENUES:		
Rent a car	$ 64,885,785	$ 59,437,578
Truck leasing	57,931,244	54,170,499
Car leasing	12,855,354	10,900,089
Other	2,353,631	1,426,621
Total	$138,026,014	$125,934,787
OPERATING EXPENSES:		
Direct operating costs	$ 73,471,989	$ 66,172,182
Depreciation of revenue earning assets	32,615,944	29,723,244
Administrative and selling	15,394,750	14,023,266
Total	$121,482,683	$109,918,692
Net income from operations	$ 16,543,331	$ 16,016,095
OTHER INCOME:		
Profit from sale of vehicles	$ 1,392,902	$ 840,478
Miscellaneous	32,706	103,029
Total	$ 1,425,608	$ 943,507
Gross income	$ 17,968,939	$ 16,959,602
OTHER DEDUCTIONS:		
Interest	$ 4,932,083	$ 4,124,697
Miscellaneous	551,339	428,000
Total	$ 5,483,422	$ 4,552,697
Net income before Federal income tax	$ 12,485,517	$ 12,406,905
PROVISION FOR FEDERAL INCOME TAX	6,230,000	6,198,500
Net income	$ 6,255,517	$ 6,208,405
ADD—Profit from sale of investment in common stock of Gray Line Motor Tours, Inc., less Federal income tax thereon		424,500
Net income including profit from sale of investment		$ 6,632,905

The notes and the statement of consolidated surplus are not reproduced as no items specifically relating to lease presentation are included.

Gimbel Bros. Inc.[14]

6. The Company and its subsidiaries had thirty-four leases in effect at January 31, 1961, for terms of more than three years including renewal privileges. These provide for present aggregate minimum annual rentals of about $2,500,000 plus real estate taxes (these amounts are included with taxes) and, in certain instances, other expenses and additional amounts based on percentages of sales. All long-term leases which have annual rentals in excess of $100,000 each expire between 1966 and 1987 and all but one have renewal privileges.

S. H. Kress & Co.[15]

Note 3. During the year the Company sold for cash three store properties. The amount received, after providing for applicable Federal taxes on income, exceeded the carrying value of the properties by $1,132,137. The properties were concurrently leased back for initial periods of twenty-five years with renewal options for an additional fifty years. During the initial period the aggregate rental for the three properties is $135,720 per year and, in addition, the Company is required to pay real estate taxes, insurance and certain other charges.

At December 31, 1959, the Company was obligated under one hundred thirty-seven leases (including the three referred to above) for real property expiring after December 31, 1962, some of which require, in addition to minimum rentals, payment of additional rentals based on sales and payments of real estate taxes, insurance and other charges. The minimum rentals payable under these leases amount to $1,928,000 per annum.

[14] Taken from January 31, 1961 Annual Report.
[15] Taken from 1959 Annual Report.

Libby, McNeill & Libby[16]

7. *Long-term lease commitments, etc.* The annual rentals on properties operated by the Company under long-term leases amount to approximately $1,288,000. These annual rentals include amounts applicable to certain citrus groves leased by the Company, the purchase of which was financed by the lessor principally by bonds, of which $3,334,848 were outstanding at July 1, 1961. The Company owns $591,154 of these bonds and has guaranteed payment of principal and interest on an additional $1,833,218 of bonds. The Company has an option to purchase the groves on June 1 of any year at a price equal to the lessor's then unamortized cost of the property. The Company has also guaranteed $1,057,000 of short-term bank borrowings of a supplier.

Loblaw Groceterias Co., Ltd.[17]

5. The aggregate minimum rentals (exclusive of taxes, insurance and other occupancy charges to be paid by the company and its subsidiaries) under long-term leases (extending beyond five years from balance-sheet date) in effect at June 3, 1961, for each of the periods shown, are as follows:

1962-1966	$ 56,369,652	1977-1981	$ 24,730,855
1967-1971	49,992,115	1982-1986	14,011,557
1972-1976	36,035,079	After 1986	5,052,507
Total minimum rental liability			$186,191,765

During the year certain assets were sold for an aggregate consideration of $1,505,755 and long-term leases were entered into with respect to the same assets.

[16] Taken from July 1, 1961 Annual Report.
[17] Taken from June 3, 1961 Annual Report.

6. The real estate carrying charge reserve originates from the excess of sale price over depreciated cost of certain properties sold and is being amortized over the periods of long-term leases entered into by the companies on the respective properties. Additions of $309,888 were credited to the reserve during the year and amortization charges amounted to $878,272.

Lockheed Aircraft Corp.[18]

Note 8. Rent commitments under various long-term leases require annual payments excluding property taxes and insurance of from $5,700,000 to $3,200,000 through 1971 and from $2,200,000 to $1,100,-000 for the years 1972 to 1981.

Melville Shoe Corporation[19]

8. At December 31, 1960, the total minimum annual rentals, payable under leases expiring after five years, was approximately $5,612,000. Leases covering about 80 per cent of this amount expire on various dates within the next sixteen years.

During the year 1960, store properties having a cost of approximately $4,706,000 were sold at a profit of approximately $124,000 (after taxes) and leased back on a long-term basis, with options to renew. The minimum annual rentals under these leases are included in the information in the paragraph above.

[18] Taken from 1961 Annual Report.
[19] Taken from 1960 Annual Report.

Mohasco Industries, Inc. and Domestic Subsidiaries[20]

COMPARATIVE CONSOLIDATED BALANCE SHEET

ASSETS

	December 31 1958	December 31 1957
Current assets:		
Cash	$ 4,453,630	$ 4,816,445
Accounts and notes receivable, less allowances for discounts and doubtful accounts:		
Trade	12,364,622	11,110,451
Other	759,448	542,572
Inventories of raw materials, work in process, finished goods and supplies (Note 2)	28,373,141	35,003,620
Prepaid expenses and deferred charges	624,241	1,076,451
Total current assets	$46,575,082	$52,549,539
Mortgage and other notes receivable, noncurrent:		
Secured by properties in Amsterdam (Note 4)	$ 7,877,389	$ —
Other	3,060,797	2,897,564
Total mortgage and other notes receivable, noncurrent	$10,938,186	$ 2,897,564
Investments and advances, at cost:		
Foreign subsidiary (wholly owned) (Note 1)	$ 682,946	$ 905,613
Bonds on deposit with New York State	232,000	424,800
Total investments and advances	$ 914,946	$ 1,330,413
Operating property, plant and equipment (Notes 3 and 4)	$57,292,408	$63,621,607
Less accumulated depreciation and amortization	24,632,574	27,888,560
Operating property, plant and equipment—net	$32,659,834	$35,733,047
Nonoperating property, plant and equipment, at cost	—	$ 3,350,230
Less accumulated depreciation	—	2,317,125
Nonoperating property, plant and equipment—net	—	$ 1,033,105
	$91,088,048	$93,543,668

See accompanying notes to consolidated financial statements.

[20] Taken from 1958 Annual Report.

Mohasco Industries, Inc. and Domestic Subsidiaries

COMPARATIVE CONSOLIDATED BALANCE SHEET

LIABILITIES

	December 31 1958	1957
Current liabilities:		
Notes payable—banks	$ —	$13,000,000
Long-term debt due within one year (Note 5)	1,832,695	1,357,307
Accounts payable	3,969,619	4,233,656
Accrued expenses	3,299,221	2,127,084
Total current liabilities	$ 9,101,535	$20,718,047
Long-term debt due after one year (Note 5):		
4% notes payable due in 1966	$ 4,666,664	$ 5,333,331
4% notes payable due in 1970	9,400,000	10,550,000
4½% mortgage notes payable	517,265	1,138,487
Total long-term debt	$14,583,929	$17,021,818
Other noncurrent liabilities:		
Long-term rentals on Amsterdam properties (Note 4)	$ 6,601,545	$ —
Estimated liability under pension plans	1,408,980	1,683,432
Other liabilities and deferred credits	251,397	501,013
Total other noncurrent liabilities	$ 8,261,922	$ 2,184,445
Shareowners' equity:		
Capital stock:		
Cumulative preferred, par value $100 per share (Note 6):		
3½% series, 38,748 shares (42,098 in 1957) authorized and issued, less 800 shares (1,840 in 1957) in treasury	$ 3,794,800	$ 4,025,800
4.20% series, 41,790 shares (44,590 in 1957) authorized and issued, less 1,750 shares (1,550 in 1957) in treasury	4,004,000	4,304,000
Common, par value $5 per share, authorized 3,500,000 shares; issued and outstanding 3,066,925 shares (Note 8)	15,334,625	15,344,625
Capital surplus, per accompanying statement	3,629,518	3,477,174
Earned surplus, per accompanying statement (Note 5)	32,377,719	26,477,759
Total shareowners' equity	$59,140,662	$53,619,358
	$91,088,048	$93,543,668

Mohasco Industries

COMPARATIVE STATEMENT OF CONSOLIDATED INCOME

	Years ended December 31	
	1958	*1957*
Net sales	$89,698,979	79,745,593
Cost of sales (Note 2)	69,693,763	$98,349,521
Gross profit on sales	$20,005,216	$18,603,928
Selling, general and administrative expenses	13,880,938	14,811,941
Operating income	$ 6,124,278	$ 3,791,987
Interest on borrowings	1,069,443	1,545,583
	$ 5,054,835	$ 2,246,404
Other income—net:		
Interest and royalties	$ 1,024,181	$ 638,007
Gain on disposal of property, plant and equipment	1,164	310,113
Other	71,660	71,554
	$ 1,097,005	$ 1,019,674
Net income before special items (Note 7)	$ 6,151,840	$ 3,266,078
Special credit—gain on sale of Amsterdam properties (Notes 4 and 7)	8,450,923	—
	$14,602,763	$ 3,266,078
Special charge—provision for long-term rentals on Amsterdam properties (Note 4)	6,990,000	—
Net income after special items	$ 7,612,763	$ 3,266,078

Provision for depreciation and amortization charged to income amounted to $2,484,928 in 1958 and $2,570,174 in 1957.

See accompanying notes to consolidated financial statements.

4. *Sale and lease of Amsterdam properties.* In December 1958, certain land and buildings in Amsterdam, New York, owned by a subsidiary, Greenville Mills, Inc., were sold for cash of $2,500,000 and a 5 per cent purchase money mortgage receivable of $8 million and thereupon these properties were leased to Mohasco Industries, Inc. The gain on this sale, $8,450,923 net of applicable state taxes and expenses (no Federal income taxes payable, see Note 7), is included as a special item in the statement of income. The mortgage receivable and interest thereon are due in equal quarterly installments of $130,084 from April 1, 1959, to October 1, 1966, and $219,282

thereafter to October 1, 1976, which sums are to be applied first to interest and the balance to principal.

The liability for rentals due over the term of the lease, net of the estimated future tax effect, has been provided by a special charge in the statement of income.

9. *Commitments under leases.* At December 31, 1958, the company was committed to annual net rentals under leases expiring after December 31, 1961, including those due under the lease of the Amsterdam properties described in Note 4, of $1,146,000.

Montgomery Ward & Co., Inc.

[21]4. The Company had 667 leases in effect at February 1, 1961, having terms of more than three years after that date. These leases provided for present aggregate minimum annual rentals of approximately $11,373,000 (of which $1,337,000 is payable to M-W Properties Corporation) plus, in certain instances, real estate taxes and other expenses. Additional amounts based upon percentage of sales may become due on 25 per cent of these leases. The Company has no obligations under any of these leases beyond the year 1991 except for ground leases of one store which extend through the year 2020.

[22](5) As of February 1, 1961, the company and subsidiary had 1,959 leases on retail store, catalog store, warehouse, office and other properties with the following approximate minimum liability by years:

Year	*Amount*
1961	$ 17,167,000
1962	16,637,000
1963	14,789,000
1964	13,410,000
1965	12,379,000
1966–1970	52,934,000
1971–1975	46,341,000
1976–1980	42,156,000
1981–1985	37,041,000
1986–1990	22,419,000
1991–1995	1,790,000
1996–2000	500,000
2001 and after	1,992,000
	$279,555,000

[21] Taken from February 1, 1961 Annual Report.

[22] Taken from Form 10K filed with the Securities and Exchange Commission, February 1, 1961.

In the above table each lease is included for the full amount of its minimum annual rental to the expiration date of the lease or to the earliest cancellation date, and no amounts are included for rentals under options to renew which are contained in many of the leases. The table includes $40,110,000 minimum lease liability of six properties leased from M-W Properties Corporation, a wholly owned subsidiary of the registrant.

J. J. Newberry Co.[23]

2. During 1960, the company and its subsidiaries sold at a nominal profit and leased back property and equipment having a net book value of approximately $12,675,000; the leases (which are subject to renewal at reduced rentals) have initial periods which are approximately equal to the estimated useful life of the assets.

Minimum annual rentals on properties, including those sold in 1960, aggregating approximately $10,600,000 are payable by the company under leases extending more than five years; 80 per cent of such

aggregate amount is payable annually under leases expiring within twenty-five years.

4. The detail of the long-term debt less current portion is as follows:

	1960	*1959*
Mortgages payable on real estate	$ 1,759,998	$ 1,651,635
2.90% Sinking Fund Notes due August 15, 1968 (sinking fund $450,000 per annum increasing to $550,000 in 1963)	6,700,000	7,150,000
3¾% Sinking Fund Notes due May 15, 1976 (sinking fund $500,000 per annum commencing in 1961)	9,500,000	10,000,000
3⅛% Promissory Notes due in semiannual installments (presently about $20,000 per annum) to 1975	696,650	717,352
	$18,656,648	$19,518,987

Penn Fruit Co., Inc.[24]

(5) *Long-term leases and commitments.* The Company had 105 leases on properties in use expiring more than three years after August 26, 1961. Such leases call for minimum aggregate annual rentals total-

[23] Taken from 1960 Annual Report.
[24] Taken from August 26, 1961 Annual Report.

ing $3,769,153, of which about 24 per cent relate to leases expiring within fifteen years and the remainder relate to leases expiring from fifteen to thirty-one years, with the exception of one lease expiring in ninety-five years.

The Company had entered into additional long-term leases covering 11 proposed supermarkets which provide for estimated minimum aggregate annual rentals of $415,000, the rentals to commence at the various dates of completion.

The sum of $58,339 in aggregate rent on leases of transportation equipment is payable in quarterly installments of varying amounts through January 26, 1964. The leases contain options to purchase the equipment at prices declining in proportion to rentals paid.

The sum of $441,284 in aggregate rent on leases of automatic sprinklers is payable monthly in annual rentals of $151,320 at various dates extending through August 14, 1967. The leases are subject to renewal at the option of the Company at nominal rentals.

A lease entered into by the Company requires the construction of a supermarket to cost at least $350,000. At August 26, 1961, construction had not commenced.

At August 26, 1961, the Company had outstanding purchase commitments for equipment totaling approximately $400,000.

Ritter Company, Inc.[25]

3. Wilmot Castle Company, a subsidiary consolidated herein, occupies its manufacturing and general offices site under a lease agreement, as amended in 1958, covering an initial term expiring on September 30, 1980. Annual cash rental (excluding taxes, insurance and maintenance which are paid by the Company as additional rent) is $126,813. The lease is renewable for three ten-year optional periods at substantially reduced rentals. Negotiations have been entered into for the purchase of this property at a price of $1,700,000.

The lease agreement also provides that the Castle Company (a) may not declare or pay dividends which will reduce its working capital below $1 million and (b) will maintain working capital in an amount not less than $750,000. As at December 31, 1959, working capital was $2,101,192.

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[25] Taken from 1959 Annual Report.

Sears, Roebuck and Co.[26]

Rentals — long-term leases. The Company is leasing a number of store and warehouse properties from The Supplemental Savings and Retirement Plan of Sears, Roebuck and Co. Employes, as well as from various insurance, educational and other institutions. Most of these leases are for maximum terms ranging from twenty-five to ninety-nine years with the right, after initial periods ranging from twenty-five to forty-five years, to terminate or continue at reduced rentals, and contain one or both of the following two additional types of options:

The Company can, after the initial period of years, purchase the property at the then fair value of the land alone.

The Company can, on various specified dates (usually within the first twenty-five to thirty-five years), make a rejectable offer to purchase the property at specified prices and, in the event the lessor does not accept the offer, can either terminate or continue the lease.

Minimum annual fixed rentals, exclusive of taxes, insurance and other expenses paid directly by the Company, under long-term leases (over three years) in effect at January 31, 1961, total approximately $23,417,000. The aggregate minimum rental liability for the period subsequent to January 31, 1986, is $36,527,000.

Thompson Ramo Wooldridge Inc.[27]

Note F. The aggregate rental obligations of the Company and its subsidiaries under leases in effect at December 31, 1960, which expire more than three years after that date amount to approximately $43,-500,000 of which approximately $3,300,000 is payable in 1961. Provision has been made by a special charge against net income of the year 1960 for the estimated cost of canceling one of the aforementioned leases involving future rentals aggregating $2,347,660.

Rental obligations reported above do not include the obligation under a lease of land and buildings in the course of construction which a subsidiary expects to purchase upon completion for approximately $12 million. The Company expects to reinvest the proceeds of the

[26] Taken from January 31, 1961 Annual Report.
[27] Taken from 1960 Annual Report.

sale of the Space Technology Laboratories, Inc. research and development center in new facilities, which reinvestment may include the aforementioned $12 million. Because of this expectation to reinvest, the Company has elected to exclude the gain on the sale from taxable income, but has provided, as "deferred income taxes," for the estimated amount by which taxes payable in future years will be increased as a consequence of applying the gain on the sale to reduce the depreciation basis of the properties acquired by reinvesting the sale proceeds.

An additional lease entered into since December 31, 1960, is for land on which the lessor may erect buildings for a subsidiary of the company. If this construction program proceeds and is completed, the lease would be for a term ending thirty years after completion of construction with estimated total rentals over the period of about $30 million.

Tidewater Oil Company[28]

Note 7 – Commitments and contingent liabilities. Payments to others under long-term tanker charters, some of which extend to 1972, are estimated to be $12,400,000 in 1961, compared with $12,800,000 in 1960. 129

[28] Taken from 1960 Annual Report.

Tishman Realty & Construction Co., Inc.[29]

Note J—Leaseholds. Subsidiary companies as lessees had leaseholds expiring after September 30, 1963, of which the principal are as follows:

Expiration date of lease			*Annual net rental*	
1.	January	31, 1967	$299,280	
2.	April	30, 1968	66,388	(a)
3.	May	31, 1968	175,000	
4.	September	15, 1968	990,000	
5.	April	30, 1969	13,558	
6.	September	16, 1970	360,000	
7.	June	30, 1971	405,000	
8.	September	30, 1982	362,736	
9.	November	30, 1984	773,000	(b)
10.	November	28, 2005	105,000	(c)
11.	May	31, 2059	200,000	(d)
12.	June	15, 2060	25,000	(e)

(a) The parent company is lessee. Annual net rental for the period May 1, 1963, to April 30, 1968—$60,148.

(b) During the year ended September 30, 1960, a subsidiary company sold its property which was leased back to another subsidiary.

(c) Annual net rental for the period May 29, 2003 to November 28, 2005—$150,000.

(d) Rental is to commence nine months after possession of the premises. The lease requires demolition of existing structures and erection of an apartment building within two years after possession; the parent company has guaranteed the demolition and erection.

(e) Annual net rental varies from $25,000 to $40,000 over the term of the lease.

The above leases (except those designated 2, 5, 11 and 12) provide for renewal options.

In addition to the foregoing leases, a subsidiary company is a tenant in common with a nonaffiliated corporation under a lease expiring on August 1, 1982 (with renewal options to August 1, 2046), providing for a net rental of which the subsidiary company's annual share is $1,190,400 until September 30, 1978, and $1,194,000 for the balance of the initial term. The rights and obligations of the tenants in common, including, among other matters, restrictions as to sale and creation of indebtedness, are set forth in agreements between the parties. The Company manages the property under a fifty-year agreement.

[29] Taken from 1960 Annual Report.

In some cases, the Company and certain subsidiary companies have assumed the obligations of tenants for the unexpired portion of leases for premises formerly occupied by them in properties owned by others. Rentals receivable from the respective tenants are greater in each case than rentals assumed.

United States Leasing Corporation and Subsidiary Companies[30]

DECEMBER 31, 1960 AND 1959

CONSOLIDATED BALANCE SHEETS

ASSETS

		December 31 1960	December 31 1959
CASH		$ 2,741,559	$ 1,992,192
MARKETABLE SECURITIES—At cost		–	263,042
RECEIVABLES:			
Lease contracts receivable—due in installments (Note 2)		48,593,934	36,017,746
Other		144,347	52,114
Allowance for doubtful lease contracts receivable		*120,015*	–
PREPAID INTEREST		820,344	816,953
LEASED EQUIPMENT—Estimated residual valuation (Note 2)		4,876,800	3,346,494
Cost of leased equipment:			
1960	$65,855,105		
1959	46,096,881		
ADVANCES—Equipment acquisitions		517,331	659,344
INVESTMENT IN FOREIGN AFFILIATE—At cost		58,494	–
OFFICE EQUIPMENT AND IMPROVEMENTS—At cost	$ 199,564		
Less depreciation and amortization	*77,056*	122,508	104,129
DEFERRED CHARGES (less amortization):			
Organization expenses		48,305	57,327
Acquisition costs		–	98,460
TOTAL		$57,803,607	$43,407,801

(ED. NOTE: Notes to financial statements not reproduced.)

[30] Taken from 1960 Annual Report.

United States Leasing Corporation and Subsidiary Companies

CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 1960 AND 1959

LIABILITIES

	December 31 1960	December 31 1959
NOTES PAYABLE (Note 2)	$35,132,025	$28,929,447
ACCOUNTS PAYABLE	374,231	247,720
ACCRUED LIABILITIES	376,964	220,378
DEPOSITS—Lease contracts receivable collected in advance	1,144,115	1,469,939
MINORITY INTEREST — Canadian subsidiary	193,027	191,004
UNEARNED INCOME AND UNEARNED RESIDUALS ON LEASE CONTRACTS (Note 3)	8,781,364	6,566,375
RESERVE FOR DEFERRED FEDERAL INCOME TAXES—Deferred for possible payment in subsequent years (Note 4)	422,500	-
LONG-TERM NOTES PAYABLE—Subordinated notes due May 1, 1970 (Note 5)	5,000,000	-
CAPITAL STOCK AND SURPLUS (Notes 5 and 6):		
Capital stock	2,582,500	2,542,600
Capital surplus	2,521,394	2,403,260
Earned surplus	1,275,487	837,078
Total capital stock and surplus	6,379,381	5,782,938
Total long-term notes payable and capital stock and surplus	11,379,381	5,782,938
TOTAL	$57,803,607	$43,407,801

United Whelan Corporation[31]

Note E—Long-term leases, contingencies, and other comments. The Corporation and its consolidated subsidiaries in the ordinary course of business lease substantially all store properties. At December 31, 1960, there were 107 leases expiring more than three years after that date for which the minimum annual rental was approximately $1,478,000. The majority of these leases provide for additional rental based upon percentages of sales in excess of predetermined bases and upon other factors. Cost of goods sold, cost of shipments to agents and selling, general and administrative expenses include rent expense of $2,322,306 in 1960 and $2,135,763 in 1959, and loss from real estate operations includes rent expense of $469,187 in 1960 and $482,375 in 1959.

Walworth Company[32]

Annual rentals payable under long-term leases, expiring principally in thirteen to twenty-one years from December 31, 1961, aggregate $925,000 plus, in most instances, property taxes, insurance and maintenance. The annual fixed rentals under these leases will be $840,000 at December 31, 1963. Further reductions are effective every fifth year thereafter.

F. W. Woolworth Co.[33]

Note D — Long-term debt. Long-term debt payable after one year, mainly by the parent Company, is summarized below:

3.5% notes payable 1963-1973	$ 27,125,000
3.1% note payable 1963-1975	34,000,000
5.0% notes payable 1968-1982	35,000,000
5.75% bonds payable 1963-1990	4,458,087
5.0% bonds payable 1963-1991	5,977,540
3% to 6% mortgage and note obligations relating to real estate acquisitions, payable 1963-2001	25,916,844
Other	617,359
	$133,094,830

[31] Taken from 1960 Annual Report.
[32] Taken from 1961 Annual Report.
[33] Taken from 1961 Annual Report.

Payments due on long-term debt during each of the next five years are: 1962, $3,076,683 (included in current liabilities); 1963, $6,471,545; 1964, $4,772,447; 1965, $4,795,929; and 1966, $4,938,143.

Note E—Long-term leases. Minimum annual rentals for leased property, excluding rentals based on a percentage of sales and excluding payments of real estate taxes or other expenses, total approximately $47,800,000, the major portion of which relates to leases expiring subsequent to 1966.

Zed Corporation[34]

BALANCE SHEET

DECEMBER 31, 1958

($000 Omitted)

CURRENT ASSETS:		
Cash	$2,000	
Accounts receivable	5,000	
Inventories	6,000	
Total current assets		$13,000
OTHER ASSETS		1,000
Total		$14,000
CURRENT LIABILITIES:		
Notes payable	$2,000	
Accounts payable	1,000	
Accrued liabilities	1,000	
Income taxes	1,000	
Total current liabilities		$ 5,000
STOCKHOLDERS' EQUITY:		
Common stock	$3,000	
Earnings retained in the business	6,000	9,000
Total		$14,000

Note. The company leases substantially all of the plant and equipment used in its operations. The leases expire at various dates from 1959 to 1979. Aggregate rentals thereunder amount to $9,000 at December 31, 1958, of which $550 is payable in 1959.

[34] A fictitious corporation. See discussion on page 22. Reproduced from the *N.A.A. Bulletin,* December 1959, by permission.

Zed Corporation

BALANCE SHEET

DECEMBER 31, 1958

($000 Omitted)

CURRENT ASSETS:		
Cash	$2,000	
Accounts receivable	5,000	
Inventories	6,000	
Total current assets		$13,000
OTHER ASSETS		1,000
LEASEHOLD INTEREST IN FACILITIES at discounted amount of related long-term lease obligations (see Contra):		
Land and buildings	$4,000	
Equipment	2,000	6,000
Total		$20,000
CURRENT LIABILITIES:		
Notes payable	$2,000	
Accounts payable	1,000	
Accrued liabilities	1,000	
Income taxes	1,000	
Current portion of rentals payable	500	
Total current liabilities		$ 5,500
RENTALS PAYABLE ON LEASEHOLD PROPERTIES discounted at rates used in the respective leases (see Contra):		
Land and buildings expiring at various dates to January 15, 1979	$4,000	
Equipment expiring at various dates principally to December 31, 1963	2,000	
	$6,000	
Less current portion shown above	500	5,500
STOCKHOLDERS' EQUITY:		
Common stock	$3,000	
Earnings retained in the business	6,000	9,000
Total		$20,000

APPENDIX D

Chapter 14 of *Accounting Research Bulletin No. 43*

Disclosure of Long-Term Leases in Financial Statements of Lessees

1. The growth in recent years of the practice of using long-term leases as a method of financing has created problems of disclosure in financial statements. In buy-build-sell-and-lease transactions, the purchaser of land builds to his own specifications, sells the improved property, and simultaneously leases the property for a period of years. Similar transactions are the sale and lease of existing properties or the lease of properties to be constructed by the lessor to the specifications of the lessee. The lessee ordinarily assumes all the expenses and obligations of ownership (such as taxes, insurance, interest, maintenance, and repairs) except payment of any mortgage indebtedness on the property.

2. There are many variations in such types of transactions. For example, some leases contain an *option* for acquisition of the property by the lessee, while other leases contain a *requirement* that the lessee purchase the property upon expiration of the lease. In some the price to be paid upon repurchase is related to the fair value of the property or the depreciated book value; in others it is an arbitrary amount with little or no relation to the property's worth, or a nominal sum. Some leases provide for a high initial rental with declining payments thereafter or renewal at substantially reduced rentals.

3. Where long-term leases are used as a substitute for ownership and mortgage borrowing, a question arises as to the extent of disclosure

to be made in financial statements of the fixed annual amounts payable and other important terms under such leases.[1]

4. Although the types of sell-and-lease arrangements referred to in paragraph 1 differ in many respects from the conventional long-term lease,[2] the principles of disclosure stated herein are intended to apply to both. This chapter does not apply to short-term leases[3] or to those customarily used for oil and gas properties.

5. The committee believes that material amounts of fixed rental and other liabilities maturing in future years under long-term leases and possible related contingencies are material facts affecting judgments based on the financial statements of a corporation, and that those who rely upon financial statements are entitled to know of the existence of such leases and the extent of the obligations thereunder, irrespective of whether the leases are considered to be advantageous or otherwise. Accordingly, where the rentals or other obligations under long-term leases are material in the circumstances, the committee is of the opinion that:

138 (a) disclosure should be made in financial statements or in notes thereto of:

(1) the amounts of annual rentals to be paid under such leases with some indication of the periods for which they are payable and

(2) any other important obligation assumed or guarantee made in connection therewith;

(b) the above information should be given not only in the year in which the transaction originates but also as long thereafter as the amounts involved are material; and

(c) in addition, in the year in which the transaction originates,

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[1] Rule 3-18 (b) of Regulation S-X issued by the Securities and Exchange Commission reads: "Where the rentals or obligations under long-term leases are material there shall be shown the amounts of annual rentals under such leases with some indication of the periods for which they are payable, together with any important obligation assumed or guarantee made in connection therewith. If the rentals are conditional, state the minimum annual amounts."

[2] The conventional lease, a straight tenure contract between the owner of property and a lessee, generally does not involve buying, building, and selling of property by the lessee, or special repurchase arrangements.

[3] Three years has been used as a criterion in some cases for classifying leases as short-term or long-term.

there should be disclosure of the principal details of any important sale-and-lease transaction.

6. A lease arrangement is sometimes, in substance, no more than an instalment purchase of the property. This may well be the case when the lease is made subject to purchase of the property for a nominal sum or for an amount obviously much less than the prospective fair value of the property; or when the agreement stipulates that the rental payments may be applied in part as instalments on the purchase price; or when the rentals obviously are so out of line with rentals for similar properties as to negative the representation that the rental payments are for current use of the property and to create the presumption that portions of such rentals are partial payments under a purchase plan.

7. Since the lessee in such cases does not have legal title to the property and does not necessarily assume any direct mortgage obligation, it has been argued that any balance sheet which included the property among the assets and any related indebtedness among the liabilities would be incorrect. However, the committee is of the opinion that the facts relating to all such leases should be carefully considered and that, where it is clearly evident that the transaction involved is in substance a purchase, the "leased" property should be included among the assets of the lessee with suitable accounting for the corresponding liabilities and for the related charges in the income statement.

One member of the committee, Mr. Lindquist, assented with qualification to adoption of chapter 14.

Mr. Lindquist's qualification relates to paragraph 6. He believes that at any time during a long-term lease, other than a reasonable period before its expiration, no determination is possible as to *prospective fair value of the property* for comparison with the purchase price that may be stated in the lease. He also questions the ability of an accountant to carry out the implicit requirement for comparison of the lease rental with *rentals for similar properties* in view of the many physical and other factors on which would rest a conclusion of similarity of properties.

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Chapter 14 of *Bulletin No. 43,* which is reproduced as Appendix D, is substantially a restatement of *Accounting Research Bulletin No. 38.* In *Bulletin No. 38,* paragraph 3 is longer, the three-year criterion for separating short- and long-term leases does not appear, and there are no dissents or qualifications by any members of the committee as then constituted.

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