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AN ANALYSIS OF THE CURRENT REPORTING PRACTICES FOR IRREVOCABLE LEASES IN THE FINANCIAL STATEMENTS OF THE LESSEE

by
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Bachelor of Science, Wisconsin State University 1969

An Independent Study

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of the

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for the degree of

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This Independent Study submitted by David R. Weir in partial fulfillment of the requirements for the Degree of Master of Science from the University of North Dakota is hereby approved by the Faculty Advisor under whom the work has been done.

(Advisor)

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CHAPTER I

INTRODUCTION

A lease is defined as a:

> . . . conveyance of lands or tenements to a person for life, for a term of years, or at will, usually in consideration of a rent or some other recompense. The person who so conveys such lands or tenements is termed the "lessor," and the person to whom they are conveyed, the "lessee;" and when the lessor so conveys lands or tenements to a lessee, he is said to lease, demise, or let them. (1)

Leasing is not a modern day creation for the practice dates back for hundreds of years before Christ. (2) For centuries the lease was used almost exclusively in connection with agricultural land. However, since the end of World War II, leasing has been increasing at a tremendous rate and has become an important means of financing, as an alternative to purchasing. The effects of this change have given rise to perplexing problems in financial reporting and in the interpretation of financial statements of the lessee companies.

As with other forms of contracts, the lease can be "tailor-made" to meet the needs of the parties involved. As a result, leases may vary with respect to term, duties of the various parties, restrictions, alternatives at termination, method of payment, flexibility and purpose.

When classified according to purpose, there are two general types of leases in use today. The first may be designated as a "service lease," which is entered into solely for the services to be rendered by the lessor over the term of the agreement. The other type is the "financial lease," which as the name implies, has financing as its primary objective. Under the financial lease, the lessor provides all of the service which is required of him at the beginning of the contract period. From this point, the lessee is given the use of the property or equipment and the lessor is usually not called upon to render any substantial service over the term of the agreement.

It is the purpose of this paper to analyze the current reporting practices for long-term (three years or more) irrevocable leases in the lessee's financial statements to determine their effectiveness in providing a fair presentation of financial position. (3) The discussion pertains primarily to the financial type of lease and one which is not in substance an installment purchase or a sale-and-lease-back agreement.

5. The financial lease often includes a "net lease" clause which requires the lessee to pay maintenance costs, repairs, insurance, taxes, alterations, and all other costs normally associated with ownership. The purpose of such a provision is to make the rental payments clear or "net" to the lessor so the return he receives during the term of the lease may be determined in advance. (4)

Current reporting requirements

Accounting Research Bulletin No. 38, issued in 1949 was the first pronouncement of the American Institute of Certified Public Accountants (A.I.C.P.A.) on the subject of leasing. Basically the same material was later contained in Accounting Research Bulletin No. 43, published in 1953, which superseded Bulletin No. 38.

Chapter 14 of ARB No. 43 offers the following recommendations for the disclosure of long-term lease agreements:

> 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:
> a) disclosure should be made in the financial statements or in the 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 as the amounts involved are material; . . .
> 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 charges in the income statement. (3)

In 1962, the A.I.C.P.A. released Accounting Research Study No. 4 (written to stimulate discussion only) by Professor John H. Myers dealing with the reporting of leases in financial statements. This study, which does not reflect the official position of the Institute, called for the capitalization of all material noncancellable lease obligations at the present value of future lease payments. Then, in 1964, the Accounting Principles Board A.P.B.) issued Opinion No. 5 (superseded ARB No. 43) stating the Institute's requirements for the reporting of leases by lessees. This pronouncement supported the disclosure of long-term leases in the footnotes of the financial statements, but did not support the suggestion of the research study to capitalize all noncancellable leases. Selected portions of A.P.B. Opinion No. 5 are as follows:

5. The Accounting Principles Board has considered the recommendations and the supporting argument presented in Accounting Research Study No. 4. The Board agrees that the nature of some lease agreements is such that an asset and a related liability should be shown in the balance sheet, and that it is important to distinguish this type of lease from other leases. The Board believes, however, that the distinction depends on the issue of whether or not the lease is in substance a purchase of the property rather than on the issue of whether or not a property right exists. The Board believes that the disclosure requirements regarding leases contained in ARB No. 43, Chapt 14, should be extended . . .
7. It seems clear that leases covering merely the right to use property in exchange for future rental payments do not create an equity in the property and are thus nothing more than executory contracts requiring continuing performance on the part of both the lessor and the lessee for the full period covered by the leases. The question of whether assets and liabilities should be recorded in connection with leases of this type is, therefore, part of the

larger issue of whether the rights and obligations that exist under executory contracts in general (e.g., purchase commitments and employment contracts) give rise to assets and liabilities which should be recorded . . .

12. In cases in which the lessee and the lessor are related, leases should often be treated as purchases even though they do not meet the criteria set forth in paragraphs 10 and 11, i.e., even though no direct equity is being built up by the lessee. In these cases, a lease should be recorded as a purchase if a primary purpose of ownership of the property by the lessor is to lease it to the lessee and (1) the lease payments are pledged to secure the debts of the lessor or (2) the lessee is able, directly or indirectly, to control or influence significantly the actions of the lessor with respect to the lease. The following illustrate situations in which these conditions are frequently present:

a. The lessor is an unconsolidated subsidiary of the lessee, or the lessee and the lessor are subsidiaries of the same parent and either is unconsolidated.
b. The lessee and the lessor have common officers, directors, or shareholders to a significant degree.
c. The lessor has been created, directly or indirectly, by the lessee and is substantially dependent on the lessee for its operations.
d. The lessee (or its parent) has the right, through options or otherwise, to acquire controls of the lessor.

16. The Board believes that financial statements should disclose sufficient information regarding material noncancellable leases which are not recorded as assets and liabilities to enable the reader to assess the effect of lease commitments upon financial position and results of operations, both present and prospective, of the lessee. Consequently, the financial statements or the accompanying notes should disclose the minimum annual rentals under such leases and the period over which the outlays will be made.

17. In many cases, additional disclosure will be required. The Board believes that rentals for the current year on leases covered by this Opinion, should be disclosed if they differ significantly from the minimum rentals under the leases. Type or types of property leased, obligations assumed or guarantees made, and significant provisions of lease agreements (such as restrictions on dividends, debt, or further leasing or unusual options) are examples of other types of information which should also usually be disclosed. (5)

Rule 3-18 of Regulation S-X of the Securities and Exchange Commission regarding commitments states that:

If material in amount, the pertinent facts relative to firm commitments for the acquisition of permanent investments and fixed assets and for the purchase, repurchase, construction, or rental of assets under long-term leases shall be stated briefly in the balance sheet or in footnotes therein.

> 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, the minimum annual amounts shall be stated. (6)

Prior to the issuance of APB Opinion No. 5, the S.E.C. did not permit the property rights and obligations under long-term leases to be shown as assets and liabilities of registered companies as it was not in accordance with generally accepted accounting principles as defined by the A.I.C.P.A. However, the requirements of Opinion No. 5 are fully recognized by this body today.

Current reporting practices

According to Accounting Trends and Techniques-1969 (7), 73% of the companies reviewed did not capitalize their lease obligations. Thus, most of the companies which hold property or equipment under such agreements do not show the related user rights as assets and the obligations as liabilities on the balance sheet, unless the lease is in effect an installment purchase. The existence of leases was usually described in a footnote which varied in detail from paragraphs describing the property leased, lease periods, amounts of minimum rentals, et cetera, to only a brief statement such as the one below:

> WALGREEN COMPANY
> Notes to Consolidated Financial Statements
> Note 2: Lease Obligations--At September 30, 1968, the Company and its subsidiaries had 495 leases expiring more than three years after that date (some of which contain percentage rental clauses) with minimum annual rentals of approximately $ 12,927,000. (8)

While both the A.I.C.P.A. and the S.E.C. have provided a great deal of freedom as to the extent of disclosure, the fact that both of them have failed to take a definite stand against footnote disclosure has resulted in a majority of firms adopting minimal reporting standards. This has become a matter of great concern to many statement users as well as CPAs who question the rationale behind the current requirements.

CHAPTER III

SELECTED COMMENTS ON THE CURRENT METHODS OF DISCLOSURE

Probably the most strongly advocated alternative to the current reporting requirements is the lease capitalization concept. In his research study, Dr. Myers stated that:

> 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 . . . (9)

Comments on the current practices have been deferred until this chapter so that the lease capitalization concept might be used as a reference point in the discussion.

In Opinion No. 5, the A.P.B. viewed the lease as the right to use property for specified rental payments and held that the obligation to make future rental payments does not create an equity in the property. Thus, it is only an executory contract (one which calls for future services to be performed by both parties). Under generally accepted accounting principles, accountants normally do not include obligations arising from executory contracts in their definition of a liability. This might best be illustrated in the case of employment contracts, which are so conditional and uncertain, that they rightfully should be excluded from the accounts. This reasoning, however, does not appear to be applicable to most irrevocable financial leases because he lessee m ... cially when there is no ad ... the contract is executory from the stan ... cuted on the lessor's behalf, rather than purely exe

In comparing the lessee's unperformed obligation on one lessor's performance, on the other, it appears to resemble creditor relationship.

Another basis for distinguishing between lease agreements and ment-type contracts is that leases represent a means of financing use of property, whereas the latter does not.

Keeping these ideas in mind, the reader might seriously ques- ion whether a noncancellable lease is truly executory contract which should not be subject to capitalization. Current requirements seem to overemphasize the creation of a material equity as the criteria for presenting the asset and related liability in the balance sheet. Yet, one might reason that such treatment would be even more crucial for achieving a fair presentation of financial position in a firm in which no equity is created to offset the liability. In both instances, there is an identical obligation. However, the lessee is paying only for the temporary, rather than permanent, right to use the asset.

Advocates of the current practices contend that the position a lessor is different from that of a general creditor in that Secti 63a (9), Chapter 7, of the Bankruptcy Act provides that in the eve bankruptcy the landlord's claim shall not exceed the accrued rental payments plus one year's rent as damages. (11) However, a lease agreement is usually entered into on the assumption that it will be fulfilled. Accordingly, the property right and related obligation might possibly be shown in the accounts of the firm if the statement of financial position is to be prepared on the "going concern" principle. Otherwise, a Statement of Affairs might be more appropriate. (12)

It is not uncommon for a lease to cover the useful life of the property, leaving the lessor with title to an asset having an immaterial salvage value upon expiration. However, under current practices, if the property is purchased under an installment agreement (which might be accomplished by the payment of $ 1 at termination) instead of leasing it, the amounts must be reflected in the balance sheet accounts. Yet, the only basic difference between the two transactions is that in the second instance, the lessee-installment purchaser, rather than lessor, is the owner of the property having negligible worth.

Paragraph 12 of A.P.B. Opinion No. 5, requires that leases between related parties be capitalized, whether a material equity is created or not. It is quite probable that this section was intended to apply mainly to the situation where a business created by the lessee holds title as lessor, although the beneficial interest in the leased property really lies with the lessee. The ineffectiveness of this paragraph when strictly applied is rather cleverly presented in an article by Mr. William Hall, who is a partner in an international public accounting firm.

He assumed that a supermarket chain leases all but one of its stores from various lessors under similar terms in which no material equity is created. Thus, the criteria for capitalization under Opinion No. 5 does not apply. One lease, however, is with a major shareholder who merely had extra money to invest. In accordance with paragraph 12 of Opinion No. 5, the lease with the shareholder must be capitalized. Then, if the major shareholder later disposes of his interest in the lessee, the capitalization should be eliminated.

Mr. Hall believes that the entire problem would disappear if all financing leases were required to be capitalized. (13)

Financial ratio analysis

The application of the current requirements may also affect the statement user's ratio analysis. One example of this is illustrated in the following situation in applying the test of debt to net worth. (14) Company A leases 90% of its fixed assets and discloses these obligations in a footnote only, in accordance with the current requirements.

Current Assets	$ 500,000
Fixed Assets	100,000
Total Assets	$ 600,000
Debt on Fixed Assets	-0-
Other Debt	100,000
Total Liabilities	$ 100,000
Net Worth	$ 500,000

Company B also leases 90% of its fixed assets and reflects the leased assets and the related obligations in its balance sheet--a proposed treatment for the financial lease.

Current Assets	\$ 500,000
Fixed Assets	100,000
Leased Property Rights	900,000
Total Assets	\$1,500,000
Irrevocable Lease Obligations	900,000
Other Debt	100,000
Total Liabilities	\$1,000,000
Net Worth	\$ 500,000

Debt to Net Worth Ratios:

Company A = .20 Company B = 2.00

Company A at first glance appears to have a stronger financial condition than B because according to the ratios B has \$1.80 more debt per dollar of owner-invested capital than Company A. Yet, actually, its condition is the same as B if we assume the lease obligations are virtually irrevocable.

Next, consider Company C which leases no assets, but borrows 90% of the cost of its fixed assets.

Current Assets	\$ 500,000
Fixed Assets	1,000,000
Total Assets	\$1,500,000
Debt on Fixed Assets	900,000
Other Debt	100,000
Total Liabilities	\$1,000,000
Net Worth	\$ 500,000

In Company C, a purchase which has been 90% financed is properly reflected in the accounts. However, present reporting practices require that an obligation arising from a purchase made with 90% financing be reflected in the balance sheet; but, if 100% lease financing is used, the transaction is buried in a footnote.

In a study performed by Professor A. Thomas Nelson, the financial ratios of eleven major companies were computed to determine the effects of capitalization upon them. Tables 1 and 2 consist of seven ratios selected from his analysis and the related findings. (15)

TABLE 1

THE IMPACT OF CAPITALIZATION ON SELECTED FINANCIAL RATIOS
(PARTIAL REPRODUCTION)

Notes	Effect on Numer-ator	Effect on Denomi-nator	Does capitalization "improve" the firm's financial position?	Does capitalization help the ratio meet its objectives?
1) Current ratio	NC	+	No	Yes
2) Debt to equity	+	NC	No	Yes
3) Debt to total capital	+	+	No	Yes
4) Return on total capital	+	+	*	Yes
5) Times interest charges earned	+	+	No	Yes
6) Fixed assets to tangible net worth	+	NC	No	Yes
7) Funded debt to net plant	+	+	No	Yes

Notes:

*Return on total capital may or may not improve depending on the lease terms. In five of the eleven companies studied, capitalization improved the return on investment.

NC = No change.

1) The inclusion of current lease rentals makes the ratio a better measure of the current debt paying ability.

2) By including all assets used in the business, the ratio reflects more completely the relative proportion of the assets that have been furnished by owners and by creditors (outsiders).

3) Same as #2 above.

4) The ratio is improved because the "return" reflects income before implied interest and "capital" included assets furnished from all sources.

5) The ratio better meets its objectives because all interest charges are reflected, including "hidden" interest on financial leases.

6) All assets used in the business are included as well as all "funds" supplied by outsiders.

7) Since all assets are included in the computation when leases are capitalized, the ratio better reflects the proportion of capital that is tied up in fixed assets.

TABLE 2

RANKING OF THE 11 LESSEE COMPANIES BEFORE AND AFTER CAPITALIZATION (PARTIAL REPRODUCTION)

		Penn Fruit Company	Safeway Stores Inc.	Allied Stores Corp.	F.W.Woolworth Company	Peoples Drug Stores	Bond Stores, Inc.	Consolidated Food Corp.	Textron, Inc.	Miller Mfg. Company	Lockheed Aircraft Corp.	Purolator Prod.,Inc.
Current Ratio	BC	5	10	3	2	6	1	8	7	9	11	4
	AC	9	10	3	5	8	1	6	4	7	11	2
Debt to equity	BC	5	6	4	3	2	1	7	10	8	11	9
	AC	9	10	7	6	5	1	4	8	2	11	3
Debt to total capital	BC	5	6	4	3	2	1	7	10	8	11	9
	AC	9	10	7	6	5	1	4	8	2	11	9
Return on total capital	BC	7	3	9	4	8	10	6	5	1	11	2
	AC	7	3	9	4	8	10	6	5	1	11	2
Times interest charges earned	BC	8	3	4	5	2	1	9	10	6	11	7
	AC	10	7	9	6	8	5	3	4	2	11	1
Fixed assets to tangible net worth	BC	7	11	2	8	4	1	5	9	6	10	3
	AC	10	11	8	9	7	3	4	5	2	6	1
Funded debt to net plant	BC	5	3	9	6	1	2	7	11	4	8	10
	AC	8	7	9	6	2	5	4	11	1	3	10

BC = Before capitalization.
AC = After capitalization.

Rather than including an extensive table of financial ratios, the relative position of each company in the group before and after capitalization is presented in Table 2.

The significance of a company's ranking is, of course, dependent upon the particular ratio involved.

The number of firms which were given a different ranking as a result of capitalization is also of significance. Of the eleven companies, the following number received another rating:

Ratio	No. of Firms Changed
Current Ratio	7
Debt to Equity (net worth)	9
Debt to Total Capital	9
Return on Total Capital	0
Times Interest Charges Earned	10
Fixed Assets to Tangible Net Worth	10
Funded Debt to Net Plant	7

Implications from current reporting techniques

In the same study (15), the ratio analyses calculated from the published financial statements of Safeway Stores, Inc. and Consolidated Food Corporation reveals that they have almost identical ratios of debt to total capital (Safeway 41.5 percent and Consolidated Food 41.7 percent). Since these companies are both members of the same industry, one might conclude that from the standpoint of assets supplied by outsiders the two companies are comparable. All things being equal, they have approximately the same degree of relative risk. Based on these duces a rather startling change. Safeway now ha higher ratio (70.6) than does Consolidated Food (52.6). Neither portion of funds provided by outsiders nor the relative risk is for the two firms as the reader might have inferred from the al computations.

Similar comparisons may be made with other ratios. For example, current ratio of F. W. Woolworth Company was 3.43:1 before capitalization and is comparable to the 3.40:1 of Purolator Products, Inc. Based on this comparison, one might judge that the two firms should meet their current obligations with equal ease. Yet, after capitalization, Purolator Products ratio is 3.35:1 compared with Woolworth's 2.13:1. Thus, it appears that Purolator is in a much stronger current position.

One could only conclude that each of these ratios has been calculated from incomplete data, even though based on the published financial statements of the companies. Accordingly, an investor relying on this information could have been misled, because a very significant portion of the assets supplied by outsiders were omitted from the original calculations.

Capitalization, however, would have without question provided a more realistic and useful, yet less flattering picture of each firm's financial position.

r's' opinion on current practices

Throughout the preceding discussion and in accounting and financial circles, the controversy remains unsettled, with footnotes of various forms at one extreme and capitalization of the leased asset at the other.

The effects of Opinion No. 5 have caused considerable dissatisfaction to be expressed by many. For example, at its June 1, 1966 meeting, the Board of Directors of the Robert Morris Associates, the national organization of bank lending officers, unanimously passed the following resolution:

> WHEREAS lease obligations of companies are often material and irrevocable liabilities and represent a significant method of financing property and equipment used by many companies, and
> WHEREAS the AICPA published an excellent research study on this subject of the reporting of leases in financial statements (Accounting Research Study No. 4 by John H. Myers) and
> WHEREAS the manner of showing leases in the financial statements of lessees requires improvement to properly reflect the economic and accounting facts, therefore, be it
> RESOLVED that Robert Morris Associates suggest to the Accounting Principles Board of the AICPA that its Opinion No. 5 on "Reporting of Leases in Financial Statements of Lessee" be revised to more nearly conform to the conclusions of Accounting Research Study No. 4 and to require that all financing leases totaling a material amount be reflected in the balance sheets as obligations of the lessee companies. (16)

Overview of the lease capitalization concept

What accounting procedures are involved if all long-term leased property rights and the related obligations are reflected in the financial statements? Professor Myers states in Accounting Research Study No. 4 that:

> . . . the measurement of the asset value and the related liability involves two steps: (1) the determination on the part of the rentals which constitute payment for property rights and (2) the discounting of those rentals at an appropriate rate of interest. (9)

Consider the following transaction. Assume that Ajax Company, a warehousing concern, just entered into a ten-year noncancellable agreement (non-equity type) to lease a building to be used for its main operations. The terms call for ten annual payments of $2,000 at the end of each year. First, the present value of the property must be computed by discounting the future payments according to the effective interest rate. This rate may be obtained from the lease contract or may be computed from the known cost of the asset by comparison to the sum of the payments. Using the effective rate of 10%, the present value of an annuity of ten rents of $ 1 equals 6.145. So, the discounted amount of Ajax Company's payments (10 rents of $2000) is $12,290 (2000 x 6.145) which represents the rights to use the leased property and the related obligation. The balance sheet presentation might appear somewhat as follows: (9)

ASSETS:	
Current:	$ -0-
Fixed:	
Leasehold Interest in Facilities at discounted amount of related long-term lease obligations (see contra): Building	12,290
Total Assets	$12,290

LIABILITIES:

Current:		$ 771
Current Portion of Rentals Payable		
Long-Term:		
Rentals Payable on Leasehold Properties discounted at 10% (see contra): Building-expiring June 30, 1980	$12,290	
Less: Current portion above	771	11,519
Total Liabilities		$12,290

As shown above, the portion of the lease obligations due within one year should be included in current liabilities. The amount included should be the principal, or discounted amount of the obligation, rather than the total lease payment to be made at the end of the current year. Thus, the interest element would be recorded only as it becomes an expense.

When lease obligations are shown in the balance sheet the amount of the obligations should be reduced as payments are made, on a basis consistent with the terms of the lease. If, as would probably be the situation in many cases, the lease provides for level payments, the obligation might be reduced on an accelerating basis by using the "scientific" or "effective" interest method of calculating the amortization. Thus, in the earlier years a relatively larger part of the rental payments would apply to interest, whereas in the later years, a progressively smaller part of the rental payments would apply to interest. Using the scientific method for computing the amortization (10% x $12,290), the entry at the end of the first year would be as follows:

	DEBIT	CREDIT
Interest Expense	1,229	
Current Porton of Rentals Payable	771	
Cash		2,000
Ammortization of Leasehold Interest in Facilities--Building	771	
Leasehold Interest in Facilities--Building (or contra account)		771

The final entry at the end of the tenth year would be (10% x $1,820):

Interest Expense	182	
Current Portion of Rentals Payable	1,820	
Cash		2,002 *
Amortization of Leasehold Interest in Facilities--Building	1,820	
Leasehold Interest in Facilities--Building (or contra account)		1,820

* ($2 excess due to rounding)

The capitalization treatment will usually necessitate some changes in account classification in the income statement and the reader is urged to consider the possibility of a change in the reported net income and the "earnings per share" figure. As this area is not within the purpose or scope of this study, further discussion has been omitted.

The effect of discounting

As well as the previous arguments for Opinion No. 5, which opposes capitalization of all noncancellable leases, some writers also contend that very serious problems of comparability would be added to the turmoil, by estimating the interest portions of lease obligations which are to be capitalized. (17) It is true, to a certain degree, that more complex situations than the example cited, might create some distortion. However, are these problems really any more difficult than many other computations made daily by accountants in such areas as estimating useful asset lives, valuation of inventories, overhead allocations, et cetera. Accountants have been relied upon for years to make meaningful computations in these and many other areas!

There is no question, but what the gain from adequate disclosure will more than compensate for any errors which arise through estimation. It's better to make a 5% error in estimating, than a 100% one by non-disclosure!

CHAPTER IV

SUMMARY AND CONCLUSION

In recent years the lease has grown in popularity as a device for financing the acquisition of productive facilities. The long-term irrevocable lease is just another means of debt financing which usually does not appear in the balance sheet, under current accounting practices. Accountants generally agree that footnotes are not a substitute for proper financial statement presentation. However, they can and should be used, where necessary, to elaborate on or explain amounts appearing in the financial statements. In most instances, footnotes relating to long-term lease obligations force the reader to complete the job which properly belongs to management. As a result, they are often ignored, except by financial analysts, and are frequently omitted by financial reporting services.

This inadequate disclosure is primarily attributable to the requirements of A.P.B. Opinion No. 5 which reasons that a lessee does not acquire a property right under a financial lease agreement in which no material equity is created. Such an arrangement is held to be merely an executory contract which is not to be presented in the financial statements, in most instances.

The omission from the balance sheet of the lessee's liability under such agreements results in an understatement of the debt position of the firm and makes it more difficult to compare the financial position of firms that choose different methods of financing. The proper recording and disclosure of lease obligations is vital to all segments of our business community, and unless capitalization is used, financial ratios may be misleading.

There is, however, a sound basis for capitalizing the lease on the balance sheet. The Committee of the American Accounting Association which prepared A Statement of Basic Accounting Theory (1966) stated that " . . . the committee recommends the reporting of all long-term leases . . . in dollar terms in the regular framework of the statements." (18) This method has also been advocated in Accounting Research Study No. 4. Thus, under this concept, when the lessee enters into a lease, he obtains an asset and assumes a liability. The amounts to be capitalized are equal to the present worth of the lessee's future payments under the lease, discounted at its effective rate of interest.

Capitalization is a means of overcoming the weaknesses in current reporting as it reflects the impact of leases in the financial statements. I believe that this process is compatible with generally accepted accounting principles, as it merely looks through the legal details to the financial and economic facts, recognizing the lease for what is really is--a means of financing!

Accordingly, I believe all long-term irrevocable financing leases, if material, should be capitalized and reflected as assets and obligations in the balance sheet of the lessee companies. Such a treatment will provide a more reasonable approach to proper disclosure in attempting to fairly present a company's financial position!

SOURCES CONSULTED

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