

REPORTING OF LONG TERM LEASES
IN FINANCIAL STATEMENTS

by *SSO*

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INTRODUCTION

For a long time, Western Europe was ruled by feudalism. The basic characteristic of this system was local agricultural-political economy. Peasants and villen held land from the lord of the manor who gave them protection and use of the land in return for personal service and dues. The type of contract we now have under leases seems to originate from that ancient social order.¹ However, present lease arrangements were not widely used until thirty years ago.

Since World War II, rapid improvements have been made in the design and operation of machines and equipment. Every business, in order to insure cost reduction, needs up-to-date equipment and technology. Some companies, when trying to keep pace with the fast changes, face certain difficulties:

1. The shortage of working capital to replace outmoded equipment.
2. The risk involved in owning new and untried equipment.
3. The higher cost of operating and maintaining certain equipment on a full time basis.

Encountering these difficulties, many companies acquire the equipment by leasing for the following advantages:

1. It takes advantage of the talent and experience of a lessor in

¹ John H. Myers, Reporting of Leases in Financial Statements, Accounting Research Study No. 4 (New York: American Institute of Certified Public Accountants, 1962), p. 1.

operating and maintaining the equipment.²

2. It minimizes the obsolescence risk of ownership as lessors may offer to replace the outmoded equipment with new models when the lease is renewed.³

3. It is a good financing device.

a. Leasing provides cash flow advantages in the early years of the use of the asset. A comparison made by Griesinger shows that in the first years leasing provides more cash on hand at year end than other financing methods.⁴ The reasons are:

- (1). In the case of purchase by cash, the owner has to pay the full amount of the list price at the time of the purchase. In the case of purchase by seventy-five per cent bank loan or installment purchase, a down payment is usually required in the first year of the loan. This reduces the cash on hand by a greater amount than occurs under the lease plan.
- (2). Leasing, although it may not reduce taxes, does postpone them. In most lease plans, the rental payments are determined on the basic lease term, which is shorter than that used for calculating the depreciation expense when the asset is owned. Thus, the tax deductible rental payments, in most cases, are larger than the amount of

²Frank K. Griesinger, "Pros and Cons of Leasing Equipments," Harvard Business Review, XXXIII, No. 3 (March-April, 1955), 86.

³Ibid.

⁴Ibid., p. 78.

the depreciation expense. The lessee has less cash out flow in income taxes during the early years of the asset use than he would if the asset had been purchased. The cash payment for installment purchase or loan may be based on periods shorter than the useful life of the asset. But these payments are not deductible for tax purposes. The owner of the asset can not get any tax advantages from this. However, most leases are renewable, and the rental rates during the renewal periods are about one to ten per cent of the original value of the asset leased.⁵ Rental payments are substantially smaller than they are during the basic lease term. Consequently, income taxes are larger. If the lessee renews the lease contract for many years, the aggregate tax may be the same as if the asset is purchased. The lessee is, nevertheless, benefited by the postponement if he can wisely invest the additional cash in the early years. Since 1954, depreciation expense for tax purposes may be based on accelerated methods. This tax postponement advantage is no longer a unique advantage of leasing, although there is an exception when the leased asset is a piece of land. The rent on the land is tax deductible, but land is not depreciable if owned.

b. Leasing is an expensive financing device, but the profits from

⁵Ibid., p. 82.

the additional cash on hand in the early years may outweigh the disadvantages. Griesinger's comparison shows that the lease plan has the highest total dollar cost among the alternatives. This is due to an interest rate usually one half to one per cent higher than that of debt.⁶ However, in the early years of the plan, the additional cash, or the additional working capital freed, may be invested in certain profitable projects. The cumulative earnings after taxes from the projects may far exceed the additional expenses of the lease. Not only is the lessee benefited by the investments, but also the government is benefited by the additional income taxes which it would not collect if the working capital were not freed.⁷ This does not mean that leasing is the best financing method for all corporations under all circumstances. A systematic analysis has to be made before the lessee chooses from the alternatives available.

c. Leasing increases the total credit available to the lessee.

(1). According to the traditional accounting treatment, the lessee is not required to recognize the future rental payments under a lease as liabilities. Thus, the lessee can maintain a believed-to-be-better financial position and obtain more credit by leases than by loan.

(2). Many banks or financial institutions do not like to loan

⁶Myers, Op. cit., p. 90

⁷Griesinger, Op. cit., p. 80

money for fixed asset expansion, and many companies prefer to use their bank credit for normal operating needs. Leasing may turn out to be the only way to acquire the use of the asset.

(3). Leasing may provide one hundred per cent financing.⁸

Loans, especially secured ones, are usually limited to a certain percentage of the asset value.

(4). When a company has long term debts, there may be some restrictions against its incurring further obligations. Yet not until recently was there any restriction placed on a company using leases as a means of obtaining additional credit.⁹

4. Other advantages:

- a. Leasing reduces accounting efforts in cost allocation when assets are owned.
- b. A lessee may receive some advantages from the leasing corporations as they should have more experience in equipment purchasing.

In addition to these advantages to the lessee, leasing serves as a marketing instrument for manufacturers. There are different ways a manufacturer can handle his transactions through leasing without investing

⁸Donald R. Gant, "Illusion in Lease Financing," Harvard Business Review, XXXVII, No. 2 (March-April, 1959), p. 123.

⁹Alvin Zises, "From the Thoughtful Businessman: Letters Review readers," Harvard Business Review, XXXVII, No. 3 (May-June, 1959), p. 16.

his own funds.¹⁰

1. Through the service of leasing companies. A leasing company may quote on a leasing proposal under a manufacturer's requisition. When the transaction is approved, the manufacturer passes the title of the equipment to the leasing company, and the leasing company invoices the user for the rent. The transaction is regarded as an outright sale by the manufacturer. The leasing company normally reserves any value left in the used equipment at the termination of the lease term. Knowing that manufacturers usually want to control the sale of the used equipment, some leasing companies offer the manufacturer their used equipment at an agreed price, or have the manufacturer recondition the equipment.
2. Through the service of bank. The bank takes an assignment of the lease from the manufacturer and invoices the user for rent. Sometimes, if the user's credit is very good, the bank may, on a nonrecourse basis, advance one hundred per cent of the purchase price to the manufacturer when accepting the assigned lease. Banks may not hold the title of the equipment. Even if they do, it is simply for security purposes. The renewals, depreciation, and disposal of the equipment are the manufacturer's responsibility.
3. Through the manufacturer's subsidiary finance company. Some manufacturers establish their subsidiaries to handle the leases. When additional funds are needed, the subsidiary may obtain a

¹⁰ Griesinger, Op. cit., p. 87.

bank loan on its parent's credit. The overhead expenses of the subsidiary are small and the personnel requirements can be held to a minimum. Thus, the financing and service charge can be reduced to just cover the cost of money, if necessary. Manufacturers often find that by handling their own lease transactions, the regular return of their used equipment by the lessees gives them a good chance to sell their new equipment. And if the used item can be reconditioned economically, the manufacturer can sell them to a low-priced market which may not otherwise be reached.

It is also believed by many that leasing accelerates industrial progress and benefits society as a whole.

BASIC FEATURES OF LONG TERM LEASES

Because leasing is a type of contract, differences exist among lease agreements. Despite these differences, long term leases have certain basic characteristics:

1. A non-cancellable basic term. The length of a lease term varies greatly. Some leases run for more than a century, some run within ninety per cent of the economic life of the asset, and others may run for shorter periods.¹¹ Many leases offer the lessee certain options during the basic term.
 - a. The lessee can sublet the property, usually real estate.
 - b. The lessee can purchase the property.
 - c. If the property is returned to the lessor, the lessee would pay any difference between the lessor's proceeds from the sale of the property and its unamortized cost.
 - d. The lessee can cancel the lease with a new or larger asset rented in its place.
2. Periodic rental payments to the lessor in recovery of his original investment in the asset plus a fair return. Rentals are usually level throughout the lease term. However, they may be at high levels for a period of time and then decrease or they may be at low levels during the initial period and later increase. Some rentals are set up at a fixed percentage of the lessee's annual

¹¹Myers, Op. cit., p. 71.

sale or gross profit with a minimum limit. Rental payments may be increased to cover maintenance., insurance, taxes and other services to be rendered by the lessor, though in most cases, the lessee is responsible for these expenses.

3. Some of the options at termination are:

- a. The lessor is entitled to the property.
- b. The lessee has the right to purchase the property at the market price.
- c. The lessee has the right to purchase at a nominal price.
- d. The lessee has the right to renew the lease at market price.
- e. The lessee has the right to renew the lease at a nominal price.

As there are different types of lease plans, there are different types of lessors:

1. Owner-Operator. This type of lessor leases his property for a period shorter than its useful life. He also offers many services. His rent revenue covers not only interest and depreciation, but also the cost of services.
2. Financial institution. Insurance companies, pension trusts, educational institutions, though prohibited by legal restrictions from owning some types of properties as investments, become lessors through the use of intermediate corporations.
3. Leasing company. Often, leasing companies buy the equipment for specific leases. The lessee pays for taxes, insurance, and maintenance.
4. Manufacturer. Manufacturers, as mentioned earlier, use leasing as one of their marketing tools. Some manufacturers may produce

certain equipment to fit their customer's requirements. Many manufacturers offer services, such as repair and maintenance.

CURRENT PRACTICES OF DISCLOSING
LONG TERM LEASES IN FINANCIAL STATEMENTS

A. LESSEES

The information given in the 1961 edition of Accounting Trend and Techniques showed that 377 out of 600 companies under survey did not refer to or indicate long term leases in their financial statements. Some of these 377 companies did not have lease arrangements, some failed to report them. Others considered their leases as immaterial, even though their annual rental payments were a material amount compared to the total liability they had.

Among the companies that indicated their lease arrangements only a very few showed them as assets and liabilities in the balance sheet, e.g., Allied Paper Corporation, Continental Air Lines Inc., and Mohasco Industries Inc..¹² Most companies that showed their leases disclosed them through footnotes to the financial statements, and the extent of information given varied widely. According to Accounting Trends and Techniques, only a small portion of the companies under analysis, such as Marshall Field & Co., and Montgomery Ward & Co. Inc., disclosed the current rental charges either in a note or as a separate item in the income statement. Some companies though reporting the current rentals amount failed to mention the life of the leases. Several major oil companies showed the rental expenses net of rental income.

Most companies that gave lease information in their financial reports

¹²Ibid., p. 23.

indicated their future rental obligations. Some of them disclosed the obligations, typically the minimum rentals, with a brief note, while others went further into the details. Tishman Realty & Construction Company indicated in notes, its twelve leases, the expiration dates and the annual rentals of each of them. Montgomery Ward, in its Form 10k for the year ending February 1, 1961, showed the minimum annual rentals due in each year from 1961 to 1965 and the aggregate rentals due in each five-year period through the year 2000. It also showed the aggregate rentals due after year 2000.

Not many companies indicated the obligations associated with their leases in addition to the rentals. Sears Roebuck & Co. was one of the few that stated their obligations to pay taxes, insurance, and other expenses.

Only ten per cent of the recent annual reports of lessees indicated any option rights. Among all the companies under survey, only one company, the Ritter Co. Inc., stated the restrictions on dividends and working capital under its lease contracts.

There were various treatments and informations about the transactions of sale and leaseback. Some companies deferred the gain on the sale and amortized it over the lease periods, some showed the gain as a special item in income statements, while some did not mention the treatment and the gain or loss. The selling price, the cost of the asset, and the lease term were not always given.

B. LESSORS

Many lessors did not give any indication either in the balance sheet or in notes that part of their income came from leased assets. Nor did

they indicate the assets which were leased. Some manufacturing companies did give the fact that a certain part of their income was from the leased asset, though they failed to state how much it was. IBM in its income statements had the item, "Gross income from sales, services, and rentals in U. S.". Certain manufacturers had in their balance sheets separate items showing assets for lease purposes, and/or items such as, "Lease and conditional sale contracts".¹³ According to insurance regulations, life insurance companies that owned leased assets frequently carried the account in the balance sheet and wrote it off annually as depreciation expense. Real estate operating companies typically stated separately, in the income statements, the rental revenue and its related expense and in the balance sheet the assets for leases. Leasing companies did not have a typical way of handling their lease transactions. The Hertz Corporation recorded its rents as revenue and depreciation on the leased assets as an expense. The "Revenue Earning Assets" were reported separately from the "Plant, Equipment, and Intangibles". Booth Leasing Company and United Leasing Corporation both carried a "Rents receivable" account and an "Estimated residual value on lease equipment" account (cost less depreciation) as assets. Booth Corporation deducted an "Unearned income" (difference between rent receivable and the cost of the leased asset less estimated residual value) from the receivable. United State Leasing carried the "Unearned income" in liabilities. Booth Corporation stated in a footnotes to the 1960 and 1961 financial statements that "... unearned

¹³ Ibid., p. 31.

rentals ... are taken into income each month as earned on the sum-of-the-month-digits basis ... ".¹⁴ United States Leasing, on the other hand, stated 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."¹⁵ No further information is given as to how it recognizes its deferred revenue.

With the wide variety of presenting lease data, comparability among companies is very difficult, if not impossible. Most of the time, readers of the financial statements are not given enough information to enable them to estimate the effects rental obligations or rental income have on a company's position. Although the problem of disclosure of leases has been the subject of much discussion for several years, no general agreement has been reached.

¹⁴Ibid., p. 102.

¹⁵Ibid., p. 33.

TWO APPROACHES IN
PRESENTING LONG TERM LEASES ON
LESSEE'S FINANCIAL STATEMENTS

A. BALANCE SHEET AND FOOTNOTE PRESENTATION

The leasehold interests in facilities and the related rental obligations have been regarded as assets and liabilities by many accountants. They believe that the only adequate way of presenting these assets and liabilities is to report them in a balance sheet. The value of the asset, the right to use the property, to be shown on the balance sheet is the cost the lessee assumes in the lease transaction. This is equal to the liability the lessee bears. The amount of liability is believed to be the present value of the future rental payments discounted at the effective interest rate of the specific liability. This rate can be determined by analyzing the relationship among alternative purchase prices, annual rentals and the residual value at the termination of the lease.¹⁶ In a sale-and-leaseback transactions, the interest rate is readily available, because the sales price and the rental schedules are known. In other cases, the interest rate would have to be estimated. The following rates are suggested by John Myers: (a) the prime rate adjusted for the company's credit worthiness, (b) the rate the company is paying for loans recently negotiated, plus one half to one percentage point because of the lease, or, (c) the price on the bond market of similar credit (again raised a point

¹⁶Gordon Shillinglaw, "Leasing and Financial Statements," The Accounting Review, XXXIII (October, 1958), pp. 581-592

or less).¹⁷

At the termination of the lease term, whatever option is available to the lessee, it would have no effects on the method of recording the value of the assets and liabilities except it is more difficult to estimate than without the option. Rental payments occasionally reflect services to be provided by the lessor, such as heat, maintenance, and property taxes. Because this portion of the payment is not related to the acquiring of the right to use the property, it should not be discounted but rather should be charged as periodic expenses.

It is suggested that at the time when the lease agreement is negotiated, the following entry would be made:

Right to use leased asset	xxx
Rental obligation under long term lease	xxx

When the rents are paid, the following entries would be made:

Rental obligation under long term lease	xxx
Interest expense	xxx
Cash	xxx

In the early periods of the lease, the interest element will be relatively high, but will decline gradually as the amount of debt declines. The portion of the principal repayment will increase as a smaller portion of rental payment is applied to the interest.

The asset of lease right will be amortized each year for the same reason that a purchased asset is depreciated. The periodic entry would

¹⁷ Myers, Op. cit., p. 46.

be:

Amortization expense	xxx
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Allowance for amortization of right to use leased asset	xxx
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Amortization schedules for this type of asset would be determined in the same manner as depreciation schedules for other assets. They can be based on straight-line, accelerated, or other methods based on activity. The unamortized asset is not necessarily equal to the related liability account. The operating rate of the asset and the rate of reduction of the liability are independent factors. The amortization expense should be divided among cost of sales, selling and other expenses. The interest expense should be handled in the same manner as other interest.¹⁸

Many sale-and-leaseback transactions result in gains or losses. Myers considers the transaction as a single economic or financing transaction. He believes that cash would be debited and a liability account would be credited. The original property accounts on the book would still be used with their depreciation carried out as usual. No gain or loss arises as no property has been removed from the balance sheet in exchange for cash. The annual rental payments would be charged partly against income as interest and partly as a reduction of the liability. However, if the economic value of the property is substantially lower than the undepreciated cost, a write-down of the value of the property would be appropriate.¹⁹

¹⁸ Leonard E. Morrissey, Contemporary Accounting Problem. (Englewood Cliff, N. J. : Prentice-Hall, Inc., 1963), p. 374.

¹⁹ Myers, Op. cit., p. 51.

This viewpoint is not shared by many people. Arthur Andersen & Co. regards the sale and leaseback as "interrelated and interdependent transactions". Any gain resulting from the sale is a "current anticipation of profit at the expense of the future lease period". In order to match properly the costs and revenues, the company is of the opinion that the gains or losses (net of tax effect) should be spread over the lease term as an adjustment to the depreciation expenses.

Some leases ask for a minimum rental plus a given percentage of gross revenue or gross profit. Gordon Shillinglaw suggests that only the minimum rentals should be capitalized. Any excess should be reported as periodic financial expense. He believes that the liability of the firm is represented by the minimum requirement of the contract.²⁰

In the balance sheet, the leased assets would be included among the property, plant and equipment accounts. Myers argues that because they are not available in case of bankruptcy is not a reason to report leased assets separately. The mortgaged assets are not reported separately, and they are not available at bankruptcy. However, in his opinion, at the present time, the separation could be set out within the fixed asset section to let the readers get accustomed to their inclusion on the balance sheet. The obligation for lease rentals due will be shown on the liability side of the balance sheet with the current portion shown among the current liabilities. Data similar to that given in bond issue could be included, such as interest rate, termination, and annual rentals. In

²⁰Shillinglaw, Op. cit., pp. 581-592.

case there are a number of leases, a supporting schedule can be used to supplement a single figure on the balance sheet. Footnotes can be used to disclose information about the leases deemed necessary by the management.²¹

Many accountants and business managements disagree with the balance presentation. They believe that footnote disclosure is a more reasonable method of reporting long term lease agreements because leases do not in any way constitute assets or liabilities to the lessee, but rather expenses and hence should not be disclosed in the balance sheet. The annual rental payments are charged in income statements spread among cost of sales, and selling and administrative expenses. Alvin Zises suggests the use of "Schedules of Material Contractual Commitments" to provide full information on activities which do not logically belong to the balance sheet, such as purchase commitments, employee contracts and long term leases. The schedule shows the types of commitments, amount paid currently, minimum balance to be paid over the contract years, amount to be paid for each of the following five years, each of three following five year periods, and the remaining years over which each commitment extends. Any pertinent information regarding the commitments should be disclosed with the schedules. It is believed that not only does the schedule emphasize the disclosure of the commitments, but also is a more accurate way of presenting the lease arrangements.²²

²¹Myers, Op. cit., p. 57.

²²Alvin Zises, "Disclosure of Long Term Leases," The Journal of Accountancy, CXI (February, 1961), pp. 37-47

A comparison of these two method produces a very interesting result. For example, at the end of the year ZED Company had thirteen million current assets, one million other assets, five million current liabilities, and nine million owner's equity. There are no long term liabilities. A note stated that substantially all of the plant and equipment used for operations were leased. The leases expire at various dates from 1959 to 1979. Aggregate rentals amount to nine million, of which five hundred and fifty thousand is payable the following year.²³

If the company's leases were reported as assets and liabilities current and other assets remained the same. The right to use leased assets at discounted amount of future rental payments would be four million in land and buildings and two million in equipments, totaling six million. The total assets would be twenty million instead of frouteen million. Current liabilities would be five million and five hundred thousand, including five hundred thousand current portion of lease rentals. Long term liabilities composed of the discounted amount of rental payments less the current portion were five million and five hundred thousand dollars.

The asset value appearing on the second balance sheet is 1.43 times the value on the first one. The value of both current and long term liabilities are increased. Some of the ratios appear as following:

²³Kenneth R. Rickey, "Including All Leases in The Balance Sheet-A First," N.A.A. Bulletin, (December, 1959), pp. 51-60.

	first balance sheet	second balance sheet
Current ratio	2.6	2.36
Quick ratio	1.4	1.27
Liabilities to Equity	55%	122%
The return on assets in use (assuming a net income of \$2,800,000)	20%	14%

The net income in this case are assumed to be the same under both methods. In many cases, because the annual rental expenses under the footnote disclosure method may not be equal to the annual depreciation plus interest expenses under balance sheet presentation, the net incomes are different; so are the earning per common share, the return on assets in use.²⁴ Another ratio very often used is the number of times fixed charges were covered. If the leases are to be reported in the balance sheet, the number of times fixed charges were covered will be less than if the leases are disclosed through footnotes because the interest charges are buried in the rental expenses under the later method, and are not included as a portion of the fixed charges. By disclosing the lease contracts through footnotes, a company may outwardly appear to have higher credit standing and, thus, obtain more financial sources at a lower interest rate. ZED Company's capital structure is in every respect the same under both reporting methods, but appear significantly different!

In addition to these disadvantages on financial statement analysis, balance sheet disclosure has other disadvantages for the lessee.

²⁴Gant, Op. cit., p. 131.

1. Rental expenses of land, buildings and equipment are considered as a component of expenses in pricing products produced for military use by the Department of Defense. However, the Department has never regarded the cost of debt as an expense for pricing purpose.
2. If local government levies taxes on total capital, the lessee may be taxed on the leased assets.
3. The income tax postponement advantage discussed earlier may be lost, as depreciation and interest expense may be smaller than the annual rental obligations, which appear as expenses under footnote disclosure method.

B. OPINION PRO FOOTNOTE DISCLOSURE

For those who agree with the footnote disclosure their viewpoints are:

1. Leases have always been considered as operating expenses. In many cases, the court held that the agreement to pay rent is not a debt or liability until it is due.²⁵
2. If a lease with its executory contract status should be capitalized, the rights and obligations existing under other executory contracts such as purchase commitments or employment contracts should be recorded in a like manner.
3. The amount derived by present capitalization technique does not represent the true value of the liabilities of a lease contract.

²⁵Donald C. Cook, "The Case Against Capitalizing Leases," Harvard Business Review, XXXI, No. 1 (January-February, 1963), p. 151.

First of all, the appropriate discount rate is not determined. Secondly, there are great variations among different lease contracts. Can a numerical figure truly reflect the impact of these differences? Thirdly, how much of the rent should be capitalized when annual rentals are of a certain percentage of the gross sales or gross profit? Cook states that²⁶

... the simple fact is that such measurement, based on discounted values at assumed interest rates ... would in most cases be sheer guesswork which, under the certificate of the auditor, would give the illusion of certainty where none exists.

4. For evaluation purpose, footnote disclosure can present a full and meaningful picture of a company's financial position. More complete and accurate information can be provided through footnote disclosure than can be through one figure put on the balance sheet, especially when the reliability of the figure and status of leasehold interest of an asset are in doubt. It is believed that balance sheet and the statements of income and owner's equity reflect a company's financial condition at a certain point of time and its operating results during a particular period. They are not designed to reflect the effect of future operations on a company's financial conditions. Any effort in trying to reflect future events on the statements will simply cause confusion.

²⁶ Ibid., p. 154.

²⁷ Ibid., p. 155.

5. The legal status of a lease is different from that of debt.

a. According to the history of law, a lease is regarded as a contract rather than a conveyance. The early English law concerning the lease of real property considered the rights of the lessee as his contractual rights to use property. From year 1200 to 1500, the English Common Law recognized the lessee as the owner of an interest in the property. After 1800, this common law continued to emphasize the contractual nature of the lease. Modern U. S. law is a synthesis of conveyance notions. However, a trend toward recognizing the lease as a contract is getting stronger.²⁸

b. A lease of real property, in its very nature, is an executory contract.

(1). The landlord, throughout the lease term, has a continuing responsibility to grant to the lessee quiet enjoyment of the property. Whenever the landlord fails to do so, the lessee can leave premises free from any further obligations to pay rent. In a recent case, *Evans vs. Kroh*, the court specifically noted²⁹

The obligation to pay rent was not an unconditional one, since it was contingent upon the the future use and enjoyment of the leased property by Kroh(the lessee) The relationship of lessor-lessee is not always coexistent

²⁸Ibid., p. 149

²⁹Ibid., p. 151.

with that of debtor-creditor. An interruption of the peaceable enjoyment and possession of the leased property under certain circumstance would excuse the lessee from the obligation to pay any future rental.

- (2). The doctrine of anticipatory breach has been applied to lease agreements. This application is a recognition that the lease is a bilateral contract where something remains to be performed by both parties. It is quite different debt which is an executed contract where the creditor has no further obligation.
- (3). The doctrine of frustration also proves that the lease is an executory contract. Under this doctrine, a tenant is released from paying further rent when, during the lease term, some supervening event prevents him from using the property. Many courts believe that the lease is not completely executed before the lease term expires and the conditions are fulfilled.
- c. The law concerning the lease of chattels or the lease of personal property came from the Roman law. The concept of conveyance has never existed in this area. The part of law about the lease of personal property belongs to the law of bailments. This part of law regards the relationship between the bailor and bailee as contractual.
- d. Another factor which distinguishes the debtor and lessee is their legal liability under bankruptcy or reorganization. A lessor can only claim one year of rent in bankruptcy and three

years of rent in reorganization.³⁰ A creditor's position under these circumstances is quite different in that he is entitled to the full amount owed him.

C. OPINIONS PRO BALANCE SHEET TREATMENT

Those who think that the preferred procedure of reporting long term leases is through balance sheet state their reasons as following:

1. Leasing is a method of debt financing similar to purchasing by borrowed funds. The lessee is obligated to make a series of payments in the future. Their rental payments are similar to the payment of interest and principal under a debt. An investor, upon deciding whether to enter into a lease transaction, looks more to the lessee's general credit as a security factor rather than to the values of the property involved.³¹ Banks, insurance companies, and other lending institutions also recognize that because the credit pool of a lessee is not a bottomless one, the lease affects a company's ability to meet its obligations. Because of the similarity between debt and lease, the lessee is believed to acquire an asset, the property right, while creating a fixed obligation.³²

³⁰ Gant, Op. cit., p. 124

³¹ Ibid., p. 123.

³² Arthur Andersen & Co., Accounting and Reporting Problems of The Accounting Profession, (October, 1962), p. 31.

2. Footnotes should not be used as a substitute for proper financial presentation. They should disclose supplemental information, explain captions and amounts in financial statements to complete the statements. Because the lease creates assets and liabilities for the lessee, they should be presented in the balance sheet rather than disclosed through footnote.³³
3. The right to the use of the property and the related obligations are, in fact, asset and liability. Moonitz states that "Accounting data are based on prices generated by past, present or future exchanges which have actually taken place or are expected to." John Myers believes that in a lease contract, an exchange has already taken place. The right to use the property is a resource, an asset to the lessee, and the obligation to pay rents is a claim against his interest. As the function of accounting is to measure the resources held by specific entities and to reflect the claims against and the interests in those entities,³⁴ presenting the right and the obligation under a lease contract is compatible with the function. Myers also states that according to the definition given by Kohler, an asset is

Any owned physical object(tangible) or right (intangible)

³³ John L. Hennessy, "Recording of Lease Obligations and Related Property Rights," The Journal of Accountancy, CXI (March, 1961), pp. 40-46.

³⁴ Robert T. Sprouse & Maurice Moonitz, A Tentative Set of Broad Accounting Principles for Business Enterprise, Accounting Research Study No. 3 (New York: American Institute of Certified Public Accountants, 1962), p. 7.

having a money value; ... any cost benefiting a future period. ... The accounting meaning of ownership as 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) ...

Assets, then, can be rights to use certain property not owned in the legal sense. A leasehold improvements, for example, which legally belongs to the lessor is considered as asset of the lessee.³⁵ Canning in his Economics of Accountancy defines an asset as

... 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 person. Such a service is an asset only to the person or set of persons to whom it runs.

According to this definition, the future service in a lease transaction, the right to the use of the property, is an asset to the lessee. If the lessor would render other services in the future, they should not be regarded as assets to the lessee. They are services arising from a contract the two sides of which are

³⁵ Myers, Op. cit., p. 39.

proportionately unperformed.³⁶

Liability is defined by Canning as

...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 specified services of equal or greater money value due from this second person to the proprietor.

In a lease contract, except for some services, such as maintenance, heat or elevator, the lessor has completed his service by making the property available. The lessee thus bears a liability to the lessor.³⁷ Moonitz believes that the basic characteristics of a liability are:³⁸

- a. A liability involves a future outlay of money, or an equivalent acceptable to the recipient.
- b. A liability is the result of a transaction of the past, not of the future.
- c. The amount of the liability must be the subject of calculation or of close estimation.
- d. Part of a double-entry system is taken for granted.

He states that "The outlays under leasehold contracts clearly qualify as liabilities not only under the definition developed in this article, but also under the legal definitions."

³⁶ Ibid., p. 40.

³⁷ Ibid.

³⁸ Maurice Moonitz, "The Changing Concept of Liability," The Journal of Accountancy, CIX (May, 1960), pp. 41-46.

4. many financial institutions and financial analysts are fully aware that lease commitments are in fact a form of indebtedness. Many of them, while analyzing the financial position of a company, can only estimate the obligations its leases represent in an attempt to rebuild the company's balance sheet. Due to the lack of information, the estimation may be dramatically different from the real figure. In addition to the institutions, there are many investors who are not aware of the significance of lease rental. For those investors who are aware of it may lack the knowledge of evaluating it from limited informations available. In order for the financial statements to be useful, meaningful, and to represent fairly the financial position of a company, the property rights and the rental obligations should be included in the balance sheet. It also help to compare the positions of different firms using different financing methods.³⁹
5. Purchase commitments and employment contracts are different from leases in that leasing is a financing device while the future commitments are not a means of financing. They are contracts to be performed in the future by both parties, and are what Canning refers to as "one in which the liability is unconditionally an agreed set-off against the service". So they should not be regarded as assets.⁴⁰

³⁹Myers, Op. cit., p. 52.

⁴⁰Arthur Andersen & Co., Op. cit., p. 31.

D. SEC REQUIREMENTS

S-X Rule 3.18 recommends that rental payments under long term leases should be presented in balance sheets or footnotes. Any important information should also be disclosed. Besides, SEC requires companies that fill out the form S-9 to include, in addition to interest, an appropriate portion of rental obligations under long term leases in computing the times their fixed charges have been earned.

E. AICPA'S POSITION

The Accounting Principle Board of the AICPA issued its Opinion No. 5, "Reporting of Leases in Financial Statements of Lessee", in September, 1964. This Opinion is to supersede Chapter 14 of Accounting Bulletin No. 43, "Disclosure of Long Term Leases in Financial Statements of Lessees". The recommendations are:

1. Leases that are in substance purchases should be capitalized. The assets and the related liabilities should be stated at the discounted amount of the future rentals, excluding the payments for taxes, insurance, and other services to be rendered by the lessor. The assets are to be depreciated each year according to their nature and use.
2. Leases with any of the following characteristics should be considered as purchases:
 - a. If it requires a rather high rental payment in the early years of the lease with the option of purchase or renewal during or at the termination of the lease term at a price far less than

the fair value of the property at that time.

- b. The property was acquired by the lessor to fit the lessee's specified requirements and can not be used for other purposes.
 - c. The lease term is about the same as the useful life of the asset, and the lessee pays for taxes, insurance, and maintenance which are considered as owner's expenses.
 - d. The lessee and lessor are closely related, e. g., the lessor is an unconsolidated subsidiary of the lessee, or the lessee and lessor have common officers, directors, or shareholders.
3. For material non-cancellable leases, sufficient information should be disclosed so that the reader can estimate the effect of lease agreements on the lessee's financial position. The financial statement or the accompanying notes should state the minimum annual rental payments, the lease term, the current rentals if they differ greatly from the minimum types of asset leased, obligations assumed or guarantees made, and any provision of significance, such as restrictions on further leasing.
4. Material gains or losses (together with the tax effect) resulting from the sale and leaseback transactions should be amortized over the lease term as an adjustment to the rental cost or depreciation expense. However, if the fair value of the asset at the time of the transaction is less than its undepreciated cost, the loss should be recognized as a write-down of the asset value.

F. SOME OBSERVATIONS

Due to the arguments between the group that favors footnote disclosure and the group that favors balance sheet treatment, Richard F. Vancil and Robert N. Anthony made a survey about the practices and attitudes of the financial community toward the problem of lease presentation. The following are some of their discoveries:⁴¹

Many financial institutions think that some fromal analytical techniques for evaluating lease obligations, such as capitalizing lease obligations or adding part or all of the lease obligations to interest in computing times fixed charges are earned are desirable. But only a few of them use certain fromal procedures. Insurance companies and commercial banks use some of those techniques more often than mutual funds, invertments banks, and pension fund trustees. Among the ninety-four insurance companies and ond hundred and forty-eight commercial banks under survey, twenty-eight insurance companies and thirty-three commercial banks consider the lease payments as fixed charges with most of them treating the minimum annual rentals as the portion of the fixed charges. Some however, treat two third of the rentals as fixed charges. Twenty-five of ninety-four insurance companies and seventeen of the one hundred and forty-eight commercial banks use the capitalization procedure. However, the discounting rate used varies widely. Some use 5% to 6%, others use either 4% or 7%, or any rate considered appropriate.

Among the corporations under survey, 35% of them have some restrictions against their noncancellable leases because of their debt.

⁴¹Richard F. Vancil and Robert N. Anthony, "The Financial Community Looks at Leasing," Harvard Business Review, XXXVII, No. 6 (November-December, 1959), pp. 113-130.

One fourth the corporations have effective lease restrictions, i.e., restrictions that limit the amount of new assets to be acquired on a lease financing basis. By excluding utility companies, however, 47% of the companies having restrictions on debt have effective lease restrictions. Among the companies that have effective lease restrictions, 94% of them apply to real estate and 53% of them apply to equipment and chattels. Usually, it is when a company's long term debt is equal to 15% of its total capitalization (long term debt + capital + surplus), that effective lease restrictions emerge.

Among the financial analysts under the survey, 86% of them consider leases as equivalent to debt. Many of them believe that the reasons leasing bears a higher interest rate than debt are:

1. The financial institution has a greater risk of loss.
2. The financial institution has greater administrative and clerical costs.
3. The lessee is willing to pay more for the advantages he can obtain.

Most of them believe that leasing enables a company to obtain more credit than it can from debt.

PRESENTATION OF LONG TERM LEASES
ON LESSOR'S FINANCIAL STATEMENTS

So far, the presentation of long term leases by the lessor has not received widespread public interest as has presentation by the lessee. Little has been written about this subject. Presently, the two most frequently used methods are:

1. Financing method. This method is similar to that used by most lending institutions in accounting for level repayments. The excess of aggregate rentals over the cost of the leased property in the form of interest income is recognized as revenue over the lease term on a declining basis. At the inception of the transaction, a receivable account is debited and a property account is credited. The amount of the receivable should be the present value of the periodic rentals, excluding any to be paid for services to be rendered by the lessor. The asset amount to be removed from lessor's statements should be equal to the asset cost less its value at termination, if any.⁴²
2. Operating or rental method. This method asks for recognition of current rental receivable as periodic revenue, unless it distorts the periodic revenue. Depreciation, maintenance, service costs, and other costs related to the leased property determined in the normal manner are charged as periodic expenses.

⁴²Myers, Op. cit., p. 64.

The Accounting Principles Board in its Opinion No. 7 "Accounting for Leases in Financial Statements of Lessor" recommends that:

1. In reporting the lessor's lease agreements, the method chosen should be the one that presents fairly the lessor's income.
2. For companies that engage among other activities, in lending money at interest, such as banks, insurance companies, and pension funds, the financing method should be used.
3. For companies that bears the ownership risks, provides maintenance and other services relating to the lease activities, the operating method should be used.
4. If a company engages in both type of leases, both methods should be used. If a single lease has both characteristics, the method that can state most fairly the net income of the lessor should be chosen.
5. When the leasing investment is relatively large, a separate account should be used on the balance sheet. If the financing method is used, rental receivables should be classified with or near receivables with the current and noncurrent portion separately stated. Any residual value should be classified with or near the plant and equipment account. If the rental method is used, "property held for or under lease" should be used with or near the plant and equipment account and an allowance account should be set up for depreciation. The method used in reporting leases should be indicated and sufficient information should be disclosed, so the readers can estimate the effects of leasing

arrangements to the company. The ordinary disclosure requirements also apply to these accounts.⁴³

Myers does not share the same opinion. He believes that the method to be used should be judged on the basis of which leases are presented on lessee's book. If there has been a transfer of property right, and the lessee has recognized his assets and liabilities, the lessor instead of preserving his property, should write the asset account off and debit a receivable account. The rental method can be used when the receivables from the lessee are for services rendered rather than the transfer of the asset.⁴⁴

⁴³Accounting for Leases in Financial Statements of Lessors, Accounting Principle Board, Opinion No. 7, (American Institute of Certified Public Accountants, May, 1966), p. 55.

⁴⁴Myers, Op. cit., pp. 64-65.

CONCLUSION

Leasing has a growing importance as a device of financing. However, only a few companies indicate their lease arrangements in their financial statements. It is believed that in order to provide statements which represent fairly a company's financial condition, more information about long term leases should be disclosed. The problem is how to report them.

From the way long term leases have been applied in recent years, it can be seen that they bear a close relationship to other forms of long term debts. The lessees are required to make a series of payments over fixed periods. The rentals during the basic period or the term of the lease are designed to recover the net cost of the property (cost less salvage value, if any) plus a fair return to the lessor on his invested funds.⁴⁵ These rental payments are as much fixed obligations as interest and sinking fund requirements of a debenture issue. Lessors, before making the decision whether to enter a lease contract, generally looks to the credit of the lessee for security. Many of the financial institutions believe that lease commitments take away part of a company's total credit pool. They take into consideration a company's lease obligations when evaluating its ability to meet its debts. Every business needs fixed assets, not because of the desire to own them, but rather because of the desire to use them. With the hope of avoiding heavy investment of company funds or of conserving working capital, companies

⁴⁵ Richey, Op. cit., p. 52.

sometimes choose leases instead of ownership. Another reason is because of the inability to borrow long-term money. The advantages of income tax postponement and the current accounting practice of not showing leases in balance sheet also affect a company's decision. In many cases, the decision is not based on operating considerations, but rather on financial considerations. Leasing is, in essence, a form of borrowing, perhaps borrowing an asset rather than the funds with which to purchase it. But it results in obligations substantially the same as those incurred in borrowing money.

Besides the fact that leasing is a form of borrowing, the right to use the leased property and the rental obligation are asset and liability respectively. Many accountants pointed out that assets are economic in nature, that they are service potentials against future wants. Kohler includes intangible rights having a monetary value as assets. He states that legal ownership is not a necessary element in constituting an asset, an equity in the asset coupled with possession and use, is an asset to the owner of the equity. An automobile purchased on the installment basis is regarded as an asset to the purchaser even though the legal title may not belong to him. Moonitz and Sprouse defined assets as "... expected future economic benefits, rights to which have been acquired by the enterprise as a result of some current or past transaction."⁴⁶ Assets can be tangible or intangible. For intangible assets, the future services may be the result of some contractual arrangements, other legal

⁴⁶ Sprouse and Moonitz, Op. cit., pp. 20-22.

rights, or some unique economic characteristic. Although the lessee has no legal ownership of the assets leased, the right to use them embodies some future economic benefits for him and is the result of some contractual arrangements of the past. According to the definitions by Kohler, Sprouse and Moonitz, that right does fall in the class of assets.

The liabilities of a business enterprise are defined as " ... obligations to convey assets or perform services; obligations resulting from past or current transactions and requiring settlement in the future."⁴⁷ Canning states in his definition of liability that " ... which (liability) 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 (creditor) to the proprietor." When a lessee enters into a contract, he agrees to make a series of future payments for the right to use the property made available by the lessor at the inception of the contract. The obligation to make future payment is "... a result of past or current transaction requiring settlement in the future." without any "... set-off against specific services ..." due from the lessor. They do fall within the category of liability. In some leases, the lessor provides maintenance, taxes, heat and elevator services. This portion of the rentals appears to be set-off against the services to be rendered and are not to be shown as liabilities, but rather expenses.

An argument against capitalizing leases has been that the legal status of a lease is different from that of a debt, that when the lessee

⁴⁷Ibid., p. 37.

is under bankruptcy or reorganization his legal liability is junior to that of a debtor. However, there are cases in which the court has held that the lessee's rental obligations are as much liabilities as debts.⁴⁸ The essential point is that accounting is mainly concerned with the economic activities of a business. The financial position shown by the statements should be a function of the economic position of a business rather than a function of the legal forms of it. Also the financial statements ordinarily do not contemplate liquidation. When a company is in financial difficulty, a completely different approach is used which will affect not only lease obligations, but also many other items on the balance sheet.

In the financial statements of the Great Atlantic and Pacific Tea Company for the year ending February 27, 1960, no long term liabilities were shown.⁴⁹ The company disclosed in its footnotes that on February 27, 1960, it had approximately four thousand and six hundred leases with an annual rental of about fifty-six million and five hundred thousand dollars, ranging from three to ten years. Some people believe that the present value of the rental obligations was about five hundred and sixty million dollars which is about fifty-five per cent of total long term liabilities and capital and surplus.⁵⁰ Others believe that the figure may be

⁴⁸ Moonitz, Op. cit., pp. 41-46.

⁴⁹ Myers, Op. cit., P. 112.

⁵⁰ T. A. Wise, "The Auditor Have Arrived (Part II)," Fortune, (December, 1960), p. 144.

considerably smaller than that.⁵¹ Whatever figure it may be, the readers of the statements must make their own judgement with whatever inadequate information he can obtain from the footnotes. Many of the readers may not be aware that the lease obligations constitute a debt and may ignore the footnote disclosure completely. Those who are aware of the fact can, only at the best, make a rough estimate of the value of the obligations, which very often is far different from the real figure. Business managements are the only ones that have all the information necessary to compute the present value of their rental obligations. They are responsible for presenting them to the public to prevent the misconceptions about their financial positions. Neither of the two reporting methods will make any difference to the business managements for decision-making purposes. They know (or presumably should) that lease obligations are fixed obligations. However, business managements are reluctant to capitalize the leases because of the expected adverse effect upon their credit standing. As has been discussed earlier in the ZED Company's case, the outward appearance of the Company's financial position is a much stronger one if the lease arrangements are reported through footnotes rather than through balance sheet. But the fact is that most financial institutions already recognize the effect of lease obligations and are using certain techniques to reconstruct the financial statements of the companies with lease agreements. It might be better for the managements to present the lease obligations in a balance sheet to prevent some false estimation, which may

⁵¹Myers, Op. cit., p. 52.

have an even greater harmful effect for the company.

It is generally agreed that the amount of a long term liability is the present value of the future payments discounted at the effective interest rate of the specific liabilities. The value of the liabilities under long term leases should then be the present value of the future rental obligations. The difficulty is that for most of the liabilities, the discounting rate is known, while the interest rates have to be estimated for long term leases. Concerning the value of the asset to be put on the balance sheet, Ziese suggests that the figure should be adjusted for the operation, financial and tax effect. Theoretically, the true worth of an asset is the discounted present value of the probable future earnings it can produce.⁵² However, not only are estimates of future earning power highly subjective and often inaccurate, but also the earnings of a business are a joint product of all its resources. Thus it is virtually impossible to identify the contribution of any specific asset. So accountants have been reporting assets at cost, because it is the most unbiased appraisal of the economic value of the assets. The discounted cash flow method of evaluating investments is a good device for decision-making purposes. It reveals the future cash flow advantages among alternatives of investment in an asset. However it does not represent the discounted present value of an asset's service potential. Before any technique can be developed that can truly represent the earning power of an asset, the value of the right to use the property

⁵²Walter B. Meigs, Charles E. Johnson and Thomas F. Keller, Intermediate Accounting, (McGraw-Hill Book Company, 1963), p. 579.

should be the discounted present value of the lessee's future rental obligations, because it is the price he pays for the purchase of it. When other depreciable assets are reported at cost on the balance sheet, it would not be consistent to report the right on a different basis. As for the lessor, the valuation of the receivable should be the discounted present value of his future rental receivables excluding any rentals for any service to be rendered by him. The amount of the property account to be removed from the lessor's books should be the cost of the property less any residual value to be left to the lessor at the termination of the lease.

Myers suggests that the sale and leaseback transaction should be considered as a single economic transaction to raise money with a property given for security. No gain or loss arises from the transaction because no property has been removed from the balance sheet in exchange for cash. This suggestion, though it simplifies the recording of the event, may not be sound. Sale and leaseback transactions are interrelated and interdependent transactions. Any gain resulting from the sale is a current anticipation of profit at the expense of the future periods. In order to match properly the costs and revenues, the gain or loss should be spread over the lease term as an adjustment to the depreciation expenses.

From what has been discussed above, it would appear that balance sheet presentation is a more appropriate method of reporting long term leases on lessee's books. This is not only because the right to use the asset and the related obligations are asset and liability, but also

because it is fairer to all the parties involved. The same reasons should be applied to the lessors. If the lessee recognizes that he has acquired an asset and assumed the obligation to pay for it, the lessor no longer has the same asset, but instead has a receivable. The rental method can be used only when the receivables are for services to be rendered.

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REPORTING OF LONG TERM LEASES
IN FINANCIAL STATEMENTS

by

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Since the 1940's, long term leases have been a popular financing method. The presentation of them in financial statements varies greatly among companies. Accountants have been trying to work out an appropriate way to report them. Some believe that long term leases should be disclosed through footnotes, other believe that they should be reported on the balance sheet.

From the way long term leases have been applied recently by the lessees, it appears that they are a form of debt. The right to use the leased property and the related rental obligations both fall in the categories of assets and liabilities. They should be presented in the balance sheet in order that the financial statements represent fairly the financial position and operation results of the lessee.

The two frequently used methods in reporting lessor's lease transactions are financing method and rental method. Which of these two methods is more appropriate should be judged on the same basis applied to the lessee. If the lessee recognizes that through a lease transaction he has acquired an asset and assumed debt, the lessor no longer has the asset but instead has a receivable.