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Proceedings: Public Hearing on Leases, Section B - Position Papers

American Institute of Certified Public Accountants. Accounting Principles Board

P R O C E E D I N G S

PUBLIC HEARING ON LEASES

ACCOUNTING PRINCIPLES BOARD

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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SECTION B

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PROPOSED CHANGES IN ACCOUNTING OF LESSEES AND LESSORS

Hearing on October 14 and 15, 1971

Issued by

Committee on Accounting for Leases by Lessees
and
Committee on Accounting for Leases by Lessors
of the
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American Institute of Certified Public Accountants
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PROPOSED CHANGES IN ACCOUNTING OF LESSEES AND LESSORS

APB Hearing in October

The Accounting Principles Board of the American Institute of Certified Public Accountants is studying some aspects of the accounting of lessees and lessors for leases. Two Board committees will hold an open hearing on October 14 and 15, 1971 to consider various problems and proposed changes in accounting for leases. This memorandum is intended to inform individuals and groups who may wish to attend the hearing of the matters that the Board plans to consider.

Limited Inquiry. The study stems from problems encountered in applying APB Opinion No. 5, "Reporting of Leases in Financial Statements of Lessee," (September 1964) and APB Opinion No. 7, "Accounting for Leases in Financial Statements of Lessors," (May 1966) and from some alleged inconsistency between the two Opinions. The Board expects to define more clearly those leases that lessees should account for as in substance acquisitions of property and those that lessors should account for by the financing method and to solve some related problems.

The Board does not contemplate rescinding or changing the fundamental conclusions of Opinions No. 5 and No. 7. That is, the Board does not now plan to consider expanding the compass of the financing method to include other than financing leases or extending the provisions to capitalize leases that are not in substance acquisitions of property. Nor is it considering proposals to account for all leases by the operating method or to substitute disclosure of provisions of leases or present values of rental payments for capitalization of some leases. The Board is dealing with specific problems in accounting for leases, and accounting for executory contracts generally or commitments generally are not pertinent to the subject of the hearing.

The problems in accounting for leases may be the same for lessees and lessors even though the interests of the two parties in a lease transaction may differ. Since the Board originally issued two separate pronouncements and is now considering the question of interdependence of lessees and lessors, the present study will distinguish between the problems of each party.

Substance of Leases. Both APB Opinions No. 5 and No. 7 contain the same idea: the provisions of some lease contracts result in transactions with substantially the same economic effects as purchases or sales of similar property that are paid for in installments and financed by the seller or a third party. Since the substance of a lease contract may differ from the legal form, the Opinions attempt to describe the substance that distinguishes those leases that are in effect installment purchases of property and those that are in effect installment sales or financing for lessees. However, Opinion No. 7 expresses the idea of substance broadly and Opinion No. 5 defines it narrowly.

Problem Areas. The key problems in accounting for leases by lessees and lessors that the Accounting Principles Board plans to study fall into three main categories:

> Financing Leases. Identifying or clarifying the provisions of leases or other conditions that distinguish between financing leases and operating leases of lessors.
>
> Capitalization as Purchases. Identifying leases that lessees should capitalize as in substance installment purchases of leased property, including leases in addition to those in which the lessee creates a material equity in the property through rental payments.
>
> Interdependence of Lessee and Lessor. Specifying the extent to which accounting by lessees and lessors should be complementary and the extent to which the accounting should or may diverge.

The Board is also considering six supplementary but related problems:

> Profit (or Loss) from Manufacturing. Clarifying the recognition of a gain or loss on sale at the time the property is leased by lessors who are manufacturers, dealers, or other middlemen.
>
> Related Lessor and Lessee. Clarifying the relation between a lessor and a lessee that requires a lessee to record a lease as an installment purchase of property.

Interest and Depreciation. Considering the extent to which interest expense and depreciation expense are separate expenses from borrowing money and owning assets respectively and the extent to which both are costs of a single group of services from an asset which should be considered together in measuring periodic net income.

Sale and Leaseback. Refining the recognition of gains or losses on sale-and-leaseback transactions.

Computation of Present Value. Considering the desirability of more specific requirements to compute the present value of rental payments.

Profit on Sale to Lessor and Assignment of Lease. Considering the profit that a manufacturer or dealer should recognize at the time property is sold to a lessor with special guarantees by the manufacturer or dealer and the profit that a lessor should recognize at the time a lease is assigned to a financial institution or other third party.

The discussion in the remainder of the memorandum describes the more important problems in each area.

Financing Leases

Opinion No. 7. APB Opinion No. 7, "Accounting for Leases in Financial Statements of Lessors," describes two distinct methods for lessors to account for leases: (1) the financing method—rental payments collected are recognized as recovery of an investment and interest revenue at a level rate on the unrecovered investment—and (2) the operating method—rental payments collected are recognized as revenue. The results of the financing method of accounting are essentially the same as the accounting for lending and collecting activities of financial institutions and for installment selling and collecting activities of industrial and mercantile enterprises. The Opinion also describes and explains the reasons for the procedures of accounting for assets, revenue, and expenses that follow from the two methods.

The APB is not reconsidering the two methods of accounting themselves but is concentrating on guides or ways to determine the method that is suitable for a particular lessor or lease.

Basis for selection--Opinion No. 7 concerns allocating revenue and expenses of leasing activities to the accounting periods covered by leases and declares that fairly stating the periodic net income of a lessor is the primary objective in choosing between the financing and operating methods. The Opinion relates each method to different types of leases or leasing activities, and the distinctions depend on the underlying nature of leasing activities and the substance of lease contracts. Pertinent factors in selecting the financing or operating method include: (1) nature of business activities of lessor, (2) objectives of lessor in leasing, including relation to other activities of the lessor, (3) length of lease in relation to estimated useful life of leased property, (4) provisions of renewal or purchase options and likelihood that lessee will exercise, and (5) provisions that indicate the extent to which lessor and lessee have the usual risks or rewards of ownership (for example, obsolescence, profitable or unprofitable operations, unsatisfactory performance, idle capacity, and gain or loss in value of property at end of lease).

The Opinion emphasizes the nature of business activities of lessors and the party who holds the risks or rewards of ownership. Financial institutions—for example, lease-finance companies, banks, insurance companies, and pension funds—should, with some exceptions, use the financing method, but the operating method is appropriate for enterprises in which leasing activities are an integral part of manufacturing, marketing, or other activities because revenue and expenses of leasing and other activities are intertwined. A lessor should account by the financing method for leases that pass all or most of the usual ownership risks or rewards to the lessee and generally limit the recovery of the lessor to his investment plus a reasonable rate of interest; a lessor should account by the operating method for leases in which he retains the usual risks or rewards of ownership.

Application of Opinion--The principle that the two methods of accounting are suitable for different types of leases or leasing activities underlies the selection of an appropriate method and is set forth in the Opinion. Some lease contracts of lessors are easily classified as a financing lease or an operating lease by their provisions or the other criteria in the Opinion. Difficulties are encountered because many lease contracts are complex and combine features of both types of leases and the countereffects of some provisions seem to bar the leases from either method. The Opinion does not distinguish between leases of land, improved property, and various types of personal property. The type of property or conditions such as need for continuing service may influence the selection of method of accounting because they clarify or obscure the substance of the lease or the nature of leasing activities.

The Problems. The Accounting Principles Board is now considering ways to distinguish more clearly between financing leases and operating leases. Before the Opinion is amended or reaffirmed, the Board needs to be satisfied that pertinent aspects of the problems are discussed fully. The Board recognizes that as a minimum certain questions must be answered, and several are listed below. Other matters may, of course, be equally important.

> Which features or provisions of a lease identify its nature or substance?
>
> What features or characteristics of a lessor determine the nature of his business activities?
>
> What features of a lease or lessor may be ignored?
>
> Can a single feature control to determine the substance of a lease?
>
> Must all conditions and provisions be weighed and if so, how much weight should be given to different ones?
>
> Can a few key criteria or quantitative rules be formulated to distinguish satisfactorily between financing and operating leases?

Controlling Provisions and Conditions. Some provisions of leases may be vital in determining the nature of a lease and other provisions may be secondary features. The parties to the lease contract and other conditions are also factors.

The range of provisions and conditions that may be among the controlling characteristics is shown in the following list.

The lessor is

- a financial institution, an organization that is engaged primarily in lending money at interest.
- a nonfinancial institution, an organization that manufactures or acquires property to lease to others.

The lessor acquires title to the leased property from

- the lessee
- the manufacturer
- another party.

The lease is

- noncancellable by either party for a specified term
- cancellable at the option of one or both parties under specified conditions.

The term of the lease or the initial term plus renewal terms

- equals or almost equals the entire estimated useful life of the leased property
- expires before the estimated useful life of the leased property.

The total rental payments

- equal approximately the cost of the leased property plus interest
- equal approximately the selling price (or other fair value) of the leased property plus interest
- exceed the cost of the leased property plus interest
- are less than the cost of the leased property.

The periodic rental payments are

- obviously greater than prevailing rentals of similar property
- approximately equal to prevailing rentals of similar property
- determined by formula based on activity.

Title to the property passes to the lessee

- after payment of a specified number of periodic rental payments
- at the option of the lessee to apply the rental payments to the purchase price under a stated formula

- at the option of the lessee to purchase the property at its fair or market value at the end of the lease
- only outside the provisions of the lease, if at all.

Significant values or benefits of the leased property remaining at the end of the lease are

- likely to be obtained by the lessee either (a) without significant payments (example—nominal price of renewal or purchase option) or (b) with significant payments (example—relation of rental payments to remaining value of property dictates that the lessee exercise his option)
- likely to be retained by the lessor because either (a) the lease provides for no renewal or purchase option or (b) the lessee is unlikely to exercise the options.

The usual guarantees or warranties of the manufacturer

- are granted to the lessor who in turn grants them to the lessee
- are granted to the lessor who grants them plus others to the lessee
- are granted to the lessor with supplementary guarantees of the manufacturer and the lessor grants only the usual ones to the lessee.

Those or other conditions may be the basis for judging the nature of a lease and thus the method of accounting by a lessor.

Proposed Solutions. Brief descriptions of some proposals that the Board is studying may help to clarify the problems.

One recommendation is that the general criteria stated in APB Opinion No. 7 for applying the financing and operating methods of accounting are adequate and can be interpreted satisfactorily.

Another view is that the principles in the Opinion are sound and the criteria are generally acceptable but the criteria need to be clarified and their impact on choice of method needs to be described in more detail. For example, conditions and provisions of leases such as those listed in the preceding section might be analyzed to determine how each affects the distinctions between financing and operating leases. Some might be given more weight in the selection of method than others, and a combination or preponderance of conditions or provisions indicating one method or the other would determine the accounting by a lessor.

Another proposal is that some conditions or provisions of leases are overriding and their presence shows that a lease is a financing lease or an operating lease. For example, various proponents hold that one—or perhaps two or three combined—of the following conditions or provisions show that a lease is a financing lease: the lessor is a financial institution, the buyer acquires title to the leased property and then leases it back to the seller, the noncancellable term of the lease covers the entire useful life of the leased property, the lessor recovers his investment (or fair value of the property) plus interest from the rental payments, title passes to the lessee after specified payments, or the lessee can pay a nominal price at the end of the lease and obtain large remaining value. Similarly, one or two of the following conditions are enough to decide that a lease is an operating lease: the lessee can escape the unfavorable impact of obsolescence or idle capacity through guarantees or cancellation clauses, the lessee can obtain significant benefits of the leased property at the end of the lease only by paying more than the fair value of the property, rental payments vary with activity such as sales revenue or time used, or the lessor retains the asset at the end of the lease and its value is expected to be significant.

A fourth recommendation is to specify quantitatively the overriding or determining conditions or provisions of leases. For example, rules or tests might specify that a lease should be accounted for by the financing method if its noncancellable term covers substantially all, perhaps at least 90%, of the estimated useful life of the leased property and by the operating method if it covers less than 90%. Or the Board might specify that a lease should be accounted for by the financing method if the rental payments under the lease recover the selling price (or other fair value) of the property plus reasonable interest. That is, the present value of the rental payments discounted at a reasonable rate of interest at least equals the current selling price of the leased property. Less than full recovery of the investment should require accounting by the operating method. A rule might be that a lease should be accounted for by the financing method if the lessor retains no significant value at the end of the lease, perhaps as a test that the discounted (or undiscounted) estimated residual value does not exceed 10% of the selling price (or cost) at the date of the lease; a significant residual value (more than 10%) should lead to the operating method. Quantitative rules or tests might be applied singly or in combination.

Restraints and Complications. The problem of distinguishing between financing leases and operating leases is complicated by the need to consider interest rates, interaction of variables, and the nature of some leased property. For example, a lease that may appear to provide for recovery of investment plus interest through its rental payments may fail to provide for recovery because the interest rate is higher—that is, more of each payment is interest and less is payment of principal. Thus a nine-year lease that recovers the investment plus 10% interest will recover about 94% of the investment if the interest rate is 12% and only about 87% of the investment if the interest rate is 15%.

To the extent that a lessor's investment is not recovered through rental payments the lessor must look to the value of the property at the end of the lease. The length of the lease, the amount of the rental payments, the amount of residual value, the current selling price or other fair value of the property, and the rate of interest are interrelated variables. Uncertainty about one or more of the variables may mean uncertainty about the reasonableness of others. In general, both the approximate interest and the usual current selling price of the property must be reasonably determinable to analyze the substance of a lease with some confidence.

A lease for land and building may have all or most of the characteristics that usually distinguish a financing lease except that the property reverts to the lessor at the end of the lease, which corresponds to the end of the estimated useful life of the building. The question is whether a lease of land can ever be considered to be a financing lease or whether a building or other improvements can be separated from land to account for part of the lease as a financing lease.

A mixture of provisions in a lease may seem to lead to several conclusions and complicates designating that the lease is financing or operating. An illustration of a lease with mixed conditions and provisions is: (1) the noncancellable term of the lease is substantially less than the estimated useful life of the leased property, (2) the value of the property at the end of the lease is probably significant, (3) the present value of the rental payments discounted at the market rate of interest equals the usual selling price of the property, (4) the lessor is a financial institution which acquired title from the manufacturer, and (5) renewal and purchase options are at other than nominal prices and exercise by the lessee is at least questionable.

The lease illustrates several potentially conflicting conditions and provisions. The lessor recovers his investment plus interest, unless the interest rate is too low for the risks involved. The lessor probably retains significant value at the end of the lease. The lessor apparently passes most of the usual risks of ownership to the lessee but retains rewards of ownership.

The lease may be the same in substance as a lease for the entire estimated useful life of the property, but the substance may also be different. The fact that the term is less than the entire life may not be crucial. The substance of a lease for the entire estimated useful life of property can be the same as that of a lease with higher payments over a shorter period provided the lessee is permitted to use the property for the entire life. Renewal or purchase options may grant that privilege but doubt about the likelihood of exercise may mean that the options are ineffective. If the substance of the lease in the illustration is not essentially a lease for the entire estimated life, it may possibly be considered a financing lease on some other basis.

Capitalization as Purchases

Opinion No. 5. APB Opinion No. 5, "Reporting of Leases in Financial Statements of Lessee," provides that lessees should recognize an asset and a related liability for leases that are essentially equivalent to installment purchases of property. The accounting for the asset and liability is essentially the same as for an asset acquired in exchange for a mortgage note payable or other secured liability. Opinion No. 5, like No. 7, does not distinguish between leases for land, improved property, and various types of personal property.

Paragraph 9 of Opinion No. 5 equates some leases to installment purchases and paragraph 10 identifies those leases as noncancellable leases in which the lessee creates a material equity in the leased property through the rental payments. The characteristics usually indicating that a lease is essentially equivalent to a purchase are: (1) neither party may cancel unilaterally except for the occurrence of a remote contingency and (2) either (a) the noncancellable term of the lease is significantly shorter than the estimated useful life of the property, and the lessee has an option to renew the lease at rentals substantially below the fair rental value or (b) the lessee has an option to purchase the property at a price substantially below the probable fair value of the property.

Paragraph 11 of the Opinion contains other conditions that tend to indicate that a lease is in substance a purchase: (1) the lessor acquires the property to meet specific needs of the lessee and the property probably has no other use, (2) the term of the lease is for the entire estimated useful life of the property, and the lessee pays taxes, insurance, maintainence, and other expenses usually incidental to ownership, (3) the lessee guarantees the debt of the lessor that pertains to the property, and (4) the lessee treats the lease as a purchase for tax purposes. However, those four conditions do not apply if it is clear that no material equity of the lessee results from the rental payments.

Application of Opinion--Two major problems have been encountered in applying the concepts of the Opinion. First, the decisions on whether or not a lessee creates a material equity in the property are diverse, that is, the estimates of whether a lessee obtains an equity and, if so, that the equity is material. Uncertainties about the fair value of the property at the end of the lease and the exercise of renewal or purchase options and confusion about the relation of the conditions in paragraph 11 to those in paragraph 10 of APB Opinion No. 5 contribute to diverse application. Second, the concept and criteria for a financing lease in APB Opinion No. 7 are related to the idea that some leases are in substance installment purchases of property but are somewhat different from the concept and criteria of a material equity. Some observers say that the concepts and criteria in the two Opinions are incompatible.

The Problems. The Accounting Principles Board is now reconsidering the definition of a lease that is in substance an installment purchase of an asset. The reconsideration stems at least in part from alleged inconsistencies between Opinion No. 5 and Opinion No. 7. The problems are presented in several ways.

> Should other conditions (for example, those in paragraph 11 of Opinion No. 5) be equal to or take precedence over creating a material equity in the property to determine the substance of a lease to a lessee?
>
> Should the same general principles and criteria for distinguishing between financing and operating leases of lessors also apply to the accounting for leases of lessees?
>
> Which features or provisions of a lease distinguish its nature or substance?
>
> Which of the lease provisions and conditions listed on pages 6 and 7 indicate that a lessee has in effect acquired the property and financed it with a lease?
>
> Conversely, which of those provisions and conditions may be ignored?
>
> Does the nature of a lessor's business activities have a bearing on the substance of a lease to the lessee?
>
> Can a single feature control to determine the substance of a lease?

> Can a few key criteria or quantitative rules be formulated to distinguish satisfactorily those leases that are in substance purchases?

Some of the questions are the same as the problems of lessors in accounting for leases. Agreement or disagreement of the answers needs to be justified.

Interdependence of Lessee and Lessor

Opinion No. 7. The Accounting Principles Board notes in paragraph 18 of APB Opinion No. 7 that questions have been raised about inconsistency between the two lease Opinions. The specific question is stated as whether lessees should capitalize leases that lessors account for by the financing method. According to that paragraph, capitalization of leases other than those that are in substance installment purchases of property may not be necessary to state net income of lessees fairly because the amount of the rental payments may be a proper expense in determining net income. The paragraph questions whether lessees should report assets and the related obligations for leases other than those that are in substance installment purchases of property as described in Opinion No. 5.

The Problems. The Board is not considering whether a lessee's accounting for a lease should depend on the lessor's accounting for the lease, or vice versa. The problem is one of concept, that is, do common principles apply to both sides of a single lease transaction? In other words, should the same standards, criteria, or rules determine that a lease is in substance a financing lease to the lessor and is in substance an installment purchase by a lessee, and vice versa? If the accounting of each party is determined by the same principles and criteria, the property should, at least in concept, be reported in either the balance sheet of the lessor or of the lessee but not in both.

The question noted in paragraph 18 of Opinion No. 7 is now somewhat rephrased. The present question is whether the same characteristics that make a lease a financing lease of a lessor also make it in substance an installment purchase of a lessee. The emphasis is on financing leases that also may be in substance installment purchases.

The need for interdependence between accounting for leases by lessors and lessees or its irrelevance obviously affects the study of both Opinions No. 5 and No. 7. Views and reasons on the extent to which the accounting of lessors and lessees should or should not be complementary and the extent to which they may or should diverge will aid the study.

Profit (Loss) from Manufacturing

Opinion No. 7. Paragraph 12 of APB Opinion No. 7 permits a manufacturer-lessor to recognize sales revenue and a profit or loss on manufacturing a product that is leased under a financing lease as if the product had been sold at the date it is leased. Dealers and other middlemen who can determine normal selling prices of leased property should also recognize a trading profit at the time the property is leased. A lessor records as manufacturing or trading revenue the lower of the regular sales price of the property and the present value of the rental payments. The revenue recognized is also recorded as the cost of the property for applying the financing method to the lease. The reason underlying the recognition of manufacturing and trading profit is that the financing method accounts for a lease essentially as an installment sale of the property.

Paragraph 12 of APB Opinion No. 7 refers to the earlier guidelines in the Opinion for a manufacturer-lessor to select the financing or operating method of accounting for leases. The paragraph also enumerates the conditions necessary to recognize manufacturing or trading revenue and profit at the time property is leased: (1) credit risks are reasonably predictable, (2) the lessor does not retain sizable risks of ownership of the nature described earlier, and (3) no important uncertainties surround costs yet to be incurred or revenue yet to be earned under the lease. The three conditions differ from the criteria for financing leases because only the risks of ownership but not the rewards are mentioned and credit risks and uncertainties of future costs and revenue are added.

Application of Opinion--Opinion No. 7 says that leases should be accounted for by the operating method unless the conditions to recognize a manufacturing or trading profit are met and should be accounted for by the financing method if the conditions are met. Thus, the conditions of paragraph 12 may mean that a manufacturer-lessor is required to account by the operating method for a lease that otherwise meets the criteria for a financing lease. Some accountants believe that the conditions in paragraph 12 of Opinion No. 7 are in part inconsistent with the earlier criteria. Others interpret the conditions differently and the resulting applications are confusing.

Leases for less than the estimated useful life of the property are the most troublesome. Since a lessor can expect to receive significant revenue from the property after the lease, the accounting is for a partial "sale" of the property through the lease and a later "sale" of the remainder or rental revenue either through disposal or another lease. The result is neither accounting for an installment sale of property at its usual selling price nor accounting for an operating lease.

The Problems. If using the financing method remains prerequisite for lessors to recognize manufacturing or trading profit, the conditions for the financing method and the conditions for recognizing profit need to be reconciled. The question earlier in this memorandum of whether the financing method should be used for leases in which the lessor transfers the risks but retains substantial rewards of ownership is pertinent to the accounting of a manufacturer-lessor. Another question is whether conditions such as reasonable prediction of credit risks and reasonable certainty about future costs and revenue under a lease should be specific conditions for using the financing method as well as for recognizing manufacturing or trading profit.

The Board has not yet discussed recent suggestions that manufacturer-lessors or dealer-lessors who use the operating method may recognize manufacturing and trading revenue and profit.

Related Lessor and Lessee

Opinion No. 5. Paragraph 12 of APB Opinion No. 5 provides that a lease between related parties should often be accounted for as an installment purchase of property even though the lessee does not build up an equity in the property through the rental payments. The paragraph contains two conditions, one of which has two parts, for applying the principle: (1) the primary purpose of owning the property is to lease it to the lessee and (2) either (a) the rental payments are pledged to secure debts of the lessor or (b) the lessee can, directly or indirectly, control or influence significantly the actions of the lessor. Four illustrations indicate that candidates for applying the paragraph are leases involving unconsolidated subsidiaries, common key personnel or stockholders in lessor and lessee, dependent lessors created by lessee, and other potentially controllable lessors.

Opinion No. 10. Paragraph 4 of APB Opinion No. 10, "Omnibus Opinion—1966," provides for consolidation in consolidated financial statements of a subsidiary corporation whose principal business activity is leasing property or facilities to its parent or other affiliates. Capitalizing a lease with a leasing subsidiary is thus academic because the property is shown as an asset of the consolidated entity and rental payments are eliminated in consolidation.

The Problems. The problems in applying paragraph 12 of Opinion No. 5 are in deciding whether a relation between lessor and lessee requires application of the principle. Apparently either the conditions and examples in paragraph 12 of Opinion No. 5 need to be explained and clarified or the relationships that require capitalization should be more detailed. Among the specific relationships proposed as usually requiring capitalization whether or not the lessee obtains a material equity are: (1) leases with or between subsidiaries not covered by Opinion No. 10, (2) leases with corporate joint ventures and other corporations in which the lessee holds an influential stockholding (for example, 20% or more), (3) leases with so-called phantom or dummy corporations, whether or not created by the lessee, (4) leases with a lessee's pension trust, profitsharing fund, or charitable foundation or with entities that those organizations control or in which their investment in voting stock confers significant ability to influence, and (5) leases with entities in which officers, directors, or significant stockholders of the lessee occupy influential positions.

Factors such as pledging rental payments to secure debts of a lessor, a lessee's potential but not present control of lessor, purpose of lessor's owning of property are not discussed in detail in the Opinion. Perhaps lessees apply the provisions differently because the Opinion does not state which factors are primary, supplementary, or irrelevant if other factors override.

Interest and Depreciation

Opinion No. 5. Paragraphs 9 and 15 of APB Opinion No. 5 provide that an asset recorded because a lease is in substance an installment purchase should be depreciated without reference to the term of the lease. That is, the method of depreciation should be based on the nature, use, and the estimated useful life of the property rather than on the period over which rental payments under the lease discharge the related liability. Expenses related to a capitalized lease include a declining amount of interest over the term of the lease and depreciation of the property computed by a straight-line or accelerated method. The Opinion therefore implies that the expected result of capitalizing a lease is that expenses are normally higher in early years of a lease and lower in later years than the level rental payments.

The Problems. Some observers contend that the level expenses that result from accounting for rental payments as expense give better matching of costs with revenue than the usual accounting for ownership of property that is financed by mortgage notes or other secured liability. A lessee could obtain a level expense for capitalized leases in either of two ways: (1) by adopting an annuity, sinking fund, or equivalent compound interest method of depreciation that results in an increasing expense for depreciation that offsets the decreasing expense for interest or (2) by capitalizing interest on the related liability as part of the cost of the property and computing the combined interest and depreciation expense on a straight-line basis.

Compound interest methods of computing depreciation may or may not be generally accepted accounting principles—they are rarely, if ever, applied except by some public utilities. Capitalizing interest related to lease obligations has broad implications for other accounting procedures. The argument that level expenses produce better matching needs to be defended.

Sale and Leaseback

Opinion No. 5. Paragraphs 21 and 22 of APB Opinion No. 5 provide that gains and losses from sales of properties that are leased to the seller-lessee should generally be deferred and amortized over the life of the lease rather than recognized at the time of sale. The reason is that a sale and leaseback are not independent transactions; thus neither the sales price nor the rental payments can be evaluated objectively. The Opinion mentions a few exceptions: a seller-lessee should recognize a loss on a sale and leaseback that is properly recognizable without a sale of the property and may recognize a gain or loss on a sale and leaseback in which both the use of the property changes and the sales price reasonably approximates that determined in an independent transaction.

The Problems. The Opinion is somewhat hazy in distinguishing between leases that are capitalized as installment purchases and those that are not. The effect of deferring a gain or loss on sale of property that is leased back is the same as not recording a sale as long as the gain or loss is amortized over the life of the asset rather than over the term of the lease. Questions about recognizing gain or loss therefore pertain principally to sale and leaseback transactions in which the lease is not accounted for as an installment purchase. Some questions are:

> Should a gain or loss on sale in a sale and leaseback always be deferred or should some circumstances permit or require exceptions?
>
> Is change in use of the property a significant factor in accounting for gain or loss on sale?
>
> Should the term of the lease in relation to the estimated useful life of the property influence applying the principle?
>
> Should a seller-lessee who leases back only part of the property recognize a gain or loss? If so, what amount?

Computation of Present Value

Opinion No. 5. Paragraphs 9 and 15 of APB Opinion No. 5 state that a lessee should capitalize leased property at the discounted amount of the future lease rental payments. The rental payments exclude payments to cover taxes and operating expenses other than depreciation.

Opinion No. 7. Paragraph 5 of APB Opinion No. 7 describes interest under the financing method for lessors as the difference between total rental payments under a lease and the cost of the leased property. The unrecovered investment therefore is the present value of future rental payments.

The Problems. Lessees and lessors may have interpreted the general guides of the Opinions in various ways and not computed the present value of rental payments uniformly. Practical problems encountered in computing present values of leases involve including or excluding rental payments for the term extended by exercising renewal options, amounts of purchase options, estimated residual values, varying rental payments, and land rentals.

Since lease contracts customarily do not specify an interest rate, providing guides to help lessors and lessees select an appropriate rate might be desirable. The variety of lease provisions and individual conditions may make specific requirements impracticable.

Profit on Sale to Lessor
and Assignment of Lease

Opinion No. 7. Paragraph 12 of APB Opinion No. 7 specifies the conditions that a manufacturer, dealer, or other middleman who is also a lessor should meet to recognize a manufacturing or trading profit at the time property is leased. One of the conditions is that the manufacturer-lessor does not retain sizable risks of ownership.

The Problems. APB Opinion No. 7 covers specifically manufacturers, dealers, and other middlemen who are also lessors. Some manufacturers have sold property to financial institutions or other parties who lease the property to third parties, but the manufacturers have extended their usual guarantees through various forms of commitments to insure that the lessor will recover his investment. Other manufacturers have leased property under leases classified as operating leases and have assigned the leases to financial institutions. The problems to be considered involve the amount of manufacturing profit or loss, if any, that a manufacturer may recognize at the time property is sold to a lessor if the manufacturer assumes additional guarantees to the lessor. Unless a manufacturer recognizes a profit or loss on a sale at the time property is transferred to a lessor, the basis on which the manufacturer should later recognize a profit or loss should be determined. The discounting with a third party of operating leases by a manufacturer-lessor involves the problems of accounting for the receipts from the financial institution and determining if the manufacturer realizes a manufacturing profit or loss at the time the leases are assigned.

Accounting for Leases by Manufacturer or Dealer Lessors

Question -- APB Opinion No. 7 describes two methods of accounting for leases entered into by lessors: (1) the financing method, which essentially recognizes a lease as the equivalent of a loan or a sale, and (2) the operating method, which recognizes a lease as only a rental agreement. Although many leases can be clearly identified as being either "financing" or "operating" leases, other leases are difficult to classify. In some cases, a manufacturer or dealer may sell or assign a lease to an independent financing institution with certain guarantees, raising questions as to the accounting for the sale or assignment. Likewise, a manufacturer or dealer may sell property to an independent financing institution which leases the property with certain guarantees by the manufacturer or dealer, creating complications in accounting for the transaction. Additional complications are created if these transactions are with an affiliated entity rather than with an independent entity. How should the various factors specified in the Opinion be evaluated by a lessor in determining whether to apply the financing or operating method to account for a lease transaction?

Interpretation -- The Accounting Principles Board is currently undertaking an overall review of lease accounting and has scheduled public hearings on the broad subject. Any Opinion issued on the subject may supersede the existing pronouncements and this Accounting Interpretation. In the meantime, paragraphs 7-9 and 12 of APB Opinion No. 7 specify the factors which determine whether a leasing transaction should be accounted for by the financing method or by the operating method. Applications of the Opinion have varied in the past because of different interpretations of those paragraphs and various practices have been generally accepted. This Accounting Interpretation is being issued to clarify future application of APB Opinion No. 7 until the Board issues a pronouncement on lease accounting.

Assessing Transfer of Risks and Rewards

A lease which transfers title to the property without cost or at nominal cost to the lessee by the end of its fixed, non-cancellable term is clearly a financing lease if there are no important uncertainties surrounding credit risks and future costs. If a lease does not meet these requirements, the other major aspects of the transfer of the risks and rewards of ownership must be assessed.

When there are no significant uncertainties as discussed in this Accounting Interpretation, the lessor should account for the lease under the financing method if the present value (excluding any residual or salvage value) of the required payments under the lease (excluding any renewal or purchase option) during the fixed, non-cancellable term is equal to or greater than the selling price for an outright sale or the fair value (either of which may be less than cost) of the property.

When there are no significant uncertainties as discussed in this Accounting Interpretation and the selling price or the fair value of the property cannot be satisfactorily determined, the financing method should be followed if the fixed, non-cancellable term of the lease (excluding any renewal option) is substantially equal to the estimated useful life of the property.

This test cannot be met (a) by estimating a useful life substantially equal to the non-cancellable term if this is unrealistic or (b) if a material contingent residual interest is retained in the property.

A financing lease must have both reasonably predictable credit risks and reasonably predictable future costs (see paragraphs 8 and 12). A high credit risk *per se* does not preclude use of the financing method. Rather, a high credit risk presents measurement problems and might indicate that a higher than usual interest rate should be applied in determining the present value of the lease payments and that a larger than usual provision for bad debts would be required in determining income.

When a leasing transaction is accounted for by the financing method and a sale is recorded, the cost of the property (not reduced by salvage or residual value) and the estimated future costs should be charged against income in the period of the sale. In some cases, this will result in a loss on the sale.

Uncertainties May Preclude Evaluation

Significant uncertainties may still exist in some lease transactions that appear to meet the conditions of a financing lease. For example, the lease may contain commitments by the lessor to guarantee performance in a manner more extensive than the typical product warranty, to effectively protect the lessee from obsolescence by remodeling the property, etc. The difficulties of evaluating the future costs, both individually and collectively, and thus the maximum potential risks under such commitments may be so great that the transaction should be accounted for by the operating method.

Participation by Third Parties

Some manufacturer or dealer lessors sell or assign leases to independent financing institutions (including leasing companies). Alternatively, a manufacturer or dealer may sell property to such financing institutions at the time of securing a lessee for the property for the benefit of the institution. In either case, a third party is participating in a leasing transaction involving a manufacturer or dealer and the lessee. In these cases, the terms of the underlying lease and the risks and rewards of ownership retained by the manufacturer or dealer determine the accounting for the transaction.

The sale or assignment of an operating lease by a manufacturer or dealer should continue to be accounted for as an operating lease and the proceeds should be reflected as a loan. Likewise, the sale to a financing institution of property subject to an operating lease, with the manufacturer or dealer effectively retaining the risks of ownership, is not a sale in substance and, therefore, should not be reflected as a sale. Instead, the transaction should be reflected as a loan and income should be recognized under the operating method. (Transactions of these types are in effect collaterialized loans from the financing institution to the manufacturer or dealer.) However, the sale of property subject to an operating lease should be reflected as a sale if all risks and rewards of ownership are transferred to the purchaser.

Significant uncertainties of the type described in the preceding section may exist in some third-party participation leases that otherwise appear to meet the conditions of a financing lease.

In these lease transactions, a manufacturer or dealer may by various means guarantee recovery of the investment by the financing institution and retain substantial risks of ownership, thereby protecting the financing institution from such risks. The guarantee may involve a formal or informal commitment by the manufacturer or dealer (1) to acquire the lease or the property in the case of default or termination of the lease by the lessee; (2) to substitute an existing lease; or (3) to secure a replacement lessee or a buyer for the property. (This last commitment is often described as being on a "best efforts" basis but may be effected on a priority basis over other similar property owned by the manufacturer or dealer.)

A manufacturer or dealer may thus retain substantial risks of ownership in a third-party participation leasing transaction as a result of commitments that effectively guarantee recovery of the investment to a financing institution which purchases property. In these circumstances the transaction does not meet the conditions of a financing lease and the manufacturer or dealer is precluded from recording it as a sale. Rather, the transaction should be recorded as a loan from the financing institution with income from the transaction recognized under the operating method. However, the sale or assignment, with or without recourse, by a manufacturer or dealer of a lease that has been determined to be a financing lease does not negate the original determination that the lease should be accounted for as a sale.

Transactions with Affiliates

Some manufacturers or dealers have ownership interests in investee companies (see APB Opinion No. 18), partnerships, or unincorporated joint ventures to whom they sell or assign leases or sell property which is leased to independent lessees. The considerations discussed in this Accounting Interpretation also apply to these transactions. In addition, elimination of intercompany profits and losses may be required.

AIRLINE FINANCE AND ACCOUNTING CONFERENCE

A DIVISION OF AIR TRANSPORT ASSOCIATION OF AMERICA

1000 CONNECTICUT AVENUE, N. W. • WASHINGTON, D. C. 20036 • Telephone 296-5800

October 6, 1971

Mr. Richard C. Lytle
Administrative Director
Accounting Principles Board
American Institute of Certified
Public Accountants
666 Fifth Avenue
New York, N. Y. 10019

Dear Mr. Lytle:

In connection with the October 14-15, 1971 Public Hearing on Accounting For Leases, the Airline Finance and Accounting Conference (Committee on Accounting Principles Board) is submitting these comments for consideration by all parties interested in the development of generally accepted accounting principles.

The airline industry presently leases $2.5 billion worth of flight equipment representing 25% of the value of the commercial aircraft in use in this country. Moreover, the industry also has on order, or optioned, an additional $3.5 billion worth of equipment, a substantial portion of which will be leased. In addition to aircraft leases, the airlines also lease hangars, office space, computers, terminal space, airport ramp equipment and facilities under many different forms of leases and similar contractual arrangements. In light of the magnitude of these sums, we believe the airline industry ranks among the larger lessee groups in the business community.

Traditionally a capital intensive industry, this aspect of our business is growing in emphasis with the advent of technological advance. Each breakthrough in speed, economy and comfort is made available to industry and the traveling public only through the commitment of an increasingly heavier proportion of capital investment. Consequently, long range capital planning and the accompanying fiscal stability thereby achieved is of paramount importance in maintaining this vital segment of the domestic and international transportation system. The proposed capitalization of leases, with its establishment of related liabilities on the balance sheet, will place future leasing and other financing arrangements in jeopardy. This can only result in causing a serious adverse impact on the financial health of an already troubled industry.

Obviously, any external change which may affect the industry's fiscal policies is of serious consequence to us. Accordingly, to assist you in your deliberations relative to prospective lease accounting changes we would like to bring to your attention some of the problems which may or may not be peculiar to our industry, but should be carefully weighed before changes are made in the previously established accounting principles related to leases and other executory contracts.

1. Conflicting Published Reports

A recurring problem which could be of significant dimension, should equipment lease accounting be changed to require capitalizing leases in which the lessee does not acquire a material equity interest, is that of differences in financial reporting in published statements. The air carrier financial statements prepared and published pursuant to the requirements of the Civil Aeronautics Board may differ markedly from those covering the same entities and time periods, but prepared and published pursuant to any changed criteria incorporated in the prospective APB Opinion. Different account and reporting requirements will result in two sets of published financial statements of air transportation companies circulating simultaneously, but varying in such material aspects as net assets, net liabilities, depreciation charges, interest expense, rentals, deferred credits, operating income, net income, etc. The measures derived by examination of published financial statements, including asset ratios, return on investment, debt/equity ratios, etc. would become invalid due to differences virtually irreconcilable without major analysis, interpretation and recalculation which would add greatly to the risk of error and misinterpretation of this data.

2. Executory Contracts

Executory contracts other than leases are also of great importance in the analysis of financial position and results of operations. However, the prospect of adding to the interpretation problem by altering traditional asset and liability accounting to include capitalization of these types of executory contracts would, in our opinion, be premature at this time. There would appear to be little rationale in requiring asset and liability status for equipment lease contract rights and obligations while excluding similar, equally significant contracts. For example, we feel that long-term service (sales) contracts are as important as long-term contracts to supply the equipment and other resources with which to provide the service.

It is hoped that the initial stages of reporting financial and statistical data relevant to executory contracts will be limited to development of meaningful supplementary schedules and intelligible narrative statements. In this manner the level and quality of disclosure would be enhanced, rather than made all the more confusing by inclusion of theories lacking widespread support within both the accounting community and the groups served by the profession.

3. Application to Prior Transactions

The airline industry, as noted above, has already under lease $2.5 billion worth of flight equipment. One of the more vexing problems in considering accounting for these leases involves the restrictive covenants embodied in some of our senior loan agreements and bond indentures. There are air carriers whose loan agreements presently require the inclusion of some types of equipment loan certificate guarantees related to leases (lessor obligations guaranteed by lessees) in determining their present indebtedness and, consequently, the debt levels still available for future borrowing. A requirement to capitalize the guaranteed leases would expose them to the possibility of a double liability by including the capitalized lease liability as well as the related guarantees in debt computations. There is also the danger that recording the liability in connection with leases might, in effect, be treated as mortgages on assets, something which cannot be done under most loan agreements. In this connection, we are advised by legal counsel that capitalizing these leases may be interpreted as violations of negative pledge covenants in certain senior debt agreements which prohibit installment purchases. Generally the senior debt security holders advance funds only upon the condition that they be first in the order of priority in the liquidation of the borrowers' liabilities. A new definition of liabilities might recast this order.

There are carriers who would face the gravest financial consequences if leased assets and related liabilities were capitalized in their financial statements. One major air carrier, with approximately $450 million unpaid principal balance of leased equipment in operation, is concerned that a requirement to capitalize the future obligations of present leases would distort its debt posture to the extent that total liabilities reflected "... in accordance with generally accepted accounting principles..." (the term applied to define "liabilities" within its debt instruments) would reduce permissible borrowings by over fifty percent! An accounting effect of this magnitude would seriously impair the ability of this carrier to obtain financing for future operations.

The foregoing statments have specific reference to leases entered into prior to the effective date of the proposed new Opinion. We are cognizant of the Accounting Principles Board's general practice regarding non-retroactive application of newly enunciated accounting principles, whereby accounting for prior transactions is usually not altered. However, with $2.5 billion of long-term leases already in effect, the anomaly which would be created by excluding them while capitalizing future leases would produce a serious inconsistency in financial statements published by the industry.

We believe these types of problems warrant widespread agreement on their resolution prior to the establishment of changes in accounting rules by the Accounting Principles Board.

4. Tax Consequences

It is of considerable concern that the Internal Revenue Service could hold that future leases recorded as "in substance equivalent to ownership of property" should be treated by the recording entity as owned property for tax purposes. This would result in a substantial loss in investment tax credit if lessors could no longer claim this credit. The air carriers, as lessees, would then be required to indemnify leasing institutions for the loss, plus the tax effect thereon, or incur a greater rental rate. The investment tax credit would thereupon revert to the air carriers who, in many cases, would not be able to use it due to depressed earnings, and have purposely excluded it from their long-range tax planning activities.

5. Income Statements

Costs heretofore recorded as rentals and reclassified to depreciation and interest expense in the income statement would result in a distortion of historical data used for trend analysis, particularly as to levels of operating and non-operating income. The variety of methods suggested for determination of imputed interest rates vary significantly in their resulting expense impact, and each would be of only limited value in terms of its being an appropriate measure of the "cost" of a leasing transaction. For instance, in addition to repaying the lessor for the purchase price of leased aircraft plus a finance charge (interest), the air carriers also give up the investment tax credit and accelerated tax depreciation charges that accrue to the owner of an aircraft. These lost benefits occur when the air carrier assigns its equipment purchase contract with the manufacturer to the third-party lessor. The question arises whether the loss of these tax benefits should be recorded as "interest" or some other charge, and how to measure such lost benefits. Certainly these items constitute relevant income or cash producing factors to lessors.

Another problem area is produced when different interest and principal amortization techniques are applied, resulting in changes in interperiod net earnings. Also to be considered is variances in depreciation lives of owned equipment versus the variety of lease lives in existence for like equipment. Serious confusion to stockholders, management analysts and the general public is the likely result.

6. Financial Statement Disclosure

Today, the ownership of corporate securities is more widespread than previously, and in the hands of less sophisticated investors whose needs for more financial data are far greater. We feel that more comprehensive disclosure of pertinent lease agreement terms is required so that users of financial statements may be able to more fully recognize the impact of leases on the operating results and the financial position of lessee companies. However, we are of the firm belief that this disclosure improvement can best be accomplished via supplementary schedules and improved narrative sections in financial reports, as opposed to incorporation within the formal accounting statements.

The members of the Airline Finance and Accounting Conference (Committee on Accounting Principles Board), whose names appear below, appreciate this opportunity to express their comments on this matter.

Respectfully,

W. M. Hawkins
Executive Secretary

Committee on Accounting Principles Board:

T. W. Morton, Vice President - Finance & Secretary, Piedmont Aviation, Inc.
D. W. Thomson, Vice President & Comptroller, Pan American World Airways, Inc.
W. B. Thompson, Vice President & Controller, Allegheny Airlines, Inc.
R. W. Dunn, Treasurer, National Airlines, Inc.
R. J. Phillips, Vice President and Comptroller, Northwest Airlines, Inc.
J. R. Lynch, Vice President & Controller, Eastern Air Lines, Inc.
J. L. Semple, Vice President & Comptroller, United Air Lines, Inc.
J. K. Kilcarr, Vice President & Controller, American Airlines, Inc.

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ROBERT O. WHITMAN
Vice President and Treasurer

October 1, 1971

Mr. Richard C. Lytle
Admin. Director of APB
American Institute of Certified Public Accountants
666 Fifth Avenue
New York 10019

Dear Richard:

I am pleased to submit 200 reprints of my recent article in Public Utilities Fortnightly entitled "Accounting Issues in the Capitalization of Leases", for advance distribution to participants and other interested parties with regard to the APB Public Hearings thereon on October 14 and 15.

This article reflects the American Electric Power Company position on the issues and reasons for such position.

Sincerely yours,

Bob Whitman

Robert O. Whitman

ROW:DLM

Accounting Issues in the Capitalization of Leases

By ROBERT O. WHITMAN

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Accounting Issues in the Capitalization of Leases

The proposal to capitalize so-called financing-type leases, but not the operational type, has raised grave questions of consistency and accounting validity. It is not based on any differences bearing on the reasons for capitalizing leases. This article suggests that capitalization of leases, by increasing costs to consumers and financially hampering access to property and equipment needed to meet competition, control pollution, and serve a growing population and rising standard of living, may be against the public interest, and that this detrimental effect should be weighed carefully against any benefits that may be supposed to be derived from capitalization.

By ROBERT O. WHITMAN

MOST of the discussion with regard to accounting for leases is directed toward long-term leases, and that is wise. The lease will still be around when the question of how to account for it has been settled. I refrain from adding, "to everybody's satisfaction."

It is only fair to say that the accountants are not alone in having a problem with the true nature of leases. In an article in the *Harvard Business Review* early in 1963, Donald C. Cook showed how, in law, leases of real property had originally been treated as contracts. In the late Middle Ages they had come to be regarded as conveyances, but in the last century and a half the legal pendulum has been swinging back toward the contract concept, agreeing with the view of leases of personal property, which have always been classified in law as executory contracts. Some accountants are on the same trail but on the wrong fork and about 150 years behind when they assert that true leases should be accounted for as purchases.

It must be admitted that there is a problem. Some leases are indeed so much like instalment purchase contracts that it would be unrealistic to account for them otherwise. When a lease provides that the lessee may, or even shall, take title at the end of the lease term upon paying some consideration that appears to be nominal in relation to the prospective value of the property, few would argue that the arrangement is not in substance an instalment purchase contract.

In 1949, in Accounting Research Bulletin No. 38, and again in September, 1964, in Accounting Principles Board Opinion No. 5, it was held that leases should be capitalized if they were in substance purchases. In Opinion No. 5, this determination was based upon a finding, in a noncancelable lease, of the creation of a material equity by the right to purchase the property at a bargain price or to renew the lease for the remaining life of the property at bargain rentals. That requirement was relaxed in the cases of related parties, presumably because the terms of a lease may not be indicative of its substance when one party is subject to the control or influence of the other. Otherwise, the opinion considered and explicitly rejected the theory advocated by some that leases which convey merely the right to use property in exchange for future rental payments should be recorded as assets and liabilities in the balance sheet.

Within less than two years, however, it appeared that the board was suffering a bad case of irresolution. In May, 1966, the Accounting Principles Board issued Opinion No. 7, Accounting for Leases in Financial Statements of Lessors, and somewhat gratuitously indicated that it would continue to give consideration to the question of whether assets and the related obligations should be reflected in balance sheets of lessees for leases other than those that are in substance instalment purchases. In other words, it was considering not simply clarifying but revising the basic principle on which Opinion No. 5 rested.

Impact of Opinion No. 7

Opinion No. 7 was concerned primarily with the problem of allocation of revenue and expense to accounting periods in a manner that meets the objective of fairly stating the lessor's net income, and it described two types of lease agreements, the financing type and the operating type. The financing type is one designed to pass all or most of the usual ownership risks and rewards to the lessee and to assure the lessor of, and generally limit him to, a full recovery of his investment plus a reasonable return on the use of the funds invested. This implies a lease for substantially the full useful life of the property. The operating type apparently comprises all other lease arrangements. Usual ownership risks were described as including, for example, obsolescence, unprofitable operation, unsatisfactory performance, idle capacity, and dubious residual value; ownership rewards would include profitable operation and gain from appreciation in value at the end of the lease.

The opinion provided that financing-type leases should be accounted for by lessors in a manner similar to instalment sales, both as to the description and balance sheet position of the receivable and as to the allocation of rent receipts between income and the receivable. The board took note of a question as to whether for consistency leases accounted for on the financing method by lessors should be capitalized by lessees but appeared to dispose of this question by pointing out that it considered the principal accounting problem of lessors to be the allocation of revenue and expense to accounting periods and that in the case of lessees capitalization might not be necessary in order to state net income fairly; nevertheless, as previously noted, the board went on to say that it would continue to give consideration to balance sheet accounting by lessees.

In August, 1970, the APB Subcommittee on Accounting for Leases issued a discussion outline which seemed to represent that the objective of the APB in reviewing Opinion No. 5 was to clarify that opinion and possibly to require capitalization by the lessee of leases required by Opinion No. 7 to be accounted for by lessors on the financing method. Some of the questions in the outline, however, seemed to go well beyond these objectives, and an accompanying paper, "Theoretical Issues in the Capitalization of Leases," by Richard L. Pannell, CPA, seemed to revive the old debate over the recording of liabilities.

Distinguishing Leases for Capitalization

The proposal to capitalize financing-type leases, but not operating type, seems to be divorced from any consideration of the reasons for recording assets and liabilities in the balance sheet. To begin with, the application of the description "financing" to certain classes of leases may be somewhat tendentious since all leases have a financing element; that is, the lessor supplies the capital cost. The usefulness of the

property to the lessee is the same regardless of whether the lessor recovers his capital cost or whether the lessor receives a reasonable or greater return on his investment. There is some passing of the risks of ownership in any noncancelable lease. The same considerations apply to the liability side—the existence or nonexistence of a liability is not affected by whether the lessor will recover his investment, the reasonableness of his return, or the risk assumed by the lessee of obsolescence, unprofitability, etc. Indeed, to the extent that the rentals may be set higher under an operating-type lease to protect the lessor or compensate him for the risks he retains, the liability of the lessee might be greater than under a financing-type lease for the same period of time. The term of the lease would seem to have little relationship to the reasons for recording assets and liabilities, since it makes them only of shorter or longer term and of smaller or greater amount, but does not change their character.

Regardless of whether they are financing-type or operating-type, we think that where leases are true leases, and not in substance instalment purchase contracts as determined under the criteria of Opinion No. 5 relating to material equity, they are executory contracts and should be accounted for as such. The lessor has not performed his part of the contract by simply making the leased property available at the beginning of the lease. He must continue to make it available, with quiet enjoyment, in every period throughout the term of the lease, and unless and until he does so the lessee has no asset and no liability which should be recorded in the balance sheet. If the lease provides that the lessor shall supply heat, maintenance, elevator service, etc., he must do so because without them the leased space might be useless to the lessee and the lessor's failure might make the lease subject to cancellation. Curiously, some who argue for capitalization of the portion of the rent considered to be allocable to the space as a "service receivable" would omit capitalization of the other services, which are equally receivable and without which the space might be worthless. Similarly, the argument that leases should be capitalized to reflect liabilities falls when it is proposed to omit the portion of the rent allocable to property taxes. This liability is inseparable from the remainder of the rent. Indeed, if the lease should be on a gross rent basis, it is problematical whether the lessee could obtain a reduction in rent even if property taxes were to be abolished.

It has been pointed out frequently in discussions of the capitalization of leases that the lessee does not have a fixed liability because in the event of bankruptcy or reorganization his liability under a lease might be greately limited. The reply that accounting normally should be on a going concern basis and the balance sheet should not reflect the special circumstances of a liquidation that is not anticipated ignores the fact that it is in just those circumstances that a creditor is most interested in the liabilities shown in the balance sheet. In legal reality, and therefore in economic substance, a true lease is not the same thing as debt. To report it as if it were, even though it might be described identifiably, would inevitably cause some confusion and misleading inferences.

Function of the Balance Sheet

Some will say that creditors and others look to the liabilities reported in the balance sheet not as an indication of the amount payable in the event of financial difficulty but as an indication of whether future cash flows might lead to that predicament. This view misinterprets the function of the balance

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sheet and the nature of a lease, which is not a present liability but a commitment. Many enterprises have executory contracts and commitments in the way of contracts for purchase of material, employment contracts, etc., which involve very substantial amounts, in some cases greatly exceeding their commitments under leases. These commitments are now generally omitted from the balance sheet, in part, at least, on the ground that it is not known that the other party will perform. It should be considered, however, that the subject matter of some of these commitments is so essential to the operations of some enterprises that if the enterprises are to be regarded as going concerns it would be necessary to assume that they would have to obtain equivalent materials or services from other suppliers if there should be default in their existing contracts.

Take, for example, a natural gas distribution company which enters into a long-term contract with a pipeline company for a supply of gas. The distribution company might breach a noncancelable lease, perhaps incurring a severe penalty, and still survive, but if it were to terminate its contract for supply of natural gas it would be out of business. For cash flow purposes it would not matter that it might be able to enter into a contract with another pipeline company since it is unlikely that the commitment would be of a different order of magnitude. Therefore, if the balance sheet is to be looked to as a source of information regarding future cash flows and demands upon the company's revenues, it should reflect all material existing contracts and commitments.

Since different commitments could cover different periods, however, the amounts shown in the balance sheet would be an incommensurable hodgepodge which would have to be recast on the basis of the information in the footnotes to produce any meaningful information. Then it would be found that some very material elements of the cash flow, such as labor, are not reflected in any contract or commitment. It quickly becomes apparent that the disclosure of future cash flows is not the proper function of the balance sheet.

It appears clear that any amount computed on the basis of present value of future rentals would not represent an amount owing at the date of the balance sheet; in most cases it would not represent an amount that would have to be paid in the event of liquidation; and it would at best be only a partial and unsatisfactory indication of future cash flows.

The answer to the problem lies in adequate footnote disclosure. Some writers contend that the proper function of footnotes is to supplement, not substitute for, items in the financial statements, but this posture is not realistic when we consider the various kinds of significant commitments for construction contracts, unfunded pension costs for past service, etc., which are regularly disclosed by companies in footnotes to their financial statements but which few people believe should be presented in the balance sheet. It does not meet the objections of those who believe that leases are not a present liability that should appear in the balance sheet, that the amount of the liability is so dependent upon circumstances that any one presentation would not be meaningful, and that it would not be useful, and perhaps might be misleading, to include one commitment—a lease—in the balance sheet but not others. Footnote disclosure permits the reader to make interpretations suitable to his purpose unprejudiced by interpretations made for other purposes.

Effect of Lease Capitalization

Much of the opposition to the capitalization of leases arises from the foreseeable detrimental financial effect on many enterprises and on the public interest. Many bond indentures and other credit agreements impose restrictions relating to the amount of debt, ratio of debt to equity capital, interest coverage, etc. Regulatory authorities give effect to these factors in connection with the issuance of new debt and equity securities. Lenders and security analysts are influenced to some degree by the recorded amounts of liabilities irrespective of their origin. Under some contracts, including defense contracts, rents are a recoverable expense but interest is not. Some taxes are based on the amounts recorded in the balance sheet for assets or liabilities. Income taxes are affected by rulings that certain transactions are leases or purchases.

In the cases of some regulated industries, rents are treated as operating expenses recoverable through the allowed rate of return on the rate base, whereas interest is classified "below the line" and has only an indirect and uncertain effect on the allowed rate. In all these cases an adversary party may take the position that a company's books and statements create a presumption at the very least. Some of those who favor capitalization of leases take a somewhat lighthearted, let the chips fall where they may, view of these factors, but those responsible for the enterprise cannot share their unconcern. They know that the treatment of leases as debt would be likely to have repercussions not only on lessees but on consumers and the economy as well. In addition to the probability that it would lead to an increase in interest rates on borrowed funds, there is a likelihood that in many cases restrictions on debt or a requirement to meet certain ratios would necessitate an increased investment of equity capital, requiring an even higher rate of return.

The increases in cost of capital and other costs would inevitably exert inflationary pressure toward higher prices and rates, to the detriment of the consumer and the competitive position of the enterprise in domestic and world markets. In some cases the increased costs or the difficulty in raising capital at any cost might tend to discourage business expansion and addition or modernization of plant and equipment. When we consider the competitive disadvantages of some of our industries because of more modern installations in certain other countries, the enormous investment in modernization and in special facilities that is now in prospect to control pollution, and the equally great or greater investment just to meet the demands of our growing population and rising standard of living, we must question whether the public interest is well-served by theoretically inspired accounting innovations that tend to impede the development of solutions to the basic financial problems involved.

An example of the inconsistency and possibly detrimental effect of the proposal for capitalization of leases may be found in the case of the supply of nuclear fuel to an electric utility. The utility might enter into a long-term, firm purchase contract for natural gas to be used as fuel. No liability would be recorded except as gas was taken for current fuel requirements or except as periodic minimum charges became payable. For a proposed nuclear plant, the utility might consider entering into an energy supply contract whereunder the supplier would provide the nuclear material and sell to the utility the heat produced by the fuel in a reactor, with certain minimum charges.

This is perhaps too new an arrangement for it to be possible to say how it would be regarded by accountants, but there does not seem to be any real difference between recording a liability for gas as it is received and recording a liability for heat as it is received. Alternatively, perhaps for technical legal reasons, the utility might consider leasing the nuclear material. There does not seem to be any substantial difference between this arrangement and the one for buying the heat produced by the material, and, if not, neither is it substantially different from a long-term, firm purchase contract for natural gas. Yet, if the utility were required to capitalize leases it would be necessary for it to record a very large liability in its balance sheet which, if not in immediate contravention of debt agreements or regulatory policies relating to debt, might at least require the investment of additional equity capital with consequent increases in the costs which utility customers must ultimately pay. Furthermore, a difference in accounting for two arrangements having substantially the same economic purpose and effect might distort the economic choice between fossil and nuclear fuel, with possibly adverse effects upon the utility and its customers.

Unsound Accounting Not Excusable

With regard to leases generally, it is possible that commissions may require or permit leases to be accounted for as such even though they might be of kinds which the APB might decide should be capitalized. Because of the effect on the rate-making process, we think that it would be desirable for the APB to recognize in any opinion that it may issue that its statement with regard to Accounting Principles for Regulated Industries, which was cited in

APB Opinion No. 2, is applicable also to the matter of capitalization of leases.

This is not to say that because the financial need is great unsound accounting and misleading or uninformative financial statements should be considered tolerable. Yet, when so much is at stake, generally accepted accounting principles should not be developed in a vacuum on the basis of finespun theories as to what items are assets and liabilities or on the basis of certain resemblances, ignoring the differences and without regard for the usefulness or consequences. Furthermore, hammering and squeezing leases into the shape of purchases in the financial statements, in order that they may be more directly compared, is as if we were to require that automobiles be described in catalogues and prospectuses as if they were carriages in order that they might be judged by the standards developed for carriages.

To present leases as purchases and debt in the financial statements is to invite judgment by inappropriate standards and to risk conclusions that may be harmful to the enterprise and to the public interest. Full disclosure in footnotes, on the other hand, if it does not require judgment by the appropriate standards at least does not encourage judgment by inappropriate ones.

It is suggested that the Accounting Principles Board, in arriving at a decision with regard to capitalization of leases, might well consider carefully whether that course would yield any benefits outweighing the possible harm to the economy. The ultimate objective of some parties is not new. As early as 1962, Professor John H. Myers, in his *"Accounting Research Study,"* reflected the views of some previous writers in concluding that ". . . the present value of contracted lease payments should be placed among the assets and liabilities to the extent that they represent the acquisition of the right to use property."

In Opinion No. 5, as previously noted, the Accounting Principles Board did not go that far; it limited capitalization to leases involving the creation of a material equity. However, in the course of its discussion it made perhaps ominous reference to "generally accepted accounting principles as presently understood." In Opinion No. 7 the board indicated (unnecessarily as far as that opinion was concerned) that it would continue to give consideration to the question of additional capitalization by lessees. Now the board has under active consideration a new opinion which would require the capitalization by lessees of certain types of leases which do not involve the creation of any equity.

Supplemental Footnotes

One of the proposals being considered in this connection is that where other noncancelable leases are not capitalized, an equivalent amount should be disclosed in the footnotes. Today the footnotes, tomorrow the balance sheet! In a preface to Professor Myers' *"Accounting Research Study,"* Maurice Moonitz, then director of accounting research for the AICPA, significantly stated that Professor Myers had been asked to study leases, not the whole area of commitments. In Opinion No. 5, the Accounting Principles Board remarked that the question of capitalization of leases covering merely the right to use property in exchange for future rental payments is part of the larger issue of executory contracts in general. Yet now, without any published study of commitments, the board is proceeding to take up only a portion of the issue. Is it not time for accountants to stop and consider where they are going and for others to understand where they are being led? If they do not like what they see—a balance sheet so loaded with commitments that it founders in meaningless confusion—the time to call a halt is now, before the first commitment is taken aboard.

AtlanticRichfieldCompany 717 Fifth Avenue
New York, N.Y. 10022
Telephone 212 758 2345

T. F. Bradshaw
President

October 1, 1971

Accounting Principles Board
American Institute of Certified Public Accountants
666 Fifth Avenue
New York, N. Y. 10019

Gentlemen:

We have received and reviewed the "Outline of a Possible Opinion on Leases" which you have issued to help structure comments to be received at public hearings October 14 and 15 on "Reporting of Leases in Financial Statements of Lessees". We understand the kinds of problems that might induce some members of the Board to feel that action in this area is necessary, but it is our impression that the recently published "Accounting Interpretation" regarding the reporting of leases by lessors deals with the most pressing issues (i.e. whether an outright sale, an installment sale or a lease).

We would urge the Board to refrain from premature action regarding leases in the accounts of lessees since it would have to anticipate some of the Trueblood Committee's deliberations concerning the objectives of financial statements, including clarification of the question as to what constitutes an asset for inclusion in the balance sheet (legal title, enjoyment of use, etc.). We look to the Trueblood Committee's work as a basic foundation for future reviews of financial reporting guidelines in all specific areas.

We urge restraint pending the completion of the Trueblood Committee's work in areas where serious problems are not present. However, we would urge this specially in cases, such as leases for lessee reporting, where any interim changes would seriously upset the accumulated infrastructure of financial avails, financial reporting, and the burden of current charges to income. It is our

Accounting Principles Board

October 1, 1971

feeling that any significant movement in the direction of increased capitalization of leases would have these effects on a number of leasing-intensive industries, including petroleum. If we are to move in the direction of increased capitalization of leases by lessees, it should be on the basis of the kind of a well developed underlying rationale that we all hope will be the product of the Trueblood Committee's work.

Sincerely,

T. S. Bradshaw

BANCOHIO CORPORATION
FIFTY-ONE NORTH HIGH STREET
COLUMBUS, OHIO 43215

PHILIP F. SEARLE
PRESIDENT

September 24, 1971

Mr. Richard C. Lytle, Administrative Director
Accounting Principles Board
American Institute of Certified Public Accountants
666 Fifth Avenue
New York, New York 10019

Dear Mr. Lytle:

The impending hearings to be held by the Accounting Principles Board in regard to Opinion No. 5, "Reporting of Leases in Financial Statements of Lessees", are of significant interest to BancOhio Corporation.

During recent years, the BancOhio affiliated banks have offered equipment leasing to their customers through Ohio National Leasing Corporation. This added service has been extremely beneficial to both commercial and industrial concerns throughout the State of Ohio. The necessary acquisition of capital equipment by means of leasing has enabled many of our customers to stay abreast of competition within their industry.

It is our opinion that capitalization of leases by the lessee will seriously affect future acquisition of equipment. Leasing presently offers several advantages beyond that of present accounting interpretations:

1. The smaller required cash outlay protects working capital;

2. The lessee is not vulnerable to technological obsolescence;

3. In cases of indenture limitation, additional equipment is available by means of leasing.

Requiring the lessee to capitalize leases most likely will restrict the corporations in their efforts to update their equipment needs. The end result of this course of action may prove detrimental to our competitive economy and to a number of individual corporate lessees.

Your consideration of our position during these hearings will be appreciated by BancOhio Corporation and our customers throughout the State of Ohio.

Most sincerely yours,

Philip F. Searle
President

PFS:lb

G. E. DIXON
VICE PRESIDENT-FINANCE

BLUE BELL, INC.

335 CHURCH ST

September 20, 1971

RK ✓ JW ✓ RS ✓
Tally ✓ Leases File
Ack ✓ SEP 27 1971 NR
Tick Ref.

Mr. Richard C. Lytle
Administrative Director
Accounting Principles Board
American Institute of Certified Public Accountants
666 Fifth Avenue
New York, New York 10019

Dear Mr. Lytle:

I understand the Accounting Principles Board will hold hearings on changing Opinion No. 5, "Reporting of Leases in Financial Statements of Lessees," on October 14th and 15th.

I would urge you to take the position that straight forward reporting is preferred over undue complexity and reporting that is susceptible to subjective miscalculations. I would further urge that as a condition precedent to consideration for changing Opinion No. 5, the Accounting Principles Board consider the functions and structure of the balance sheet and determine what is an asset and what is a liability.

I would further suggest that the Accounting Principles Board should consider the consequences of capitalization. Some of the consequences are:

1. Indentures which limit the incurrence of additional "indebtedness" may be default.

2. Corporate franchise taxes calculated on the basis of the balance sheet would be higher.

3. Cost of power would rise as utilities, all with long-term fuel commitments, would petition for rate increases to support the higher revenue requirements of additional equity capital issued to offset the greater balance sheet obligations.

4. Railroads, encumbered with higher balance sheet obligations, would find their credit postures affected and would require higher freight rates.

5. Many small companies, unable to obtain credit through term borrowing and having recourse only to leasing for property acquisitions, would be hurt.

Mr. Richard C. Lytle
September 23, 1971

6. The credit positions of many businesses would suffer.

7. The cost of new financings would probably be higher.

8. American industry would be less able to compete in world markets, and our free enterprise system would suffer further impairment.

Sincerely,

BLUE BELL, INC.

G. E. Dixon

GED/pa

THE CHESAPEAKE AND OHIO RAILWAY COMPANY
THE BALTIMORE AND OHIO RAILROAD COMPANY
ACCOUNTING DEPARTMENT
BALTIMORE, MARYLAND 21201

R. L. HINTZ
COMPTROLLER

B. G. LAWLER
DEPUTY COMPTROLLER

September 29, 1971

Mr. Richard C. Lytle, Administrative Director
Accounting Principles Board
American Institute of Certified Public Accountants
666 Fifth Avenue
New York, New York 10019

Dear Mr. Lytle:

The purpose of this letter is to place The Chesapeake and Ohio Railway Company and The Baltimore and Ohio Railroad Company on record as opposing any change in the Accounting Principles Board Opinion No. 5, "Reporting of Leases in Financial Statements of Lessees."

The arguments against recording capitalization of leases in financial statements have been so well disseminated that it would serve no useful purpose to repeat them in this letter. Suffice it to say, we are convinced that the present rules for reporting lease obligations are quite satisfactory for financial presentation purposes.

Very truly yours,

R L Hintz

cc
Peat, Marwick, Mitchell & Co.
Members of the Accounting Principles Board

Chicago, Milwaukee, St. Paul and Pacific Railroad Company

848 UNION STATION – CHICAGO, ILLINOIS 60606

C. E. CRIPPEN
President

October 1, 1971

Mr. Richard C. Lytle, Administrative Director
Accounting Principles Board
American Institute of Certified Public Accountants
666 Fifth Avenue
New York, New York 10019

Dear Mr. Lytle:

It is my understanding that the Accounting Principles Board will soon consider a revision of its Opinion No. 5, "Reporting of Leases in Financial Statements of Lessees", and that serious consideration will be given to a change which would require that many long-term leases be capitalized for financial accounting purposes.

It is respectfully suggested that the Board give careful consideration to the inevitable effect of capitalizing leases upon the accounting for other executory contracts and to the question of whether or not this effect will be consistent with emerging broad accounting concepts.

Capitalizing leases will drastically upset financial ground rules upon which businessmen have acted in good faith and are therefore entitled to rely. The nature of the impact will not always be obvious.

In our case, for example, capitalizing leases would not create a default under a debt indenture. Our First Mortgage does, however, establish certain debt-to-equity relationships. Failure to satisfy these ratios would trigger a special sinking fund provision that would divert into retirement of low-interest debt one half of our earnings, all of which are desperately needed for working capital and property improvement.

I submit that full disclosure of lease commitments adequately serves the interests of all concerned, and I respectfully urge that no drastic change be made in existing Opinion No. 5.

Sincerely,

C. E. Crippen

C.I.T. FINANCIAL CORPORATION
650 MADISON AVENUE NEW YORK, N.Y. 10022

RICHARD H. LUND
VICE PRESIDENT AND CONTROLLER

October 15, 1971

Mr. Richard C. Lytle, Administrative Director
Accounting Principles Board
American Institute of Certified Public
Accountants
666 Fifth Avenue
New York, N. Y. 10019

Dear Mr. Lytle:

This letter sets forth the views of C.I.T. Financial Corporation regarding the proposed accounting for leases by lessors. Copies of the letter have been forwarded to each member of the Accounting Principles Board.

C.I.T. Financial Corporation (CIT) is a diversified organization engaged primarily in financing, factoring and leasing and also in banking, insurance, manufacturing and merchandising.

CIT owns a portfolio of leasing transactions totaling in excess of $300,000,000 and involving individually significant investments in aircraft, railroad rolling stock, computers and other equipment. These transactions are largely tax oriented; that is, a significant part of the return to be realized by CIT is derived from tax benefits made available to a lessor under the Internal Revenue Code. These benefits consist primarily of accelerated depreciation (as rapid as a five year amortization of leased property with an estimated useful life in excess of fifteen years) and Federal investment tax credits. These leases generally have terms of from eight to fifteen years and have estimated useful lives in excess of the lease terms of at least two years (otherwise the lease would not qualify as such under existing Internal Revenue Regulations). Taxable income arising from activities other than leasing insure CIT's ability to realize these tax benefits as they occur. Residual values are also an important part of the consideration expected to be realized by CIT from the lease transactions.

A significant portion of this leasing portfolio consists of leveraged leases which involve acquisition by CIT of 100% ownership of the leased property for a relatively minor portion (20%-35%) of the total cost of the leased property. The balance of the purchase price of the property is provided by institutional investors who obtain a prior lien on the property, but without any recourse to CIT in the event of default on the part of the lessee. Under these circumstances, the residual value and the tax benefits available to CIT as owner of the leased property frequently represent in part a source of recovery of CIT's investment in the property as well as the compensation or service charges to be earned on the transaction.

Based on Opinion 7 of the Accounting Principles Board, CIT has accounted for charges to be earned on lease transactions (including a portion of the estimated residual expected to exist at the end of the fixed term of the lease) generally at a constant ratio to the uncollected rent receivable balances expected to be outstanding, with an overriding requirement that the "bottom line" income reported over the life of the lease be reasonably constant in relation to the net funds invested in the lease. This accounting practice is also followed in giving income recognition to any Federal investment tax credits available. Overall, it is consistent with the method used to account for similar charges on the usual financing transaction and results in a reasonable and proper matching of revenues and expenses over the life of the lease.

In our opinion, CIT has always reported its financial position and results of operations in accordance with conservative and preferable generally accepted accounting principles. We are now greatly disturbed by recent pronouncements of the Accounting Principles Board of the American Institute of Certified Public Accountants which might have the effect of altering the application of the traditional accounting principles which we have followed in accounting for what we believe to be financing leases.

In summary, we believe the Board should consider particularly the following points and recommendations in its deliberations:

<u>The tax benefits which are present when property is "financed" under a lease</u>. We believe an established organization such as CIT, with a proven uninterrupted record of earnings from other sources, should be allowed to recognize such tax benefits in determining whether a lease transaction can be accounted for under the financing method.

<u>The similarity of estimated residual values in financing leases and estimated salvage values in operating leases</u>. We believe that it would be wrong to ignore residual values in determining the present value of future payments to be realized by the lessor under a lease.

Income distortions in accounting for a long-term lease under the operating method. We believe that financing company - lessors should be allowed to account for all service charges (including assured tax benefits and residuals) on long-term leases over the fixed non-cancellable term of the lease in a manner which results in a level net income return in relation to funds invested, thereby eliminating the distortions which would otherwise result from the use of the operating method.

Differences between a manufacturing company - lessor and a financing company - lessor. We believe that additional consideration is justified in establishing criteria for the use of the financing method by financing company - lessors.

The discount rate for determining present values. We believe the discount rate used to determine present values should be based on the cost to borrow of the lessor.

Tax Benefits which are present when Property is "Financed" under a Lease

Tax benefits available under a lease of property are generally two fold:

Deferral of tax otherwise payable by depreciating the leased property for tax purposes by an accelerated method.

Forgiveness of tax otherwise payable through the Federal investment tax credit.

Both of these benefits have the effect of accelerating the cash flow from a lease transaction as compared to a financing transaction, thereby reducing the interest cost to the financing company - lessor of carrying the investment. The Federal investment tax credit has a double barrelled effect because not only are interest costs reduced but taxes otherwise payable are permanently saved.

Exhibit A attached sets forth a typical eight year lease transaction, which assumes a property cost of $1000, the use of accelerated depreciation for tax purposes and the availability of the 7% Federal investment tax credit. Exhibit B shows the same transaction structure as a financing transaction so that the financing company - lessor receives the same yield on funds employed in both transactions. In summary the results are as follows:

	Lease (Exhibit A)	Finance (Exhibit B)	Lease Over (Under) Finance
Service earned -			
Rents	$ 170.26	$ 497.99	$(327.73)
Residual value	100.00	-	100.00
Federal investment tax credit (pretax)	140.00	-	140.00
Total	410.26	497.99	(87.73)
Interest cost	220.34	267.36	(47.02)
Pretax income	189.92	230.63	(40.71)
Provision for income taxes	94.96	115.31	(20.35)
Net income	$ 94.96	$ 115.32	$(20.36)
Percent to average earning asset	2.59%	2.59%	- %

The amount of net income under the lease is lower than under the finance transaction because funds are employed under the lease for a shorter period of time. This is apparent in the lower interest cost incurred under the lease. However, the rates of return on the earning asset (funds employed) are the same. We recognize this in accounting for service earned on a lease so that there is a matching of income and expense and net income remains reasonably constant in relation to the earning asset.

The service earned charged to the customer under either the lease or the finance transaction is covered by contract. The residual under the lease represents a conservative estimate of the value of the property at the end of the lease based on an independent appraisal. The investment tax credit and the interest cost savings are assured by CIT's proven record of taxable income from other sources. Obviously, failure to give recognition to these tax benefits in establishing criteria to be used to determine whether a leasing transaction should be accounted for by the financing method or by the operating method would simply ignore the economic realities of a tax oriented lease transaction. We believe such tax benefits should be recognized in determining whether a lease transaction can be accounted for under the financing method.

The Similarity of Estimated Residual Values in Financing Leases and Estimated Salvage Values in Operating Leases

The recent interpretation of APB Opinion 7 on accounting for leases by lessors excludes residual or salvage value in determining whether a lessor should account for a lease under the financing method. Only payments required under the lease during the fixed non-cancellable term are allowed in determining present values to be related to selling price or fair value of the leased equipment. We believe this is unrealistic and ignores economic realities. The APB certainly recognizes that residual or salvage values normally exist. There may be differences of opinion in attempting to quantify these values at some point of time in the future but practically everyone would agree that some value, even if only scrap value, will exist. In accounting for depreciable property, it would be unusual not to recognize an estimate salvage value. Therefore, we do not understand why the APB has chosen to ignore the existence of a residual value in accounting for finance leases. We agree that in practice this principle can be abused but to rule out recognition of residuals completely in determining whether a transaction can be accounted for under the financing method is certainly not the answer. We believe residual values should be recognized in determining the present values of future payments to be realized by the lessor.

Income Distortions in Accounting for a Long-Term Lease using the Operating Method

Exhibit C attached sets forth the accounting for the same eight year lease transaction presented in Exhibit A using the operating method. The results are summarized as follows:

Year	Average Earning Asset	Net Income Amount	Net Income % to E.A.
1	$ 879.89	$ 7.26	.83%
2	708.46	9.15	1.29
3	591.09	10.42	1.76
4	487.90	11.56	2.37
5	394.48	12.58	3.19
6	302.56	13.58	4.49
7	205.43	14.65	7.13
8	102.80	15.76	15.33
Total	$ 459.08	$94.96	2.59%

The distortions are obvious:

Reported profits during the earlier years are significantly understated and during the latter years are significantly overstated.

There is no consistent or reasonable relationship between the investment in leased property (earning asset) and the profit reported each year.

Under such circumstances, it is hard to believe that the APB would consider such accounting to be acceptable for a financing company-lessor, particularly for a long-term lease. The overall profit on the transaction (assuming the residual value is conservatively stated) is assured. Nevertheless, stockholders would be completely misled regarding profitability of the transaction throughout the entire term of the lease. Initially, the lessor would not report a reasonable profit on the lease and later income would be inflated as the deferred profit applicable to the earlier years was recognized. The overall rate of return to the average earning asset is 2.59% but, by using the operating method to account for the lease, the lessor would report a return ranging from a low of .83% in the first year of the lease to a high of 15.33% in the last year. Such distortions are even more severe when the operating method is used to account for longer term leases.

We believe that financing company - lessors should be allowed to account for all service charges (including assured tax benefits and residuals) on long-term leases over the fixed non-cancellable term of the lease in a manner which results in a level net income return in relation to funds invested, thereby eliminating the distortions which would otherwise result from the use of the operating method.

Differences between a Manufacturing Company - Lessor and a Financing Company - Lessor

There are distinct differences between a manufacturing company engaged in leasing its own manufactured products and a financing company - lessor.

A manufacturing company - lessor is primarily interested in selling his product, hopefully at a profit from the manufacture of the product in an amount sufficient to provide a reasonable return to stockholders. Competition or other influences may dictate that this be accomplished at least in part by leasing the product to customers for substantially the life of the product. Furthermore, the manufacturer - lessor may determine that the product should have a certain residual value at the end of the lease term that can be recovered by renewal of the lease or by sale. If this judgement is wrong and the residual established cannot be ultimately realized, the manufacturing company - lessor must reduce the profit initially recognized when the sale was recorded. Admittedly, stockholders would have been misled as to earnings in the year sales were recorded but after the write off of the residual, the error in judgement on the part of the manufacturing company - lessor would not have benefitted some third party. The lease rentals should have been higher but no doubt they were as high as competition and market conditions allowed at the time the lease was entered into. The choice was probably either to lease or lose the "sale". On balance, the manufacturing company - lessor is no worse off than if he had not entered into the lease.

On the other hand, a financing company - lessor is in a vastly different position. Competitive forces do not permit latitude in setting rates for leasing transactions. If the rate decided upon includes an estimated residual value on the product and such residual is not ultimately realized, the financing company - lessor suffers a real loss and someone else benefits. This loss is not offsetable against a profit realized at an earlier date. Therefore, a financing company - lessor is not overly optimistic in appraising and recognizing residual values in lease transactions. Instead, the tendency of the financing company - lessor is to under rather than over value residuals. We strongly recommend that additional considerations are justified in establishing criteria for the use of the financing method by financing company - lessors.

The Discount Rate to be used to determine Present
Values should be based on the Cost to Borrow of the Lessor

The recently released APB interpretation dealing with accounting for leases by lessors does not make clear how the discount rate to be used to arrive at present values should be determined.

A financing company - lessor does not have a range of rates to be used to determine the service charges to be collected from the customer, which depend upon the credit worthiness of the customer, under either a finance or lease transaction. In other words, widely different rates are not used at any point in time for transactions with the same general characteristics. Rates are based primarily on the cost of borrowed money and the cost of operations and are designed to provide a fair and reasonable profit to the financing company - lessor. Naturally, competitive forces also at work influence the rates finally adopted. But the rate at which the lessee can borrow in the market place is not considered in determining the rate to be charged on a particular transaction. Rather, the financing company - lessor looks primarily to the protection of its investment from loss, the ability of the customer to pay in accordance with the terms of the finance or lease contract and the reasonableness of the profit to be realized from the transaction.

The use of the borrowing rate of the lessee to arrive at a discount rate would ignore the realities of the transaction and would unfairly penalize the financing company - lessor. Therefore, we believe the discount rate to be used to determine present values should be based on the cost to borrow of the lessor.

* * * * *

It is regreted that this expression of our views was not prepared on a more timely basis. Nevertheless, we feel that our comments have substance and request that they be considered by the members of the APB in their deliberations on this most important subject.

Should you require clarification of our comments or additional information, please do not hesitate to contact me.

Respectfully,

RH Lund

RHL:dl

EXHIBIT A

REPORTING INCOME FROM A LEASE TRANSACTION
UNDER THE FINANCING METHOD

	FOR THE YEAR ENDED								
	1	2	3	4	5	6	7	8	Total
Service Earned									
Rents	$ 40.79	$ 32.84	$ 27.41	$ 22.62	$ 18.28	$ 14.02	$ 9.52	$ 4.78	$ 170.26
Residual	23.96	19.29	16.10	13.28	10.74	8.24	5.59	2.80	100.00
Investment Tax Credit (Pretax)	33.55	27.01	22.53	18.60	15.04	11.53	7.83	3.91	140.00
Total	98.30	79.14	66.04	54.50	44.06	33.79	22.94	11.49	410.26
Interest Cost	52.79	42.51	35.47	29.27	23.66	18.15	12.32	6.17	220.34
Pretax Income	45.51	36.63	30.57	25.23	20.40	15.64	10.62	5.32	189.92
Provision for Income Taxes	22.75	18.31	15.29	12.62	10.20	7.82	5.31	2.66	94.96
Net Income	$ 22.76	$ 18.32	$ 15.28	$ 12.61	$ 10.20	$ 7.82	$ 5.31	$ 2.66	$ 94.96
Average Earning Asset	$ 879.89	$ 708.46	$ 591.09	$ 487.90	$ 394.48	$ 302.56	$ 205.43	$ 102.80	$ 459.08
Net Income as a Percent of Average Earning Asset	2.59%	2.59%	2.59%	2.58%	2.59%	2.58%	2.58%	2.59%	2.59%

EXHIBIT B

REPORTING INCOME FROM A
FINANCING TRANSACTION

	For The Year Ended								
	1	2	3	4	5	6	7	8	Total
Service Earned	$104.41	$ 94.90	$ 84.29	$ 72.46	$ 59.27	$ 44.57	$ 28.18	$ 9.91	$497.99
Interest Cost	56.06	50.95	45.25	38.90	31.82	23.93	15.13	5.32	267.36
Pretax Income	48.35	43.95	39.04	33.56	27.45	20.64	13.05	4.59	230.63
Provision For Income Tax	24.18	21.97	19.52	16.78	13.72	10.32	6.52	2.30	115.31
Net Income	$ 24.17	$ 21.98	$ 19.52	$ 16.78	$ 13.73	$ 10.32	$ 6.53	$ 2.29	$115.32
Average Earning Asset	$934.31	$ 849.16	$ 754.23	$ 648.39	$ 530.39	$ 398.83	$ 252.17	$ 88.66	$557.02
Net Income As A Percent Of Average Earning Asset	2.59%	2.59%	2.59%	2.59%	2.59%	2.59%	2.59%	2.58%	2.59%

EXHIBIT C

REPORTING INCOME FROM A LEASE TRANSACTING
UNDER THE OPERATING METHOD

	For The Year Ended								
	1	2	3	4	5	6	7	8	Total
Service Earned	$146.28	$146.28	$146.28	$146.28	$146.28	$146.28	$146.28	$146.28	$1,170.24
Expenses:									
Depreciation	112.50	112.50	112.50	112.50	112.50	112.50	112.50	112.50	900.00
Interest Cost	52.79	42.51	35.47	29.27	23.66	18.15	12.32	6.17	220.34
Total	165.29	155.01	147.97	141.77	136.16	130.65	124.82	118.67	1,120.34
Pretax Income (Loss)	(19.01)	(8.73)	(1.69)	4.51	10.12	15.63	21.46	27.61	49.90
Income Taxes:									
Provision For Income Taxes	(9.50)	(4.37)	(.84)	2.25	5.06	7.81	10.73	13.80	24.94
Amortization Of Investment Tax Credit	(16.77)	(13.51)	(11.27)	(9.30)	(7.52)	(5.76)	(3.92)	(1.95)	(70.00)
Total	(26.27)	(17.88)	(12.11)	(7.05)	(2.46)	2.05	6.81	11.85	(45.06)
Net Income	$ 7.26	$ 9.15	$ 10.42	$ 11.56	$ 12.58	$ 13.58	$ 14.65	$ 15.76	$ 94.96
Average Earning Asset	$879.89	$708.46	$591.09	$487.90	$394.48	$302.56	$205.43	$102.80	$ 459.08
Net Income As A Percent Of Average Earning Asset	.83%	1.29%	1.76%	2.37%	3.19%	4.49%	7.13%	15.33%	2.59%

THE CLEVELAND ELECTRIC ILLUMINATING COMPANY

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Thornton L. Thurber
CONTROLLER

September 29, 1971

Mr. Richard C. Lytle
Administrative Director
Accounting Principles Board
666 Fifth Avenue
New York, New York 10019

Dear Mr. Lytle:

The opportunity to comment on the "Outline of the Possible Opinion on Accounting for Leases by Lessees" before an exposure draft is prepared is appreciated since this subject is vital to the utility industry.

Our Company is extremely concerned with the direction the Accounting Principles Board seems to be heading in the accounting for leases. Capitalization of leases by the lessee will present very serious problems to the electric utility industry. At the present time, the industry has embarked on the largest construction program in its history and, as a result, is having an extremely difficult time in obtaining adequate and reasonable financing. The capitalization of leases could add millions of dollars to the liability sections of many balance sheets with a very adverse effect on the balance sheet ratios which are critical to our financing program. Some companies might find themselves in violation of their mortgage indentures. Any accounting change which contributes to the difficulties of financing this construction program, which is so vital to the national interest, appears to us to be unrealistic and regrettable.

Our Company also feels that this accounting change is not consistent with the present regulatory accounting under which we operate. The regulatory accounting treatment of such an asset, particularly its inclusion in rate base, raises another set of questions which are difficult to answer and which present unnecessary implications. Accordingly, the Company must strongly object to any amendments to Opinion No. 5 which do not incorporate the provisions of the addendum to Opinion No. 2.

We certainly have no objections to an expansion of Opinion No. 5 to require further disclosure of leases through the medium of footnotes or

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other textual material. It would appear to us that the problems surrounding leasing could be solved by the fuller explanation of the agreements that the companies have entered into.

Our Company feels that this proposal is not economically sound and is not good accounting.

Thank you for the opportunity to comment on this subject.

Very truly yours,

Thornton L Thurber

Thornton L. Thurber
Controller

TLT:vfj

POSITION PAPER:

THE RECORDING OF LEASES IN THE FINANCIAL STATEMENTS OF LESSEES

By Alvin Zises, Chairman

CNA Nuclear Leasing, Inc.

PRESENTED TO THE ACCOUNTING PRINCIPLES BOARD

OCTOBER 14 AND 15, 1971

POSITION PAPER: THE RECORDING OF LEASES IN THE FINANCIAL STATEMENTS OF LESSEES

Presented to the Accounting Principles Board October 14 and 15, 1971
By Alvin Zises, Chairman, CNA Nuclear Leasing, Inc.

The question of reporting leases in the financial statements of lessees is again before the Accounting Principles Board. (I shall address myself in this paper mainly to APB Opinion No. 5. My thoughts as to APB Opinion No. 7 are recorded in "Law and Order in Lease Accounting," Financial Executive magazine, July, 1970.) Under Accounting Opinion No. 5: "The property and related obligation should be included as an asset and a liability in the balance sheet if the terms of the lease result *in the creation of a material equity* in the property." [Emphasis added.] It is unlikely that a material equity can be created under a lease which either party may cancel unilaterally. However, a non-cancellable lease is to be capitalized under which (a) the rents are "front-loaded," or under which (b) the lessee has a bargain purchase option. [See Paragraph 10, APB Opinion No. 5.] It is altogether fitting and proper for such transactions to be capitalized because, under law, such transactions would be considered conditional sales.

However, there is a second and large group of "lease" transactions which also should be capitalized and which are not subject to the requirements of lease capitalization under APB Opinion No. 5. These transactions also would be considered, under law, evidences of indebtedness and not leases. Toward the end of this discourse I shall take the privilege of addressing myself to these other "lease" transactions which are, in law, evidences of indebtedness and which we recommend also be capitalized in the financial statements of lessees.

Before we describe this second group of transactions, I would like to discuss: first, the questions as to the functions and structure of the balance sheet and the determination of what is an asset and a liability; and, second, the problems in regard to capitalizing true leases, or any other executory commitments, on the books of lessees with three questions in mind:

A. How would the public interest be affected by capitalization of true leases?

B. How useful would capitalization be to the reader of financial statements in comparison with alternative forms of disclosure?

C. Would managements accept capitalization as a "generally accepted accounting principle"?

Let us focus first on the questions as to the balance sheet.

A study of the balance sheet is now, I understand, being undertaken for the Accounting Principles Board. It would seem less than professional to place the cart before the horse and make a fundamental determination to capitalize one form of executory commitment before the questions as to the balance sheet are resolved. The resolution of the functions and structure of the balance sheet is so close at hand that precipitous action as to lease recording is unseemly. Such hasty action may confirm the growing concern in the minds of business leaders that many accounting principles are being rushed to conclusion for the protection of the accounting profession rather than for the protection of the public.

The Public Interest

The growth of leasing in the United States to a marked degree has paralleled the growth of equity and debt financing. Because of the large aggregate amount of leasing, it is important that fuller disclosure of lease and other commitments be made. *The question is not whether or not to disclose, but what form of disclosure would be fair, useful and acceptable.* Leasing has enabled American industry to utilize a greater pool of capital assets than otherwise would be available. Any accounting rule which inhibits the availability of capital assets to American industry in our competitive world would be contrary to the interests of the country.

One reason why leasing has opened new doors for lessees to the acquisition of capital assets is the substantive *difference in the risk element* between a lease, which is an indeterminate commitment, and indebtedness which is a fixed obligation. Installment debt financing and leasing are two separate and distinct industries, and are subject to different business practices, state, local and federal rules and regulations and legal principles. Significantly different economic consequences flow from whether a contract is an installment debt or a lease.

It is the great concern of managements that the capitalization of true leases or other executory commitments would impute debt characteristics to such commitments and thus adversely affect their companies, their shareholders, their customers, the public and the competitive posture of American industry. In many corporations the capitalization of leases or other similar contractual commitments could negatively affect their credit standings and their ability to finance, because capitalization may add literally hundreds of millions – perhaps billions – of dollars to the liabilities within their balance sheets. I have capitalized such commitments for certain companies, using the discounted value of the stream of future payments, and have arrived at figures of this magnitude.

Effect Upon Customers of Public Utilities

If, for example, leases of nuclear fuel were to be capitalized (and such leases do not differ in one whit in substance from utility take-or-pay commitments for coal, oil and gas), some of the larger electric utility companies would eventually have hundreds of millions of dollars added to their "indebtedness." Many analysts would be overwhelmed by such awesome figures and would insist upon a substantial increment in the equity bases of these companies before their future debt securities would be acceptable to the financial community. And if nuclear fuel commitments were to be capitalized, why not commitments for conventional fuel?

If utilities could issue mortgage bonds today at 8½%, investors would require approximately 9% on the issuance of new preferred stock. The pre-tax revenue requirements of a 9% dividend on preferred stock, at a 50% tax rate, would mean that the pre-tax cost of the preferred capital would be in the order of 18%. Because common equity (in the hierarchy of priorities common is junior to preferred stock) would require a 10% to 12% return for the shareholder (if preferred requires 9%), the pre-tax revenue requirements of the common would be 20% to 24%.

The issuance of the additional preferred and common stock to balance the "lease liability" within the balance sheet would precipitate nation-wide calls for substantial rate increases in costs of power to the public. The cost of all energy both to the consumer and industry would rise substantially.

Effect Upon Customers of Transportation Companies

If leases were capitalized within the balance sheets of airlines, the financial community would require substantial increments of equity capital to be added to airline balance sheets. Whether or not such equity could be sold, the cost of air travel to the public would soar. In the event of capitalization, some airlines would be unable to finance their requirements at all, whether by debt or equity.

If railroads were forced to capitalize their lease commitments, the cost to industry of freight traffic would rise substantially. Few railroads would be able to issue additional indebtedness to support their capital equipment programs with the substantial liabilities imposed upon their balance sheets as a result of lease capitalization.

Effect Upon Customers of Industrial and Commercial Corporations

Many industrial and commercial corporations would find their credit postures adversely affected and would be forced to seek additional equity capital, with the result that the high return requirements of equity would force additional price rises upon the public. The competitive posture of American industry in world trade would be adversely influenced. The present adverse balance of trade would continue to worsen. Nor would these problems be mitigated by prospective, rather than retrospective, lease capitalization.

Further, foreign industrial corporations, as in Japan, often enjoy lower capital costs as a result of leverage of up to 70% or 80%, in part because of governmental support. Such ratios for domestic industrials are unthinkable to American investors, but leverage of this magnitude is one reason among others why such foreign corporations are able to out-compete American industry. The capitalization of leases would result in an eventual reduction in leverage to American producers. Reduced leverage, however nominal, will cause an increase in overall composite costs of capital for American businesses, a reduction in per-share earnings and a lowered competitive capability.

Effect Upon Small Businesses

Another major detriment to the public interest which will be precipitated by lease capitalization would be its effect upon small and growing businesses. Since 1962 the Federal Reserve Bank of Boston has made continuing studies of the methods by which small and growing manufacturers have been able to finance their capital equipment requirements. The conclusions drawn are: ". . . borrowing on collateral and buying on installment fail to adequately provide equipment financing. A rather recent development which meets this need is leasing." If capitalization of leases were to take effect and be imputed upon the balance sheet as indebtedness, small businesses and their competitive vitality would be seriously and adversely damaged.

Increases in State and Federal Taxes of Businesses

A further consequence, adverse to the public interest, would be the effect of capitalization upon state and federal taxation of corporations. Most states, by letter of the law and administration of their revenue-gatherers as to corporate franchise and property taxes, calculate taxes on the basis of the company's balance sheet. If capitalization were to take effect, either the leased "assets" or the lease "liability" of the lessee would be taxed. These taxes would be duplications of the taxes imposed upon the lessor, which lessor taxes are normally transferred directly or indirectly to the lessee under terms of any lease. Costs of doing business would increase, and the competitive posture of American business would suffer.

The Internal Revenue Service has announced that it wants corporate tax payers to change or adjust their tax accounting methods with the financial reports to shareholders. Under lease capitalization the Internal Revenue Service would treat a net or finance lease as a conditional sale or other form of indebtedness and not allow depreciation to the lessor. Where lessors under net finance leases have used the finance method of accounting under Opinion No. 7, the IRS had challenged the transaction (see Lockhart Leasing Company vs. U. S., Court of Appeals, 10th Circuit No. 91-70). Although the District Court, the Tax Court and the Federal Court of Appeals held for the lessor [Lockhart], the Revenue Service continues to make assessments against lessors, and litigation continues to take place. If lessors were unable to obtain the benefits of liberalized depreciation because of an IRS challenge resulting from the accounting treatment, their rents to lessees would increase. Although it may be claimed that, alternatively, the lessee may be entitled to the depreciation under a net lease [an incorrect assumption, see Section 57(c) IRC], the lessee's tax years may have been closed and the benefits of accelerated depreciation would have been lost to both lessor and lessee.

Effect Upon Outstanding Indentures

The effect of lease capitalization upon outstanding indentures and other debt agreements may be devastating to corporations. For purposes of indentures "indebtedness" is often defined in balance-sheet terms. In such instances indebtedness is defined as all items on the liabilities side of the balance sheet excepting capital. Most indentures limit the amount of indebtedness which a borrower may incur and often require certain ratios be met as to long-term indebtedness. If lease obligations were to be capitalized within the balance sheet, defaults under indentures and loan agreements would create havoc among many corporations.

It has been stated, almost capriciously by some, that such balance sheet recording should not result in such possible catastrophes. However, insurance company and bank lenders, whether in commercial banks or trust departments, hold a fiduciary capacity. By law they must comport themselves as such because of their responsibilities to shareholders, depositors, beneficiaries, and insureds. Furthermore, in periods of rising interest rates, with loans outstanding under such indentures at lower rates, investment officers would have an incentive to call defaults in debt instruments for either refunding at higher rates or repayment.

Because many indentures are open-ended, with the debt securities widely held, it would be almost impossible to rewrite or revise the indentures without refunding. An open-ended indenture is one under which securities of a certain class may be issued from time to time in the future as long as predetermined ratios and other requirements are met by the borrower.

Other Adverse Consequences

In the case of non-regulated companies with outstanding loan indentures restricting the issuance of additional indebtedness, many questions arise, i.e., does the new capitalized "indebtedness" rank "pari pasu" with original indebtedness subject to the indenture?

In the case of regulated industries, most if not all states have statutes restricting the issuance of stocks, bonds, notes, "or other evidences of indebtedness payable at periods of more than 12 months after the date thereof, unless in addition to other requirements of law [the regulated company] shall first have secured from the commission an order authorizing the issue . . ." [California Public Utility Code, Section 18] Corporations subject to federal regulation are generally governed by federal statutes of a similar nature.

In some jurisdictions the consequences of failure to comply with this type of requirement are not clear. In other jurisdictions the transactions are "void," and the investor may have no rights under law.

Motor vehicle title laws are such that if the lessee's books record the lessee, rather than the lessor, as the owner and there is an improper registration and title in effect as a result, there are potential financial as well as criminal penalties involved.

If a lease is recorded as indebtedness, the lessor may have violated usury laws which at best may relieve the lessee from paying the "interest" portion of the rents and at worse may relieve the lessee from paying any rent whatsoever. In a highly leveraged industry like leasing, this consequence could create a situation where lessors are unable to meet their obligations and lenders may suffer losses.

These are only some of the problems that would face American industry and the financial community that would be of damaging proportions – that would negatively affect shareholders and customers – and be contrary to the public interest.

Posture of Congress as to Leases

That instrumentality which is the protector of final resort of the public interest is the Congress of the United States. In at least three pronouncements Congress has determined that leasing as an instrument of American industry is in the public interest and should be maintained as a viable technique. Its pronouncements reveal that leasing not be treated or characterized as indebtedness. This intent of the Congress, both implicitly and explicitly, is evidenced in its enactment of the following laws.

In a review of the *Private Ownership of Special Nuclear Materials Act*, the *Legislative History* reveals that Congress intended that it would continue to keep its sights focused on the competitiveness of nuclear material as a fuel in comparison with conventional fuels. The *Legislative History* states: "The Atomic Energy industry [should] be able to plan on a long-term basis in the context of normal economic conditions. This is particularly true with respect to *commitments* for fuel.

"A utility contemplating the construction of a conventional steam-electric plant can execute *long-term contracts* for fuel and project, with a reasonable degree of certainty, the fuel costs over the life of the plant. The enactment of this legislation will provide the same opportunity to a utility contemplating the construction of a nuclear plant. Such a utility could, *under free market conditions*, negotiate *long-term contracts for nuclear fuel . . .*"

"Moreover, a utility's long-term plan should be less affected by *artificial conditions*. . ." [Emphasis added.]

Within the *Legislative History*, Congress explicitly contemplated that financial institutions would operate as lessors under net leases; that the rents under such leases would be based upon the cost of the material; that there were distinctions between a lease, a lease with option to buy, and a deferred purchase plan; that utilities should be able to make "commitments" for nuclear fuel under long-term contracts under "free market conditions" in the same way that utilities make such commitments for conventional fuels; and that "arbitrary" restraints (one of which may be interpreted as capitalization of nuclear fuel leases but not of long-term commitments for conventional fuel) may create an unfair disadvantage for nuclear power.

Although Congress did not contemplate that any professional body might impose different characterizations, with all the economic consequences flowing from such, upon "commitments" for nuclear fuel than would be imposed upon "commitments" for conventional fuel used by utilities, it is a reasonable conclusion to draw from the letter and spirit of the *Private Ownership of Special Nuclear Materials Act* that, if a utility were impelled not to lease because of an edict of the Accounting Principles Board, such arbitrary restraint would be in contravention of the intent and spirit of the Act.

Under the *1970 One-Bank Holding Company Act* Congress recognized that certain additional activities might be performed by banks and subsidiaries of bank-holding companies. One such additional function was the leasing of equipment under full-payout leases. Here the Congress determined that a full-payout lease was a lease, and as such, was not a debt. Congress, in its discussions of the "laundry list" of new activities which may be allowed to banks and bank-holding company subsidiaries, considered the activity of leasing and understood its implications including the differences in the element of risk between a lease and debt, and its recording in the accounts of lessees.

In the *Tax Reform Act of 1969* Congress focused directly on the nature of a net lease (sometimes called a finance lease by accountants) to determine its own position where net leases were used by high income bracket individuals to reduce their tax liabilities through the use of liberalized depreciation. Hundreds of individuals earning in excess of $200,000 yearly were able to pay no taxes as a result of certain tax "benefits" including the use of liberalized depreciation when these individuals acted as lessors under net leases. As a result, Congress enacted a number of tax preference penalties.

In the deliberations of Congress before the Tax Reform Act was passed, Congress had the option of mandating that a net lease, for tax purposes, would be treated as a conditional sale and thus causing the lessor to lose any deductions arising from accelerated depreciation. Congress determined, however, that such legislative determination would adversely affect the public interest and exacted a different penalty from individual tax payers acting as lessors by imposing a tax of ten percent on the difference between the straight-line and liberalized rates of depreciation. The net or "finance" lease was retained as a viable instrument of American business by the Congress of the United States. Congress rejected any proposals that a net or "finance" lease be treated as a conditional sale. The Congressional determination is now part of the Internal Revenue Code under Section 57(c) where a net lease is defined as follows:

> ". . . property shall be considered to be subject to a net lease for a taxable year if - (1) for such taxable year the sum of the deductions with respect to such property which are allowable solely by reason of section 162 is less than 15 percent of the rental income produced by such property, or (2) the lessor is either guaranteed a specified return or is guaranteed in whole or in part against loss of income."

"Risks of Loss" Test Rejected Under Law

The Courts in a parade of cases have continued to support the legislative determination that a net or "finance" lease is a lease and not indebtedness, thus implicitly or explicitly arriving at the conclusion that there is a significant difference in the risk elements between a lease and indebtedness. Although the Courts and the statutes continue to distinguish between a net or finance lease and indebtedness, some accountants hope to rule that a net or finance lease may be recorded on the books of lessees as Opinion No. 7 treats such a lease for lessors, as debt. Such treatment presents an erroneous impression to the reader and distorts the differences in risk.

Nowhere to be found in the law, the statutes or cases, is the criterion of the "benefits and burdens" of ownership. Yet this is the criterion, which incorrectly and erroneously Opinion No. 7 and the new exposure draft of Opinion No. 5 make determinative as to whether or not a transaction is to be recorded by lessors as a lease or a purchase.

The major difference between a lease and an evidence of indebtedness or conditional sale is the intent of the parties, as evidenced by their conduct, *that the transaction be governed by the laws of executory contracts.* Section 162(a) (3) of the IRC reveals that, if there is no intent for a lessee to build an equity in the property nor to take title (for a nominal amount) the transaction shall be considered a lease. This is the same concept as exists in Paragraph 10 of APB Opinion No. 5.

The so-called "benefits and burdens" or "risks of gain or loss" test was brought to the fore by the Internal Revenue Service after the Investment Tax Credit was enacted into law. Under the terms of those sections of the Tax Code dealing with investment credit, taxpayers incurred statutory limitations on the amount of investment tax credit they may use. Lessors, generally individuals and banks, took investment tax credits and passed them on to lessees as a reduction in rent. Many of the lessees were airlines and railroads which had used up their availability, under statutory limitations, to investment tax credit because so much of their property acquisitions were "Section 38 property."

The Internal Revenue Service saw the potential revenue loss resulting from tax-motivated leasing and tried to staunch the flow. Although the law, the cases and statutes, had determined that the "reasonable rental" rule (that the lessee not build an equity by front-loading" the rents) was the primary rule, to place obstacles in the path of leasing, the Internal Revenue Service in some instances took an opposite tack. Under law, if rents are "front-loaded," the transaction is considered a conditional sale. In order to reduce incentives to lease, the IRS in its Private Ruling Section apparently interposed some arbitrary requirements which went in the opposite direction and most of which requirements addressed themselves to a "risks and rewards" test. Substantially all such rulings, however, applied to full-payout leases. The Ruling Section in its private letter policy determined that the lease term was to be substantially shorter than the life, a policy which must result in "front-loading." It ruled that a substantial residual must be available to a lessor, and that the lessor assume the risk of the value of the residual. This is understandably available in real estate leasing, but runs contrary to the economics of personal property leasing and also contrary to law. For a substantial residual to be available to a lessor in a full-payout lease, the personal property lease must be "front-loaded." The IRS policy also required that the lessor assume the risks of loss but, contradictorily, its private letter rulings countenanced full-payout leases and indemnity provisions that - despite IRS pronouncements - resulted in the risks of loss being incurred by lessees and not lessors.

Recent Court Decisions Follow Same Precedent

In three important recent cases, which followed the same basic principles as decisions in the past, the decisions ran counter to these policies of the IRS Ruling Section - and counter to the principles enunciated for finance leases in Opinion No. 7.

The first case is that of *Sanders, Trustee in Bankruptcy for the Atlanta Times vs. Commercial Credit Company* in the Fifth Circuit Court of Appeals. Here we have a full-payout net lease in a bankruptcy rather than a tax action. The lease is a "finance" lease and capitalization on the books of the lessor would be imposed under Opinion No. 7. The Court held that the transaction was a net lease - an executory contract with an indeterminate liability - and not an installment sale. The lease contemplated a full payout of the lessor's investment, continuing renewal options available to the lessee at its option, and substantially all or most of the risks of loss upon the lessee.

In the case of *Owen W. Garner,* a Federal District Court case decided in February 1971, the Court's charge to the jury held that the "reasonable rental" rule was the primary rule; that as to a net full-payout lease of personalty, if there were a substantial residual at the end of the lease term, the transaction was not a lease (the rents would have to be "front-loaded"); and that this net or finance lease under review was a lease and not an installment sale.

In *Lockhart Leasing Company vs. U. S.* the Circuit Court of Appeals for the 10th Circuit affirmed the former decisions of both the Tax Court and the Federal District Court that the net full-payout leases in question were good leases. This was a landmark case because the IRS sought to prove that a net finance lease was a conditional sale in three separate court tests against this lessor. The three courts recognized the "reasonable rental" rule and disavowed the "incidents of ownership" (sometimes called the benefits and burdens, or risk of loss) test. It might be useful to quote some passages from the decision:

> "The Equipment Lease Arrangement states that the arrangement is a lease and that title does not pass . . . *The customer assumes all the risks of loss . . . The customer was to pay any taxes on the equipment, to insure it against loss and to pay for repairs and maintenance.* The 'loss value' [some times stated as stipulated casualty value or unamortized balance] was stated in the agreement . . . The taxpayer [lessor] *had no repair or storage facilities* . . . We must agree with the analysis of the transactions as made by the Tax Court, considering also as it did, the nature of taxpayer's business as a whole . . . The general business of taxpayer and the manner in which it is conducted must be examined . . . The rental payment and the options provisions or negotiated options all had a reasonable relationship to the value of the property during the term of the agreement or at the option date . . . *The length of the agreement was negotiated on the basis of the type of the equipment and its expected use by the customer . . . The rentals were based on the cost of the equipment, how long it was to be used, and what the value was expected to be at the end of the agreement.*" [Emphasis added.]

In an analysis of these and a parade of other cases relating to capitalization of leases, we conclude that net or finance leases are leases - and as such there is a *difference* the economic substance, in the risk imposed upon the lessee as compared with indebtedness upon a borrower. The economic substance as to the "risk effect" upon the lessee is not that of an installment purchase. The economic substance is derived from the law. Any practice, accounting or otherwise, which would tend to distort these conclusions would be misrepresentative.

Economic Differences in Risk Flow from Legal Distinction between Debt and Lease

Although accounting deals in economic rather than legal concepts and although *a lease is a legal concept, the economics flowing from the legalities creates a difference in the economic elements of risk.* Under a debt or security transaction, the transaction is covered by the laws as to securities and indebtedness. Indebtedness is described as a sum certain payable at a fixed date or dates in the future. A debt is a fixed and definite obligation.

A lease is covered by the laws of executory contracts. The obligation under any lease is always an unknown, indeterminate and uncertain one. Carmen Blough, former Director of Research for the American Institute of Certified Public Accountants, maintained correctly that the amount of legal liability would probably never be the discounted value of the future rents. This is so because of problems of proving damages, the requirements upon the lessor to mitigate damages, the requirements that damages be immediate and not remote, the obligation upon the lessor, even under a net lease, that he provide continuing "quiet enjoyment." A parade of cases reveals this truth.

Erroneous Concepts Regarding Leasing

If the law requires a net or "finance" lease to be treated, in consideration of the difference in risk elements, as an executory contract rather than indebtedness, it is fallacious for accounting to impute the characteristics of indebtedness to a lease and to imply that the obligation is a sum certain. Under a lease, lessor and lessee acknowledge to the world that they are to be governed by the laws of executory contracts rather than the laws as to securities and indebtedness. The lessor willingly accepts a position inferior to that of a creditor, and the lessee assumes a position superior to that of a debtor.

Calling a lease an installment purchase does not make it so. And using fallacious criteria to judge whether a transaction is a lease or a purchase will lead only to economic error.

Thus, we arrive at some erroneous concepts which have been promulgated about leasing.

1. A misconception involves the phrase "substantially the same economic effects as purchase or sales of similar property." If this term means that the lessee, like an owner-user, enjoys the use of the property, then ownership and leasing are one and the same – and they are not one and the same. If the term means that there is a difference in the risk elements, imposed upon the user of the property, between a debt and a lease, this is true. The difference in risk is caused by differences in law. One, then, may assume only that a difference "in economic substance" means a difference "in legal substance," the difference between an executory contract of lease and a debt.

2. One erroneous concept is that a net or "finance" lease is a completed or executed agreement upon the part of the lessor. If this were so, the transaction would be an installment purchase or sale and so held by the courts. The courts, however, have held differently – that "finance" leases are executory and that the differences in risk elements between debt and leasing do exist. One difference between a net lease and debt is that a lessor under a net or "finance" lease may breach the quiet enjoyment of the lessee by either act or omission. In one example a lessor by omission breached the lessee's quiet enjoyment when he neglected to pay certain taxes in the State of Ohio where he leased vehicle fleets of substantial magnitude. The State of Ohio telegraphed the lessor that his vehicles were trespassers on the public highways, and Ohio gave the lessor 24 hours within which to remove the vehicles. Obviously, this was not a completed but an incomplete or executory transaction, and the lessees would have the right not only to withhold rent but also to file an action against the lessor for breach of quiet enjoyment. Furthermore, recent cases in New Jersey, California and other states held a lessor under a net finance lease liable for damage or injury caused by the equipment to third parties despite broad indemnities within the lease of the lessor by the lessee – primarily because the lessor, as owner, bears the risks of an owner.

A corollary of this erroneous concept is that, if the lessee has possession of the property, the transaction is completed and capitalization within the balance sheet should be practiced. Every lessee possesses the leased property. Not only is this concept legally incorrect, but lenders and investors could not care less from an economic viewpoint as to the location or possessor of the property. Lenders want to know the projected cash outflows from rents and all other material commitments. If the "going-business" concept is an important accounting concept and if economic reality is a basic accounting postulate, not capitalization but a funds-flow statement that provides projections of cash outflows of continuing commitments is the real solution to the problem of disclosure.

3. Another erroneous concept is that, if a lessor anticipates recovering his full investment under a lease, the transaction is not a lease. Such an erroneous concept is contrary to the most fundamental law of economics. If any business, including that of a lessor, does not recover its full investment, that business must eventually make its peace with its creditors. Lessors must, by the inexorable law of economics, recover their full investments – from their lessees or others.

4. Still another erroneous concept is that, if the lessee incurs or pays for most of the risks of ownership, the transaction is not a lease. Not only has this newly emphasized misconception been contravened by the higher courts, but also it is a violation of basic economics. Every lessee, either directly or indirectly, bears or pays for the lessor's costs. The lessee does so either directly [see IRC 57(c)(1)] or indirectly within the rental payments. It is a fundamental axiom of economics that every lessor must ultimately recover his costs or find himself in financial difficulty.

Net or finance leases have been described as "cost-plus" leases designed to reduce costs in a competitive and inflationary economy. As a result, these transactions are decidedly in the public interest. The net lease developed as a result of two fundamental principles. The first was that the costs and risks of use will be reduced to the lowest possible level if they fall, directly or indirectly, on the lessee who is the person best able to control such costs as a result of being in possession of the property. The second principle is that the lessee's total rents are minimized to the extent that costs and risks of unknown amount are immediately or ultimately charged to lessees in their exact amounts rather than charged to them in a flat amount based on estimates. Whenever charges are based upon estimates, the lessor must prudently charge more than his best estimate to be sure that he will cover all his costs. For the lessor to do otherwise, he would court economic disaster. To avoid high flat charges, based on estimates, the net lease places responsibility for costs and risks of unknown amount upon the lessee.

5. Another fallacy concerns the imputed differences between a "finance" and an "operating" lease. Economically both are one and the same. The physical services performed by the lessor under a so-called operating lease are not leasing services at all, but maintenance, accounting, garaging, insurance and similar services. All or most such services are often contracted-out by the lessor. The only leasing service performed by the "operating lessor" is providing the capital asset.

6. Another erroneous concept, focused upon and rejected by law, is that a lease may not be drafted for a term equivalent to its useful life in the hands of the lessee. The first problem with this specious reasoning is that no one really knows the useful life of a unit of property. In the tens of thousands of units of personal property we as lessors have leased under net leases, at least 99 percent has been sold, or sometimes leased, to a second user. These include vehicles, aircraft, computers, machine tools, etc. Nevertheless, the first user under the lease negotiated its terms so that he had the opportunity of leasing the property for its useful life to him as lessee. Secondly, this question has arisen in a number of court actions, and the courts decided that the transactions were leases. Finally, there is economic logic for a lessee to seek to lease property so long as he believes it is profitable to him and for the lessor to continue to lease such property so long as it is profitable to the lessor. Every Hertz, IBM and Xerox rental agreement offers the lessee the opportunity to lease the property so long as he believes it is profitable to him.

7. An important economic misconception involves residual characteristics and such misunderstandings may result in unsound accounting conclusions. Customary practices in the net leasing of tangible personal property have developed in a markedly different manner from usual practices in such leasing of realty. The most important differences arise from the dependence of real estate lessors upon the existence of substantial reversionary values. Lessors of tangible personalty cannot, however, rely upon residual values to a material extent. A substantial reversionary value almost inevitably exists in real estate even over generational time-spans. Further, experience shows that by reason of inflation, population trends, and economic growth, real property values tend to appreciate on an overall basis in the face of physical deterioration and economic obsolesence. Thus, residual values in realty are regarded as economic realities.

When tangible personal property is considered, however, a different situation is discovered. All items of tangible personal property – e.g., machinery, equipment, vehicles, etc. – are from the date first placed in service, on an inexorable march toward the junkyard. The market value of trucks usually drops immediately after the property is placed in service, and continues dropping thereafter. The overwhelming preponderence of experience with depreciable personal property is that its value declines continuously regardless of inflation, population trends, economic growth or other factors. Hence the customary practice in long-term leasing of tangible personal property is to structure a "full payout" lease under which the contractual provisions provide the lessor with full recovery of the asset cost plus a sufficient margin to cover any additional cost which, under the lease terms, may be borne by the lessor. All other costs respecting the leased property (other than lessor's net income taxes) are borne directly or indirectly by the lessee.

The lessor may reserve a reversionary interest or "residual", either in full, or in part through the granting of an option to purchase. In economic terms and in reality, however, the reserved interest is a "sweetener" or "kicker" which will increase the lessor's overall return; but the lessor does not in most instances depend upon the residual to recover his costs and make a minimum profit.

This situation contrasts with that of real property leasing, with a reliance upon reversionary values as such that the long-term lessor needs not look to rents from the first lessee of each property to stay in business and make a minimum profit. Indeed, the realty lessor may derive his principal return from the reversionary value. Lenders to lessors of realty often look, in substantial part, to the value of the realty as their security. On the other hand, lenders to personal property lessors place greater reliance upon the rental flows for the funds for repayment. Despite these fundamental differences between realty leasing and personalty leasing, the net lease exists in the case of both types of property. The lesson derived from these economic differences is that characterizing a lease of personal property as a financial or operating lease, based on anticipated reversionary interests, is to draw such conclusion on economic misconceptions.

8. Another error in economic concepts is that there must be "symmetry" between the accounting principles of lessor and lessee. Lessees lease property rather than own for a purpose different from the lessor's purpose of ownership. Further, accountants question symmetry between tax and "book" accounting; why, therefore, should there be symmetry between lessor and lessee accounting? Finally, APB Opinion No. 7 imputes indebtedness to a net lease transaction and, consequently, is fundamentally incorrect for many of the reasons set forth here. Opinion No. 7 is based on fundamental legal and economic error. If the lessees are required to capitalize true leases, such economic error will be compounded.

9. Another erroneous concept involves the question: what is a "hell-or-high-water lease"? There are many misconceptions as to what constitutes a hell-or-high-water lease which is an evidence of debt. The hell-or-high-water clause, either within a lease or in a separate instrument, involves a guarantee by the lessee of the lessor's indebtedness to the lessor's lenders, third parties. In such a transaction the guarantee converts the transaction to a fixed obligation under which the lessee agrees to pay a sum certain at a specified time or times in the future. This transaction is similar to a railroad equipment trust arrangement under which the borrower guarantees the indebtedness of the trustee directly to the trustee's creditors and under which the creditors enjoy special privileges granted under Section 77(j) of the Bankruptcy Act. An equipment trust arrangement is an evidence of indebtedness and is capitalized as debt. A hell-or-high-water lease is also indebtedness and also should be capitalized.

What is not a hell-or-high-water lease? A net lease under which the lessee indemnifies the lessor against costs or expenses of use is *not* a hell-or-high-water lease. All lessees must incur directly or indirectly the costs of the lessor. Most leases offer the lessor various protections by the lessee in form of the lessee's indemnification of the lessor. Such requirements of the lessee do not convert an executory contract to a debt or completed contract. In leases with indemnities the lessee incurs only the exact, rather than estimated, costs of use. As a consequence, the lessee's rents are lower under a net lease. Studies made by independent research groups over a period of years have revealed that total rents of cars and trucks under a net lease are at least 20 percent lower than rents under a so-called "gross" or "operating" lease. Thus, indemnities under net leases help produce lower rentals in an inflationary economy.

Furthermore, indemnities by the lessee of the lessor are no more than an obligation to pay a component of the rent either to the lessor or for his account. The exact cost – instead of an estimate within the rents – helps produce a savings. The usual indemnification in a net lease is part of an executory agreement between lessor and lessee and is not an obligation to a third party, such as a guarantee by the lessee of the lessor's indebtedness, which changes a lease with an indeterminate obligation to indebtedness.

Thus, leases with indemnities are not "hell-of-high-water" leases because indemnities do not relieve a lessor from the primary burden, incurred by an owner, of responding in the first instance. Indemnities do not protect the owner if the lessee is financially unable to perform; the owner has the primary responsibility, and the circumstances in which the indemnity would come into play may often be at a time the lessee is unable to respond. Indemnities, as components of an executory contract, are subject to narrow interpretation by the courts. Courts have held lessors, as owners, liable for damage or injury to third parties by the equipment even though the lessee has indemnified the lessor. Indemnifications, as components of an executory contract or lease, do not relieve the lessor of his obligation to provide quiet enjoyment. If the lessor under a net lease does not provide quiet enjoyment, the lessee may be relieved of his obligation to pay rent. This is not so in a "hell-or-high-water" lease where the lessee guarantees to pay the lessor's debt service come hell or high water, whether or not the lessor provides the lessee with quiet enjoyment.

Often the equipment subject to a hell-or-high-water lease is installed or constructed in such manner that the intent is for the lessor to abandon the property to the lessee.

A hell-or-high-water "lease" should be capitalized; a net lease with no hell-or-high-water clause should be fully disclosed in footnotes and detailed schedules of anticipated cash flows.

Usefulness of Capitalization Questioned

The usefulness of capitalization, in comparison with alternative forms of disclosure of true leases, has been questioned by many analysts and credit men. There are fairer, more objective and more truthful ways of disclosing lease commitments. Such disclosure should be in a form that would reveal all projected outflows for material commitments.

Lenders and investors want to know the *ability of a company to service its cash flows.* By providing cash flow information in detailed schedules, fair and objective disclosure is offered, and an erroneous impression is eliminated. A suggested funds-flow statement for this purpose is attached at the conclusion of this paper.

Would Capitalization of True Leases Become a "Generally Accepted Accounting Principle"?

Almost universally managements reject the concept of capitalizing leases or any other forms of executory commitments because of the damage of such method of recording to the comapny, its shareholders, its customers and the public. Any objective survey taken of major corporations will confirm this observation. Consequently, any certification that implies that capitalization of leases is a "generally accepted accounting principle" would be misrepresentative.

Conflict of Interest?

Capitalization of leases, if required before a professional analysis and determination are made of the functions and structure of the balance sheet and of generally accepted definitions of the nature of an asset and a liability, would become a method arbitrarily imposed upon corporate clients. It would confirm the growing belief among managements that there is a substantial conflict of interest growing between some accountants and their clients - and that accountants, by imposing certain accounting rules upon clients are seeking to protect themselves from legal action by forsaking the interest of their clients.

Legal Exposure of Accountants

For the accounting profession, heightened legal responsibility exists if it believes that by merely changing accounting rules it would avoid the lawsuits and settlements which have plagued the profession. By imposing accounting rules, rather than gaining general acceptance, the financial reports become those of the accountants rather than those of the company. Accountants would be creating an unreasonable burden for themselves by placing themselves in such an exposed legal posture.

Capitalization has become accepted by some members of academia. From their cloistered towers they have determined that a "nice" figure within the balance sheet will settle the problems of lease disclosure. These technicians have not come to grips with the broader practical consequences, the public interest, the usefulness, or the basic concept of general acceptance.

The accounting profession should objectively, first, survey managements to learn if capitalization or other forms of disclosure would be a "generally accepted accounting principle," and, second, determine the functions and structure of the balance sheet.

We Recommend Broader Capitalization of "Leases" Considered Indebtedness Under Law

Our recommendations as to those types of transactions which should be capitalized on the books of lessees are based on fundamental principles: that a lease is a legal concept, and the economic consequences (the differences in risk) flow from such legal concept.

Under present APB Opinion No. 5 only those leases which will result in the creation of a "material equity" are to be capitalized on the books of lessees. This type of transaction would be considered indebtedness under law.

There is another class of transaction which, under law, would be considered indebtedness and which now should be capitalized on the books of the lessee. Any transaction under which the lessee guarantees a sum certain payable at a fixed date or dates in the future to the lessor's lenders should be capitalized.

The "sum certain" transaction also should be imposed where the lessee is obligated to pay the rents whether or not the leased property is made available to the lessee by the lessor, or where the equipment subject to the "lease is expected to be abandoned to the "lessee." The latter situation often exists where "personal" property is installed upon realty so that such installed property becomes a legal fixture, and removal would destroy either the "leased" property or the integrity of the realty. These elements create a debt transaction and the decisions of the courts have so held. Non-cancellability is critical to any type of transaction which should be capitalized.

If a question arises as to the economic effect of the transaction, the accountant may obtain a resolution of the question, is it a debt or lease, by obtaining an opinion of counsel. Although generally accountants do not seek economic advice from lawyers, it would be the height of incongruity for the accountants to seek to capitalize a transaction which under law would be a lease and to footnote as a lease a transaction which the lawyers opine to be a debt. Whether they realize it or not, some accountants are proposing such a condition.

Leases between related parties should generally be capitalized where one party may exercise influence over the other. In effect, the borrowings of one generally become the "sum certain" of the other.

Effect of Rents Upon Earnings

The effect of rents upon earnings – assuming adequate disclosure is accorded leases in detailed schedules of cash flows – is of greater importance than balance sheet disclosure. Leases which bear rents that do not fairly represent the reasonable rental value of the property may affect earnings pro or con. "Rear-loaded" leases, for example those in which most of the rents are paid or incurred during the second half of the lease term, may overstate earlier earnings. Even level payment rents in sizable amounts may overstate earlier earnings. If a material overstatement of earnings occurs (where earnings are increased by 5% or more than they otherwise might be) I recommend recalculating the rents for recording purposes only. Such recalculation may consist of amortizing the value of the property on a straight-line basis over the term of the lease with the lessor's return calculated on the declining unamortized balance. Such restructuring of the rental deduction for financial reporting purposes would increase rental expense during earlier years and lower it during later years.

On the other hand, if leasing were a continuing method of acquiring the use of certain classes of property, once a complete cycle occurred, there would appear to be less cause for recalculating level payment rentals. Obvious "rear-loaded" rents, however, should generally be recast to avoid distortion of earnings.

No need exists to capitalize rentals for such purposes if full disclosure is given. Appropriate adjustments may be made in the financial statements of the lessee to reserve any deferred amounts.

Until the Functions and Structure of the Balance Sheet are Determined What Should Be the Interim Practice?

The amount capitalized as indebtedness on the balance sheet has always been a "sum certain," the legal liability. Any cancellable net (finance) or operating lease between unrelated parties which is, under law, a lease incurs an obligation uncertain and should not be capitalized, but should be disclosed fully in detailed footnotes and schedules of all types of projected cash flows over their anticipated terms including anticipated renewals. A "short" caption within the balance sheet, with no figures, but referring to an expanded funds-flow schedule or footnotes should also be a requirement. (See attached Exhibit.) The anticipated cash outflows of each type of commitment, whether economic or legal so long as they are material, may be discounted to a present value figure by some stipulated percentage or percentages which figures would appear in the footnotes or schedules.

Just because the Internal Revenue Service may question a transaction for tax purposes does not by itself mean that the transaction is not a lease. The IRS has been challenging lessors on a continuing basis -- and on a continuing basis the courts have been upholding lessors and generally overruling the IRS on leases as described.

Any opinion should recognize that the treatment of a contract by a regulatory body with jurisdiction over a regulated lessee should control the accounting method.

It is urged that any application of these suggestions be prospective and not retrospective.

One final matter about which we hold strong feelings is the accounting treatment of a seller of products to a lessor. If the seller relinquishes all responsibilities, other than the normal warranties granted to a purchaser by a seller, the seller may record the transaction as a completed sale. If, however, the seller retains responsibilities not normally retained by a seller in the ordinary course of business, (i.e., repurchase or obligation to resell for lessor in event of lessee's default), then a completed sale has not occurred.

Before any further consideration is accorded capitalization of true leases, deliberation should determine what are the functions and structure of the balance sheet and what is an asset and a liability.

SCHEDULE OF MATERIAL CONTRACTUAL COMMITMENTS (SX #3.18 & 3.19)

Type of Commitment	Amount Paid This Year	Amounts Contracted or Estimated For Each of Next 5 Yrs. and For Each of Three 5-Yr. Periods Beyond								Minimum Amt. of Commitment If Determinable*	Remaining Period (yrs.) From date of report
		Year 1	Year 2	Year 3	Year 4	Year 5	Years 6-10	Years 11-15	Years 16-20		
Purchase and Repurchase For:											
a) Investments											
b) Fixed Assets											
c) Inventory & Supplies											
d) Other											
Construction											
Long-Term Leases											
Royalties											
Pension and Retirement											
Employee Contracts											
Other (Explain)											
Totals											

*The minimum balance payable, in each type of commitment, may be discounted over the remaining period by a stated per annum percentage. Where such minimum balance is discounted, state the percentage used in each case.

Where amounts both paid and payable for any type of commitment are not material, a statement to that effect for any such type of commitment will suffice. Show amounts separately for each type of commitment if amounts paid or payable are material.

Any pertinent information of a material nature regarding any commitment should be furnished within footnotes to the schedule.

From August 20 through September 11, petitioner was employed by Wheless Drilling Company at a site near Chatham, Louisiana, some 36 miles from his residence. From October 3 through October 12, petitioner was employed by Barnwell Drilling Co., Inc. (Barnwell) at a site near Waverly, Louisiana. Waverly is 52 miles from petitioner's residence. From October 13 through December 31, Barnwell employed petitioner at a site near Eros, Louisiana. This site was 18 miles from petitioner's residence.

Petitioner claimed as a business deduction for 1963, $481.37. This amount, which represents 75 percent of the amounts expended by petitioner for the operation of ($348.73) and repairs to ($132.64) his automobile, constitutes his expenses in connection with travel to and from the various job sites at which he was employed during 1963. The Commissioner denied the deduction, explaining that the amounts were personal commuting expenses.

We must decide if the claimed amount constitutes an allowable travel deduction. Although petitioner did not file a brief herein, we are able to discern the thrust of his argument, *i.e.*, his employment at any particular job site was temporary in nature and hence he should be allowed the deduction on the temporary versus indefinite period of employment concept. See *William B. Turner* [Dec. 30,717], 56 T. C. 27 (1971). There it was stated that temporary and indefinite relate to the issue of whether it is reasonable for a taxpayer to move his residence near to his employment. The concepts are of little concern in distinguishing transportation from commuting expenses. *William B. Turner, supra;* sec. 1.62-1 (g), Income Tax Regs. Our concern herein, is whether the expenses of daily trips between petitioner's residence and the places of his employment are deductible. Such expenses are commuting expenses, those necessary, but yet personal expenses required for an employee to reach his job. It matters not, in this instance, that the various jobs are temporary in duration, since the expenses involved are only those which enable petitioner to reach his place of employment. The situation would be no different if petitioner could have availed himself of some form of public transportation; the fares involved in that form of travel would likewise be nondeductible as a commuting expense.

"Commuting is commuting, regardless of the nature of the work engaged in, the distance traveled, or the mode of transportation used." *William B. Turner, supra* at 33.

Decision will be entered for the respondent.

[CCH Dec. 30,969(M)] Glynn W. Keeling v. Commissioner.

Docket No. 5560-68. T. C. Memo. 1971-224. Filed September 1, 1971.

[Code Secs. 61 and 162—Result unchanged by '69 Tax Reform Act]

Business expenses: Rent: Sale and leaseback: Legal fees.—The Court found a sale and leaseback arrangement to be a bona fide transaction instead of an installment sale or a financing arrangement. Accordingly, rent paid under the lease was a deductible business expense. Legal fees paid by the corporation were properly deductible since they were related to the corporation's business.—CCH.

Henry Schwartz, II, 340 Tyler Bk. & Tr. Co. Bldg., Tyler, Tex., for the petitioner. Frederick B. Strothman, for the respondent.

Memorandum Findings of Fact and Opinion

STERRETT, Judge: The respondent determined a deficiency in the Federal income tax of the petitioner of $3,187.78 for his taxable year ending December 31, 1966.

We have before us three issues for consideration. First, we are to determine whether petitioner, during the calendar year 1966, actually or constructively, received rental income in the amount of $11,154.32. This requires us to determine if the transaction involved was in fact a lease with an option to buy or rather, as the respondent contends, an installment sale or a financing arrangement. Secondly, we are to determine whether petitioner's corporation, Reo Palm Isle Ballroom, Inc., taxable as a small business corporation, was entitled to deduct the legal and accounting expenses paid by it in the amount of $1,093.35. Finally, we are to determine whether petitioner's small business corporation was entitled to a deduction for the rental expense paid by it in the amount of $2,200 for the fiscal year ending January 31, 1966, applicable to the first month of the following year. This last issue requires us first to ascertain whether Reo Palm Isle Ballroom, Inc., was on the cash or accrual basis of accounting.

Findings of Fact

Some of the facts have been stipulated and the stipulation of facts and the exhibits attached thereto are incorporated herein by this reference.

Glynn W. Keeling (hereinafter referred to as petitioner), whose legal residence at all times material hereto has been Longview, Texas, filed his Federal income tax return for the calendar year 1966 with the district director of internal revenue at Dallas, Texas.

Petitioner is now and throughout 1966, was the president and sole stockholder of Reo Palm Isle Ballroom, Inc. (hereinafter referred to as Reo). Reo is in the business of operating a ballroom. It is open for business three nights a week and has a matinee on Wednesday.

Reo was organized as a corporation under the laws of the State of Texas on February 3, 1964. The incorporators and initial directors were Jack B. Mosher (hereinafter referred to as Mosher), owner of Reo immediately prior to its incorporation, Robert R. Arms (hereinafter referred to as Arms), accountant for the business, and W. W. Keeling, father of the petitioner, who at all times and in all transactions leading up to and including the organization and incorporation of Reo, represented the interests of petitioner and acted in the capacity of trustee on his son's behalf. At all times petitioner, and not his father, was the real party in interest and will be so treated for purposes of this decision. On February 24, 1964, Reo filed its election on Form 2553 with the district director of internal revenue, Dallas, Texas, to be taxed as a small business corporation. The election so filed was first effective for the fiscal year ended January 31, 1965. Reo duly filed its Federal income tax returns (Form 1120-S) for the fiscal years ended January 31, 1966, and 1967 with the district director of internal revenue at Dallas, Texas.

On March 22, 1961, W. W. Keeling, the owner of a parcel of land located 5/10th of a mile outside the city limits of Longview, Texas, on a 3.57 acre tract of land, leased said land to Mosher for a period of 10 years with an option to purchase. Mosher exercised his option and purchased the property on May 24, 1962, for $8,100. On June 19, 1962, Mosher contracted for the construction of Reo at a cost of $75,000. In order to finance the construction Mosher borrowed $70,000 from Republic National Life Insurance Company of Dallas, secured by a deed of trust on the property.

On January 31, 1964, Mosher conveyed an undivided one-half interest in and to all such properties to W. W. Keeling, trustee, who purchased it on behalf of his son, the petitioner. The facts further indicate that W. W. Keeling was acquiring title as a trustee solely by reason of the petitioner's poor financial position, and that, as previously noted, in reality, petitioner was the real party in interest. The consideration consisted of $55,000 and the assumption by the trustee and his agreement to pay one-half the unpaid balance remaining on the mortgage on the real estate in the original amount of $70,000. Of the $55,000 consideration, $10,458.27 was paid in cash, and the remaining $14,541.73 in four noninterest-bearing-notes, payable at various times beginning May 1, 1964.

W. W. Keeling, in addition to advancing the cash payment of $10,458.27, also loaned the petitioner $4,541.73 to be used for operating expenses. This loan was unsecured, and as of August, 1957, only two payments in the aggregate amount of $500 had been made by the petitioner on the note executed by him evidencing the advances.

In addition to the loan owed to his father, the petitioner was also subject to several Federal tax liens which had arisen through unrelated business activities due to the petitioner's nonpayment of income and cabaret taxes. He was paying $100 per month in an attempt to satisfy this liability.

On February 3, 1964, following the above mentioned conveyance by Mosher to W. W. Keeling, Reo was incorporated. Thereupon, W. W. Keeling, on February 18, 1964, conveyed the recently acquired one-half interest to the corporation in consideration for which Reo agreed to pay all of the indebtedness assumed, and the notes executed by W. W. Keeling at the time o the conveyance of the properties to him, the payment of which indebtedness and notes was guaranteed by petitioner. In addition the corporation issued 1,000 shares of its capital stock at a par value of $10 per share to the petitioner. However, these shares were held by Mosher as security for the payment of the notes guaranteed by petitioner. Four days later, on February 22, 1964, Mosher also conveyed the remaining one-half undivided interest in such business to Reo, in consideration of the assumption by it and its agreement to pay one-half of the unpaid balance owing on the mortgage on the real estate. In addition it likewise issued 1,000 shares of its capital stock at a par value of $10 per share to Mosher.[1]

Thereafter, sometime prior to July, 1965, Mosher, motivated by a desire to obtain cash, began negotiations with L. B. Billingsly (hereinafter referred to as Billingsly) and L. A. Pate, Sr. (hereinafter referred to as Pate) for the sale of all properties both real and personal belonging to Reo. The initial proposal involved the sale of the properties to Billingsley and Pate, who then would lease it back to the petitioner for a period of five years. Petitioner, uncertain about the advisability of the transaction, conferred with his accountant, Arms. Arms considered it a "bad deal." In light of this advice and at the insistence of the petitioner, it was agreed that an option to purchase would be included in the lease so as to afford the petitioner an opportunity to buy back the property after the 5-year lease expired.

The terms of the lease between petitioner and Billingsly and Pate having been agreed to, Reo entered into a contract of sale with Billingsly and Pate providing in part as follows:

> 1. The purchase price for said property is $141,001.47 payable as follows:
>
> (a) $141,001.47 in cash, of which $1,000.00 has been deposited by Purchaser with the undersigned, Central Abstract and Title Co., receipt of which is hereby acknowledged by the Principal Agent.
>
> (b) It is agreed by Seller and Purchaser that Purchaser may pay $60,000.00 cash and assume the following described indebtedness, to wit:
>
> (1) $57,001.47 to Republic National Life Insurance Company;
>
> (2) $24,000.00 due by Glynn W. Keeling to Purchaser herein * * *.
>
> * * *
>
> 17. Special Conditions. It is specifically understood and agreed that this contract shall be null and void and shall not be consummated unless a lease agreement is executed by the Purchaser to Glynn W. Keeling covering the above described property on the terms and conditions as set out in the lease attached hereto and marked "Exhibit A" and initialed by the parties hereto including Glynn W. Keeling.
>
> It is further agreed that Jack B. Mosher, a principal stockholder of Seller, agrees to place with Purchaser the sum of $7,000.00 for the guarantee of the payment of all rentals due or to become due during the first year as provided for in the lease agreement. In the event the rentals are paid by the said Glynn W. Keeling as provided for in said lease for the first year, the $7,000.00 shall be refunded to Jack B. Mosher together with 4 percent interest from date of deposit. In the event Glynn W. Keeling defaults in the payment of any rent due under the rental contract during the first year, Jack B. Mosher shall have the right to make such payments and in the event he makes such payments the $7,000.00 shall not be forfeited to the Purchaser but the same shall be refunded to Jack B. Mosher together with the interest and in the event Glynn W. Keeling and/or Jack B. Mosher fail to meet the payments during the first year as provided for in said lease agreement, the $7,000.00 shall be forfeited in favor of Purchaser.

Concurrent with the sales contract Reo furnished the purchasers with a warranty deed which provided in part as follows:

> This deed is executed * * * subject to the terms of a Sales Contract made and entered into by and between Reo Palm Isle, Inc., and L. B. Billingsly and A. L. Pate, Sr., and the Lease Agreement made and entered into by and between Glynn W. Keeling and L. B. Billingsly and A. L. Pate, Sr., dated July 28, 1965.

The January 31, 1966, small business Federal tax return of Reo shows no gain to the corporation on the above mentioned sale. It shows a sale price of $141,001.47 and an adjusted basis of $141,001.47, consisting of:

Building & Real Estate Improvements	$113,190.81
Equipment	16,756.83
Real Estate	11,053.75
	$141,001.47

The legal fees incurred in the sale were not applied to increase the basis or reduce the sales price.

[1] This Court finds the issuance of equal amounts of stock to the petitioner and Mosher to be unusual in light of the fact that the interest conveyed by W. W. Keeling to Reo on the petitioner's behalf was subject to a greater liability. The facts presented are of no help on this point.

Following the execution of the sales contract and in accordance therewith Billingsly and Pate leased the properties to petitioner for a period of 5 years at a monthly rental of $2,200, payable in advance beginning on the date of purchase of the property by the lessor. There was no language in the lease pertaining to the right, or lack of it, of the petitioner to renew the lease. The lease agreement provided in part:

> Lessee agrees to carry total amount of $110,000.00 in fire and casualty insurance to protect lien holders as their interest may appear.
>
> Lessee is to carry a total amount of life insurance of $100,000.00 to protect lien holders as their interest may appear.
>
> (3rd) That the Lessee shall at his expense maintain in good repair the roof, foundation and exterior walls of the building. The Lessee shall maintain all glass including plate glass, and any special storefront or equipment and all personal property located therein.
>
> If Lessee leases an entire building unit then Lessee shall be responsible for keeping the roof clean and downspouts therefrom open during the term of this lease.
>
> * * *
>
> (17th) It is specifically agreed by and between the Lessor and Lessee that out of the $2,200.00 paid by Lessee to Lessor as rent, Lessor shall place in a separate account the sum of $1,050.00 and such sum shall bear 4% interest in favor of the Lessee and such account shall be used as part of the purchase price under the terms of the Purchase Agreement between Lessor and Lessee as hereinafter set out.
>
> For and in consideration of the payment of rent and the agreement to pay by Lessee, Lessor grants unto the Lessee the option and right to purchase the above described property together with all improvements located thereon and all personal property located therein for the sum of $141,001.47. In the event the Lessee exercises his option to purchase the above described property at the expiration of this lease, payment shall be made as follows, to-wit: The $69,300.00 held in escrow and special account by Lessor being the accumulation of the $1,050.00 plus 4% interest during said rental period, shall first be applied to the purchase price, the balance of $71,701.47 shall be paid to the Lessor by Lessee in monthly installments of $1,000.00 plus 1/12 of the taxes and insurance of each month. The payments to be applied first to interest, balance to principal and said indebtedness of $71,701.47 shall bear interest at the rate of 7% per annum and shall be evidenced by * * * [a] note which shall be secured by vendor's lien and deed of trust, from the date of such purchase until paid. In the event Lessee fails or refused to exercise his option to purchase the property under the option and the terms herein provided, the escrow money shall be applied as rent payments during the term of the rental contract and this option and all rights thereunder shall terminate and be of no further force and effect. In the event Lessee desires to exercise this option he shall give Lessor written notice of his intention to do so within 30 days prior to the expiration of this lease.
>
> * * *
>
> Lessor grants to the Lessee the option of sub-letting this lease to a corporation in which Lessee owns stock in said corporation.
>
> * * *
>
> Lessee agrees to pay the increase of any assessment for taxes or other levies made by governmental agencies against the above described property.

Following the sale and leaseback, the petitioner and Mosher executed an agreement which distributed the $60,000 received from the sale. It stated that all of the debts of the corporation not assumed and cancelled by Billingsly and Pate would be paid out of the $60,000 and the balance of the money would be paid to Mosher for his entire stock ownership in Reo, and such stock would be transferred to petitioner. Therefore, as of August 1, 1965, the petitioner owned 100% of the stock of Reo.

In accordance with the aforementioned lease agreement, the petitioner immediately sublet the rented property to Reo. The corporation thereupon, in satisfaction of the lease agreement, made all rental payments in advance, prior to the first of each month, directly to Billingsly and Pate. The payments for Reo's fiscal years ending January 31, 1966 and 1967 are as follows:

July 30, 1965	$2,200
August 31, 1965	"
September 30, 1965	"
October 29, 1965	"
November 30, 1965	"
December 30, 1965	"
January 31, 1966	"
February 25, 1966	"
March 31, 1966	"
April 29, 1966	"
May 31, 1966	"
June 29, 1966	"
July 28, 1966	"
August 26, 1966	"
September 28, 1966	"
October 31, 1966	"
December 1, 1966	"
December 28, 1966	"

These checks were deposited in the real estate account of Billingsly and Pate.

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During the period leading up to the sale by Reo to Billingsly and Pate, the financial position of Reo was one of cash shortage; its bank account was frequently overdrawn.

For the legal work involved in the sale and leaseback described above, John Ford (hereinafter referred to as Ford) of the law firm of Bean, Ford and Schleier, sent the petitioner and Mosher a fee statement of $718.35 consisting of:

Conference with Pate, Mosher and Keeling

Preparation of Sales Contract, Lease Agreement, Deed and Bill of Sale....	$200.00
Owner's Title Policy—$141,000.00.......	463.35
Mortgagee's Title Policy..............	15.00
Recording Releases, Assignments, Deeds and Deed of Trust..................	25.00
Telephone calls to Austin, Tyler and Longview	10.00
	$718.35

Included within this same statement was a fee of $250 discounted by 25 percent to $187.50, for legal work done in an attempted bank loan from the Longview National Bank. The total fee of $905.85 was paid with two Reo corporation checks, both dated July 30, 1965. Check no. 977 for $387.50 was signed by Mosher, and check no. 980 for $518.35 was signed by the petitioner.

Opinion

Issue 1

The respondent bases his assertion that the petitioner has received rental income of $11,154.32 on two alternative theories. He argues that the transaction was nothing more than a financing arrangement. This contention is based upon the theory that the petitioner was acquiring 100 percent control of the corporation through the use of a hybrid form of mortgage.

Alternatively the respondent contends that the rental paid by Reo directly to Billingsly and Pate was for the benefit of the petitioner and therefore, in light of the "assignment of income" doctrine is income to the petitioner. Further, he asserts that the lease with option to buy from Billingsly and Pate to the petitioner was nothing more than an installment sale; the petitioner was acquiring title to, or an equity interest in, the property. Therefore, by applying section 162(a)(3), I. R. C. of 1954,[3] the petitioner is not entitled to a corresponding rental deduction. Section 162(a)(3) states:

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) In General.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

* * *

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

The finding of a financing arrangement would necessitate a determination that the sale by Reo of its assets to Billingsly and Pate was not in fact a sale, but rather a mere transfer to a strawman who holds legal title for security purposes only. The record does not justify reaching such a conclusion. There is no evidence to show that Billingsly and Pate received anything less than full unrestricted legal and equitable title. The facts disclose that the initial acquisition of Reo's stock by petitioner occurred almost 2 years prior to the sale and leaseback. Further, the transaction here in question was initiated by Mosher, not petitioner. In fact the sale negotiations were apparently well along before petitioner even became aware of their existence. The purpose of the negotiations was to solve Mosher's problem, a need for immediate cash, and was unrelated to any need of petitioner's. This Court cannot, therefore, take it upon itself to ignore these facts in holding that the entire acquisition of stock and leasing of property was all done by the petitioner with the intent of acquiring control of the corporation.

Nor is respondent's alternative theory well-founded. The facts repeated above cast doubt upon it. Further, it is unchallenged that, pursuant to a sublease from petitioner to Reo, Reo did in fact use the assets so subleased and did in fact garner the revenue therefrom. Accordingly, the benefit from the right to use the assets accrued directly to Reo and only indirectly to petitioner as Reo's sole shareholder.

We appreciate the respondent's position that at the taxpayer's insistence an option to purchase was added to the lease, implying a possible intent to reacquire. How-

[3] All section references are to the Internal Revenue Code of 1954, unless otherwise indicated.

ever, the facts indicate that petitioner was in some financial difficulty owing money to both the Federal Government and his father. We feel that the inclusion of this option was nothing more than a reflection of petitioner's hope of reacquiring the property. As the Seventh Circuit pointed out in *Breece Veneer & Panel Co. v. Commissioner* [56-1 USTC ¶9485], 232 F. 2d 319, 323 (C. A. 7, 1956), reversing an opinion of this Court [Dec. 20,589]:

> Manifestly, one who takes an option does so with the hope of exercising it, but the hope does not create an equity.

In addition it should also be noted that the purchasers, Billingsly and Pate, did not contemplate a lease with an option to purchase upon first negotiating the sale and lease with Mosher. This is of significance in light of the language used by the court in *Breece Veneer & Panel Co. v. Commissioner, supra,* at 323 when it stated, "[t]he intention of the parties cannot be determined unilaterally." This is even more forcefully demonstrated by the clause in the sales agreement which required Mosher to deposit $7,000 as security for the petitioner's first year's rent. Obviously, the lessor had no confidence in the petitioner's ability to pay the rent let alone exercise the option. It seems extremely doubtful that the petitioner intended from the first to exercise the option when he was unable to liquidate his own liabilities.

This Court has on many occasions noted that if title is taken or if an equitable interest is created in property for the benefit of the lessee then a transaction, though termed a lease, will be treated as a sale. The respondent raises several contentions in this regard. He submits that since a portion of the rental payments were applicable to the option, the rental exceeded the fair market value and thereby created an equity in the property in favor of the petitioner. Secondly, that the option price of $71,701.47 is far below the value of the property, thereby also indicating the creation of an equitable interest in favor of the petitioner, and finally that the lease agreement imposed many of the rights, risks and responsibilities that a purchaser of property would assume.

On all three counts we feel the respondent is incorrect. This Court in *Norman Baker Smith* [Dec. 29,272], 51 T. C. 429, 438 (1968), stated:

> [W]e conclude that an amount paid as rental of a property under a contract giving the lessor an option to purchase, will not be considered not to be a rental merely because the amount of the rental payments or a portion thereof will be credited on the purchase price of the property if the option to purchase is exercised. We adhere to our view that the substance of the transaction will be considered * * *.

This case makes it clear that the mere application of a portion of the rental to the option provision does not create an equitable interest. Rather, it is the intent of the parties and the substance of the transaction which must govern.

In regard to the respondent's second theory, that being the creation of an equitable interest through the low option price, we feel compelled to point to an appraisal prepared on May 6, 1970, on behalf of the petitioner by John B. Dickson. Dickson estimated the value of the property in 1970, the year the option could have been exercised, at a value of approximately $101,000. It is evident to this Court that with a fair market value of $101,000, the payment of an additional $71,701.47 creates no substantial equity prior to exercise. Even if we disregard the appraisal value, as the respondent requests, and value the property at $141,000, we feel the required additional payment of over $71,000 clearly eliminates the possible creation of an equitable interest of such magnitude to make exercise of the option automatic in light of petitioner's meager financial position as of the time the option was granted. Again our decision in *Norman Baker Smith, supra,* is relevant wherein we stated:

> There was no agreement requiring petitioners to purchase that property. If petitioners chose to exercise the option to purchase the property there would be required a substantial additional payment over and above the credit from the rental payment. 51 T. C. at 439.

In regard to respondent's last contention this Court finds little, if any, validity in the argument that the lease agreement's imposition of certain risks and responsibilities upon the lessee raises a presumption of sale rather than lease. The cases in this area have found for the most part that the existence of these risks and responsibilities were mere surplusage in determining if in fact a sale or lease existed.

Upon an examination of the entire record we conclude that the transaction is neither a financing arrangement nor an installment sale and therefore, we find for petitioner on this issue.

Issue 2

The petitioner on behalf of Reo admits to having erroneously deducted $187.50 of the $1,093.35 in question. Therefore, only the deductibility of the remaining $905.35 remains in issue.

It is settled law that "[c]osts connected with the disposition of a capital asset are * * * capital expenditures to be added to the taxpayer's basis, or offset against the sales price, rather than expenses deductible from ordinary income." *Spangler v Commissioner* [63-2 USTC ¶ 9777], 323 F. 2d 913, 921 (C. A. 9, 1963). Therefore, if the expenses involved herein are expenses of the sale by Reo to Billingsly and Pate they should be added to the corporation's basis in the property or reduce the selling price. This determination revolves around a factual question. As the court stated in *Industrial Aggregate Company v. United States* [60-2 USTC ¶ 9806], 284 F. 2d 639, 645 (C. A. 8, 1960). "[p]racticality and substance are to be recognized. The test which appears to have been established is that of *primary purpose*."

The facts indicate that an itemized bill of $905.85 was sent to Mosher and the petitioner for legal work performed by John Ford. The itemization indicated that $718.35 was charged for work done in connection with the sale and leaseback of the property.

The respondent contends that (1) since the bill was made out to Mosher and the petitioner personally, rather than the corporation, the expense must have been personal in nature, and (2) the payment of the entire $905.85 with two separate checks on the same day indicates that the petitioner has not sufficiently demonstrated that the payment was in response to the charges.

The first contention could possibly have some merit if the bill had been in the petitioner's name only. Here however, it was in the names of the corporation's only two shareholders, indicating that it involved corporate business. The second contention, upon close examination, is also of little merit. The two checks, nos. 977 and 980, are in amounts of $387.50 and $518.35, respectively. The entire first page of the statement and the first item on the second page involve the services rendered in preparing certain legal documents. The total amount charged for this preparation is $387.50, identical to the amount stated in check no. 977. The remainder of the statement involves expenses paid by the attorney on behalf of Reo. They total $518.35, the amount stated on check no. 980. Illogical as this may seem the connection between the payment and the bill is evident. In short, the facts clearly indicate the occurrence of a sale by the corporation, and it seems logical to conclude that the expenses involved were part and parcel of that sale.

We must also point out that the authorities indicate that the expenses enunciated above are for the most part deductible selling expenses. See *Fred Wong Gunn* [Dec. 28,645], 49 T. C. 33 (1967); *Samuel C. Chapin* [Dec. 16,822], 12 T. C. 235, affirmed [50-1 USTC ¶ 9171], 180 F. 2d 140 (C. A. 8, 1950); *Victoria Paper Mills Co.* [Dec. 8971], 32 B. T. A. 666, affirmed 83 F. 2d 1022 (C. A. 2, 1936). However, the fee for the preparation of the lease agreement is not an expense associated with the disposition of a capital asset by Reo, but rather is an expense of the petitioner involving his own lease agreement with Billingsly and Pate. Therefore of the aggregate $200.00 allocated to the preparation of the sales contract, lease agreement, deed and bill of sale, we allow the capitalization of $150.00. *Cohan v. Commissioner* [2 USTC ¶ 489], 39 F. 2d 540 (C. A. 2, 1930). It follows that of the $718.35, $668.35 is a capital expenditure which should be added to the basis of the property, or offset against the selling price.

The Federal tax return of Reo indicates that there was no gain or loss on the above mentioned sale. However, the expenses incurred were not applied to reduce the sales price or increase the basis. This adjustment is therefore required. In so doing the sale by Reo to Billingsly and Pate produces a loss. This loss is deductible as an ordinary loss in accordance with the provisions of section 1231(a).

In regard to the remaining expense of $187.50, the facts indicate that Ford prepared the necessary documents and initiated the negotiations with the Longview National Bank in the hopes of obtaining a loan which as it happened never materialized. It seems evident to this Court, as we noted earlier, that this expense as well as those listed above was initiated by and on behalf of the corporation. The fee statement was addressed to the two shareholders of the corporation, the statement lists as a service performed a conference with petitioner, Mosher, Arms and the Longview National Bank. It seems illogical to hold, as the respondent requests, that these expenses were for and on behalf of the petitioner only. Though the petitioner may not have destroyed all possible negative inferences he has in our opinion satisfied his burden of proof. See *George W. Van Vorst* [Dec. [illegible]], 22 B. T. A. 632, affirmed [3 USTC ¶ [illegible]] 59 F. 2d 677 (C. A. 9, 1932). Therefore, the expenditure in the attempted loan acquisition is deductible as an ordinary and necessary business expense.

Accordingly, under the facts and circumstances, we conclude that Reo is entitled to deduct the legal expenses as hereinbefore set forth.

Issue 3

The petitioner alleges that Reo was on the cash receipts and disbursements method of accounting, and therefore, the rent applicable to February 1966, paid on January 31, 1966, was deductible as an ordinary and necessary business expense in the corporation's Federal income tax return for the year ending January 31, 1966.

This contention is not supported by the facts presented. The articles of incorporation of Reo indicate that its principal function was the conducting of a "ballroom or dancehall." However, the Federal income tax return of the corporation discloses that it sold some type of goods and that the purchase and sale of these goods were kept on the accrual method of accounting as required by the regulations.[3] In addition, the petitioner has not produced any form of evidence to substantiate his position. The records of the corporation were not introduced and the tax returns are not enlightening. The facts also indicate that the petitioner's accountant, Arms, called as a witness, was never asked by petitioner's counsel whether the corporation was on a cash or accrual method of accounting.

The burden of proof lies with the taxpayer and in this case the taxpayer has not overcome that burden. Therefore Reo is, as the respondent contends, considered to be on an accrual method of accounting.

With this determination in mind the law is clear; an accrual basis taxpayer deducts all expenses in the year applicable and not when paid.[4] The result in this case is therefore apparent; the rental payment on January 31, 1966, since applicable to the corporation's next fiscal year, is not deductible until that year.

Decision will be entered under Rule 50.

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[3] Sec. 1.446-1(c)(2)(i). In any case in which it is necessary to use an inventory the accrual method of accounting must be used with regard to purchases and sales * * *.

[4] Sec. 1.446-1(c)(1)(ii). * * * Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy.

building demolished by the lessee.

9. The Tax Court in Herman Landerman, et al, v. Commissioner, 54 T.C. No. 100 (May 20, 1970), in a case involving a factual situation quite similar to Plaintiffs' case, has declined to apply the theory of the Ninth Circuit in the Feldman case. The Tax Court refused to allow the taxpayer a demolition loss taken pursuant to the terms of the lease which provided that the tenant had the option to demolish. The Court is not impressed by the theory of the Tax Court in the Landerman case and its attempt to distinguish that case from the facts and legal conclusions reached by the Ninth Circuit in Feldman v. Wood.

10. The Court, therefore, holds that the Plaintiffs in this case are entitled to deduct the demolition loss claimed and are entitled to a refund of the deficiencies and deficiency interest sought to be recovered in this action, less such portion thereof, resulting from the other adjustments made by the Commissioner, the propriety of which has been conceded previously by Plaintiffs.

Conclusions of Law

1. The Court has jurisdiction of this case pursuant to Section 1346(a)(1), Title 28, United States Code, as amended.

2. The demolition of the buildings in this suit was not effectuated by Plaintiffs' lessee "pursuant to the requirements of a lease or requirements of an agreement which resulted in a lease", within the meaning of United States Income Tax Regulations § 1.165-3(b)(2).

3. The demolition of Plaintiffs' buildings by the lessee was not done pursuant to an underlying condition of the lease within the meaning of Section 165 of the Internal Revenue Code of 1954 and the U.S. Income Tax Reg. § 1.165-3 (b)(2).

4. Plaintiffs are entitled to the demolition loss claimed by them in filing their personal income tax return for the calendar year ended December 31, 1964, and also the resultant net operating loss carryback to the calendar year ended December 31, 1961, in the amount of $50,561.18 in accordance with the provisions of Section 165(a) of the Internal Revenue Code and U.S. Treasury Income Tax Regulations § 1.165-3(b)(2) with respect to the demolition of buildings on Plaintiffs' leased property by their tenant pursuant to permission granted by the lease.

5. In view of Plaintiffs' concession of the Commissioner's adjustment to their 1964 return involving an excessive hurricane loss deduction in the amount of $200.00, the disallowance of an excessive expense deduction—South Ponte Vedra property of $245.53, counsel for the respective parties are directed to submit to the Court within not more than 15 days from date a computation showing the amount of refund of tax and deficiency interest to which Plaintiffs are entitled for each of the calendar years involved. Counsel for the parties shall also concurrently therewith submit a proposed form of Final Judgment reflecting Plaintiffs' recovery of tax, interest and allowable costs, in accordance with these Findings of Fact and Conclusions of Law.

[¶ 71-483]

Owen W. GARNER and wife, Sheila Garner, PLAINTIFFS v. U.S., DEFENDANT. U. S. District Court, N. Dist. of Tex., Ft. Worth Div., No. 4-1243, Feb. 2, 1971. Year 1964. Decision for taxpayer.

1. **INCOME—Rents and royalties—** distinguished from sales proceeds—business and industrial equipment. Investment credit allowed lessor for amounts received under lease of equipment prior to exercise of option to purchase: transaction was lease and not sale. Lease contract contained express option to purchase equipment, and rental payments were fair rental value. Intent of parties was to rent until option was exercised. Jury Verdict. *Reference:* 1971 P-H Fed. ¶ 7217(15).

Frank B. Appleman, Weeks, Byrd, Cannon & Applebaum, Ft. Worth Tex., Attys. for Plaintiffs.

Mike Cropper, Tax Div., Dept. of Justice, Wash., D. C., Atty. for Defendant.

TAYLOR, JR., District Judge:

Judgment

This cause having been tried before the Court sitting with a jury on October 6th and 7th, 1970, and the jury having found, in response to special issues, that the transactions in question in this case were, in fact, leases; that the rentals during the primary term and any periods after the primary term were fair and reasonable; and that the price at which the lessee had the option to purchase the equipment at the end of the primary term was not substantially lower than its fair market value; and the Court, being in substantial agreement with the findings of the jury that the transactions in question were leases and not sales, it is hereby:

Ordered, adjudged and decreed that Plaintiffs recover from Defendant the sum of $[illegible] plus interest as allowed by law from date of payment (August 22, 1968) to date of payment by Defendant, and plus costs as allowed by law.

Memorandum Overruling Defendant's Motion For Judgment Notwithstanding The Verdict Of the Jury

The plaintiffs seek a refund of income tax for the year 1964 in the amount of $4,9[illegible].97, plus interest. They contend that they were entitled to the investment credit on their income tax for that year with reference to the purchase of new equipment. The crucial issue involved is whether the transactions between the plaintiffs and their customers with respect to certain equipment amounted to a lease or to a sale.

[1] The jury, in response to special issues, found that the transactions were in fact leases, that the rentals during the primary term and any periods after the primary term were fair and reasonable, and that the price at which the lessee had the option to purchase the equipment at the end of the primary term was not substantially lower than its fair market value. The Court is in substantial agreement with the findings of the jury in that the operative facts here show that the transactions in question were leases and not sales. Lockhart Leasing Co. v. United States [24 AFTR 2d 69-5791], 69-2 U.S.T.C. ¶ 9705 (D. Utah 1969) and Lockhart Leasing Co. v. Commissioner, 54 T.C. 301.

Accordingly, Government's Motion for Judgment notwithstanding the Verdict of of the Jury is overruled and Plaintiff's Motion for Judgment on the Verdict is granted. Plaintiff's attorneys will prepare and submit appropriate form of Judgment.

Charge Of the Court

The Court: Ladies and gentlemen of the Jury, you have heard the evidence in the case and the arguments of the attorneys. At this time it becomes the duty and responsibility of the Judge to charge you as to the law that pertains to this case. As I told you in the very beginning, it's up to the Jury to decide the facts. That is the exclusive province, the exclusive function of the Jury. Nothing that I say, have said or will say is intended in any way to affect your judgment of the facts.

* * * * * * * *

Now, this particular lawsuit is against the United States under the Federal Income Tax Statutes passed by Congress wherein the Plaintiffs seek refund of income taxes in the approximate amount of $4,930.00. And I might say this to you, you will not be called on to assess any taxes or fix any figures or anything of that kind. I propose to submit this case to you on special issues or on questions, asking you to find what the facts are under the law as it is given to you. Now, into the Jury Room will go with you only these questions and a few additional instructions in connection with them. Most of this charge will be oral, just as I am talking to you now. That is the way you will receive it, so I will ask you to go along with me and bear with me and keep this in mind, or keep these things in mind that I am about to say to you when you go into the Jury Room to deliberate.

As I said, this is a suit in which the Plaintiff seeks a refund of income taxes in the amount, approximate amount of $4,930.00. Now, this means the Commissioner of Internal Revenue levied an additional assessment of taxes against the Plaintiffs and that subsequently the Plaintiffs made full payment of the amount required or assessed. The Plaintiff then filed a claim for refund of taxes with the Internal Revenue and the Internal Revenue denied the claim for refund. Now the Plaintiffs sue for a refund of those additional taxes which they had paid.

* * * * * * * *

Now, in this case the Plaintiff contends that he was the owner and the lessor of certain equipment which was purchased in 1964 and that he is entitled to claim with respect to that equipment a credit called an "investment credit" against his taxes for that year. The United States, on the other hand, contends that Mr. Garner either sold the equipment to the users or merely financed the purchase of the equipment by the users, and that in either event he is not entitled to claim an investment credit with respect to the equipment.

Now, I am going to instruct you as to some factors that you may take into consideration in determining whether the transactions between the Plaintiffs and the users of the equipment were in substance leases, or something other than leases such as sales or merely financing arrangements. In resolving the question of whether the Plaintiff was the lessor of the equipment, you are instructed that the true substance of the arrangement between the Plaintiff and his customers governs the tax consequences, and not the form in which those arrangements were cast by Mr. Garner and his customer. neither names nor labels alone are determinative of the fact that the arrangements were termed "leases" and payments were made pursuant thereto, or were termed "rentals", is not alone determinative of their true nature for income tax purposes.

A transaction must be examined in terms of what was designed to be accomplished, what was actually accomplished, and the symbols or label or forms employed by the parties are not alone determinative but are factors that may be taken into consideration by you.

Generally, under a true lease the lessee makes periodic rental payments for the use of equipment over a stated period of time, at the end of which the property is reclaimed by the lessor. On the other hand, under an installment sale or financing arrangement the purchaser makes specific installments over a designated period of time, which payments equal the purchase price for the equipment plus interest on the unpaid balance, and at the time of the final payment the equipment becomes the exclusive property of the purchaser.

If you find that the so-called rentals which the equipment user had to pay at the end of the contract period for the purpose of renewing the contract were low in relation to the payments required to be made during the original contract period, you may consider that fact as showing the contract was something other than a lease. On the other hand, if you find that the rentals which the lessee could pay by renewing the lease, were in fact higher to the relation to the value of the property at the time of the renewal, you may consider that fact that the contract was a lease and not a sale.

If you find that the users of the equipment made so-called rental payments which were materially in excess of the current fair rate of the equipment, you may consider that fact that the contract was something other than a lease. If, however, you should find that the users of the equipment paid a rental which was equal to or less than the current fair rental value of the equipment, you may consider that fact that the contract was a lease and not a sale.

Life

If you find that the total of the so-called rental payments to be made over the life of the contract was approximately equal to the original purchase price of the equipment plus interest, and that the equipment would still have a reasonable value at the end of the contract, you may consider that fact as showing that the contract was something other than a lease.

Residual

If you find that the option price paid by the equipment users to purchase the equipment at the end of the contract period was nominal or token in relation to the value of the equipment at that time, you may consider that fact as showing that the contract was something other than a lease.

The mere fact that the lessee has an option to buy the leased property at the end of the lease period does not of itself require the conclusion that the transaction is in fact a sale.

If the Plaintiffs were recognized by the other Governmental agencies as the owner of the equipment, this is a factor that may be taken into account in determining that the transaction was a lease and was not a sale.

If you find that the lessees considered that they were lessees by their actions and not purchasers, you may consider this factor showing the contract was a lease and not a sale.

If you find that the Plaintiffs purchased the equipment and had no agreement with any company from whom he made the purchase of the equipment to guarantee or pay the Plaintiff's debt incurred to purchase the equipment, you may consider that fact in considering that the contract was a lease and not a financing arrangement.

If you find the Plaintiffs had no agreement with the company from whom he purchased the equipment to take it back unless the lessees did not discharge its obligations under the terms of the lease for the full rental period, you may consider this fact as showing the contract was a lease and not a financing arrangement.

* * * * * * * *

[¶ 71-484]

U.S., PLAINTIFF-APPELLEE v. Morris COOPER-SMITH, DEFENDANT-APPELLANT. U.S. Court of Appeals, Second Circuit, No. [illegible], March 12, 1971. District Court, 25 AFTR 2d 70-1063, affirmed. Years 1945-1947. Decision for Govt.

1. LIMITATIONS—Collection after assessment—waivers—duration. U.S. could reduce tax assessments to judgments after rejecting compromise offer 13 months after taxpayer made it. Waiver of statute of limitations suspending it for period compromise offer was pending or during period installments under offer remained unpaid, and one year thereafter, did not end until one year after U.S. accepted or rejected offer, not one year after last installment was paid. *Reference:* 1971 P-H Fed. ¶ 36,512(5).

Johnnie M. Walters, Asst. Atty. Gen., Virginia M. Hopkinson, Meyer Rothwacks, Crombie J. D. Garrett; Tax Div., Dept. of Justice, Wash., D.C., Edward R. Neaher, U.S. Atty., Cyril Hyman, Asst. U.S. Atty., Attys. for Appellee.

Abraham W. Seraysky, 32 B'way, New York, N.Y., Atty. for Appellee.

Before LUMBARD, Chief Judge, KAUFMAN and ANDERSON, Circuit Judges.

Appeal from an order of the Eastern District of New York, Bartels, J., granting summary judgment in favor of the government in its action to reduce tax assessments to judgment. Affirmed.

PER CURIAM:

Morris Cooper-Smith appeals from an order of the Eastern District of New York, Bartels, J., granting summary judgment in favor of the government in its action to reduce to judgment income tax and civil fraud penalty assessments for the years 1945, 1946 and 1947. Judge Bartels denied Cooper-Smith's cross-motion for summary judgment which asserted that the statute of limitations barred the government's action, and judgment was entered for $56,495.52.

[1] The sole issue raised on appeal is whether the statute of limitations bars the government's recovery. On May 6, 1960, Cooper-Smith was assessed for these deficiencies. Section 6502(a) of the Internal Revenue Code of 1954 provides that an action for collection of taxes must be commenced within six years of assessment unless otherwise agreed upon in writing by the parties before this period has expired. In the absence of an agreement, the limitations period would have expired on May 6, 1966. However, on October 26, 1965, Cooper-Smith filed an offer of compromise on a printed Internal Revenue Service form. Taxpayer offered to pay $1,000 in monthly installments of $100, with the balance payable within 30 days of acceptance, as full settlement for his liability. Paragraph 6 of the form provided:

> "The undersigned proponent waives the benefit of any statute of limitations applicable to the assessment and/or collection of the liability sought to be compromised, and agrees to the suspension of the running of the statutory period of limitations on assessment and/or collection for the period during which this offer is pending, or the period during which any installment remains unpaid, and for 1 year thereafter."

Pursuant to the terms of the offer, Cooper-Smith mailed monthly installments which the government deposited in his account. The final installment was paid on August 3, 1966 and deposited on August 10, 1966. On November 17, 1966, approximately thirteen months after the offer was submitted and after the final installment had been paid, the government rejected the offer. This action was commenced on May 22, 1968.

Under the agreement quoted above, the government contends, and Judge Bartels held, that the statute of limitations did not run until May 28, 1968, and therefore the suit was timely brought.

F. Edward Little, Baird, Holley, Baird & Galen, Suite 2400 Crocker-Citizens Plaza, 611 W. 6th St., Los Angeles, Calif., for appellant.

Before CHAMBERS, BROWNING and WRIGHT, Circuit Judges.

PER CURIAM: In this income tax fraud case there were two counts in the indictment. At issue were Buble's returns for the calendar years 1963 and 1964. Erroneously the indictment said the 1963 return was filed in April 1963 and the 1964 return was filed in April 1964.

Obviously, the literal figures made no sense. One must file his return after the end of the calendar year. The trial court amended the indictment to read that the 1963 return was filed in April 1964 and the 1964 return was filed in April 1965.

We hold that such an error, obvious to the defendant, could be corrected as it was* and that the double jeopardy argument has no merit.

Defendant really knew what years were involved. We did not find a different result required by *Russell v. United States* (1961), 369 U. S. 749; *Stirone v. United States* (1959), 361 U. S. 212; *Ex parte Bain* (1887), 121 U. S. 1; *United States v. Harvey* (9th Cir. 1970), 428 F. 2d 782; *Gaither v. United States* (D. C. Cir. 1969), 413 F. 2d 1061; *Heisler v. United States* (9th Cir. 1968), 394 F. 2d 692.

Further we would hold that this particular indictment did not require the amendments, so amendments did not prejudice the defendant. The variance in the proof from the original indictment still could have permitted the case to go to the jury.

[¶ 9470] Lockhart Leasing Company, Appellee v. United States of America, Appellant. Lockhart Leasing Company, Appellee v. Commissioner of Internal Revenue, Appellant. Lockhart Leasing Company, Appellee v. Commissioner of Internal Revenue, Appellant.

U.S. Court of Appeals, 10th Circuit, No. 91-70 (D. C. No. C-197-68), No. 289-70 (T. C. No. 523-68), No. 290-70 (T. C. No. 2445-66), 6/8/71. Aff'g District Court, 69-2 USTC ¶ 9705, and Tax Court, 54 TC 301, Dec. 29,962.

[*Code Sec. 48(d)—Result unchanged by '69 Tax Reform Act*]

Investment credit: Qualified investment: Lessor: Lease v. sale.—The taxpayer was entitled to investment credit on equipment and machinery that it leased to others. It was engaged in the business of leasing the property rather than in selling the items and financing the purchases made by its customer. The agreements under which the property was leased were leases in substance as well as in form. Back references: ¶ 503.26 and 688.542.

J. Jay Bullock, Kearns Bldg., Salt Lake City, Utah, for appellee. C. Nelson Day, United States Attorney, Salt Lake City, Utah, Johnnie M. Walters, Assistant Attorney General, Lee A. Jackson, Elmer J. Kelsey, Stephen H. Hutzelman, Department of Justice, Washington, D. C. 20530, for appellant.

Before HILL and SETH, Circuit Judges, and DOYLE, District Judge.

[*Issue*]

SETH, Circuit Judge: These appeals come to this court as two cases from the Tax Court and one case from the United States District Court for the District of Utah. Each case raises the question whether the taxpayer was entitled to the investment credit which was allowable under section 38 of the Internal Revenue Code of 1954. The Tax Court held, [CCH Dec. 29,962] 54 T. C. 301, that the taxpayer for its tax years ended in 1962 and 1961 was entitled to the investment credit with certain exceptions, and the Commissioner has taken appeals from those decisions. The Tax Court opinion contains a detailed statement of the facts and detailed statistics. The United States District Court in the refund action brought by the taxpayer also decided the taxpayer was entitled to the investment credit for the fiscal year ended in 1963. The United States has taken an appeal from that decision.

In each of the cases the initial question is whether the taxpayer was engaged in the business of leasing equipment and machinery as it contends, or whether it was instead, as the appellants contend, selling

* See, e. g., *Stewart v. United States* (5th Cir. 1968), 395 F. 2d 484.

the items and financing the sales or just financing purchases by its customers.

[*Nature of Business*]

It appears from the record that the taxpayer purchased machine tools, store equipment, business or office equipment, and similar items from a variety of sources as they were requested by its customers. The customer would request a particular machine, taxpayer would purchase it from the maker or a dealer, and it would be placed in the customer's possession and use usually under a form called an Equipment Lease Agreement. Often the customer would first contact the maker or dealer and discuss an item of equipment before negotiating with taxpayer. The agreement provided the term or length of time for the arrangement, the rental, an option to renew if such was negotiated, and occasionally an option to purchase in the customer.

The taxpayer entered into, for its fiscal year ended in 1962, thirty-two such arrangements, for the year 1963, sixty, and for 1964, one hundred eleven, and in all but four of these the same form was used. The terms of this agreement and the general business conducted by the taxpayer constitute the center of the dispute.

The Equipment Lease Agreement states that the arrangement is a lease and that title does not pass. It also provides that the customer assume all the risks of loss of the property. If the customer does not perform its obligations, it is stated that the equipment may be repossessed. The customer was to pay any taxes on the equipment, to insure it against loss, and pay for repairs and maintenance. The "loss value" was stated in the agreement as was the place where the equipment was to be kept. The taxpayer had no repair or storage facilities. The taxpayer did not transfer or assign its ownership or its position under the agreement to others. The issue relates only to transactions with a term of more than four years.

[*Trial Courts*]

The trial courts found that in a number of instances the taxpayer was required to retake possession of the equipment as provided in the agreement before the end of the term and to make some disposition of it, and was also required on occasion to dispose of equipment at the end of the term. The record shows that the parties to each agreement negotiated the provisions with a view to the worth of the equipment at the end of the term. The record does not show that the total amount paid by the customer during the term was disproportionate to the value of the equipment for such period. The record shows that where the agreement contained an option to buy in the customer, it was an amount based upon the expected value of the property at the time the option could be exercised. In two out of some two hundred agreements, there was an arbitrary option price of one or ten dollars. When the agreement contained no option to buy the courts below found that if the customer was to buy a price was then negotiated.

[*Statutory Provisions*]

The Revenue Act of 1962 added section 38 to provide for a special credit against tax for the investment in certain depreciable property. The provisions were limited to tangible property other than buildings put to qualified uses and limited to property to which depreciation, or amortization in lieu thereof, is allowable, and having a useful life of four years or more. This last limitation relating to depreciation raises the issue here, as the person who has the depreciable interest is the one who can claim the credit. The investment credit provisions were repealed by section 703 of the Tax Reform Act of 1969.

The purpose of the investment credit was to encourage the purchase and use of new productive machinery by giving a limited tax incentive to those who would invest in such new equipment. It is apparent that the incentive was not for the sellers of such equipment nor for those who were merely financing the purchases. The Act did make express reference to leased property in section 48(d) to provide that a lessor of qualified property may under appropriate regulations " . . . elect with respect to any new Section 38 property to treat the lessee as having acquired the property." Also in the House Report No. 1447 relating to the 1962 Revenue Act, a statement was made that the bill provided that the lessor of property could treat the investment as made by the lessee rather than himself. It thus appears that the Act contemplated that a taxpayer who leased qualified property to others was entitled to claim the credit. Thus the question on this appeal is whether the taxpayer had a depreciable interest in the property which was the subject of its agreements with its customers.

[*Agreements Were Leases*]

We must agree with the analysis of the transactions as made by the Tax Court, considering also as it did, the nature of taxpayer's business as a whole. It cannot be said that any one element present in the agreements is conclusive on the depreciation question, including an option to purchase; nor can it be said that all provisions considered together place the burdens of ownership on the customer to the extent that the agreement transferred from the taxpayer a depreciable interest in the equipment. The Tax Court found that the rental payments and the option provisions or negotiated options all had a reasonable relationship to the value of the property during the term of the agreement or at the option date. The court also found that in only one instance did the taxpayer make an arrangement with the supplier to it of the equipment to assist taxpayer in the event the agreement with a customer was breached. This is a factor relating to the bona fide nature of the purchases by the taxpayer. The Tax Court also found that the taxpayer was not here engaged in financing the purchases and this is also supported by the facts. Taxpayer's recordkeeping was in a form ordinarily used by those engaged in financing, but the Tax Court found there was a reasonable explanation for this method, and the method as such was not a determinative fact.

The United States District Court found that the length of the agreement was negotiated on the basis of the type of the equipment and its expected use by the customer. It also found that the rentals were based on the cost of the equipment, how long it was to be used, and what the value was expected to be at the end of the agreement. The court also found that when an option price was stated it was based on the fair market value of the equipment at the end of the lease. The trial court thus concluded that the property subject to the agreements was a qualified investment under section 38(a) of the 1954 Code to allow taxpayer the investment credit.

[*Burden of Proof*]

The burden was on the taxpayer before the Tax Court and the District Court to establish that it was entitled to the credit. *Wallis v. Comm'r* [66-1 USTC ¶ 9312], 357 F. 2d 313 (10th Cir.); *Anson v. Comm'r* [61-1 USTC ¶ 9293], 328 F. 2d 703 (10th Cir.). This standard was applied by both courts. The appellants urge that the cases of *Mt. Mansfield Television, Inc. v. United States* [65-1 USTC ¶ 9270], 342 F. 2d 994 (2d Cir.); *Starr's Estate v. Comm'r* [60-1 USTC ¶ 9191], 274 F. 2d 294 (9th Cir.), and *Oesterreich v. Comm'r* [55-2 USTC ¶ 9733], 226 F. 2d 798 (9th Cir.), should control this determination. In *Oesterreich* however the lease period was for sixty-eight years and gave the lessee the option to purchase for ten dollars at the end of the lease, having paid some $670,000.00 in rentals. This type of option is not comparable to the ones before us. The cited case did, however, consider the effect of the obligation of the lessee under the agreement to make repairs and assume the risks of loss or damage. As indicated, the options were with only one or two exceptions not for an arbitrary amount. The Tax Court and the District Court found in the instances where an option price was stated, as it was in about one-third of the agreements, that it related realistically to the actual market values. Further, the presence of an option price was not itself a determinative factor. See *Kitchin v. Comm'r* [66-1 USTC ¶ 9104], 353 F. 2d 13 (4th Cir.). Further as indicated above, the record demonstrates that the rentals were related to standard rates and did not represent a recovery of the purchase price plus interest. Thus the unusual factual situation represented in *Starr's Estate v. Comm'r* [60-1 USTC ¶ 9191], 274 F. 2d 294 (9th Cir.), prevents its application here. There the lease of a sprinkling system installed in the building for the indefinite term at a normal rate, and with the repossession problem, presents quite a different problem. In *Mt. Mansfield Television, Inc. v. United States* [65-1 USTC ¶ 9270], 342 F. 2d 994 (2d Cir.), the agreement covered a transmission system designed for the taxpayer, the agreement provided for interest on the balances, and was sold by the lessor to a bank. This again is not comparable here under the findings of the courts below. We do not consider Revenue Ruling 55-540 to be applicable here because it considered the position of a lessor in the business of leasing property.

[*Affirmed*]

There has been much litigation under a variety of circumstances as to what constitutes a lease generally and for tax purposes. See *Breece Veneer & Panel Co. v. Comm'r* [56-1 USTC ¶ 9185], 232 F. 2d 319 (7th Cir.). As indicated above, no one factor is controlling and, of course, substance must prevail over form. The general business of taxpayer and the manner in which it is conducted must be examined. When this is done with the record before us we must hold that the Tax Court and the United States District Court were correct in their conclusions. The evidence that the agreements were loans in substance as well as in form is clear, and we find the taxpayer carried its burden in the several proceedings. The bits and pieces of evidence which the appellants here urge are not convincing and in any event the findings of the trial courts are supported by the evidence. The application of the law to the taxpayer's business must come from a variety of sources and this also was properly applied by the trial courts. Accordingly each of the three cases is hereby *AFFIRMED.*

[¶ 9471] H. F. Campbell Company (formerly H. F. Campbell Construction Company), Petitioner-Appellant v. Commissioner of Internal Revenue, Respondent-Appellee.

U. S. Court of Appeals, 6th Circuit, No. 20793, 6/9/71. Aff'g Tax Court, 54 TC 1021, CCH Dec. 30,110.

[Code Sec. 481(b)(4)—Result unchanged by '69 Tax Reform Act]

Tax accounting: Change in method: Construction contracts: Recomputation of profits: Taxable year of inclusion.—The Court affirmed the Tax Court holdings that the taxpayer initiated the change in its method of accounting for uncompleted construction contracts and that the taxpayer was not entitled to adjustments under Code Sec. 481(b)(4) because its attempted change in method of accounting was not consented to by the Commissioner. Back references: ¶ 2835.0585 and 2882.53.

[Tax Court Rule 17(d)]

Tax Court Rules: Motion to amend answer: Conforming answer to proof.—The Court affirmed the Tax Court decision that the Commissioner timely amended its answer to claim an increased deficiency for 1961 after trial because of certain findings made by the Tax Court as to which tax years should reflect the profits of unfinished construction contracts. Back reference: ¶ 5939.65.

Victor R. Wolder, 350 Fifth Ave., New York, N. Y., for petitioner-appellant. Johnnie M. Walters, Assistant Attorney General, Leonard J. Henzke, Jr., Meyer Rothwacks, William Massar, Department of Justice, Washington, D. C. 20530, for respondent-appellee.

Before EDWARDS, PECK and BROOKS, Circuit Judges.

BROOKS, Circuit Judge. This is an appeal by taxpayer, H. F. Campbell Company, from the Tax Court's determination of added income tax liability for taxpayer's fiscal years 1960 and 1961.[1] The Tax Court's findings of fact and opinion are reported at [CCH Dec. 29,889] 53 T. C. 439 (1969), and a supplemental opinion is reported at [CCH Dec. 30,110] 54 T. C. 1021 (1970). Since the facts out of which this controversy arose are narrated in the Tax Court's opinion, [CCH Dec. 29,889] 53 T. C. 439, 430-435, only the briefest factual sketch of the case is necessary here.

The major issue in this case arises as a result of the disallowance by the Commissioner of taxpayer's claimed net operating loss deduction from its building construction business for 1960 and 1961 based on a carryback of alleged losses incurred in 1962. The Commissioner, over protest, included in taxpayer's gross income for 1962 certain disputed income, thereby eliminating taxpayer's claimed operating loss. This situation developed because of a change in taxpayer's accounting methods.

Prior to 1954 (tax years 1946-1953) taxpayer used one method of accounting for uncompleted contracts. Beginning in 1954, taxpayer changed its accounting method (the old method) and continued to use this method until 1962. In 1962 the Internal Revenue Service began an audit of taxpayer's 1960 and 1961 returns. Following the revenue agent's examination of taxpayer's record, the agent concluded that certain income from five construction con-

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[1] Deficiencies assessed for the years 1960 and 1961 were in the respective amounts of $10,195.31 and $[illegible].

IN THE

United States Court of Appeals

FOR THE FIFTH CIRCUIT

No. 24304

WALTER D. SANDERS, Trustee in Bankruptcy for THE ATLANTA TIMES, INC., Bankrupt,
Appellant,

versus

COMMERCIAL CREDIT CORPORATION,
Appellee.

Appeal from the United States District Court for the Northern District of Georgia

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(July 10, 1968)

Before COLEMAN and AINSWORTH, Circuit Judges, and CARSWELL, District Judge.

CARSWELL, District Judge: The principal issue here rather frequently recurs in bankruptcy proceedings and was the subject of this Court's opinion in *Sanders v. National Acceptance Co.*, 383 F. 2d 606 (1967), involving the same bankrupt although a different creditor and a totally unrelated contract.

Do the particular transactions constitute a lease or a conditional sale? If a lease, then the chattel, or its monetary equivalent after sale, reverts to the lessor without the necessity of filing to protect its rights. If the agreement be deemed a security agreement (or conditional sale) the Trustee prevails in behalf of the bankrupt and its common creditors.

We affirm the Referee and the District Court's determination that the agreement here was a lease — and thus beyond the requirements for filing under the Uniform Commercial Code under Georgia law. Ga. Code §109-A-1-201 (37).

To acquire the necessary equipment to publish a newspaper, The Atlanta Times, Inc., entered into a written contract with Commercial Credit Corporation which in pertinent portions provided that:

(1) The agreement ". . . is and is intended to be a lease, and Lessee does not hereby acquire any right, title or interest in and to the Chattels, except the right to use the same under the terms hereof."

(2) Upon expiration the TIMES agreed to return possession of the chattels to CCC or load them for shipping elsewhere as designated by CCC.

(3) The TIMES leased the equipment for 120 months at a specified monthly rental.

(4) This was a ten year agreement with a monthly rental of $5,940.61. Thereafter the TIMES had

the option to continue to lease the equipment from year to year for an annual rental of $5,701.16.

(5) The TIMES was required to make a "Security Deposit" of $145,000 with CCC. This deposit was applicable at the option of CCC to the performance of the TIMES' obligation under the agreement.

The first two of these provisions of the agreement combine to give us a hornbook definition of a lease.

The appellant-Trustee for TIMES urges, however, that this is nothing more than a ploy to avoid the provisions of statutes requiring the filing of conditional sales contracts by: (1) phrasing the agreement in terms of a lease, (2) requiring fixed amounts for rentals for a fixed period but then (3) orally stipulating that on completion of the so-called rental payments, a bill of sale shall vest in the lessee for some nominal amount.

We agree with the Trustee that if the payments are designated as rent but are in reality payments toward the purchase price of the property the Court must pierce through the shell of words, give force to the actual intention of the parties, and determine the contract in its true character to be a conditional sale.

The difficulty with the Trustee's case here, however, is, first, there is very little if anything in the written instrument itself which subjects it to suspicion as a masquerade, and, second, the Trustee's position is more battered than buttressed by the parol evidence which was considered by the Referee after considerable cautionary deference to the Trustee's insistence that the written contract was ambiguous or incomplete. The parol evidence itself showed that a lease was indeed intended by the parties for a number of reasons including the legitimate consideration of tax consequences flowing only from a genuine lease.

The testimony for the appellant did, in fact, contradict the clear written agreement by insistence that there was some kind of loose, ill-defined and unwritten agreement to the effect that the lessee would receive a bill of sale for some unspecified nominal amount upon completion of the rental payments. Such oral arrangement was categorically denied by oral testimony of CCC and the Referee was justified in determining from this entire record that the testimony of CCC was worthy of greater credence and in accord with the clear language of the written contract.

The Trustee also points to provisions of the written contract dealing with default which allow CCC to take possession of the property without notice, to hold the property free and clear of any rights of the TIMES under the agreement, to maintain the agreement in effect despite its possession of the property and its right to re-lease or sell all or some of the property. It is urged that all this adds up to the TIMES making an unconditional commitment to make a total payment of money which is called rent but which is in fact the same liability of a debtor which exists under a conditional sales contract, chattel mortgage or other similar contract under which a borrower unconditionally agrees to pay a lender a sum certain and property is put up as security.

The Trustee relies upon *In re South View Country Club, etc.*, 229 F. Supp. 105, 106 (1) (D.C. Minn. 1963), and 4 Collier on Bankruptcy, section 70.18 [13] (14th Ed., 1962), as authority for the valid general proposition that a contract of sale creates an obligation to pay the agreed price, while a lease does not impose such an obligation.

This contention of the Trustee, as has been noted by the Referee and approved by the District Court, ". . . overlooks the prime essential distinction between a lease and a conditional sale, to wit: in a lease the lessee never owns the property. In the absence of a right or option in the lessee to acquire ownership of the leased property, the transaction is one of lease."

It is on this central issue that appellant-Trustee fails. The written instrument in its extracted clauses and in its totality is consistent with the idea of lease, considered with or without the parol evidence.

Finally, with respect to the security deposit clause the appellant contends that this is in the nature of a penalty and as such is unenforceable in that the agreement does not provide for reduction of the sum of unpaid rentals under the lease to present value. We agree with the Referee and the District Court that these liquidated damages provisions are limited to the present value of unpaid rentals under the lease. See *Irving*

Trust Co. v. A. W. Perry, Inc., 293 U. S. 307, 55 S. Ct. 150, 79 L. Ed. 379 (1934).

The District Court correctly recognized that since the leased property was purchased by CCC specifically for the use of the TIMES, reducing the likelihood of reletting such property, the default provision permitting the lessor the alternative of either reletting the property or selling it was reasonable. The sum of the price received at the court directed sale of the chattels plus the security deposit was still less than the present value of the rent reserved at the time of default. Under such circumstances the District Court was correct in directing CCC to retain the security deposit and set it off against the damages incurred.

The judgment appealed from is

AFFIRMED.

Adm. Office, U.S. Courts—Scofields' Quality Printers, Inc., N. O., La.

EQUIPMENT LEASE

Lease No. CC A 573

THIS LEASE entered into this 7th day of February, 19 64, by and between Commercial Credit Corporation, hereinafter called "Lessor," a Georgia corporation, of Atlanta (City) Georgia (State), and The Atlanta Times, Inc. hereinafter called "Lessee," a Corporation (Corporation, Partnership or Individual Venture) of 700 Forest Avenue (Street), Atlanta (City), Georgia (State),

WITNESSETH:

1. *Leasing.* Lessor hereby rents and leases to Lessee, and Lessee hereby rents and leases from Lessor the equipment described herein for the terms, at the rentals and subject to the conditions herein contained.

2. *Equipment.* The equipment leased hereunder, hereinafter called "Chattels," is described in schedules signed by the parties and identified herewith, and attached or intended to be attached hereto.

3. *Term, Rental and Deposit.* The term of this lease and the rental payable hereunder with respect to each Chattel shall be the number of months and the amount stated after the description of such Chattel in the schedule describing the same. The rental shall be payable monthly in advance on the day of the month stated in said schedule. At the time of the payment of the first rental hereunder, Lessee will deposit with Lessor such additional sum, if any, specified in the schedule as security for the payment and performance of any obligation of Lessee hereunder. Such deposit shall be applicable at Lessor's option but shall not relieve Lessee of the payment or performance of all of its obligations hereunder. The deposit, or any remainder thereof, shall be returned to Lessee at termination of this lease.

4. *Location and Use of Chattels.*

4.1 The Chattels leased hereunder shall at all times be located at 700 Forest Avenue (Street Address), Atlanta, Georgia (City and State). If it is intended that any of the Chattels be not located at said address, then the address at which such Chattel shall be located for the term of the lease shall be indicated on the attached schedule which describes such Chattel. Chattels shall not be removed from the said location or locations without the prior written consent of Lessor.

4.2 Lessee will not use, operate, maintain or keep any Chattel leased hereunder improperly, carelessly or in violation of any laws or regulations relating to the possession, use or maintenance thereof, or in a manner or for a use other than contemplated by the manufacturer thereof, as indicated by the instructions furnished therewith. Lessee at its own expense will keep and maintain the Chattels in good condition and working order, paying when due all costs and expenses of every character occasioned by or arising out of the use and maintenance of the Chattels. Insignia, tags, decals or other identification furnished by Lessor will be maintained on each Chattel and will not be removed by Lessee. Lessor may inspect any Chattels at any reasonable time.

5. *Insurance.*

5.1 Lessee assumes all responsibility for the maintenance, repair, testing, use and operation of the Chattels and, as between the parties, the liability, if any, for personal injuries and property damage howsoever arising from or incidental thereto, whether such injuries be to agents or employees of Lessee or to third parties and whether such damage be to the property of Lessee or of others. Lessee will indemnify and save Lessor harmless of, from, and against all claims, costs, expenses and liabilities resulting from or pertaining to the Chattels or the ownership, maintenance, storage, use or operation thereof. Lessee shall also be liable to indemnify and save Lessor harmless from any loss, damage, or destruction of any Chattel.

5.2 Lessee will maintain fire, with extended coverage, insurance for the term of the lease on each Chattel for the value thereof, and will maintain public liability and property damage insurance with respect to each Chattel. All such insurance shall name Lessor and Lessee as Insured, shall be in such amounts and with such insurers as approved by Lessor, and shall provide that the same may be altered or canceled only after ten (10) days prior written notice to, and that losses shall be adjusted only with, and paid to, Lessor, the insurer named therein being hereby directed by Lessee to make payment for any such loss to Lessor and not to Lessor and Lessee jointly. If any such loss be paid by check or draft payable to Lessor and Lessee jointly, Lessor may endorse Lessee's name thereon. Lessee shall deliver to Lessor, prior to the beginning of the lease term, or prior to the effective date of any cancellation or expiration of such insurance, as the case may be, the insurance policy or a certificate or other evidence, satisfactory to Lessor, of the maintenance of such insurance.

6. *Loss or Damage to Chattels.* All risk of loss, theft, destruction and damage to Chattels, from whatever cause, are assumed by Lessee. Should any Chattel be damaged and the applicable insurance proceeds be not adequate to repair the same or to reimburse Lessor for the value thereof, which, in the absence of a determinable amount, shall be deemed to be the aggregate unpaid rentals with respect thereto, including those provided for in the renewal option, Lessee will either repair or replace the same at its cost, or pay Lessor the value thereof.

7. *Expenses, Fees, Taxes.* Lessee shall pay all costs, expenses, fees and charges incurred in connection with the use and operation of the Chattels during the lease term hereof. Lessee shall pay any and all sales taxes, use taxes, excise taxes, stamp and documentary taxes, declare, report and pay all assessments and other governmental charges whatsoever by whomsoever payable on or relating to the Chattels and the purchase, sale, rental use or operation thereof (other than Federal or State income tax of Lessor). Lessor is under no duty to contest any tax or governmental charges payable by Lessee hereunder. Lessee shall reimburse Lessor, upon demand, as additional rent, the amount or amounts of any such costs, expenses, fees, charges or taxes paid by Lessor.

8. *Delivery, Acceptance and Return of Chattels.* Upon delivery of each Chattel to Lessee, Lessee shall execute and deliver to Lessor a dated receipt, identifying the Chattel and acknowledging acceptance thereof. By such acceptance Lessee agrees that such Chattel is in good operating order, repair, condition and appearance, and in all respects satisfactory to Lessee. After the expiration or sooner termination of the lease term pertaining to each Chattel, or any renewal thereof, Lessee, if so requested by Lessor, will promptly return each Chattel to Lessor in the same operating order, repair, condition and appearance as when received, excepting only for reasonable wear and tear and damage by any cause covered by collectible insurance, paying for any repairs necessary to restore such Chattel to its original condition. If so requested by Lessor, Lessee will load such Chattel at its expense on board such carrier as Lessor may specify and ship the same collect to the destination specified by Lessor.

9. *Renewal.* Lessee shall have the option to renew this lease with respect to any or all Chattels for such additional term and for such rental as is stated in the schedule or schedules describing the Chattels, such option to be exercisable only if sixty (60) or more days prior written notice to Lessor be given of Lessee's intent to do so.

10. *Title and Encumbrances.* The Chattels shall remain personal property notwithstanding the manner in which they may be affixed to the realty and title thereto shall at all times continue in Lessor. Lessee will not sub-let, mortgage, pledge, sell or otherwise encumber or dispose of the Chattels or its interest therein, except that, with the prior written consent of Lessor, Lessee may in the manner provided in such consent sub-lease the Chattels to the sub-lessee designated in such consent. Any such consent shall not in any way alter Lessee's responsibilities hereunder with respect to the Chattels and the rentals payable hereunder.

11. *Default.*

11.1 Time is of the essence hereof. If Lessee should default in the payment of any sum to be paid hereunder, or should breach or default in performance of any other of the terms or conditions hereof, and such default or breach continue for more than ten (10) days, or if a petition under any Chapter of the Bankruptcy Act, as amended, or for the appointment of a receiver of any part of the property of Lessee, or any other proceedings for the relief of debtors, be filed by or against Lessee, or if Lessee should make a general assignment for the benefit of creditors, should suspend business or commit any act amounting to business failure, or if an attachment be levied or a tax lien be filed against any of Lessee's property, or if Lessee should make a voluntary assignment or transfer of all or substantially all of its property, or an unauthorized assignment of its interests hereunder, then in any of such events, Lessor, at its option, may consider this lease as being in default. Thereupon, Lessor may (i) terminate this lease and/or demand a return of the Chattels to the destination specified by Lessor, freight prepaid, and/or (ii) take possession of the Chattels, without notice to or consent of Lessee, for that purpose entering upon any premises owned or leased by Lessee, without liability for any damages occasioned thereby. Lessor shall thereafter hold the Chattels, including any security deposit made hereunder, free and clear of this lease and of any rights of Lessee hereunder. The return or retaking of the Chattels shall not constitute termination of this lease unless Lessor so notifies Lessee in writing. Lessor may lease all or any of the Chattels to such persons, for such term and rentals, and upon such conditions as Lessor may elect, and/or sell all or any of the Chattels at private sale or sales, with five (5) days prior written notice to Lessee, at such price or prices and upon such terms as Lessor may elect, or at public sale or sales, at which Lessor may bid for and purchase any or all of the Chattels. After deducting Lessor's expenses incurred in connection with such sales or leasing, the total proceeds of (i) such sale or sales, less the value of the Chattels at the end of the term provided for herein, as determined by an independent appraiser selected by Lessor, and (ii) such leasing, with respect only to the balance of the term provided for herein, shall be subtracted from the total rentals provided for herein then remaining unpaid. The remainder shall be liquidated damages for the breach hereof by Lessee and shall be payable by Lessee to Lessor upon demand, with interest at the highest legal rate after demand.

11.2 The retaking by Lessor of the Chattels and the sale or leasing of all or any of the Chattels shall not affect the right of the Lessor to recover from Lessee any and all damages which Lessor may have sustained by reason of the breach by Lessee of any of the terms or provisions of this lease. In the event of any default, Lessee will pay to Lessor any attorneys' reasonable fees incurred in enforcing or attempting to enforce its rights under this lease and any other costs and expenses incurred by Lessor in connection therewith.

12. *Warranties; Limitations.* Lessor hereby assigns to Lessee, for and during the lease term with respect to each Chattel, the warranties, if any, of the manufacturer issued on such Chattel, and hereby authorizes Lessee to obtain the customary service furnished by the manufacturer in connection therewith, at Lessee's expense. Lessor is not a manufacturer or engaged in the sale or distribution of Chattels, and has not made and does not make hereby, any representation as to merchantability, condition or suitability of any Chattel for the purposes of Lessee, or any other representation with respect thereto. Lessor shall not be liable to Lessee for any loss, claim, demand, liability, cost, damage or expense of any kind caused, or alleged to be caused, directly or indirectly, by any Chattel, or by any inadequacy thereof for any purpose, or by any defect therein, or the use or maintenance thereof, or any repairs, servicing or adjustments thereto, or any delay in providing or failure to provide the same, or any interruption or loss of service or

use thereof, or any loss of business, profits, consequential or any other damage of any nature. Lessee agrees that its obligations hereunder to pay the rentals herein provided for shall not in any way be affected by any such defect or failure of performance.

13. *Miscellaneous.*

13.1 This agreement is and is intended to be a lease, and Lessee does not hereby acquire any right, title or interest in and to the Chattels, except the right to use the same under the terms hereof.

13.2 The relationship between Lessor and Lessee shall always and only be that of Lessor and Lessee. Lessee shall not hereby become the agent of Lessor, and Lessor shall not be responsible for the acts or omissions of Lessee.

13.3 Lessor's rights and remedies hereunder or by law shall be cumulative, not exclusive, and shall be in addition to all of the rights and remedies available to Lessor. Lessor's failure to enforce strictly any provisions of this lease shall not be construed as a waiver thereof or as excusing Lessee from future performance.

13.4 Lessee agrees to pay Lessor interest at the highest legal contract rate on all sums not paid by Lessee to Lessor when due under provisions of this lease.

13.5 This lease shall continue in full force and effect and be non-cancellable, except in accordance with its terms, for the rental term herein provided. No representations, warranties, or agreements, oral or written, expressed or implied have been made by either party hereto with respect to this lease or the Chattels covered hereby, except as expressly provided herein. This lease, together with the schedules from time to time attached hereto, constitute the entire agreement between the parties hereto. Any change or modification to this lease must be in writing and signed by the duly authorized representatives of the parties hereto. Subject to the limitations of Paragraph 10, this lease shall be binding upon and inure to the benefit of the heirs, personal representatives, successors and assigns of the parties hereto.

13.6 This lease has been entered into by Lessor for and in behalf of itself and its associated or affiliated companies, and performance of all or any part of its obligations hereunder or the exercise of all or any part of its rights hereunder may be, at its election, by such associated or affiliated companies, and in such event Lessee makes the same agreement with and to such companies as it makes to lessor hereunder.

IN WITNESS WHEREOF, Lessee has executed this lease as of the date first above written.

ATTEST OR WITNESS: (Corporate Seal)

Walter T. Cussarie

The Atlanta Times, Inc.
(Lessee's Trade, Copartnership or Corporate Name)

BY A.P. Jackson
(Title)
A.P.Jackson, President

Accepted by Lessor as of the date thereof.

at Atlanta, Georgia

ATTEST: (Corporate Seal)

Walter T. Cussarie
(Secretary)

COMMERCIAL CREDIT CORPORATION

BY [illegible]
(Vice President)

ATTEST: (Corporate Seal)

[illegible]
Asst. (Secretary)

LESSEE ACKNOWLEDGMENT

STATE OF Georgia)
SS
COUNTY OF Fulton)

I, ARLINE G. STEPHENS, a Notary Public in and for the County and State aforesaid, duly commissioned and acting, do hereby certify that on this 18th day of February, 1964, personally appeared before me ARTHUR P. JACKSON,

d..., the person(s) named in and who executed the above Lease as Lessee, to me personally well known and known to be the person(s) who signed said Lease, who, being by me duly sworn and being informed of the contents of said Lease, stated and acknowledged on oath that (t)he(y) signed, executed, sealed and delivered same as ... free and voluntary act and deed for the uses, purposes and considerations therein mentioned and set forth.

me personally well known and known to me to be the person who signed the above Lease, and known to me to be and who, being by me duly sworn and being informed of the contents of said Lease, stated and acknowledged to me on oath that he was President (Title) of THE ATLANTA TIMES, INC., the Corporation named in and which executed said Lease as Lessee, and that he knows the corporate seal of said Corporation, and that the seal affixed to said Lease is the corporate seal of said Corporation, that he was duly authorized to execute said Lease for, in the name of, and on behalf of said Corporation, and that same was signed, sealed, executed and delivered by him in the name of and on behalf of the said Corporation by authority of its Board of Directors and that the execution of said Lease was his free and voluntary act and deed in his said capacity, and acknowledged to me that said Corporation executed the same as its voluntary act and deed and was by him voluntarily executed, on behalf of said Corporation for the uses, purposes and considerations therein mentioned and set forth.

WITNESS my hand and seal as such Notary Public the day and year in this certificate above written.

My Commission Expires: Notary Public, Georgia State at Large My Commission Expires March 18, 1966

Arline G. Stephens
Notary Public

LESSOR ACKNOWLEDGMENT

STATE OF Maryland)
SS
~~COUNTY~~ City OF Baltimore)

I, J. M. SANTOS, a Notary Public in and for ~~the~~ Anne Arundel County and State aforesaid, duly commissioned and acting, do hereby certify that on this 21 day of FEBRUARY, 1964, personally appeared before me A. W. SUTCLIFFE, to me personally well known and known to me to be the person who signed the Lease to which this acknowledgment is attached, and known to me to be and who, being by me duly sworn and being informed of the contents of said Lease, stated and acknowledged to me on oath that he was ASST VICE PRESIDENT (Title) of Commercial Credit Corporation, the Corporation named in and which executed said Lease and that he knows the corporate seal of said Corporation, and that the seal affixed to said Lease is the corporate seal of said Corporation, that he was duly authorized to execute said Lease for, in the name and of on behalf of said Corporation, and that same was signed, sealed, executed and delivered by him in the name of and on behalf of said Corporation by authority of its Board of Directors and that the execution of said Lease was his free and voluntary act and deed in his said capacity, and acknowledged to me that said Corporation executed the same as its voluntary act and deed and was by him voluntarily executed, on behalf of said Corporation for the uses, purposes and considerations therein mentioned and set forth.

WITNESS my hand and seal as such Notary Public the day and year in this certificate above written.

My Commission Expires: 5/3/65

J. M. Santos
Notary Public

SCHEDULE NO. 1

This schedule is executed pursuant to and made a part of the Equipment Lease No. CC A-573 dated 2/7/64 between Commercial Credit Corporation, as Lessor, and The Atlanta Times, Inc. as Lessee,

1. DESCRIPTION OF CHATTELS:

(If additional space needed attach list appropriately identified with this schedule)

Quantity	Make and Type	Model	Serial No.
See Invoices attached for description of equipment covered hereby. Invoices are numbered Page 1 through 50			

2. TERM OF LEASE WITH RESPECT TO CHATTELS: 120 Months, commencing on the date hereof.

3. RENTAL:

Total Rental - $ 712,873.20 ;

Payable monthly in 120 rental installments

(Monthly, quarterly, etc.) (Number)

of $ 5,940.61 each, or as provided by schedule of rental payments shown on reverse side hereof, commencing on the date hereof, the first rental installment being payable herewith and the remaining rental installments being payable on the first day of each succeeding monthly rental period.

(Monthly, quarterly, etc.)

4. SECURITY DEPOSIT:

$ 145,000.00 to be refunded to the Lessee by the Lessor at the termination of the Lease.

5. RENEWAL OPTION: Lessee has an option to renew lease with respect to the Chattels covered by this schedule on a year-to-year basis upon expiration of the lease term at an annual rental of $ 5701.16 payable annually in advance.

Monthly, quarterly, etc.

6. LOCATION OF CHATTELS: Chattels will be located at 700 Forest Avenue

Street

Fulton Atlanta Georgia

County City State

7. ACKNOWLEDGMENT OF RECEIPT OF CHATTELS: Lessee acknowledges that the Chattels above described have been delivered to and received by it, are as represented, and are acceptable and satisfactory to it, and that the same have been accepted as Units leased by it under said Equipment Lease.

Executed as a schedule to and part of Equipment Lease No. CC A-573.

June 29, 1964

Date

Accepted as of the date thereof

Commercial Credit Corporation

Lessor

BY C. E. Sutcliff Asst. V. P.

The Atlanta Times, Inc.

LESSEE

BY Arthur [illegible] Pres

We are convinced the facts of this case bring it more closely in line with *Cornelius Vanderbilt, Jr.*, 1957, 16 TCM 1081, CCH Dec. 22,709(M), T. C. Memo. 1957-235; *Margaret E. Amory*, 1931, 22 B. T. A. 1393 [CCH Dec. 6917]; and *George D. Widener et al.*, 1927, 8 B. T. A. 651 [CCH Dec. 2910], affirmed, 3 Cir., 1929, 33 F. 2d 833 [1929 CCH Dec. D-9279], than the cases of *Henry P. White*, 1954, 23 T. C. 90 [CCH Dec. 20,611], affirmed, 6 Cir., 1955, 227 F. 2d 779 [56-1 USTC ¶ 9139]; *Morton v. Commissioner*, 2 Cir., 1949, 174 F. 2d 302 [49-1 USTC ¶ 9254]; and *Coffey v. Commissioner*, 5 Cir., 1944, 141 F. 2d 204 [44-1 USTC ¶ 9233].

The opinion below recognizes the good faith of petitioner, and mentions "her desire to benefit mankind," and her commendable "innate drive as a pure scientist." The Tax Court judge then rules that her testimony of prospective monetary award from her research was "hope" and not based on fact. In *Doggett v. Burnet*, D. C. Cir., 1933, 65 F. 2d 191 [3 USTC ¶ 1090], at 194, there appears the following language which we believe is applicable here:

"The proper test is not the reasonableness of the taxpayer's belief that a profit will be realized, but whether it is entered into and carried on *in good faith* for the purpose of making a profit, or in the belief that a profit can be realized thereon, and that it is not conducted merely for pleasure, exhibition or social diversion." (Italics added.)

The judgment of the Tax Court is *reversed*.

[¶ 9191] **Estate of Delano T. Starr, Deceased, Mary W. Starr, Executrix, and Mary W. Starr, Petitioners v. Commissioner of Internal Revenue, Respondent.**

U. S. Court of Appeals, 9th Circuit, No. 16,268, 12/29/59.—(274 F. 2d 294.) Rev'g the Tax Court, 30 TC 856, CCH Dec. 23,076.

[1939 Code Sec. 23(a)(1)(A)—similar to 1954 Code Sec. 162(a)]

Rent v. capital expenditures: Sprinkler system: Lease v. contract to purchase.—Looking to substance rather than form, CA-9 agreed with the Tax Court that annual payments of $1,240 under a "Lease Form of Contract" were payments on the purchase price of a sprinkler system rather than deductible rental payments, where at the expiration of the original lease period the "lessee" could have renewed it for an additional period with annual payments of $32. The decision of the Tax Court was reversed, however, with directions to determine what portions of the annual payments were deductible interest. (Depreciation had been allowed by both the Commissioner and the Tax Court.) Back reference: ¶ 1382.5513.

Roy B. Woolsey, Los Angeles, Calif., for petitioners. Charles K. Rice, Assistant Attorney General, and Robert P. Turner, Lee A. Jackson, Robert N. Anderson and Davis W. Morton, Jr., Department of Justice, Washington, D. C., for respondent.

Before CHAMBERS, HAMLEY and JERTBERG, Circuit Judges.

CHAMBERS, Circuit Judge: Yesterday's equities in personal property seem to have become today's leases. This has been generated not a little by the circumstance that one who leases as a lessee usually has less trouble with the federal tax collector. At least taxpayers think so.

But the lease still can go too far and get one into tax trouble. While according to state law the instrument will probably be taken (with the consequent legal incidents) by the name the parties give it, the internal revenue service is not always bound and can often recast it according to what the service may consider the practical realities.[1] We have so held in *Oesterreich v. Commissioner*, 226 F. 2d 798 [55-2 USTC ¶ 9733], and *Commissioner v. Wilshire Holding Corporation*, 244 F. 2d 904 [57-1 USTC ¶ 9231], certiorari denied, 355 U. S. 815. The principal case concerns a fire sprinkler system installed at the taxpayer's plant at Monrovia, California, where Delano T. Starr,[2] now deceased, did

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[1] Thus it shifts rental payments of a business (fully deductible) to a capital purchase for the business. If the nature of the property is wasting, then depreciation may be taken, but usually not all in one year.

[2] Presumably the plant and the business were California community property of Starr and his wife, Mary W. Starr. For each of the calendar years 1951 and 1952, they filed joint tax returns.

business as the Gross Manufacturing Company. The "lessor" was "Automatic" Sprinklers of the Pacific, Inc., a California corporation. The instrument entitled "Lease Form of Contract" (hereafter "contract") is just about perfectly couched in terms of a lease for five years with annual rentals of $1,240. But it is the last paragraph thereof, providing for nominal rental for five years, that has caused the trouble. It reads as follows:

> "28. At the termination of the period of this lease, if LESSEE has faithfully performed all of the terms and conditions required of it under this lease, it shall have the privilege of renewing this lease for an additional period of five years at a rental of $32.00 per year. If LESSEE does not elect to renew this lease, then the LESSOR is hereby granted the period of six months in which to remove the system from the premises of the LESSEE."

Obviously, one renewal for a period of five years is provided at $32.00 per year, if Starr so desired. Note, though, that the paragraph is silent as to status of the system beginning with the eleventh year. Likewise, the whole contract is similarly silent.

The tax court sustained the commissioner of internal revenue, holding that the five payments of $1,240, or the total of $6,200, were capital expenditures and not pure deductible rental.[3] Depreciation of $269.60 was allowed for each year. Generally, we agree.

Taxpayers took the deduction as a rental expense under trade or business pursuant to Section 23(a) of the Internal Revenue Code, as amended by Section 121(a) of the Revenue Act of 1942.[4]

The law in this field for this circuit is established in *Oesterreich v. Commissioner, supra*, and *Robinson v. Elliot*, 262 F. 2d 383 [59-1 USTC ¶ 9129]. There we held that for tax purposes form can be disregarded for substance and, where the foreordained practical effect of the rent is to produce title eventually, the rental agreement can be treated as a sale.

In this, *Starr's* case, we do have the troublesome circumstance that the contract does not by its terms ever pass title to the system to the "lessee." Most sprinkler systems have to be tailor-made for a specific piece of property and, if removal is required, the salvageable value is negligible. Also, it stretches credulity to believe that the "lessor" ~~ever intended to or would~~ "come after" the system. And the "lessee" would be an exceedingly careless businessman who would enter into such contract with the practical possibility that the "lessor" would reclaim the installation. He could have believed only that he was getting the system for the rental money. And we think the commissioner was entitled to take into consideration the practical effect rather than the legal, especially when there was a record that on other such installations the "lessor" after the term of the lease was over had not reclaimed from those who had met their agreed payments. It is obvious that the nominal rental payments after five years of $32.00 per year were just a service charge for inspection.[5]

Recently the Court of Appeals for the Eighth Circuit has decided *Western Contracting Corporation v. Commissioner* (No. 16,202 decided November 10, 1959) [59-2 USTC ¶ 9751], reversing the tax court in its determination that the commissioner could convert leases of contractor's equipment into installment purchases of heavy equipment. The taxpayer believes that case strongly supports him here. We think not.[6]

There are a number of facts there which make a difference. For example, in the

[3] *Starr, Estate of, v. Commissioner*, 30 T. C. 856 [CCH Dec. 23,076].

[4] Sec. 23. DEDUCTIONS FROM GROSS INCOME

"In computing net income there shall be allowed as deductions:

"(a) Expenses.—

"(1) Trade or business expenses.—

"(A) In General.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including * * * rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * "

[5] It is true that the normal inspection fee would be $61.00. However, the difference between $32.00 and $64.00 would not seem to ruin the tax court's determination for income tax purposes that there was a sale.

[6] It is unnecessary to determine here whether the Ninth Circuit would follow the decision of the Eighth Circuit or the decision of the tax court. (*Western Contracting Corp. v. Commissioner*, 17 TCM 371, T. C. Memo. 1958-77, CCH Dec. 22,960(M)). It is enough here to say that the Ninth Circuit regards the Eighth Circuit's opinion distinguishable from *Starr's* case and not inconsistent with the holding herein.

contracts of Western there is no evidence that the payments on the substituted basis of rent would produce for the "lessor" the equivalent of his normal sales price plus interest. There was no right to acquire for a nominal amount at the end of the term as in *Oesterreich* and the value to the "lessor" in the personalty had not been exhausted as in *Starr's* case. And there was no basis for inferring that Western would just keep the equipment for what it had paid. It appears that Western paid substantial amounts to acquire the equipment at the end of the term. There was just one compelling circumstance against Western in its case: What it had paid as "rent" was apparently always taken into full account in computing the end purchase price. But on the other hand, there was almost a certainty that the "lessor" would come after his property if the purchase was not eventually made for a substantial amount. This was not even much of a possibility in *Oesterreich* and not a probability in *Starr's* case.

In *Wilshire Holding Corporation v. Commissioner*, 262 F. 2d 51 [59-1 USTC ¶ 9123], we referred the case back to the tax court to consider interest as a deductible item for the lessee. We think it is clearly called for here. Two yardsticks are present. The first is found in that the normal selling price of the system was $1,960 while the total rental payments for five years were $6,200. The difference could be regarded as interest for the five years on an amortized basis. The second measure is in clause 16 (loss by fire), where the figure of six per cent per annum discount is used. An allowance might be made on either basis, division of the difference (tor the five years) between "rental payments" and "normal purchase price" of $1,240, or six per cent per annum on the normal purchase price of $4,960, converting the annual payments into amortization. We do not believe that the "lessee" should suffer the pains of a loss for what really was paid for the use of another's money, even though for tax purposes his lease collapses.

We do not criticize the commissioner. It is his duty to collect the revenue and it is a tough one. If he resolves all questions in favor of the taxpayers, we soon would have little revenue. However, we do suggest that after he has made allowance for depreciation, which he concedes, and an allowance for interest, the attack on many of the "leases" may not be worth while in terms of revenue.

Decision reversed for proceedings consistent herewith.

[¶ 9192] Steven Voloudakis and Katherine Voloudakis, Petitioners v. Commissioner of Internal Revenue, Respondent.

U. S. Court of Appeals, 9th Circuit, No. 16,092, 1/7/60.—(274 F. 2d 209.) Affirming the decision of the Tax Court, CCH Dec. 22,887, 29 TC 1101.

[*1939 Code Sec. 117(a)(1)—similar to 1954 Code Sec. 1221*]

Sublease v. sale: Ordinary income v. capital gain: Fact finding.—The actions of the parties and the instrument used to transfer a leasehold interest from one tenant to another clearly indicated a sublease was intended rather than a sale. Amounts paid under the sublease were therefore ordinary income (rent), instead of installment, capital gain from a sale of a property interest. Back reference: ¶ 4717.154.

[*1939 Code Sec. 294(d)—changed in 1954 Code Sec. 6654(d)*]

Additions to tax: Concurrent penalties.—Under the Supreme Court rule of the *Acker* case, 59-2 USTC ¶ 9757, concurrent penalties may not be imposed for failure to file an estimate and for substantial underestimation of tax. Back references: ¶ 5542.32 and 5542.4321.

McDannell Brown, Portland, Ore., for petitioners. Charles K. Rice, Assistant Attorney General, and Carolyn R. Just, Lee A. Jackson and Harry Baum, Department Justice, Washington, D. C., for respondent.

Before DENMAN, POPE and CHAMBERS, Circuit Judges.

Exhibit II
SCHEDULE OF MATERIAL CONTRACTUAL COMMITMENTS (SX #3.18 & 3.19)

Type of Commitment	Amount Paid This Year	Amounts Contracted or Estimated For Each of Next 5 Yrs. and For Each of Three 5-Yr. Periods Beyond								Minimum Amt. of Commitment If Determinable*	Remaining Period (yrs.) From date of report
		Year 1	Year 2	Year 3	Year 4	Year 5	Years 6-10	Years 11-15	Years 16-20		
Purchase and Repurchase For:											
a) Investments											
b) Fixed Assets											
c) Inventory & Supplies											
d) Other											
Construction											
Long-Term Leases											
Royalties											
Pension and Retirement											
Employee Contracts											
Guarantees											
Contingent Liabilities											
Other (Explain)											
Totals											

*The minimum balance payable in each type of commitment, may be discounted over the remaining period by a stated per annum percentage. Where such minimum balance is discounted, state the percentage used in each case.

Where amounts both paid and payable for any type of commitment are not material, a statement to that effect for any such type of commitment will suffice. Show amounts separately for each type of commitment if amounts paid or payable are material.

Any pertinent information of a material nature regarding any commitment should be furnished within footnotes to the schedule.

CONSOLIDATED PAPERS, INC.

L. A. ENGELHARDT
CONTROLLER

ADMINISTRATIVE OFFICES:
WISCONSIN RAPIDS, WIS. 54494
715 • 422-3818
TWX: 715-423-0820

September 16, 1971

Mr. Richard C. Lytle,
Administrative Director
Accounting Principles Board
American Institute of Certified Public Accountants
666 Fifth Avenue
New York, New York 10019

Dear Mr. Lytle:

In October, the Accounting Principles Board will hold hearings regarding the possibility of capitalizing leases. I would like to offer some comments on this.

It is my feeling that leases are not truly a combination of asset to the reporting firm and liability to the same firm. Even full payout leases, seven-year leases in our case, do offer the lessee cancellation privileges with the risk of added cost if the item being leased cannot be sold for the unamortized lease amount. Thus, the capitalization of leases would be difficult since it would be impossible to determine the full liability on any one reporting date.

I do agree with the Board's approach that some form of reporting on leases is necessary. In this regard, I would like to suggest that reporting entities show annual lease payments in either the income statement or in the footnotes to the financial statement in the same fashion as depreciation is shown. For further disclosure, the outstanding lease balance could also be shown in the footnotes.

In summary, if leased items are significant, disclosure in the income statement or in the footnotes to the financial statement would be meaningful; however, I do not believe leases are a balance sheet item.

I appreciate the opportunity to offer this opinion.

Yours very truly,

L.A. Engelhardt

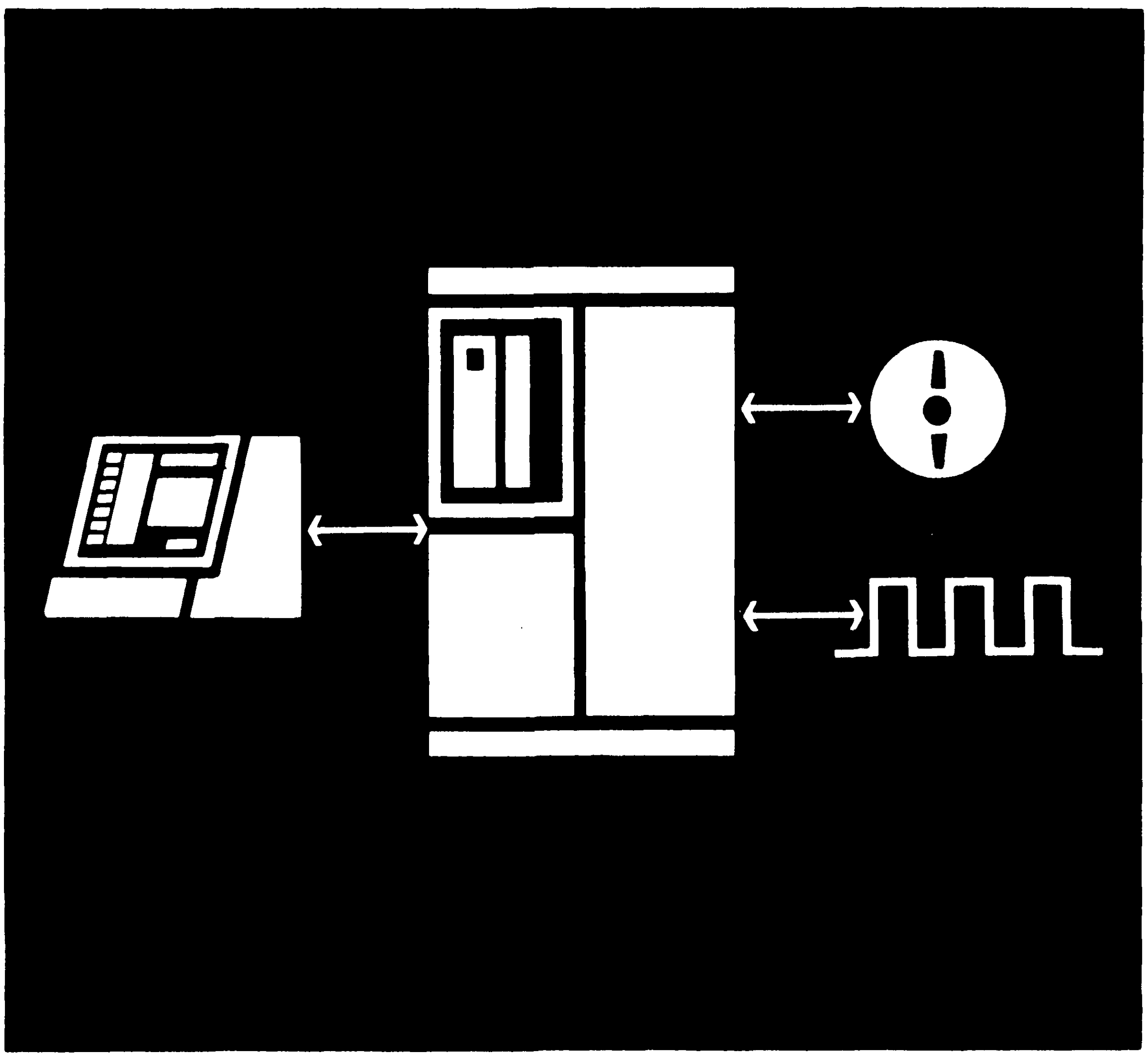
L.A. Engelhardt

DATA PATHING INC.

SOURCE DATA SYSTEMS

POSITION PAPER

ACCOUNTING FOR LEASES BY LESSORS
PRESENTED TO
ACCOUNTING PRINCIPLES BOARD
OCTOBER 14 AND 15, 1971



DATA
PATHING
INC

October 7, 1971

Accounting Principles Board
American Institute of Certified
Public Accountants
666 Fifth Avenue
New York, New York 10019

Gentlemen:

Data Pathing Incorporated is a manufacturer of Source Data Management Systems. We are deeply involved in the equipment leasing business and, as a result, wish to take advantage of the opportunity presented by the October 14-15, 1971 public hearing to submit material which we ask the Board to consider before arriving at its conclusion concerning the matter of accounting for leases in the financial statements of lessors. In compliance with your instructions, we have attempted to be as specific as possible. Accordingly, we have prepared a brief description of the Company, a history of the development of the accounting principles followed by the Company, and a discussion of the application of APB No. 7 and the recent "interpretation" of that opinion to the transactions in which the Company is engaged. It is the burden of this material to demonstrate that the "interpretation," as applied by our auditors to the transactions in which this Company is engaged, produces financial statements which are completely at variance with the underlying economic and legal facts.

Our financial statements for the fiscal year ended June 30, 1971 have been prepared on the basis of accounting policies that have been applied consistently since the Company's inception. The transactions in which the Company was engaged during this most recent fiscal year were unchanged from those of earlier years.

Our auditors have now informed us that based upon their understanding of the Accounting Principles Board's recent "interpretation" of APB Opinion No. 7, our financial statements for the year ended June 30, 1971 do not "present fairly in accordance with generally accepted accounting principles."

370 SAN ALESO AVE., SUNNYVALE, CA 94086 TEL. (408) 734-0100

October 7, 1971

Were we to prepare our most recent financial statements in accordance with what our auditors now believe to be the generally accepted accounting principles required by the Board's "interpretation," those financial statements would indicate that the Company had failed in its business goals, that it was bankrupt, and that it was in violation of all of its financing agreements. These simply are not the economic facts. The Company is successful, it is growing and it is in a position to meet its financial obligations.

We earnestly recommend that the "interpretation" not be issued and that the Board reconsider the entire matter.

We appreciate this opportunity to present our case.

Very truly yours,

Russell C. Dubois

Russell C. Dubois
Chairman of the Board

RCD:vmm

POSITION PAPER OF DATA PATHING INCORPORATED ACCOUNTING FOR LEASES BY LESSORS

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POSITION PAPER OF DATA PATHING INCORPORATED

ACCOUNTING FOR LEASES BY LESSORS

Presented to the Accounting Principles Board October 14 and 15, 1971

As a manufacturing company engaged in leasing activities to a significant extent, we feel a special responsibility to provide whatever constructive assistance we can to the Accounting Principles Board in its efforts to improve the financial reporting of lease transactions. Accordingly, since the receipt of the announcement of the October 14-15, 1971 public hearing and the document "Proposed Changes in Accounting of Lessees and Lessors" which accompanied that announcement, this matter has been the subject of intense consideration within our organization. In this endeavor, the knowledge and experience available within our organization has been supplemented by two consultants -- one, a member of the Institute who, for several years, was the chief financial officer of a major corporation and until recently was a partner in a well-known investment banking firm; the other, a professor at one of the leading graduate schools of business who has been deeply involved in corporate financial reporting during the past twenty years.

Our original intention was to respond fully to the Board's invitation by submitting the results of our consideration of the complete set of accounting issues raised in APB Opinions No. 5 and No. 7 dealing with accounting by lessees and by lessors, respectively. This intention was abruptly abandoned, however, upon the receipt of an "advance copy" of the Board's "interpretation" of APB Opinion No. 7. Our planned response was aborted for two reasons. First, the issuance of this "interpretation" only a few weeks before the scheduled public hearing strongly suggests that the Board has already considered the subject and reached its conclusions, at least with respect to some of the most critical issues. A presentation of the results of our consideration of the complete problem would, therefore, be largely futile. Second, we find the restrictive and arbitrary nature of the "interpretation" to be inimical to the improvement of corporate financial reporting and the advancement of professionalism in accounting. The apparent thrust of the "interpretation" is to eliminate consideration of the unique circumstances of individual reporting companies and remove the need for professional judgment that such consideration entails. By lumping together a wide variety of companies engaging in lease transactions, the provisions and potential consequences of which are unlimited in number and extremely diverse in character, the "interpretation" can effectively conceal the basic economic results of the operations of a business and produce a balance sheet that does not remotely resemble the actual financial position. It does just this in our case and, because of this impact of the "interpretation", we have now chosen to address ourselves exclusively to the issues raised therein.

The specific problem with which our Company is faced can be summarized briefly as follows: the accounting procedures originally recommended to the Company by its auditors, adopted by the Board of Directors and used consistently since the Company's inception are, according to our auditors' understanding of the APB's "interpretation" of Opinion No. 7, no longer in conformity with generally accepted accounting principles. The financial statements that have consistently reflected these accounting procedures have been relied on by a variety of parties dealing with our Company and have served as a basis for specifying certain financial requirements in debt indentures. None of the possible alternative responses to our auditors' application of the "interpretation" is tenable. If we continue the consistent application of the accounting procedures that have been used in the past, the auditors would acknowledge that consistency but must state that although the 1970 statements "fairly present," the 1971 statements do not. If different accounting procedures that satisfy our auditors' application of the "interpretation" are adopted for 1971, the auditors' opinion must state that we have been inconsistent in the application of accounting principles, but that the financial statements "fairly present" for both 1970 and 1971. If we were to adopt different accounting procedures retroactively and restate all previous years' financial statements, the auditors would not qualify their opinion with respect to consistency and conformity, but the Company would be erroneously portrayed as being continuously in default under its debt instruments and its commercial loan agreements, and the stockholders' equity would be erroneously reported as having been wiped out. Indeed, the Company, which has been enjoying significant success, would report a substantially negative stockholders' equity -- a result that is clearly not realistic.

THE COMPANY AND ITS FINANCIAL ARRANGEMENTS

To appreciate the impact of the APB "interpretation," it is necessary to have some understanding of our business.

The Company was incorporated on April 22, 1964. From the date of incorporation through September 1966, the Company's efforts were devoted to the design and development of Source Data Management Systems. Production commenced in late 1966 and the first system was installed in the summer of 1967. As of June 30, 1971, the Company had 80 systems installed.

In July 1967, the Company organized a wholly-owned lease financing subsidiary, DPI Systems, Inc., to purchase the Company's Source Data Management Systems for lease or resale to its customers. Substantially all sales and leases of the Company's systems are through DPI Systems, Inc.

The Company's customer base is largely comprised of the Fortune "500" companies (please refer to the marketing brochure enclosed) who prefer to lease rather than purchase the Company's Source Data Management Systems. This preference does not entirely represent the choice of the Company, but rather the demand of the marketplace. For nearly twenty years, the computer industry has been dominated by IBM and, in that period of time, IBM has so shaped the computer marketplace as to force competitors to provide non-payout leases to their customers. This provision of extraordinary credit terms has become a keystone of the IBM marketing technique and, because of IBM's 70%+ control of the marketplace, is a competitive point which all other manufacturers must meet. IBM, as a result of its tremendous financial strength, is able to provide this credit from its own resources. Our Company and other manufacturers with limited financial resources are unable to do so and must develop banking relationships to provide, within the standards normally established by commercial banks, a continuing flow of funds needed to support the ever-growing total of equipment in the marketplace. Because the credit for lease financing available from the banks is limited, manufacturers have had to seek other financial resources. The "third party" leasing companies have been responsive to this need.

The Company's response to this financing need was twofold. First, a separate but wholly-owned lease financing subsidiary, DPI Systems, Inc., was established to purchase essentially all of the Company's Source Data Management Systems for lease or resale to its customers. Because of the exceptional quality of the credit of the lessees of the systems, DPI Systems, Inc. has been able to negotiate very favorable bank financing for its leases

(90% of the non-cancellable lease receivables) with much higher leverage rates than could have been obtained by Data Pathing Incorporated, the parent manufacturing Company.

The Company sells its Source Data Management Systems, at 90% of list price, to DPI Systems for resale or lease. The sale to DPI Systems is normally made at the time the equipment is installed by the Company and accepted by the customer. The equipment lease agreement is entered into between DPI Systems, Inc. and the customer; however, all servicing and maintenance of the equipment is performed by the Company under an Equipment Maintenance Agreement between the Company and the customer. The lease terms offered by DPI Systems, Inc. vary in duration from one to five years and, currently, a majority of the outstanding leases is for three to five year terms. Each lessee has the option to extend the lease at any time, to renew the lease at the time it expires or to purchase the equipment at any time at list price less an allowance equal to 50% of rental payments previously made but not exceeding 75% of the list price. To date, 21 lessees have extended their leases; 5 have renewed their leases at the lease expiration date and 2 have exercised the option to purchase the system.

In 1969, DPI Systems, Inc. entered into an agreement with an independent financial institution to which it has sold approximately $15,000,000 worth of systems through June 30, 1971. The agreement expired on August 3, 1971 and was not renewed. The financial institution paid 95.5% of the Company's list price for the equipment and continues to lease the equipment to the Company's customers at the Company's rental rates. The Company provides, under an Equipment Maintenance Agreement between the Company and the customer, maintenance service and warrants the equipment in accordance with its normal standards. If at any time during a period not longer than 72 months the lease term ends or the equipment is returned by the customer, DPI Systems, Inc. will be obligated to re-lease the equipment within sixty days by giving first priority to the equipment in the Company's lease order backlog. In the event that the equipment is not so leased, the Company agrees to pay to the financial institution the net monthly rental due on the equipment for a period not to exceed two months per item of equipment. If the equipment is not on lease, the financial institution is free to sell or re-lease the equipment to anyone, subject to the Company's right of first refusal to purchase the equipment. When the equipment has been leased for a sufficient period of time for the financial institution to recover its purchase cost plus taxes and fees, the financial institution will pay DPI Systems, Inc. a marketing fee equal to 45% of the monthly rentals the equipment continues to earn. In addition, DPI Systems, Inc. is entitled to certain fees for administering the leases.

THE COMPANY'S PRODUCT

The Company develops, manufactures and markets Source Data Management Systems which combine the functions of collecting data, editing and checking the data for accuracy, and the processing and preparation of the data for entry into the customer's main computer system, usually by means of magnetic tape or by direct connection to the main computer. Data collected may also be fed back to remote printers. Feedback to the remote printers can either be under the direction of the data collection system or the main computer. The present system is primarily designed for use by large companies with a need to quickly and accurately gather and store large volumes of data from the factory level of operations. The system consists of a variety of input/output terminal devices, a computer which acts as a receiver-processor of data and related equipment. The terminal devices are used to gather and transmit data from remote locations to the receiver-processor. The terminals are usually located strategically in the industrial complex and are normally connected to the receiver-processor by standard two-wire telephone-type lines. The receiver-processor is a communications computer which controls the operation of the entire system. Information is entered into the system at the terminal by direct labor or other personnel utilizing varied combinations of badge, punched card and/or variable data from a keyboard. Once entered, the data is collected by the receiver-processor, where it is checked for errors, edited and processed. The receiver-processor is designed to provide output of data to magnetic tape and/or for direct connection (on-line interface) to the customer's main computer system. The size and complexity of the receiver-processor dictates the total number of terminals that may be utilized in any installation. For instance, the Company's Model 2104 Computer controls up to 120 terminals. For systems which require more than 120 terminals, multiple 2104 Computers may be interconnected in parallel to provide additional capability. The computers can be augmented with conventional data processing peripherals, such as disc files and drums, to provide for more sophisticated queuing and edit checking as may be required in the system. Inherent to the system are coded instructions (software programs) which enable the Company to provide each customer with programs designed to serve his specific needs while making use of the system. The Company offers a standard software operating system for data accumulation, error control and output. In addition, tailored software programs designed for specific customer requirements are provided with the operating system. Typical applications for which the system is now being used include time and attendance, labor distribution, order tracking, parts inventory, machine utilization, quality control, document control, etc. (for additional information, please refer to the marketing brochure enclosed).

PRODUCT LIFE

To understand the true nature of the Company's business, it is necessary to realize that the total "hardware cost" of the Source Data Management System acquired from the Company by its customers represents a small part of the customer's total commitment to its overall management information system. Typically, the purchase of the Company's hardware follows an extensive period of evaluation on the part of the customer in which the Company's equipment, as well as the equipment of all of its major competitors, has been thoroughly evaluated and the part that this subsystem is to play in the customer's total management information system has been thoroughly defined. The total cost of this evaluation and definition is substantial and may take a period of time ranging from several months to a year or more to complete. The total period following the initial installation until the source data hardware is fully integrated into the overall system might well exceed, in time, the term of the initial lease. Involved in this period is not only the hardware installation but the software integration of the subsystem into the total system, and the training of the user's personnel not only in the computer center but also on the factory floor. With these factors in mind, it should be clear that a decision to select one variety of source data collection equipment is not a decision to be lightly changed in the future. The management of the Company is aware of several installations of competitive systems which are technically obsolete and working at less than optimal levels but which the users hesitate to replace, not because of the cost of new equipment, but because of the problems attendant to making the change itself. Under these circumstances, a one year lease for this type of equipment is almost a contradiction in terms; three year leases will probably cover the total period of installation and implementation; and, a five year lease represents probably a minimum economic lease period. The key point is not the cost of the equipment nor its technical capabilities as compared with competitive equipment, but, rather, its integration into the total system.

Historically, the useful product service life of source data systems has been longer than that of mainframe computers and their associated peripheral equipment. This is due mainly to the mode in which the equipments are utilized. Source data collection equipment is "open shop" type equipment. "Open shop" equipment, as opposed to "closed shop" equipment (computer mainframe and associated peripherals), is operated by individuals whose mainline functions are not associated with the use of the equipment (i.e., a drill press operator's main function is to produce products on the drill press; his use of source data collection equipment to report on his production is a control function and not a line function).

Source data collection equipment, once successfully installed and utilized, becomes an integral part of the manufacturing facility. Isolated incidents of unsuccessful source data collection systems have almost always been traced to the failure of the data processing center to properly implement the processing of the data collected.

In many ways the recent, rapid advancement of technology of the past few years has not had as much effect on source data systems as it has had on the mainframe products. Mainframe computers have been highly affected by circuit and memory speed advances. The use of standard voice grade communication line facilities has insulated the source data collection equipment from major design conceptual changes.

ACCOUNTING POLICIES

Substantially all of the Company's gross sales from inception through June 30, 1971 have been made to its wholly-owned subsidiary, DPI Systems, Inc. The subsidiary has, in turn, made sales to the outside financial institution and end user customers; the balance has been retained and leased to unaffiliated end users. All of the manufacturing profit on equipment sold to the subsidiary is recognized at the time of sale, except that equipment with end user initial lease terms of less than thirty-six months (short-term leases). In the case of the latter sales, the manufacturing profit is reflected in income only to the extent of the portion covered by the lease term and the balance of the profit is deferred by the Company through a reserve for unrealized income. In those instances in which DPI Systems, Inc. has subsequently sold equipment subject to short-term leases, the Company has recognized the remaining unrealized income in the period in which the sale was made.

DPI Systems, Inc. utilizes the finance method to account for income under long-term (thirty-six to sixty months) lease contracts. The operating method is used to account for income under short-term (less than thirty-six months) lease contracts. For the leased equipment, a reserve for refurbishment is provided by a charge against income.

On the equipment that has been sold to the outside financial institution, a reserve for re-leasing and remarketing expenses that may be incurred in the future has been provided by a charge against income.

The financial statements of the Company's wholly-owned lease financing subsidiary, DPI Systems, Inc., are not consolidated. The Company carries its investment in the subsidiary on the equity basis. Separate financial statements of DPI Systems, Inc. are presented immediately following the financial statements of the Company.

AUDITORS' EVALUATION OF COMPANY'S ACCOUNTING POLICIES

The accounting and financial reporting policies of the Company were established in 1968 based upon the recommendations of the Company's independent auditors. Their recommendations were, in turn, based upon their interpretation of APB Opinion No. 7 as applied to our operations, giving consideration to all of the economic and legal facts pertinent to the business. The management of the Company and the Board of Directors approved the auditors' recommendations. The Company's accounting and financial reporting policies that were developed were deemed by the Company's auditors to be in conformity with generally accepted accounting principles. The Company has consistently followed those accounting and reporting policies up to the present time.

The judgments of the auditors upon which the Company's accounting and reporting policies are based are quoted as follows:

"APB No. 7 requirements and conditions to be met in order for DPI to (1) recognize manufacturing profit at the time of entering into a lease and (2) report in the income statement on essentially the same basis as outright sales of similar equipment are discussed below. It should be noted that our conclusions would be the same whether DPIS existed or DPI itself leased the equipment.

"(1) Credit risks are reasonably predictable since DPIS leases to major, sophisticated companies with large computer installations and top credit standings.

"(2) DPI and DPIS do not retain sizeable risks of ownership with respect to obsolescence. The Company leases most of the equipment on a three year to five year basis. On a five year lease, the lessee bears essentially all the risks of obsolescence since substantially all the manufacturing profit would be recovered by then. On a three or four year lease, the lessor bears some risk but the majority of risk is borne by the lessee since approximately 70% of lease revenues are assured on a three year lease and residuals from lease extensions or outright sales should cover the remaining 30%.

"The systems are an integral part of the lessee's overall computer installation. However, a change to another computer would not obsolete DPI's system. Furthermore, once the system is installed, it is not likely that a lessee will remove such sizeable equipment at any time short of its useful operating life but probably in no event before the manufacturing profit has been recovered.

"Our conclusion is that although some risks of obsolescence remain with the lessor, they are not sizeable risks in this case.

"(3) With substantial portions of the lease rental payments allowed against the purchase price during the entire lease term, it would seem likely that most of the rewards of ownership have been transferred to the lessee during the period manufacturing profit will be recovered through rental payments. In addition, rental payments beyond five years may be lower since it would be expected that a sophisticated lessee would insist on reduced rental payments for extended leases when they have in effect paid for the equipment once or, what is possibly more likely, the lessee will exercise the purchase option within the first two or three years.

"(4) Unsatisfactory performance is borne by the lessor. However, acceptance of quality and performance of the system seems to make this risk minor. The fact that DPI is able to obtain firm three-five year leases, in competition with IBM's one year lease terms, gives the clearest indication that this risk is minor.

"(5) DPI and DPIS meet all the tests for the following:

"(a) Idle capacity is a very minor problem, if any, since it deals with the lessees' idle capacity.

"(b) Unprofitable operations is borne entirely by the lessee.

"(c) The residual value should not be a major concern because of the long-term nature of the leases. Rewards of ownership are substantially relinquished (see discussion at (3) above).

"(6) For the most part, there are no important uncertainties surrounding revenues to be received or costs to be incurred.

"There are some revenue uncertainties on leases of less than five years. The Company has mostly three and five year leases, and expects that about half of future leases will be for three years. The fact that between 30% to 50% of the leases are expected to be for five years, combined with the fact that initial three year leases will generate with no uncertainties 70% of total revenues, would seem to indicate that overall there are no important uncertainties surrounding revenues to be received.

"There are no important uncertainties surrounding costs to be incurred.

"Our conclusion is that DPI substantially meets the conditions required by APB No. 7 to permit the manufacturing profit to be recognized upon execution of the lease, with some relatively minor uncertainties as to future revenues on short-term leases. In matching the conditions of APB No. 7 to DPI's situation, it seems to us that the primary reason for not recognizing the manufacturing profit immediately would be simply conservatism. Accordingly, we conclude it would be appropriate under the circumstances to recognize manufacturing profit on leases in the same manner as sales.

"Financial statement presentation on consolidated or separate company basis must also be considered. The purpose of consolidated statements is to present, primarily for the benefit of shareholders and creditors of the parent company, the results of operations and financial position as if the group were a single company. The presumption is that consolidated statements are more meaningful than separate statements for a fair presentation when one of the companies (in this case DPI) has a controlling financial interest in another company (in this case DPIS). The usual condition for a controlling financial interest is ownership of over 50% of outstanding voting shares. In this case, DPI owns 100% of DPIS which is obviously a controlling financial interest. However, we must further explore whether consolidated statements in this situation would be a fairer or more meaningful presentation than separate statements.

"ARB No. 51 states, in essence, that the reader of financial statements should be given information most suitable to his needs and that consolidated statements most often meet this test even though a group of companies may be heterogenous in character. However, ARB No. 51 further states that (1) separate statements would be preferable for a subsidiary if presentation of financial information concerning its particular activities would be more informative to shareholders and creditors of the parent company and (2) separate statements may be preferable for a finance company where the parent and other subsidiaries are engaged in manufacturing operations.

"Based upon our understanding of the facts, we believe that separate financial statements would be most meaningful for DPI and DPIS for the following reasons:

"1. DPI is a manufacturing company.

"2. DPIS is in the nature of a finance-leasing company since its primary purpose is to finance long-term leases. DPI has a capital investment and will continue to invest funds over the 90% of lease rentals financed by banks. However, this investment will represent a small and relatively insignificant portion of DPIS' balance sheet.

"3. The substantial financial risks (90% of lease revenue) are borne by DPIS and the banks. Obligations of DPIS to banks and other creditors are in no way directly or indirectly (through guarantees) tied to its parent, DPI. In other words, DPIS essentially stands alone in satisfying its major creditors. To reflect

> substantial financing liabilities in this case would not be a clear presentation to shareholders and creditors of the parent company."

During the summer of 1969, the Company and DPI Systems, Inc. entered into negotiations with an independent financial institution for the sale of Source Data Management Systems, subject to leases with the Company's customers. These negotiations were concluded in the execution of a sales agreement on August 4, 1969 between the Company, DPI Systems, Inc. and the independent financial institution, whereby the Company or DPI Systems, Inc. could sell to the financial institution up to $20,000,000 (through August 3, 1971) of equipment leased to the Company's customers. During the course of those negotiations, the management of the Company availed itself of professional advice, both from its legal counsel and auditors. There was no question, at that time, on the part of our professional consultants but that the agreement provided for legitimate sales. There was a question about the amount of reserve that would have to be provided for out of income to cover the possible future obligations of the Company under the remarketing provision of the agreement. After thorough review, it was the consensus of our auditors and the management of the Company that a reserve of 3% to 4% of the sales price should be adequate and that, in the future, appropriate adjustments could be made to the reserve based upon experience. The remarketing provision of that sales agreement states as follows:

> "If at any time during a period of sixty months (subsequently amended to 72 months), but not longer than the recapture period, following initial purchase by Transamerica rental of the equipment is discontinued by a customer, manufacturer agrees that it will again place the equipment on rent in accordance with the Master Sales/Purchase Agreement within sixty days by giving first priority to the Transamerica equipment in manufacturer's lease order backlog. In the event that the equipment is not so leased manufacturer agrees to pay to Transamerica the net monthly rental due on the equipment for a period not to exceed five months (subsequently amended to two months) per item of equipment. During any

"period of time when the equipment is available for remarketing or not subject to an agreement for equipment service, Transamerica shall be free to sell or lease the equipment to anyone, persons or company, whether such person is a customer or prospect of manufacturer, for any rental or purchase terms that Transamerica can negotiate. Manufacturer shall have the first right of refusal on such equipment. Transamerica agrees to provide fifteen days for manufacturer to exercise such right."

On December 8, 1970, the sales agreement was amended to eliminate Data Pathing Incorporated as a party to the agreement and thereby cause the agreement to be solely between Transamerica Computer Company and DPI Systems, Inc. Data Pathing Incorporated has no further rights or obligations under the agreement.

LEGAL COUNSEL'S EVALUATION OF TRANSACTIONS AND ACCOUNTING POLICIES

After receipt of the advance copy of the "interpretation" of APB Opinion No. 7, the management of the Company requested a legal review of the "interpretation," particularly as it applied to the sales agreement with Transamerica Computer Company. Particularly relevant excerpts from opinion of legal counsel follow:

"Accordingly, we have examined the release to determine whether its guidelines in this area comport with legal realities. It is our conclusion that in some respects they do not; that is, certain transactions which are, in legal effect, clearly sales might, under the release, be treated for accounting purposes as loans."

"If the release means that the retention of any risk prevents a transfer from being considered a sale, it would surely result in treating, for accounting purposes, many transactions as loans which by any legal standard are in fact sales."

"However, the Board would find a guarantee to exist where there is 'a formal or informal commitment by the manufacturer or dealer... (3) to secure a replacement lessee or a buyer for the property. (This last commitment is often described as being on a "best efforts" basis but may be effected on a priority basis over other similar property owned by the manufacturer or dealer.)'
It is here that we think the release deals inadequately with legal realities. It is quite clear that there is a wide range of commitments of this general description which could be undertaken by a

"seller of property without altering the operative legal fact that a sale has been consummated. The legal effect given to a particular agreement will depend upon its specific provisions, supplemented in some cases by evidence of the parties' practice under the agreement."

"It is our opinion that under the TCC Agreement Transamerica has acquired title to and ownership of the equipment subject to the substantial risks of ownership."

AUDITORS' APPLICATION OF APB "INTERPRETATION"

It now appears to us that all of the time and effort that has been expended by the management, our auditors and our legal counsel in striving to develop and maintain sound and fair accounting and financial reporting policies have been in vain. Our auditors are now of the opinion, based upon their interpretation of the APB "interpretation" of APB Opinion No. 7, that: (1) our long-term non-cancellable leases (three and five years) no longer qualify as financing leases, (2) our sales to an independent financial institution are not sales in substance because of the remarketing provision in the sales agreement, and (3) therefore, revenue from all of these transactions must be accounted for under the operating method in the income statement for the fiscal year ended June 30, 1971.

The Company, having already prepared the June 30, 1971 financial statements in a manner consistent with prior years, has three choices:

1. Present unconsolidated financial statements based upon the accounting policies which we have consistently followed, in which case the auditors' opinion would, in substance, state that the 1971 financial statements have been presented on a basis consistent with that of prior years, that for the year ended June 30, 1970, the statements present fairly the financial position of the Companies in conformity with

generally accepted accounting principles, but that for the 1971 year, the statements do not present fairly the financial position of the Companies in conformity with generally accepted accounting principles.

2. Present consolidated financial statements which restate fiscal year 1971, recognizing revenue from long-term non-cancellable leases and from sales to an independent financial institution on the operating method of accounting, in which case the opinion would state that the Companies have not been consistent in the presentation of the financial statements for 1970 and 1971, but that the statements do present fairly the financial position of the Companies for both years in conformity with generally accepted accounting principles.

3. Present consolidated financial statements which restate all years through June 30, 1971, recognizing revenues from both long-term leases and sales to an independent financial institution on the operating method, in which case the opinion would state that the financial statements have been restated and present fairly the financial position of the Companies for both 1970 and 1971 in conformity with generally accepted accounting principles consistently applied during the periods.

Not one of these choices is acceptable. Choice No. 1 states we have been consistent, but that one year fairly presents while the other does not. This kind of an adverse opinion would not be acceptable to our investors, bankers, customers or suppliers. Choice No. 2 states that both years are fairly presented, but that we have not been consistent. In addition, the

Company would be in default under its debt instruments and under its commercial loan agreements. Choice No. 3 states that we have been consistent and both years fairly present, but the Company would not only be in default under its debt instruments and its commercial loan agreements, it would have a negative net worth of approximately $1 million and liabilities of approximately $23 million.

On the following page are summaries of the liability/equity side of the Balance Sheets as of June 30, 1971 under the three choices available to the Company.

CHOICE NO. 1

Data Pathing Incorporated

Current Liabilities	$ 2,833
Subordinated Notes	4,000
Total Liabilities	6,833
Shareholders' Equity:	
Capital Stock	2,139
Other Paid-In Capital	4,083
Retained Earnings (deficit)	(2,096)
	4,126
	$10,959

DPI Systems, Inc. (Note 1)

Accounts Payable and Accrued Liabilities	$ 506
Notes Payable to Banks (Note 2)	5,913
Total Liabilities	6,419
Reserve for Re-leasing (Note 3)	675
Shareholders' Equity:	
Capital Stock	700
Other Paid-In Capital	2,600
Retained Earnings	447
	3,747
	$10,841

CHOICE NO. 2

Data Pathing Incorporated and DPI Systems, Inc. Consolidated

Current Liabilities (Note 4)	$ 4,691
Notes Payable to Banks	3,204
Loans Payable - Financial Institution (Note 5)	4,293
Subordinated Notes	4,000
Total Liabilities	16,188
Reserve for Re-leasing (Note 6)	539
Shareholders' Equity:	
Capital Stock	2,140
Other Paid-In Capital	4,083
Retained Earnings (deficit) (Note 7)	(5,422)
	2,801
	$19,528

CHOICE NO. 3

Data Pathing Incorporated and DPI Systems, Inc. Consolidated

Current Liabilities	$ 4,691
Notes Payable to Banks	3,204
Loans Payable - Financial Institution (Note 8)	11,159
Subordinated Notes	4,000
Total Liabilities	23,054
Shareholders' Equity:	
Capital Stock	2,140
Other Paid-In Capital	4,083
Retained Earnings (deficit) (Note 9)	(7,267)
	(1,044)
	$22,010

Note 1. The statement format is that which classically is used by leasing companies.

Note 2. Secured notes payable to banks including $2,709,188 due within one year.

Note 3. Reserve for possible future expenses to be incurred with respect to sales made to the outside financial institution through June 30, 1971.

Note 4. Includes the following:

DPI current liabilities	$2,833
DPIS current liabilities	506
Current portion of notes payable to banks	2,709
Intercompany accounts	(1,357)
	$4,691

Note 5. Sales to the outside financial institution for the year ended June 30, 1971 now treated as loans.

Note 6. Reserve for re-leasing for sales to the outside financial institution prior to June 30, 1970.

Note 7. Retained earnings (deficit) after deferring $1,143,000 of marketing expenses and $647,000 of product development expenses to be amortized over future periods.

Note 8. All sales to the outside financial institution treated as loans through June 30, 1971. Accordingly, the reserve for re-leasing is eliminated.

Note 9. Retained earnings (deficit) after deferring $2,168,000 of marketing expenses and $1,646,000 of product development expenses to be amortized over future periods.

That the fundamental responsibility for the content of financial statements is that of management is well established. As stated in the "Codification of Statements on Auditing Procedure," management is "charged with the primary responsibility to stockholders and to creditors for the substantial accuracy and adequacy of statements of position and operations." This is an empty charge when management is forced to adopt accounting procedures that have been "legislated" in such a way as to preclude consideration of the unique circumstances in which business is conducted and to present financial statements that fail to reflect a realistic economic measure of performance and financial position.

In Accounting Research Study 7, Paul Grady observed that

> "not many decades ago, it was often said that accounting was a reflection of good business practice. In proper perspective this is equally true today. It does not mean that any accounting practice found in business is automatically acceptable or that the businessman's view dominates the view of the accountant. It does mean that both good business and good accounting judgments are based upon the experiences of business."

There is serious danger that the universal application of the detailed rules contained in the Board's "interpretation" of APB No. 7 will cause "good business practice" and "the experience of business" to be ignored to the detriment of corporate financial reporting.

Accounting has frequently been referred to as "the language of business." It is the process by which the effects of economic events in a unique business entity's operations and financial position are communicated. This is a challenging process that is not likely to be improved by oversimplifying the author's (management's) vocabulary. Of course, management must not be permitted to describe a red object as green, but effective communication is bound to be frustrated by a solution that requires all objects, regardless of their position in the color spectrum, to be reported as either black or white.

This proposition has been and is so fundamental to the evolution of corporate financial reporting that it must not be sacrificed in our zeal to pin to the wall a very small minority of unscrupulous operators. The important point we wish to make is stated in clear and unmistakable language in Montgomery's Auditing, one of the profession's leading references for more than fifty years:

> "It is not to be expected that there will ever be compiled one body of authoritative, exhaustive, and permanent accounting principles against which the auditor may weigh all of the practices he encounters. The reason is inherent in the nature of accounting, which must be readily adaptable to changes in business practices as well as to conditions under which business operates. The application of accounting principles to the infinite variety of business situations is a matter for judgment of the experienced accountant rather than for mechanical application of a set of fixed rules."

CONCLUSIONS AND RECOMMENDATIONS

1. "Interpretation" of APB Opinion No. 7: The Board's "interpretation" of APB Opinion No. 7 attempts to provide "black and white" rules for an extremely complex set of problems. As a result, in some cases auditors may be placed in the untenable position of rendering unqualified opinions about financial statements that knowledgeable users will reject as patently absurd. After all, unduly "conservative" financial statements that fail to reflect the substantial success of a firm's basic business operations and exaggerate a firm's liabilities beyond any semblance of economic and legal realism can be just as misleading as financial statements that reflect unbridled optimism.

If the accounting profession is to continue to meet the ever-increasing weight of its responsibilities, it is essential that consideration of individual circumstances and exercise of professional judgment be facilitated. Broad guidelines to insure that transactions that are similar will be reflected in financial statements similarly and that transactions that are different will be reflected differently are very much in order. Because the application of the Board's "interpretation" is so specific and so restrictive, its application would inevitably preclude recognition of different circumstances.

<u>We recommend that the "interpretation" not be issued</u>.

2. <u>APB Opinion No. 5 and APB Opinion No. 7</u>: We recognize the Board's interest in making the reporting of leases in the financial statements of lessees coordinate with accounting for leases in the financial statements of lessors. Our examination of the "Proposed Changes in Accounting of Lessees and Lessors" that accompanied the announcement of the October 14-15 public hearing, however, suggests that the Board should proceed with great caution. If coordination of solutions to these two sets of problems can be accomplished only by the promulgation of arbitrary criteria and/or rigid detailed rules that effectively hamstring managements in their fundamental responsibility to attempt to communicate realistic economic information about their businesses and preclude auditors from exercising their professional judgment, the consequences would be unjustified.

In general, the broad guidelines provided in APB Opinions Nos. 5 and No. 7 appear to be operational and adequate.

<u>We recommend that Accounting Principles Board Opinion No. 5 and Accounting Principles Board Opinion No. 7 remain basically unchanged</u>.

3. <u>Transactions involving third party leasing companies</u>: Probably the most complex problem in accounting for lessors grows out of the increasingly frequent involvement of third party leasing companies. This is a relatively new business arrangement that has become especially common in the relatively new and rapidly growing computer and computer related industries. The variety of financial arrangements among manufacturers, financial institutions and computer users is already very great and future possibilities are almost infinite. Under these circumstances, involving new accounting problems and a wide variety of individual circumstances in a rapidly expanding environment, the prevalence of something less than uniform accounting practices is surely understandable and probably desirable. Any search now for a few specific criteria that effectively and equitably discriminate transactions into two categories -- black and white -- is likely either to be futile or to reek havoc with the financial statements and, hence, the credibility of the accounting profession.

Some guidelines that are sufficiently basic and broad to facilitate professional judgment rather than inhibit it are surely needed. The critical question in the context of third party leasing is: When does a transaction constitute a "sale" for accounting purposes? It is important to recognize that this is the same question that is critical in a number of other currently controversial areas of financial reporting -- franchise operations, land development companies, sale-and-leasebacks, guaranteed trade-in allowances, etc.

Under these circumstances, the objective of the Board should be to provide basic and broad guidelines that are applicable to all such transactions and which would, therefore, have relevance for many of the current problems in corporate financial reporting.

<u>We recommend that as an independent project, free from the desire for a particular result in a particular industry, the Board address itself to the fundamental accounting issue of what constitutes a sale</u>.

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Data Pathing Incorporated Annual Report For The Fiscal Year Ended June 30, 1970

TO OUR SHAREHOLDERS:

The performance results set forth in the annual report reflect significant changes related to DPI and DPI Systems, Inc. During the year, DPI elected to change its fiscal year end from September 30 to June 30 for both financial and income tax reporting purposes, in order that the Company's reporting would conform more closely to its natural business year. Restated revenues for the fiscal years ended June 30, 1970 and June 30, 1969 are $8,815,321 and $5,442,463, respectively, resulting in net income of $654,470 in 1970 and $222,805 in 1969 after deducting Federal and state income taxes and applying the tax loss carry-forwards of prior years. Earnings per Common share and Common equivalent share are as follows:

	1970	1969
Earnings Per Share:		
From fully taxed income	$.41	$.11
From tax loss carry-forward	.33	.11
Total	$.74	$.22

The results of operations for the years ended June 30, 1970 and 1969 include losses from operations of approximately $632,000 and $858,000 (before Federal income tax effect) for the nine month periods October 1, 1969 to June 30, 1970 and October 1, 1968 to June 30, 1969, respectively. For the three month periods July 1 to September 30, 1969 and 1968, income from operations was approximately $1,286,000 and $1,081,000 (before Federal income tax effect), respectively, resulting in the net income as stated above.

DPI Systems, Inc. (our finance leasing subsidiary) changed its fiscal year to June 30 to coincide with the fiscal year end of DPI and also changed its method of accounting for long-term lease income to provide a more classical presentation of its lease financing operations. These changes did not have a significant effect on retained earnings at June 30, 1970 or the results of operations for any particular period prior to June 30, 1970.

As of June 30, 1970, the Company had installed fifty-one data collection systems. These systems are leased under separate contracts by thirty-eight different customers, principally large industrial companies with extensive and complex manufacturing operations. A reprint of the article which appeared in the June issue of the American Machinist and describes the sophisticated system at the Black & Decker Manufacturing Company is enclosed with this report.

As was mentioned in our 1969 Annual Report, DPI and DPI Systems, Inc. entered into an Agreement with an outside financial institution which provides that the companies may sell (through August 3, 1971) to the institution up to $20,000,000 of leased equipment. During the fiscal year ended June 30, 1970, DPI Systems, Inc. has re-sold equipment purchased from DPI for $10,200,213, together with the related lease contracts, to the outside financial institution. This represents twenty-nine of the fifty-one data collection systems referred to above, with lease terms ranging from one to five years.

At June 30, 1970, the Company's backlog of orders for leases of its equipment (stated at list price value of equipment) was approximately $5,178,000.

The Company continues to market its data collection systems through its own marketing staff and maintains sales offices in Baltimore, Chicago, Cleveland, Dayton, Detroit, Fort Worth, Hartford, Kansas City, Los Angeles, New Orleans, Sunnyvale, Philadelphia, Pittsburgh, Rochester and Washington, D. C. At June 30, 1970, the Company had a marketing organization of 115 employees. Of this number, approximately one-half are field engineers who maintain and service the data collection systems after installation.

In the 1969 Annual Report, we announced our intention to enter into the international market in Europe and Japan in 1970. This program is now established. DPI has concluded an Agreement with a major Japanese company to market our data collection systems in the Japanese Empire. The first pilot system has been installed in Japan and is in operation. We have orders currently under negotiation there which we expect to finalize in the near future. An office has been established in Cologne, Germany under the direction of an experienced Systems Manager and we have a number of orders currently under negotiation in Germany and France. Recently, a Manager has been employed for our United Kingdom operation. He is well-experienced in industrial data collection and was formerly employed by our major British competitor. We continue to believe that the potential business in England, Europe and the Far East will provide a major growth and profit contribution to the Company in the coming years. Our International Operations are directed by Frederick G. Ramback, who has a broad background in international marketing.

In our last Annual Report, we also discussed the planned introduction of new products scheduled for delivery in mid-1970. These new terminals and processors have been introduced and are expected to provide the Company with continued leadership in the data acquisition and collection field. A substantial number of new processors have already been delivered; first deliveries of our new family of terminals are scheduled for December 1970.

The Company is committed to a program of continued product development. During the fiscal years ended June 30, 1970 and 1969, approximately $1,159,000 and $542,000, respectively, were spent on product development. At June 30, 1970, a staff of fifty-two persons was engaged full-time in the Company's research and development programs, of which twenty hold bachelor degrees, primarily in engineering.

In order to broaden the market for the Company's existing products, we have established a Business Development group directed by Donald J. Birmingham. The major responsibility of this group is to develop new systems concepts utilizing our standard products to enable us to penetrate growing new markets which are expected to be of major importance over the next few years. Included in these objectives is a major penetration of the hospital and medical market, and an extension of our current systems into companies that are not yet ready for full-scale, free-standing data collection systems. The initial impact of this program appears to be most favorable.

In February 1970, the Company consummated its investment in Transaction Systems, Inc. through the purchase of 20,000 shares of Class A Common Stock of TSI for an aggregate price of $1,300,000. The Class A Common Stock owned by the Company as of June 30, 1970 represents approximately 50% of all voting stock of TSI and may be converted, at any time after December 1, 1970, into Class B Common Stock of TSI on the basis of 4½ shares of Class B Common Stock for one share of Class A Common Stock, which would result in the Company's owning 80% of the stock of TSI. TSI has just announced its first point-of-sale data collection system for the retail merchandising market. A copy of the product literature, briefly describing the system, is enclosed with this report. Initial field trials are expected to commence in the near future. Based upon the results of these field trials and further development of the system over the next few months, an overall operating and financing program will be established for TSI.

In order to further strengthen the Company's Management organization, Mr. Dennis A. Fairclough joined the Company in May as the Director of Operations, with responsibility for the development, software and manufacturing programs of the Company. Mr. Fairclough had been, for the prior eight years, in various key management positions with IBM. In September of this year, Mr. Robert R. Ditto joined DPI as the Director of Planning, with primary responsibility for the development of the Company's outside expansion programs that will enhance DPI's continued growth in the future.

The current economic conditions have had an unfavorable impact on the Company's business over the last nine months, as capital goods spending throughout United States industry has declined significantly. To offset this effect, the Company has taken positive action to curtail all but essential programs and expenses in order to conserve its cash liquidity. While in recent weeks there has been some positive evidence of a turn-around, it is too early to suggest that the market for data collection systems has returned to the level of activity prevalent in 1968 and early 1969. Despite this decline, we believe strongly in our position of leadership in the industry and are confident that the next twelve months will offer opportunities to the Company which will result in new levels of achievement for both our shareholders and employees. We are sincerely appreciative for the continuing support from our investors and our growing list of customers.

Russell C. DuBois

President

ARTHUR ANDERSEN & CO.

SAN JOSE, CALIFORNIA

TO THE BOARD OF DIRECTORS,

DATA PATHING INCORPORATED:

We have examined the balance sheet of Data Pathing Incorporated (a California corporation) as of June 30, 1970, and the related statements of income (loss) and shareholders' equity for the three years then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The Company changed its fiscal year end for both financial and income tax reporting purposes from September 30 to June 30. This change has been adopted retroactively and accordingly the accompanying financial statements cover the three years ended June 30, 1970. In addition to the change in the fiscal year, the Company's subsidiary changed its method of accounting for lease rental income as described in Note 3 to the accompanying financial statements. This change has been reflected retroactively in the accompanying financial statements as of June 30, 1970.

The Company has an investment of $1,300,000 as of June 30, 1970, in an affiliate, Transaction Systems, Inc. as stated in Note 4 to the accompanying financial statements. Realization of this investment is dependent upon the success of the affiliate's future operations.

In our opinion, subject to the realization of the investment in the affiliate, the financial statements referred to above present fairly the financial position of Data Pathing Incorporated as of June 30, 1970, and the results of its operations for the three years then ended, in conformity with generally accepted accounting principles consistently applied during the periods after giving retroactive effect to the change in accounting for lease rental income by the Company's subsidiary as described above.

Arthur Andersen & Co.

August 28, 1970.

DATA PATHING INCORPORATED

BALANCE SHEET

June 30, 1970 (Note 1)

ASSETS

CURRENT ASSETS:		
Cash		$ 343,125
Accounts receivable		117,891
Inventories, at the lower of cost (first-in, first-out) or market—		
Finished goods	$2,230,733	
Work in process	646,308	
Sub-assemblies and purchased parts	640,061	3,517,102
Prepaid expenses		27,056
Total current assets		4,005,174
INVESTMENT IN SUBSIDIARY (Notes 2 and 3):		
Common stock	4,300,000	
Undistributed net earnings	238,701	
	4,538,701	
Less—Reserve for unrealized income	93,348	4,445,353
INVESTMENT IN AFFILIATE (Note 4)		1,300,000
EQUIPMENT AND LEASEHOLD IMPROVEMENTS, at cost less allowance of $138,752 for depreciation and amortization (Note 5)		657,430
OTHER ASSETS:		
Debt discount and expenses in process of amortization (Note 8)		199,963
Deferred charges for state taxes based on income (Note 6)		19,055
Deposits		2,900
		$10,629,875

The accompanying notes are an integral part of this balance sheet.

DATA PATHING INCORPORATED

BALANCE SHEET

June 30, 1970 (Note 1)

LIABILITIES

CURRENT LIABILITIES:		
Notes payable to subsidiary (Note 7)		$ 1,131,271
Notes payable to affiliate (Note 7)		522,980
Accounts payable		458,116
Wages and amounts withheld from employees for taxes		167,104
Accrued interest		75,000
Advance billings on maintenance contracts (Note 9)		65,470
Total current liabilities		2,419,941
7½% CONVERTIBLE SUBORDINATED NOTES (Note 8)		4,000,000
COMMITMENTS AND CONTINGENT LIABILITIES (Note 9)		
SHAREHOLDERS' EQUITY:		
Capital stock (Notes 10, 11 and 12)—		
Preferred stock, 6% cumulative, par value $100 per share— Authorized and outstanding—6,000 shares	$ 600,000	
Junior preferred stock, 6%, par value $100 per share— Authorized—20,000 shares Outstanding—10,500 shares	1,050,000	
Common stock, par value $1 per share— Authorized—2,000,000 shares Outstanding—487,559 shares	487,559	
Other paid-in capital	4,067,976	
Retained earnings (deficit)	(1,995,601)	4,209,934
		$10,629,875

The accompanying notes are an integral part of this balance sheet.

DATA PATHING INCORPORATED

STATEMENTS OF INCOME (LOSS)

FOR THE THREE YEARS ENDED JUNE 30, 1970 (NOTE 1)

	1970	1969	1968
REVENUES:			
Net sales (Note 2)	$8,195,331	$5,142,479	$3,237,310
Customer services	619,990	299,984	69,013
	8,815,321	5,442,463	3,306,323
OPERATING COSTS AND EXPENSES:			
Cost of products sold	3,809,981	2,193,192	1,730,092
Cost of customer services	1,003,100	707,929	407,625
Research and product development	1,158,902	542,146	562,792
Marketing, general and administrative	2,076,311	1,350,338	926,579
	8,048,294	4,793,605	3,627,088
Income (loss) from operations	767,027	648,858	(320,765)
OTHER INCOME AND (EXPENSE):			
Interest	(340,045)	(126,067)	(32,408)
Amortization of debt discount	(16,200)	—	—
Other, net	5,067	(398)	953
Provision for unrealized income and releasing (Note 2)	137,616	(350,379)	(132,340)
Equity in net income of subsidiary (Note 3)	136,005	61,791	40,905
Income (loss) before provision for income taxes	689,470	233,805	(443,655)
PROVISION FOR INCOME TAXES (Note 6):			
Federal	280,000	90,000	—
State	35,000	11,000	—
	315,000	101,000	—
Income (loss) before extraordinary item	374,470	132,805	(443,655)
EXTRAORDINARY ITEM, representing reduction of Federal income taxes resulting from carryforward of prior years' net losses	280,000	90,000	—
Net income (loss)	654,470	222,805	(443,655)
DIVIDENDS ON PREFERRED STOCK	36,000	36,000	36,000
Net income (loss) applicable to common stock and common stock equivalents	$ 618,470	$ 186,805	$ (479,655)
EARNINGS (LOSS) PER COMMON SHARE AND COMMON EQUIVALENT SHARE (Note 13):			
Income (loss) before extraordinary item	$ .41	$ .11	$(1.12)
Extraordinary item	.33	.11	—
Net income (loss)	$ .74	$ .22	$(1.12)

The accompanying notes are an integral part of these statements.

DATA PATHING INCORPORATED

STATEMENTS OF SHAREHOLDERS' EQUITY

FOR THE THREE YEARS ENDED JUNE 30, 1970 (NOTE 1)

	Preferred Stock	Junior Preferred Stock	Common Stock	Other Paid-in Capital	Retained Earnings (Deficit)	Total
Balance, June 30, 1967	$600,000	$1,050,000	$369,675	$ 941,246	$(2,235,721)	$ 725,200
Net loss for the year					(443,655)	(443,655)
Proceeds from sale of common stock			104,600	2,993,400		3,098,000
Proceeds from sale of common stock to employees under stock option plan			3,400	13,788		17,188
Dividends on preferred stock				(9,000)	(27,000)	(36,000)
Expenses related to sale of stock				(983)		(983)
Balance, June 30, 1968	600,000	1,050,000	477,675	3,938,451	(2,706,376)	3,359,750
Net income for the year					222,805	222,805
Proceeds from sale of common stock to employees under stock option plan			8,131	36,889		45,020
Dividends on preferred stock					(36,000)	(36,000)
Dividends on junior preferred stock					(31,500)	(31,500)
Expenses related to sale of stock				(1,196)		(1,196)
Balance, June 30, 1969	600,000	1,050,000	485,806	3,974,144	(2,551,071)	3,558,879
Net income for the year					654,470	654,470
Proceeds from sale of common stock to employees under stock option plan			1,753	19,832		21,585
Proceeds from sale of warrants				80,000		80,000
Dividends on preferred stock					(36,000)	(36,000)
Dividends on junior preferred stock					(63,000)	(63,000)
Expenses related to sale of stock				(6,000)		(6,000)
Balance, June 30, 1970	$600,000	$1,050,000	$487,559	$4,067,976	$(1,995,601)	$4,209,934

The accompanying notes are an integral part of these statements.

DATA PATHING INCORPORATED

NOTES TO FINANCIAL STATEMENTS

JUNE 30, 1970

1. Change in Fiscal Year

In June, 1970, the Company elected to change its fiscal year end from September 30 to June 30 for both financial and income tax reporting purposes. The accompanying statements of income (loss) have been retroactively restated on the basis of a June 30 fiscal year. The change in fiscal year end was made in order that the Company's reporting would conform more closely to its natural business year. The results of operations for the years ended June 30, 1970 and 1969, include losses from operations of approximately $632,000 and $858,000 (before Federal income tax effect) for the nine-month periods October 1, 1969 to June 30, 1970 and October 1, 1968 to June 30, 1969, respectively. For the three-month periods July 1 to September 30, 1969 and 1968, income from operations was approximately $1,286,000 and $1,081,000 (before Federal income tax effect), respectively, resulting in the net income as shown in the accompanying statements of income for the years ended June 30, 1970 and 1969.

2. Accounting for Sales

All of the Company's sales for the three years ended June 30, 1970 have been made to its wholly-owned subsidiary, DPI Systems, Inc. The subsidiary has in turn resold a portion of the equipment ($10,200,213) to an outside financial institution.

Prior to October 1, 1969, sales to the subsidiary were at list price value of the equipment. The Company provided a reserve for releasing on the portion resold by the subsidiary to the outside financial institution.

Under an agreement, effective October 1, 1969, sales to the subsidiary are made at 90% of list price and the subsidiary provides a reserve for releasing on the equipment resold to the outside financial institution. The balance in the reserve for releasing on the Company's books at October 1, 1969 ($148,100) was transferred to the subsidiary.

The subsidiary leases its equipment to unaffiliated end-users primarily on noncancellable long-term leases. Lease rental payments to be received by the subsidiary on equipment leased with initial lease terms of 36 and 60 months cover the majority of its investment in the equipment. Manufacturing profit on equipment sold to the subsidiary with initial lease terms of less than 36 months (short-term leases) is reflected in income only to the extent of the portion covered by the lease term with the balance of the profit deferred by the Company through a reserve for unrealized income. The reserve was reduced $285,716 by a net credit to income in fiscal year 1970 when the subsidiary resold certain equipment on short-term leases to the outside financial institution referred to above.

3. Investment in Subsidiary

The accounts of the Company's wholly owned subsidiary, DPI Systems, Inc., are not consolidated. The income of the subsidiary is included in the accompanying statements of income (loss) on the equity basis. The financial statements of DPI Systems, Inc. as of June 30, 1970 are shown immediately following these financial statements.

In line with the Company's change in fiscal year end (Note 1), the subsidiary also changed to a fiscal year ending June 30. In addition, the subsidiary also changed its method of accounting for lease revenues and costs as described in its financial statements.

4. Investment in Affiliate

Transaction Systems, Inc. (TSI), an affiliated company, was organized in October, 1968, by an outside technical group of engineers to develop data collection equipment for the retail merchandising

NOTES TO FINANCIAL STATEMENTS—(Continued)

industry. In February 1970, the Company purchased all of the Class A Common Stock (20,000 shares) of TSI for $1,300,000. The Class A Common Stock represents a present voting interest of approximately 50% in TSI and is convertible into an 80% voting interest on or after December 1, 1970. In addition, the Company has entered into an agreement with the founders of TSI, whereby, during the period January 1, 1976 to December 31, 1980, the Company, or the founders as a group, have an option to require the exchange of all Class B Common Stock of TSI (except such stock held by the Company) for common stock of the Company pursuant to an exchange formula based upon the relative performance of TSI and the Company. Since inception, TSI has been engaged in product development and has had no sales. Realization of the Company's investment in the affiliate is dependent upon TSI's ability to complete the product development and upon the success of its future operations.

The June 30, 1970 summary balance sheet of TSI is presented below:

ASSETS	
Cash	$ 6,989
Receivables	5,027
Notes receivable from Data Pathing Incorporated	522,980
Total current assets	534,996
Equipment and leasehold improvements, net	13,013
Deferred product development costs	859,635
Other assets	2,240
	$1,409,884
LIABILITIES	
Current liabilities	$ 39,447
Deferred federal and state taxes based on income	7,500
Shareholders' equity	1,362,937
	$1,409,884

5. Depreciation and Amortization

The Company provides for depreciation and amortization by charges to income based upon manufactured or acquisition cost and estimated useful lives of individual property items using the straight-line method. Depreciation and amortization charges for the years ended June 30, 1970, 1969 and 1968 were $84,636, $41,814 and $13,827, respectively.

6. Federal and State Taxes Based on Income

The timing of certain expenses for financial statement purposes differs from that required to be used for income tax purposes. For both Federal and state tax reporting purposes, the provisions for unrealized income and releasing are not deductible until the year the income is realized or the expenses incurred. For Federal income tax reporting purposes, state taxes based on income are deductible in the year paid.

Deferred charges for state taxes based on income represent the state tax effect of the above timing differences as of June 30, 1970.

For Federal income tax purposes, the Company has a net operating loss carry-forward of approximately $1,630,000 available to offset taxable income in future years. The carry-forward expires as follows:

June 30,	
1972	$ 733,000
1975	897,000
	$1,630,000

NOTES TO FINANCIAL STATEMENTS—(Continued)

Investment tax credits on equipment purchases have not been material in amount and are available to offset Federal income taxes in future years.

7. Notes Payable to Subsidiary and Affiliate

The notes payable to the Company's subsidiary (DPI Systems, Inc.) and affiliate (Transaction Systems, Inc.) are due on demand and bear interest at 1¼% over the prime rate charged by the Company's banks.

8. Convertible Subordinated Notes

The notes, issued in September, 1969, are convertible into 80,000 shares of the Company's Common stock. The Company is required to redeem, on a pro rata basis, $400,000 of the notes on September 30, of each year from 1974 to 1978. The remaining balance is due September 30, 1979. In addition, the Company may redeem, on a pro rata basis, all or part of the notes on April 1, and October 1, of any year beginning October 1, 1974 at the face amount of the notes plus unpaid interest. The notes provide, among other things, that specific minimums of current ratio and equity capital must be maintained. The notes are subordinated to senior indebtedness as defined in the note agreement. The note holders also have detachable warrants for the purchase of 40,000 shares of Common stock at $50.00 per share, expiring on September 30, 1974. In the event of issuance of Common Stock (subject to certain exceptions including the issuance of Common Stock under the Employee Stock Option Plan and an Employee Stock Purchase Plan) at a price below $50.00 per share, the Conversion and Warrant prices are automatically adjusted to such lower price.

Debt discount and issue expenses applicable to the convertible subordinated notes are being amortized, by charges to income, over the term of the notes.

9. Commitments and Contingent Liabilities

The Company occupies its main facility under a lease which expires in 1976, but which may be renewed for two additional five-year periods. Also, additional office space and fourteen sales offices are being leased under contracts which expire at various dates to May 31, 1973. Aggregate future rentals as of June 30, 1970, are approximately $420,000, payable during the years ending June 30 as follows:

1971	$100,000	1975	$ 58,000
1972	$ 74,000	1976	$ 58,000
1973	$ 62,000	1977	$ 10,000
1974	$ 58,000		

In addition, the Company is obligated under long-term equipment lease agreements expiring at various dates to June 14, 1973. Aggregate future rentals as of June 30, 1970 are approximately $300,000, payable during years ending June 30 as follows:

1971	$149,000	1973	$ 44,000
1972	$107,000		

Under independent contracts with end-users, the Company provides maintenance on the equipment sold to DPI Systems, Inc. and the financial institution referred to in Note 2. The majority of the maintenance contracts are for 12-month periods and all are billed monthly.

10. Preferred Stock

This stock has a liquidation preference of $106 until October 1, 1971, decreasing ratably to $100 on October 1, 1981. The Company may redeem the stock on any quarterly dividend date after September 30, 1970, at the then current liquidation preference price plus any unpaid dividends. Beginning October 31, 1971, the Company is required to make annual sinking fund payments of $60,000. The Preferred stock is non-voting except in the event of certain defaults by the Company.

NOTES TO FINANCIAL STATEMENTS—(Continued)

The Preferred stockholder also has warrants for the purchase of 160,500 shares of Common Stock at $3.738 per share. These warrants are exercisable at any time prior to October 2, 1975.

11. Junior Preferred Stock

Dividends on this stock are payable when the Company's net income for the preceding fiscal year, after deducting all dividends paid in such year on the Preferred stock, equals or exceeds twice the amount of the annual (6%) dividend on the Junior Preferred stock. This stock—after payment of the amounts due to the Preferred stockholder—has a liquidation preference of $106 until March 1, 1973, decreasing ratably to $100 after March 1, 1982. The Company may redeem the stock on any quarterly dividend date after March 1, 1972, at the then current liquidation preference price plus any dividends payable. Beginning November 30, 1971, the Company is required to make annual sinking fund payments of $105,000. The Junior Preferred stock is non-voting except in the event of certain defaults by the Company. Junior Preferred stockholders also have warrants for the purchase of 210,000 shares of Common stock at prices ranging from $6.00 to $10.00 per share depending on the date warrants are exercised. These warrants are exercisable at any time prior to March 2, 1982.

12. Common Stock Options and Warrants

The Company has reserved 111,141 shares of its Common stock for issuance under Qualified Stock Option Plans. Under these plans, options may be granted to officers and key employees at not less than 100% of fair market value of the stock at date of grant. The options are exercisable in cumulative annual installments of 25% after the first year and expire five years from the date granted.

The following table summarizes the stock options for the five years ended June 30, 1970:

	Number of Shares	Option Price Per Share		Option Price Total	Fair Value at Date of Grant or When Exercisable or When Exercised① Per Share		Fair Value Total
Options outstanding as of:							
June 30,							
1966	10,800		$ 5.00	$ 54,000		$ 5.00	$ 54,000
1967	47,650	$5.00	$10.00	$ 277,000	$ 5.00	$10.00	$ 277,000
1968	48,613	$5.00	$40.00	$ 618,915	$ 5.00	$40.00	$ 618,915
1969	69,338	$5.00	$60.00	$2,367,340	$ 5.00	$60.00	$2,367,340
1970	71,835	$5.00	$60.00	$2,503,575	$ 5.00	$60.00	$2,503,575
Options which became exercisable during the period ended:							
June 30,							
1967	2,362		$ 5.00	$ 11,810	$ 5.00	$10.00	$ 13,560
1968	10,250	$5.00	$10.00	$ 54,562	$10.00	$40.00	$ 337,220
1969	10,507	$5.00	$40.00	$ 108,250	$40.00	$60.00	$ 442,220
1970	15,211	$5.00	$60.00	$ 503,632	$10.00	$40.00	$ 375,580
Options exercised during the period ended:							
June 30,							
1967	575		$ 5.00	$ 2,875	$ 5.00	$ 7.50	$ 3,375
1968	3,400	$5.00	$ 7.50	$ 17,187	$10.00	$40.00	$ 115,625
1969	8,131	$5.00	$30.00	$ 45,020	$40.00	$50.00	$ 329,550
1970	1,753	$5.00	$40.00	$ 21,585	$10.00	$40.00	$ 62,620

① No quoted market values are available for the Company's Common stock; accordingly, the fair values per share are those determined by the Board of Directors at the various grant dates.

NOTES TO FINANCIAL STATEMENTS—(Continued)

In addition, the Company has reserved a total of 494,500 shares of its Common stock for issuance to holders of convertible subordinated notes and warrants as follows:

Convertible note holders	80,000 shares
Convertible note holders—warrants	40,000 shares
Preferred stockholders—warrants	160,500 shares
Junior Preferred stockholders—warrants	210,000 shares
Warrants issued to certain banks in consideration of loans made to the Company	4,000 shares
	494,500 shares

The warrants issued to certain banks in February, 1970 for purchase of the Company's Common stock at a price of $50.00 per share expire on December 31, 1972.

13. Earnings (Loss) Per Share

Earnings per share have been computed based on the weighted average number of Common shares and Common equivalent shares outstanding each period. Common equivalent shares for this computation include shares covered by stock options and warrants which result in dilution. Equivalent shares are reduced by the number of shares of Common stock that could have been purchased at the average price per share during the respective years with the funds obtained from the exercise of the stock options and warrants, after first applying $1,050,000 of the proceeds to redeem the Junior Preferred stock which may occur under the terms of the related warrants. The average number of shares used in the computations were 834,249 and 840,655 for the years ended June 30, 1970 and 1969, respectively.

Earnings per share, assuming full dilution, are the same as earnings per share computed as above.

The loss per share, for the year ended June 30, 1968, has been computed based on the weighted average number of Common shares outstanding (428,135) during the year.

ARTHUR ANDERSEN & CO.

SAN JOSE, CALIFORNIA

TO THE BOARD OF DIRECTORS,
DPI SYSTEMS, INC.:

We have examined the balance sheet of DPI Systems, Inc. (a California corporation and a wholly-owned subsidiary of Data Pathing Incorporated) as of June 30, 1970, and the related statements of income and shareholder's equity for the three years then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The Company changed its fiscal year end for both financial and income tax reporting purposes from September 30 to June 30. This change has been adopted retroactively and accordingly the accompanying financial statements cover the three years ended June 30, 1970. In addition to the change in the fiscal year, the company changed its method of accounting for lease rental income as described in Note 1 to the accompanying financial statements. This change has been reflected retroactively in the accompanying financial statements as of June 30, 1970.

In our opinion, the financial statements referred to above present fairly the financial position of DPI Systems, Inc. as of June 30, 1970, and the results of its operations for the three years then ended, in conformity with generally accepted accounting principles consistently applied during the periods after giving retroactive effect to the change in accounting for lease rental income as described above.

Arthur Andersen & Co.

August 28, 1970.

DPI SYSTEMS, INC.
(A wholly-owned subsidiary of Data Pathing Incorporated)

BALANCE SHEET

JUNE 30, 1970 (Note 1)

ASSETS

CASH		$ 118,596
CERTIFICATES OF DEPOSIT (Note 6)		1,500,000
ACCOUNTS RECEIVABLE		1,198,806
NOTES RECEIVABLE FROM DATA PATHING INCORPORATED (Note 2)		1,131,271
LEASE RENTALS RECEIVABLE, including $1,561,960 due within one year (Notes 3 and 6)	$4,112,799	
Less—Unearned lease income (Note 4)	831,987	3,280,812
LEASED EQUIPMENT (Notes 3 and 4):		
Under long-term leases, at estimated residual value		2,396,732
Under short-term leases, at cost	217,491	
Less—Accumulated depreciation and reserve for equipment refurbishment	22,782	194,709
DEFERRED CHARGES FOR FEDERAL AND STATE TAXES BASED ON INCOME (Note 7)		11,678
OTHER ASSETS		158
		$9,832,762

LIABILITIES

ACCOUNTS PAYABLE AND ACCRUED LIABILITIES:		
Interest		$ 99,091
Federal and state taxes based on income (Note 7)		9,550
Sales taxes and other		24,671
		133,312
NOTES PAYABLE TO BANKS (Note 6):		
Secured installment notes including $1,072,268 due within one year	$3,018,161	
Secured, due December 31, 1970	1,500,000	4,518,161
RESERVE FOR RELEASING (Note 5)		642,588
SHAREHOLDER'S EQUITY:		
Common stock, par value $1 per share— Authorized—1,000,000 shares Outstanding—700,000 shares	700,000	
Other paid-in capital	3,600,000	
Retained earnings	238,701	4,538,701
		$9,832,762

The accompanying notes are an integral part of this balance sheet.

DPI SYSTEMS, INC.
(A wholly-owned subsidiary of Data Pathing Incorporated)

STATEMENTS OF INCOME
FOR THE THREE YEARS ENDED JUNE 30, 1970 (Note 1)

	1970	1969	1968
REVENUES (Note 4):			
Lease income on long-term leases	$373,956	$243,809	$ 76,250
Rental income on short-term leases	251,223	198,398	76,270
Less—Provisions for depreciation and equipment refurbishment	(125,869)	(123,284)	(52,221)
	125,354	75,114	24,049
Income from sales of leased equipment, net of provision for releasing (Note 5)	45,080	—	—
	544,390	318,923	100,299
OPERATING EXPENSES:			
Interest	282,872	227,638	50,073
General and administrative	86,513	24,194	6,621
	369,385	251,832	56,694
Income from operations	175,005	67,091	43,605
PROVISION FOR INCOME TAXES (Note 7):			
Federal	27,000	1,000	—
State	12,000	4,300	2,700
	39,000	5,300	2,700
Net income	$136,005	$ 61,791	$ 40,905

STATEMENTS OF SHAREHOLDER'S EQUITY
FOR THE THREE YEARS ENDED JUNE 30, 1970 (Note 1)

	Common Stock	Other Paid-in Capital	Retained Earnings	Total
YEAR ENDED JUNE 30, 1968 (Initial fiscal year of operations):				
Proceeds from sale of common stock	$300,000	$	$	$ 300,000
Net income for the year			40,905	40,905
BALANCE JUNE 30, 1968	300,000	—	40,905	340,905
Net income for the year			61,791	61,791
BALANCE JUNE 30, 1969	300,000	—	102,696	402,696
Proceeds from sale of common stock	400,000	3,600,000		4,000,000
Net income for the year			136,005	136,005
BALANCE JUNE 30, 1970	$700,000	$3,600,000	$238,701	$4,538,701

The accompanying notes are an integral part of these statements.

DPI SYSTEMS, INC.
(A wholly-owned subsidiary of Data Pathing Incorporated)

NOTES TO FINANCIAL STATEMENTS
JUNE 30, 1970

1. Change in Fiscal Year and Change in Accounting

In June, 1970, the Company elected to change its fiscal year end from September 30 to June 30 for both financial and income tax reporting purposes. The change in fiscal year end was made in connection with the change of fiscal year by the Company's parent.

In addition, the Company changed its method of accounting for lease rental income and costs to the method described in Note 4. Previously, gross lease rentals were recorded as income when billed under the lease contracts and lease costs (equipment cost less estimated residual value) were amortized on a straight-line basis over the initial lease term. The change did not have a significant effect on retained earnings at June 30, 1970, or the results of operations for any particular period during the three years ended June 30, 1970.

The above changes have been retroactively reflected in the accompanying financial statements.

2. Notes Receivable from Data Pathing Incorporated

The notes receivable from Data Pathing Incorporated are due on demand and bear interest at 1¼% over the prime rate charged by the Company's banks.

3. Leased Equipment and Related Lease Contracts

Leased equipment consists of data collection systems acquired from Data Pathing Incorporated, the Company's parent. The leases provide for renewal, extension, or purchase at the option of the lessee. Most of the leases have initial terms of 36 and 60 months, and lease payments cover the majority of the Company's investment in the related equipment. In management's opinion full recovery of the investment will be realized from extensions of existing leases, obtaining new leases, or selling the equipment.

The lessee is responsible for maintenance and under most leases is also responsible for taxes other than those measured by income. Lessees normally provide for maintenance under independent maintenance contracts which are severable from the terms of the equipment lease agreements.

4. Accounting for Leases

Long-term leases—

The finance method is used to account for income under long-term (36 to 60 months) lease contracts. Lease income is the difference between (a) total contract receivables and (b) the cost of the related equipment reduced by the estimated residual value of the equipment at the expiration of the initial lease term. A portion of the lease income is recognized immediately upon inception of the lease to offset the costs of acquiring and consummating the lease. The balance is taken into income over the lease term in decreasing amounts, generally related to the declining balance of the investment, using the sum-of-the-months-digits method.

Leased equipment under long-term lease contracts is carried at its estimated residual value at the end of the initial lease term. The residual value is determined by (a) reducing equipment cost on a straight-line basis at 15% per year over the first six years and 5% per year over the next two years and (b) providing a reserve for equipment refurbishment.

NOTES TO FINANCIAL STATEMENTS—(Continued)

Short-term leases—

The operating method is used to account for income under short-term (less than 36 months) lease contracts. Monthly lease rentals are recorded as income when billed. The leased equipment is depreciated on a straight-line basis at 15% per year over the first six years and 5% per year over the next two years. A reserve for refurbishment is also provided as a charge against income recorded.

5. Sales of Leased Equipment and Related Lease Contracts

The Company has sold a portion of the equipment ($10,200,213) purchased from its parent together with the related lease contracts to an outside financial institution. These sales have been made pursuant to an agreement between the Company, its parent and the financial insitution, which provides that the companies may sell (through August 3, 1971) to the institution up to $20,000,000 of leased equipment. If rental of the leased equipment is discontinued by the customer prior to the end of the defined recapture period, the Company and its parent will use their best efforts to re-lease the equipment. The Company has provided a reserve based upon management's estimate of the possible future liability under the agreement.

Prior to October 1, 1969, purchases from the parent were at the list price value of the equipment. The parent provided a reserve for releasing on the portion resold by the Company to the outside financial institution.

Under an agreement, effective October 1, 1969, purchases from the parent are made at 90% of list price value of the equipment and the Company provides a reserve for releasing out of the proceeds from the equipment resold to the outside financial institution. The balance in the reserve for releasing on the parent's books at October 1, 1969 ($148,100) was transferred to the Company.

6. Notes Payable to Banks

A loan agreement dated March 31, 1970, was executed by the Company with certain banks for a $10,000,000 line of credit expiring on December 31, 1970. The line of credit is reduced by any loans, not to exceed $3,000,000, made by the banks to the Company's parent. The interest rate on loans outstanding is 1¼% over the prime rates charged by the respective banks. Loans under the agreement are limited to the aggregate of (a) 90% of unpaid rentals on lease contracts assigned to the banks and (b) 100% of non-interest bearing certificates of deposit. The loans are secured by assignment of the related leases, a security interest in the equipment, and assignment of the certificates of deposit. Loans outstanding at December 31, 1970, will be payable in equal monthly installments over the following 43 months.

7. Federal and State Taxes Based on Income

For income tax reporting purposes, the Company reports lease rentals as income when billed under the lease contracts. The related leased equipment is depreciated over its estimated useful life on the straight-line basis except for certain equipment which is depreciated for Federal tax reporting purposes on the double-declining balance method.

In addition, the timing of certain expenses for financial statement purposes differs from that required to be used for income tax purposes. For both Federal and state tax reporting purposes, equipment refurbishment and re-leasing expenses are deductible in the year paid. For Federal income tax reporting purposes, state taxes based on income are deductible in the year paid.

Deferred charges for Federal and state taxes based on income represent the net effect of the above timing differences as of June 30, 1970. Taxes currently payable are included in current liabilities.

The provisions for Federal income taxes have been reduced by investment tax credits of $51,087, $25,575, and $13,834, for the years ended June 30, 1970, 1969, and 1968, respectively.

In addition, an investment tax credit carryforward of $63,580 is available to reduce future years' Federal income taxes through the year ending June 30, 1976.

DIRECTORS:

ROGER L. MOSHER
Chairman
Partner, Wilson, Mosher & Martin,
Attorneys at Law

RUSSELL C. DUBOIS
President and Chief Executive Officer

WILLIAM H. BURKHART
President, Transaction Systems, Inc.

JOHN HARTMANN
General Partner, J. Barth & Co.

E. F. HEIZER, JR.
President, Heizer Corporation

DR. GEORGE KOZMETSKY
Dean of the College of Business Administration
The University of Texas

LEROY J. SCORE
President, Score Incorporated

ARNOLD R. TERNQUIST
Retired Partner, Peat, Marwick, Mitchell & Co.

L. L. VANOOSTEN
Vice President, Allstate Insurance Company

OFFICERS AND PRINCIPAL EXECUTIVES:

RUSSELL C. DUBOIS
President and Chief Executive Officer

PETER J. DAVIS
President, DPI Systems, Inc.

DONALD J. BIRMINGHAM
Vice President, Director of New Business Development

PAUL W. BYALL
Secretary Treasurer, Director of Finance

ROBERT R. DITTO
Director of Planning

DENNIS A. FAIRCLOUGH
Director of Operations

LESTER C. FROM
Director of Industrial Relations

EUGENE J. MASCOLI
Vice President, Director of Marketing

COUNSEL:
Wilson, Mosher & Martin

PATENT ATTORNEYS:
Flehr, Hohbach, Test, Albritton & Herbert

AUDITORS:
Arthur Andersen & Co.

CORPORATE OFFICES:
370 San Aleso Avenue
Sunnyvale, California

DATA
PATHING
INC.

October 18, 1971

Mr. Richard C. Lytle
Administrative Director
Accounting Principles Board
American Institute of
Certified Public Accountants
666 Fifth Avenue
New York, New York 10019

Dear Mr. Lytle:

As requested by Mr. Philip L. Defliese (Chairman of the Accounting Principles Board), for supplemental documentation supporting my testimony at the public hearing on leases held on October 14, 1971, please find enclosed copies of the following documents:

1. Opinion of legal counsel with respect to the Accounting Principles Board's interpretative release entitled "Accounting for Leases by Lessors Question," dated September 20, 1971.

2. Prospectus of Computer Machinery Corporation dated September 23, 1971.

3. Prospectus of Inforex, Inc. dated September 23, 1971.

With respect to the Prospectus of Computer Machinery Corporation, quotations were made from the following pages at the public hearing:

Pages 8 and 9	-	Note (A)
Page 36	-	Deferred Marketing Costs
Page 41	-	Note (7) Deferred Marketing Costs
Page 37	-	Deferred Income Relating to Sales to Transamerica; and Total Shareholders' Equity (Deficiency)
Pages 17, 18 and 19	-	New Lease Financing - with emphasis on the definition of tangible net worth appearing at the bottom of page 18 and the top of page 19

370 SAN ALESO AVE., SUNNYVALE, CA 94086 TEL 408 734-0100

Pages 30 and 31	-	Convertible Notes
Page 35	-	Accountants' Opinion
Page 1	-	Underwriters; price per share and total amount of the underwriting

With respect to the Prospectus of Inforex, Inc., quotations were made from the following pages at the public hearing:

Page 2	-	Change in Method of Accounting
Pages 8 and 9	-	Note (A)
Pages 35 and 36	-	Note (2)
Page 30	-	Absence of Deferred Charges
Page 31	-	Unamortized Advance Payments on Systems Transferred to Inforex Leasing; and Stock-holders' Investment
Pages 5 and 6	-	Financing Arrangements

I hope the enclosed material will be helpful to the Board and the Committees in their further deliberations on this challenging subject of accounting for leases. If I can be of further assistance, please do not hesitate to call on me.

Yours very truly,

Paul W. Byall

Paul W. Byall
Treasurer

PWB:vmm
Enclosures

MCCUTCHEN, DOYLE, BROWN & ENERSEN
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CABLES MACPAG
TELEX 470318

October 7, 1971

Data Pathing Incorporated
370 San Aleso Avenue
Sunnyvale, California 94086

Dear Sirs:

You have requested our comment on the Accounting Principles Board's interpretative release entitled "Accounting for Leases by Lessors Question", dated September 20, 1971, with particular reference to that part of the release which deals with the accounting treatment recommended for transfers by lessors of their rights to equipment subject to lease. We understand that the entire subject of accounting for leases by lessors and by lessees, which is presently covered by APB Opinions No. 5 and 7 and by the September 20 release, will be the subject of hearings before the Accounting Principles Board on October 14 and 15 and that this opinion may be furnished to the Board as a part of the presentation of your views as to the appropriate accounting principles.

The business of equipment leasing is characterized by the widespread use of independent financing institutions which acquire leases or equipment subject to leases. While there is, of course, significant variation in the details of third party participation arrangements which in any given case will necessarily influence the accounting and legal characterization, we think that the accounting treatment of those arrangements should be consistent with their legal effect. Accordingly, we have examined the release to determine whether its guidelines in this area comport with legal realities. It is our conclusion that in some respects they do not; that is, certain transactions which are in legal effect clearly sales might, under the release, be treated for accounting purposes as loans.

The section of the release entitled "Participation by Third Parties" concerns transfers to financing institutions of property subject to lease. It begins with the proposition, supportable in law, that such a transfer should be reflected as a loan by the financing institution to the transferor (manufacturer or dealer) where the transferor retains the risks of ownership. Though ostensibly sales, such transactions are, according to the release, "in effect collaterialized [sic] loans from the financing institution to the manufacturer or dealer." That is true in law also. West Pico Furniture Co. v. Pacific Finance Loans, 2 C.3d 594 (1970) (loan found where transferor of accounts receivable guaranteed full payment of the accounts); Milana v. Credit Discount Co., 27 C.2d 335 (1945) (same, citing numerous similar decisions in other jurisdictions).

The problem with the release is that it appears to treat every transfer of property subject to a lease as a loan unless "all risks and rewards of ownership are transferred to the purchaser." (Emphasis added.) If the release means that the retention of any risk prevents a transfer from being considered a sale, it would surely result in treating, for accounting purposes, many transactions as loans which by any legal standard are in fact sales. It should be recognized that, in many of these transactions, the principal party who requires credit and upon whose credit the risk is taken is the lessee. Indeed, one of the most important reasons for the existence of the leasing business has been to provide an alternative source of credit for equipment users who wish to avoid the internal budget problems with which they are confronted when required to submit proposals for capital expenditures. We do not quarrel with the proposition that when the financing institution is substantially fully protected against credit risks by the manufacturer or dealer, the transaction is in substance a loan to such manufacturer or dealer, or at least is a dubious sale. In fact, the existence of such protection is the critical factor for determining whether at law an ostensible "sale" to a financing institution is in reality a loan.[1]

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[1]For example, in West Pico Furniture Co. v. Pacific Finance Loans, supra, 2 C.3d at 604-05, and Milana v. Credit Discount Co., supra, 27 C.2d at 340-42, the California Supreme Court held that transfers, similar to the ones considered here, to financing institutions were loans rather than sales for the very reason that the transferor (manufacturer or dealer) guaranteed the customers' payments to the financing

But when the financing institution takes the substantial risk on the transaction, we see no reason why it should be treated, for accounting purposes or otherwise, as a loan. The law treats it as a sale, not a loan.[2] The reason

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(Ftnt. 1 continued)
institution. Accord, Home Bond Co. v. McChesney, 239 U.S. 568, 575-76 (1916) (assignment of accounts receivables held to be a loan since the assignor guaranteed payment of the accounts); Brierly v. Commercial Credit Co., 43 F.2d 724 (E.D. Pa. 1929), aff'd, 43 F.2d 730 (3d Cir. 1930) (same); Baruch Investment Co. v. Huntoon, 257 C.A.2d 485, 493-95 (1967) (same); Golden State Lanes v. Fox, 232 C.A.2d 135, 139-41 (transfer of master lease, with obligation of transferor guaranteed by its stockholders, to re-purchase it at a specified price--held a secured loan); Koessler, "Assignment of Accounts Receivable," 33 Calif. L. Rev. 40, 53-54 (1945). Cf. "California Chattel Security and Article Nine of the Uniform Commercial Code," 8 U.C.L.A. L. Rev. 806, 827 at n. 104 (1961). (There is authority that even the transferor's guarantee may not always be enough to convert an ostensible sale of accounts receivable into a loan. See Note, "Accounts Receivable Financing and the California Personal Property Brokers Act," 14 Stan. L. Rev. 520, at 520-21, n. 6 (1962)).

[2] The courts have held that where the substantial burden of ownership falls on the financing institution the transaction is a sale, even though the institution has limited recourse against the transferor. See Advance Industrial Finance Co. v. Western Equities, Inc., 173 C.A.2d 420 (1959) (transfer of accounts receivable held to be a sale rather than a loan despite its partial guarantee of amounts by Seller and despite its limited residual interest in the amounts paid); Refinance Corp. v. Northern Lumber Sales, Inc., 163 C.A. 2d 73 (1958) (court held (a) that transfers of accounts receivable without recourse were clearly a sale--even though the transferor would receive less if the accounts were not paid--and (b) that the trial court was justified in treating as sales even some transfers which were with recourse). In West Pico Furniture Co. v. Pacific Finance Loans, supra, 2 C.3d at 605, the court found that because the contractual 10% limitation on the transferor's guarantee was disregarded in practice, so that the guarantee was in reality full, the transaction was a loan rather than a sale.

The fact that a transfer of chattel paper, accounts or contract rights may be a sale even though the transferee has some recourse against the transferor is explicitly recognized in the Uniform Commercial Code (see § 9-502(2) and the Official Comment in that Section, para. 4.).

the purchase price for the transfer cannot be a loan to the transferor is that the transferor does not have to pay it back. See Calif. Civil Code § 1912; West Pico Furniture Co. v. Pacific Finance Loans, supra, and the other cases cited in the first footnote above. See also, In re San Francisco Industrial Park, Inc., 307 F.Supp. 271, 275 (N.D. Cal. 1969) (without an obligation to repay the amount received, there could not be a loan); Burr v. Capital Reserve Corp., 71 C.2d 983, 991 (1969) (loan found because obligation to repay full amount, and more, "created a debit and credit relationship"); Rochester Capital Leasing Corp. v. K & L Litho Corp., 13 C.A.3d 697, 702 (1970) (same); Develop-Amatic Eng. v. Republic Mortgage Co., 12 C.A.3d 143, 149 (1970) (no surviving debt--sale found); Munger v. Moore, 11 C.A.3d 1, 10 (1970) (same); Workmon Constr. Co. v. Weirick, 223 C.A.2d 487, 492 (1963) (same); Glasgow v. Andrews, 129 C.A.2d 660, 666 (1954) (same); Spataro v. Domenico, 96 C.A.2d 411, 413 (1950) (same).

There may, of course, be some obligations and risks retained by the transferor (the manufacturer or dealer). But where these are incidental and do not add up to an obligation to repay the purchase price, they should not change the fact that the transaction is a sale. (See the authorities cited in footnote 2 above.) In such a case, the transferor (the manufacturer or dealer) has received the proceeds of the sale, and we see no reason why there should not be immediate recognition of income, assuming, of course, that proper reserves are established to provide for any measurable risks undertaken as a part of the contract of sale.

It may well be that, in approaching the question of whether a sale or a lease has occurred, the Accounting Principles Board means to give the same critical importance the law gives to the question of who bears the principal credit risks. The interpretive release is susceptible to such a reading. For example, the release seems to suggest, as do the courts, that the test boils down to whether the manufacturer or dealer "effectively guarantee[s] recovery of the investment to a financing institution which purchases the property". However, the Board would find a guarantee to exist where there is merely "a formal or informal commitment by the manufacturer or dealer . . . (3) to secure a replacement lessee or a buyer for the property. (This . . . commitment is often described as being on a 'best efforts' basis but may be effected on a priority basis over other similar property owned by the manufacturer or dealer.)" It is here that we think the release deals inadequately with legal realities. It is quite clear that there is a wide range of commitments of this general description which could be undertaken by a seller of property without altering the operative legal fact that a sale has been consummated. The legal effect given to a particular agreement will depend upon its specific provisions, supplemented in some cases by evidence of the parties' practice under the agreement.

For example, the master agreement for the sale from your subsidiary, DPIS (described in the agreement as "Manufacturer"), to Transamerica of equipment subject to lease contains the following provisions:

> "19. Remarketing
>
> "If at any time during the period of sixty (60) months, but not longer than the Recapture Period, following initial purchase by TRANSAMERICA rental of the equipment is discontinued by a customer, Manufacturer agrees that it will again place the equipment on rent in accordance with the Master Sales/Purchase Agreement within sixty (60) days by giving first priority to the TRANSAMERICA equipment in Manufacturer's lease order backlog. In the event that the equipment is not so leased Manufacturer agrees to pay to TRANSAMERICA the net monthly rental due on the equipment for a period not to exceed five (5) months per item of equipment.
>
> "During any period of time when the equipment is available for remarketing or not subject to an Agreement for Equipment Service, TRANSAMERICA shall be free to sell or lease the equipment to anyone, persons or company, whether such person is a customer or prospect of Manufacturer, for any rental or purchase terms that TRANSAMERICA can negotiate. Manufacturer shall have the first right of refusal on such equipment. TRANSAMERICA agrees to provide fifteen (15) days for Manufacturer to exercise such right."

The December 1970 amendment included the following:

> "Paragraph 19, Remarketing, is changed so that the word 'five (5)' in the second sentence is changed to read 'two (2).'"

It is our opinion that under paragraph 19, as amended, the limit of DPIS' obligation with respect to equipment which goes off rent during the time specified is two months' net monthly rental. This amounts to essentially a rebate of a small portion of the purchase price. The provision in the second paragraph which gives DPIS a first right of refusal means only that and nothing more.[3] This view of the contract is supported by the language of the agreement itself, which clearly transfers ownership to Transamerica, and by the experience of Transamerica under similar agreements with other customers, among them Xerox Corporation. You have advised us that Transamerica is holding in warehouse storage substantial quantities of Xerox equipment which has gone off lease, has not been remarketed and which Transamerica is now endeavoring to re-lease or sell for its own account. You have further advised us that the value of the "first priority" provision is not substantial. As indicated by Transamerica's experience with respect to the Xerox equipment, there is little demand for leases of used equipment of the kind in question and, accordingly, the residual value of that equipment is not significant.

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[3]The purchase price at which DPIS would exercise the right of refusal would, apparently, be the market price. Such a right should not make the master agreement with TCC any less a sale. See, e.g., Workmon Constr. Co. v. Weirick, supra, 223 C.A.2d at 492 (existence of option to repurchase does not indicate that a transaction is a loan); Glasgow v. Andrews, supra, 129 C.A.2d at 664 (same). Cf. Mission Hills Development Corp. v. Western Small Business Inv. Co., 260 C.A.2d 923, 927 (1968) (the price of the option may be so low as to compel its exercise and thereby suggest the overall transaction is a loan). Here, the consideration for the sale of DPIS' interest appears to be consistent with the fair market value of that interest; that fact supports our conclusion that the transaction is a sale. Compare, Abramson v. Printer's Bindery, Inc., 440 S.W.2d 326, 329-30 (Tex. Ct. of Civ. App. 1969), with, Beeler v. American Trust Co., 24 C.2d 1, 17 (1944).

Other provisions in the agreement which bear upon the position of Transamerica as purchaser and owner are summarized below:[4]

(i) Certain equipment will be "sold to TRANSAMERICA". (Paragraph 1(a).)

(ii) The invoice to Transamerica is required to include a bill of sale from Manufacturer to Transamerica. (2(c).)

(iii) All right, title and interest in the lease to which the equipment is subject and to all amounts payable thereunder are assigned to Transamerica. (2(e).)

(iv) Title passes to Transamerica upon invoicing of the equipment. (5.)

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[4] Certain other provisions of the agreement seem either awkwardly worded or unnecessary, but do not in substance affect the nature of the agreement. For example:

> Paragraph 9(b) purports to secure a security interest in favor of Transamerica in the equipment lease and rentals to secure the performance of Manufacturer's obligations under the Master Sales/Purchase Agreement. Since Transamerica is the owner of the equipment and of all rights under the lease, we are of the opinion that this provision is unnecessary. It probably was included in the agreement out of an abundance of caution to protect against the possible assertion of a claim by a trustee in bankruptcy that the transaction was not a true purchase.
>
> Paragraph 11 provides: "From time to time Manufacturer may grant to Customer with TRANSAMERICA approval an option to purchase the equipment covered by Agreement for Equipment Service." This is really an inartful way of saying that the manufacturer, with Transamerica's approval, may amend an equipment lease to add a purchase option.

(v) Manufacturer "recognizes and agrees that as between the parties hereto TRANSAMERICA is the sole owner of equipment and shall receive the full benefit of any and all investment tax credit allowable . . ." (6.) The fact that the agreement explicitly provides (in this paragraph and in the others mentioned directly above) that it is a sale and that title passes to Transamerica means that it should be treated as a sale absent compelling circumstances to the contrary. See, e.g., In re Nottingham, 6 U.C.C. Rep. Serv. 1197 (E.D. Tenn. 1969); Lyon v. Ty-Wood Corp., 5 U.C.C. Rep. Serv. 27, 29 (Pa. Sup.Ct. 1968); In re Atlanta Times, Inc., 3 U.C.C. 893, 898-901 (N.D. Ga. 1966). This principle is incorporated in the U.C.C. (§§ 2-106, 2-401), in the California Evidence Code (§ 662) and is enunciated in practically every case cited in this opinion.

(vi) The default clause in paragraph 17 provides, among other things, that if the manufacturer fails "to pay over any monthly rental charge" within 30 days of its due date and remains in default 30 days after written notice, Transamerica has the right

"(a) to proceed against the lessee,

"(b) to sue Manufacturer for and recover all charges and other payments accrued and unpaid at the time of default,

"(c) to terminate this Master Sales/ Purchase Agreement, and,

> "(d) to pursue any other remedy at law or in equity."

It could be argued that 17(b) permits Transamerica to sue the manufacturer in the event of a lessee's default, in which event manufacturer would have a limited obligation as guarantor. The president of DPIS has informed us, however, that no such thing was intended or understood as the meaning of the language referred to; all that was contemplated was that Transamerica could sue manufacturer if it failed to turn over monthly rental charges which it had collected from lessees for Transamerica's account. This understanding is supported by the further provision that Transamerica has the sole right to proceed against the customer under the equipment lease.

(viii) Paragraph 22 includes a provision that,

> "For equipment sold outright by Manufacturer after the Recapture Period, TRANSAMERICA agrees to pay to Manufacturer a sales commission equal to twenty percent (20%) of the sales price."

This seems to be an awkward way of describing a sale for Transamerica by Manufacturer as sales agent. Manufacturer clearly has no title to convey. If there were any doubt about that, it should be put to rest by the first two sentences of paragraph 24: "TRANSAMERICA may assign all of its right, title and interest under this Master Sales/Purchase Agreement. No equipment shall become the property of Manufacturer, but shall remain the property of TRANSAMERICA." Paragraph 22 also provides:

> "At the conclusion of the Recapture Period . . . TRANSAMERICA agrees to pay Manufacturer a marketing fee equal to forty-five (45%) percent of the net monthly rentals . . . earned by the equipment . . . . For this marketing fee, Manufacturer agrees to continue to furnish normal new equipment marketing and maintenance service . . . . In addition, the Manufacturer agrees to continue to provide TRANSAMERICA first priority in the Manufacturer's backlog for similar equipment."

The marketing fee would be paid only on equipment which is earning rentals after the Recapture Period. The marketing fee and the sales commission are not significant because, as noted above, there is very little market for the used equipment. If anything, the fact that Transamerica is to receive a share of the profits from the equipment (slight though they may be) tends to support construction of the agreement as a sale rather than a loan. In a loan, the lender generally receives a fixed payback (amount advanced plus interest) and does not obtain a share in further contingent profits. Golden State Lanes v. Fox, supra, 232 C.A.2d at 139; Martin v. Ajax Construction Co., 124 C.A.2d 425, 433 (1954).[5]

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[5] Provisions for sharing by the manufacturer or dealer in the residual value after expiration of the non-cancellable fixed primary lease term simply amount to a deferral of the time when the full sale price will be realized (if at all) and when realization of income is recognized. In some cases a manufacturer or dealer may realize little or no immediate income from the sale, but this does not alter the fact that the equipment has been sold.

It is our opinion that under the agreement, Transamerica has acquired title to and ownership of the equipment subject to the substantial risks of ownership.

We would hope that the accounting principles which the A.P.B. enunciates as a result of its re-evaluation of third party participation lease transactions will not give agreements such as this one, which are in economic and legal effect sales, a different cast.

Very truly yours,

McCUTCHEN, DOYLE, BROWN & ENERSEN

By Graham B. Moody, Jr.

Graham B. Moody, Jr.

COMPUTER MACHINERY CORPORATION AND SUBSIDIARIES

NOTES TO STATEMENT OF CONSOLIDATED OPERATIONS

(A) The Company manufactures equipment for sale and lease. Net sales for the year ended December 31, 1970 and the six months ended June 30, 1971 include approximately $1,828,000, and $2,384,000, respectively, relating to fixed noncancellable leases for terms of at least 36 months. All related costs less estimated residual value (approximately 10% of the cost of the related equipment) of $73,876 and $178,432 at December 31, 1970 and June 30, 1971, respectively, have been expensed. Such leases provide for full recovery of the Company's investment in the leased equipment. The amount included in sales represents the aggregate rentals due under these leases less, where applicable, unearned finance and maintenance service charges. The amounts due under such leases at December 31, 1970 and June 30, 1971 have been reflected as accounts receivable.

On leases for terms of less than 36 months, the revenues generated thereunder are recognized ratably over the term of the lease. Depreciation of rental equipment is being provided under the sum-of-the-years-digits method over an estimated useful life of five years.

The Company has entered into agreements with Transamerica Computer Company, Inc. ("Transamerica") whereby Transamerica agreed to purchase new equipment on lease together with related leases. Generally such leases are for an initial term of one year. In previously reporting the results of its operations for the two years ended December 31, 1970, the Company treated all purchases of equipment by Transamerica as outright sales. In 1971 the Company changed its method of reporting the sales of such equipment. As a result of this change in accounting, the revenues, costs and expenses related to these sales have been deferred and will be recognized in the Company's statement of operations ratably over the period in which Transamerica recovers 167% of its investment (if such equipment remains continually on rent at current rental rates, these amounts will be recognized in full by December 31, 1977).

The Company's financial statements have been retroactively restated to reflect the above change in accounting method. The effect of the change on previously reported revenues and net earnings (loss) is as follows:

	1969	1970
Revenues previously reported	$ 2,105,905	12,221,541
Adjustment	(2,059,925)	(9,017,089)
Revenues as restated	$ 45,980	3,204,452
Net earnings (loss) previously reported	$ (577,505)	1,014,187
Adjustment	(991,067)	(4,928,847)
Net (loss) as restated	$(1,568,572)	(3,914,660)
Per share:		
Previously reported:		
Earnings (loss) before extraordinary items	$(0.18)	0.18
Extraordinary items	—	0.08
Net earnings (loss)	$(0.18)	0.26
As restated	$(0.49)	(1.03)

Under the Transamerica agreements referred to above the Company is obligated for a period of approximately 10 years to use its best efforts to sell or re-lease equipment in respect of which leases have been terminated. If the Company is unable to sell or re-lease such

COMPUTER MACHINERY CORPORATION AND SUBSIDIARIES

NOTES TO STATEMENT OF CONSOLIDATED OPERATIONS (Continued)

equipment, prior to the recovery of 167% of Transamerica's cost of such equipment (approximately 72 net monthly rentals at current rental rates), the Company must offer to substitute for such equipment its own and on-lease equipment of substantially the same type and value. To facilitate such substitution the Company has agreed to eventually own, free and clear of liens and encumbrances, units of equipment up to 40% of the units purchased by Transamerica for which Transamerica has not recovered 167% of its cost. As of June 30, 1971 Transamerica had purchased $16,431,130 of equipment from the Company. As of December 31, 1970, the Company was not obligated to repurchase any of the equipment covered by the agreements; however, an amendment to the agreements dated August 25, 1971 provides for repurchase under certain conditions. (See "Business — Financing — Transamerica Agreement" elsewhere in this Prospectus).

(B) Substantially all of the amount shown as cost of sales for the six months ended June 30, 1970 represents amounts relating to the write down of customer service parts to market value and the write off of certain unallocated manufacturing costs.

(C) Included in cost of service are costs relating to the opening of service offices, training of service and other related personnel and other costs associated with the development of the Company's service capability which the Company has elected to expense as incurred.

(D) See Note 7 of Notes to Consolidated Financial Statements.

(E) The Company and its domestic subsidiary file consolidated income tax returns on a June, 30 fiscal year. The foreign subsidiaries file their income tax returns on the calendar year basis.

Deferred income taxes relate principally to the use of different methods for income tax and financial reporting purposes in accounting for sales to Transamerica, sales relating to financing leases, depreciation expense and marketing costs.

Income tax expense is summarized as follows:

	December 31, 1970	June 30, 1970 Unaudited	June 30, 1971 Unaudited
Currently payable:			
Federal	$ 270,000	—	(175,000)
State	154,775	60,000	(25,600)
Foreign	94,000	—	452,000
	518,775	60,000	251,400
Deferred — Net:			
Federal	(270,000)	—	175,000
State	(154,775)	(60,000)	25,600
Foreign	(10,000)	—	(232,000)
	(434,775)	(60,000)	(31,400)
	$ 84,000	—	220,000

(F) Loss per common share amounts are calculated using the weighted average number of shares outstanding during each period. Shares issuable upon exercise of stock options and stock purchase warrant, contingently issuable shares pursuant to the agreement described in

COMPUTER MACHINERY CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

ASSETS

	December 31, 1970 (Audited)	June 30, 1971 (Unaudited)
Current assets:		
Cash	$ 249,625	1,276,180
Receivables (Note 2):		
Trade (less unearned finance charges of $69,506 at December 31, 1970 and $190,903 at June 30, 1971)	4,909,344	3,488,754
Other	309,737	138,165
Total receivables	5,219,081	3,626,919
Inventories (Note 3)	5,322,179	7,421,657
Prepaid expenses	354,348	661,485
Total current assets	11,145,233	12,986,241
Long-term receivables (less unearned finance charges of $57,608 at December 31, 1970 and $155,643 at June 30, 1971) (Note 2)	546,532	2,107,417
Rental equipment, at cost (less accumulated depreciation of $98,190 at December 31, 1970 and $372,546 at June 30, 1971) (Notes 4 and 5)	907,996	1,819,881
Investments, at cost (Note 14)	105,072	105,072
Property, machinery and equipment, at cost (Note 5):		
Machinery and equipment	650,386	757,824
Furniture and fixtures	245,956	278,250
Leasehold improvements	126,753	161,957
	1,023,095	1,198,031
Less accumulated depreciation and amortization	123,236	209,591
Net property, machinery and equipment	899,859	988,440
Deferred charges:		
Financing costs (Note 6)	—	370,021
Marketing costs (Note 7)	1,056,717	1,495,378
Income taxes (Note 8)	360,000	156,320
Other (Note 11)	—	177,546
Total deferred charges	1,416,717	2,199,265
Other assets	135,234	277,188
	$15,156,643	20,483,504

See accompanying Notes to Consolidated Financial Statements

COMPUTER MACHINERY CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(4) Rental Equipment

See Note A to Statement of Consolidated Operations.

(5) Depreciation and Amortization

Depreciation of rental equipment has been provided under the sum-of-the-years-digits method over an estimated useful life of five years. Depreciation of machinery and equipment and furniture and fixtures has been provided by use of the straight-line method based on estimated useful lives ranging from 3 to 10 years. Leasehold improvements are amortized over the terms of the related leases.

Maintenance and repairs have been charged to expense as incurred. Betterments and renewals have been charged to the property, machinery and equipment accounts which have been relieved of the cost and accumulated depreciation with respect to items sold or otherwise disposed of; any gain or loss on dispositions is included in the Statement of Consolidated Operations.

(6) Long-Term Debt

The 7% Convertible Subordinated Notes are convertible into common stock of the Company at a price of $8 per share until April 1, 1973, and thereafter until March 31, 1977 at a price increasing by $1 per year. Accordingly, 281,250 shares of common stock are reserved for conversion. The applicable note agreements restrict the payment of cash dividends, the repurchase of common stock and the incurrence of certain indebtedness and require the Company to maintain working capital of at least $500,000 (see "Description of Common Stock — Convertible Notes" elsewhere in this Prospectus).

The notes payable to banks arose from the sale and assignment of certain equipment leases and are payable over the term of such leases, which are generally 36 months.

The long-term lease obligation relates to the sale and leaseback of certain equipment and is payable over 48 months.

The financing costs relating to the indebtedness described above are being amortized over the related terms.

The estimated amount of principal payments on total long-term debt maturing in each of the five fiscal years subsequent to December 31, 1970 is as follows:

1971	$433,000
1972	646,000
1973	515,000
1974	340,000
1975	130,000

(7) Deferred Marketing Costs

The Company defers marketing costs approximating 5% of the sales value of equipment. The deferred amounts are amortized (1) at the time ordered equipment is sold, (2) over the period in which revenues from the sales of equipment are recognized (see Note A to Statement of Consolidated Operations), or (3) over applicable lease terms.

COMPUTER MACHINERY CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIENCY)

	December 31, 1970 (Audited)	June 30, 1971 (Unaudited)
Current liabilities:		
Notes payable to banks (Note 14)	$ 2,758,349	2,540,000
Current maturities of long-term debt (Note 6)	—	613,200
Accounts payable	3,872,197	3,925,884
Accrued expenses:		
Salaries and wages	288,706	670,379
Taxes, other than income taxes	136,719	8,722
Interest	53,003	46,795
Other	151,386	71,516
Total accrued expenses	629,814	797,412
Income taxes payable (Note 8)	518,775	770,175
Total current liabilities	7,779,135	8,646,671
Long-term debt, less current maturities (Note 6):		
7% Convertible Subordinated Notes, due April 1, 1977	—	2,250,000
10% to 12% notes payable to banks	—	576,425
10¼% long-term lease obligation	—	875,359
Total long-term debt	—	3,701,784
Deferred income (Note 9):		
Income relating to sales to Transamerica	6,948,766	9,165,945
Service income	83,650	201,322
Total deferred income	7,032,416	9,367,267
Stockholders' equity (deficiency) (Notes 6, 10, 11 and 12):		
Common stock, par value $0.10 per share. Authorized 25,000,000 shares; issued 3,852,101 at December 31, 1970 and 3,876,006 at June 30, 1971	385,210	387,600
Additional paid-in capital	6,597,079	7,300,724
Notes receivable from employees for stock purchases	(1,078,660)	(1,578,795)
Accumulated deficit	(5,558,537)	(7,341,747)
Total stockholders' equity (deficiency)	345,092	(1,232,218)
Commitments and contingent liabilities (Note 13)		
	$15,156,643	20,483,504

See accompanying Notes to Consolidated Financial Statements

the month following the month in which they accrue (subject to later refund for monies not actually received by the Company), to provide periodic reporting on lease administration, and to pay for all transportation and storage charges with respect to the equipment. The fee the Company receives for such administration and service varies, but aggregates between 9% and 10% of the monthly rentals on the leases so administered.

The Company must also at its expense, for the term of the Transamerica Agreement: refurbish equipment which comes off-lease (but not update unless Transamerica pays for the costs of updating); use its best efforts to cause this equipment to be re-leased or sold; and must, in general, give first priority to re-leasing or selling Transamerica's equipment. In addition, during the recapture period for a unit of equipment (defined as that period ending when Transamerica has received rental payments on a unit of equipment equal to 167% of its purchase price, which is approximately 72 months if such equipment remains on lease continuously at currently prevailing rental rates), if the Company cannot re-lease or sell Transamerica's equipment within 90 days after it comes off-lease, the Company must at no additional cost to Transamerica offer to exchange ownership of such equipment for similar equipment, if any, which the Company owned as of July 2, 1971 and at the time of the proposed exchange has on lease to customers. The Company is required to own at all times, free and clear of all encumbrances (other than leases), an amount of equipment equal in units of up to 40% of that equipment purchased by Transamerica with respect to which the recapture period has not expired; the Company is not obligated to keep its own equipment on lease. On August 25, 1971 the Transamerica Agreement was modified in part to provide that if any of such equipment is sold or destroyed or rendered unrepairable, the Company is obligated to purchase back from Transamerica at a price determined by the amount of rentals received on such units by Transamerica similar on-lease equipment in order to maintain the same percentage of ownership as existed at July 2, 1971. The repurchase price will not be less than 50% of the price originally paid by Transamerica nor more than such original price.

After the recapture period for each unit, the Company is entitled to receive a marketing fee equal to 35% of all rentals paid thereafter, and if the Company sells such equipment, 35% of the sales price of such equipment. As of yet no such fees have been paid; if Transamerica-owned equipment remains continuously on lease at currently prevailing rentals, no such fees would be received prior to July, 1975. This right is subject to termination by Transamerica if the Company breaches any of its obligations under the Transamerica Agreement. No assurance can be given that the Company will ever receive any of such fees. The Transamerica Agreement also grants the Company for the term of such agreement the right of first refusal on any sale or lease of Key-Processing Systems owned by Transamerica.

In connection with the Transamerica Agreement, Transamerica purchased from the Company for $20,000 a warrant to purchase 200,000 shares of the Company's Common Stock at $10 per share (see "Capitalization"). In the opinion of Management, the exercise price of the warrant exceeded the market value of the Common Stock underlying the warrant on the purchase date.

New Lease Financing

The Company has entered into a Lease Financing Agreement (the "Agreement") dated as of August 30, 1971, with Security Pacific National Bank, Los Angeles, and First National City Bank, New York (the "Banks") which entitles the Company to borrow and have outstanding at any time through February 1973 an amount which does not exceed the lesser of $20,000,000 or the Borrowing Base as defined below. The Banks are not obligated to make any advances under the Agreement until the Company has raised at least $10,000,000 (determined at the public offering price, less underwriters' discount) through a public offering of its Common Stock. The Borrowing Base is determined by multiplying the aggregate monthly rentals of Eligible Equipment (defined below) by a number which is 21 during the first two months of the Agreement and thereafter decreases on a bi-monthly basis to 0 in the 37th month, at which time all borrowings outstanding will be payable in full. Although repayments of principal may be required at any time during the term of the Agreement if the aggregate principal amount outstanding exceeds the Borrowing Base, after the 18th month no further additions can be made to the Borrowing Base and thus the Company will be required then to begin repaying principal. In general, loans under the Agreement may be prepaid without penalty.

Eligible Equipment is defined as Company-owned equipment on lease to a lessee whose creditworthiness is acceptable to the Banks. No equipment can become Eligible Equipment for purposes of increasing the amount of the Borrowing Base after 18 months from August 30, 1971, and if lease payments on Eligible Equipment are in arrears more than 90 days or if Eligible Equipment remains off lease for 60 days, such equipment will be removed from the Borrowing Base.

Interest on the aggregate principal amount outstanding is at a rate of 1½% per annum in excess of the then existing prime rate. The Company is also obligated to pay a commitment fee of ½% per annum on the daily average unused amount of credit under the Agreement for the first 18 months, an agent's fee of ½% per annum on the aggregate principal amount outstanding to $10,000,000 and ¼% on the amount in excess of $10,000,000, and a deferred fee of 3% per month of one month's rent of each unit of equipment which was ever included in the Borrowing Base, payable monthly from September 30, 1974 to March 31, 1976. The Company must also maintain compensating balances with the Banks equal to 17½% of the aggregate principal amount outstanding and borrow the amounts required for such balances from the Banks at an annual interest rate of 1½% above the prime rate. Borrowings to satisfy the compensating balances requirement are in addition to the maximum of $20,000,000 of credit available under the Agreement. While the actual effective rate of interest under the Agreement is subject to the variables set forth above and cannot at this time be accurately predicted, assuming that the prime rate remains at 6%, Management believes that the effective rate will be between 10% and 13% per annum over the term of the Agreement.

The obligations of the Company under the Agreement will be secured by a security interest in substantially all of the Company's assets now owned or hereafter acquired (including all of the shares of Computer Machinery Corporation International) other than realty and other than equipment required to satisfy its obligations under the Transamerica Agreement described above.

The Company has agreed that during the term of the Agreement it will not merge or consolidate with or acquire substantially all of the assets of any entity; pay any dividends (other than stock dividends); create additional indebtedness other than indebtedness subordinate to its obligations under the Agreement; mortgage, pledge, assign, encumber or create any security interest with respect to any of its assets other than those arising from purchases in the ordinary course of its business up to $200,000 through December 31, 1971 and $700,000 annually thereafter; assume or guarantee any obligations of others, including its subsidiaries; make any loans to or acquire any securities of other corporations other than certain limited advances to its subsidiaries; dispose of any assets in excess of $100,000 per year other than in the ordinary course of business; or purchase, redeem, retire or otherwise acquire shares of stock of the Company or its subsidiaries. The Company has also agreed for the term of the Agreement to maintain on both a consolidated and unconsolidated basis a ratio of not more than 1.75 to 1 of total liabilities to tangible net worth (generally defined as equity less intangible assets plus subordinated debt, deferred income taxes and up to $10,000,000 of deferred income); maintain on an unconsolidated basis a 90 day ratio of 1.25 to 1 of cash, cash receipts and borrowings available under the Agreement to current liabilities and payments required under the Agreement; maintain a consolidated tangible net worth of at least $14,100,000 from the date of the first advance under the Agreement decreasing to $12,000,000 as of July 1, 1972; and limit consolidated net average monthly losses to $700,000 through September 30, 1971 ($800,000 on an unconsolidated basis), decreasing to $250,000 through September 30, 1972 ($200,000 on an unconsolidated basis) and maintain profitable operations after October 1, 1972 (July 1, 1973 on an unconsolidated basis). Upon the consummation of this public offering, the Company will meet the initial requirements set forth above.

The Company anticipates that it will not borrow under this Agreement until January 1972.

Foreign Operations

General

Computer Machinery Corporation International ("International") was formed by the Company as a wholly-owned subsidiary in July 1969, for the purpose of conducting the international operations of the Company.

Computer Machinery Company Limited ("Limited"), a wholly-owned (except for qualifying shares) subsidiary of International, was formed in September 1969 and is headquartered in Wembley, England. As of August 31, 1971 Limited employed 165 people. Limited began manufacturing operations in Stanmore, England in March 1970. It is currently responsible for manufacturing a majority of the KeyProcessing Systems for the Company's European operations and is responsible for marketing and service in Great Britain.

A wholly-owned (except for qualifying shares) subsidiary of International, CMC France, S.A., was formed in July 1970 and is headquartered in Versailles, France. As of August 31, 1971 this subsidiary employed 85 people. CMC France currently obtains approximately 65% of its equipment from Limited, with the balance coming principally from the Company. CMC France commenced manufacturing and assembly operations at its Maurepas plant in limited quantities in July 1971, and anticipates that by the end of the year it will be manufacturing a significant portion of its equipment.

Another wholly-owned subsidiary, Computer Machinery Deutschland, GmbH, was formed in August 1971 to conduct the Company's German operations, and is presently headquartered in Stuttgart, with a sales and service office in Munich. As of August 31, 1971 this subsidiary had 13 employees.

The Company has entered into a distributorship agreement in the Republic of South Africa and is presently examining the feasibility of extending into other foreign markets. No assurance can be given that such operations will be profitable.

At present, foreign-based manufacturing operations are dependent upon shipment of certain components from the United States. Failure of the Company or its suppliers to ship such components may impair the ability of the Company's subsidiaries to manufacture their own products.

Foreign Financing and Leases

Leases on equipment in Great Britain and Europe are generally three years or more in length and non-cancellable. The Company's subsidiaries have from time to time entered into financing arrangements to facilitate the leasing of their equipment. In France, CMC France has sold and assigned leases, at discounts on the aggregate rentals ranging from 10% to 12%, to two banks, Credit Lyonnaise and Banque Regionale D'Escompte et de Depots. CMC France guarantees the payments of rental to the banks. As of June 30, 1971, CMC France had financed an aggregate of $951,505 with these banks. The aggregate rental of the leases is

On September 9, 1969, the Company sold a nontransferable, nonqualified stock option to Mr. Dohn R. Johnson, Vice President of the Company, for an aggregate purchase price of $50.00. The option covered 3,000 shares of the Company's Common Stock and was exercisable at $5.33⅓ per share. The option was subsequently exercised in full. In the opinion of Management, the exercise price on July 1, 1969, the date of grant of the option by the Company's Board of Directors, equalled or exceeded the market value of the Company's Common Stock on such date.

The Company has from time to time paid fees and issued warrants to Sutro & Co. Incorporated (see "Underwriting").

The Company has since its formation paid legal fees aggregating $149,162 to Nossaman, Waters, Scott, Krueger & Riordan, of which Richard J. Riordan, a director of the Company, is a partner.

DESCRIPTION OF COMMON STOCK

The Company's Articles of Incorporation authorize the issuance of up to 25,000,000 shares of Common Stock, $.10 par value. The holders of Common Stock are entitled to one vote for each share held of record and to cumulate their votes in the election of directors. Such shareholders have no preemptive rights or other rights to subscribe to additional securities, have no rights to convert shares of Common Stock into other securities and have no liability for further calls or assessments. The holders of Common Stock are entitled to receive such dividends, if any, as may be declared by the Board of Directors out of funds legally available therefor, and share pro rata in any distribution to shareholders. Except for the 15,500 shares to be issued to Messrs. Carbone, Ringer and Williams (see "Certain Transactions") which, until payment in full of the related promissory notes, will not be validly issued, fully paid and non-assessable, all outstanding shares of Common Stock are, and those being offered by the Company will be upon delivery and payment therefor, validly issued, fully paid and non-assessable.

The Company will furnish to its shareholders annual reports containing certified financial statements and interim quarterly reports containing unaudited financial information. The Company's Transfer Agents are Security Pacific National Bank, Los Angeles and First National City Bank, New York City. The Company's Registrars are Union Bank, Los Angeles and Chemical Bank, New York City.

Convertible Notes

On May 5, 1971, the Company issued and sold $2,250,000 principal amount of its 7% Convertible Subordinated Notes Due April 1, 1977 (the "Notes"). The Notes are convertible into Common Stock of the Company during the life of the Notes at $8 per share until April 1, 1973, and thereafter until March 31, 1977 at a price increasing $1 per year. The Note Agreements under which the Notes were issued contain restrictions on the conduct of the Company's business, including the following: (i) the Company cannot declare or pay any dividends (other than stock dividends), or in general repurchase, redeem or retire any shares of its Common Stock, or declare any distributions in respect of its stock, unless after giving effect to the dividend or distribution, the Company's consolidated retained earnings equal at least $3,000,000, and then only to the extent of one-half of the Company's consolidated net income (excluding extraordinary items) earned after the fiscal year in which consolidated retained earnings equalled $3,000,000 (as of June 30, 1971, the Company had a consolidated retained earnings deficit of $7,341,747); (ii) the Company must maintain a net working capital of at least $500,000; and (iii) the Company cannot create, assume, or incur any indebtedness senior to the Notes (other than indebtedness relating to lease financing operations) unless, after giving effect thereto, its consolidated senior indebtedness is less than 150% of the sum of its tangible net worth, the Notes, and all indebtedness on a parity with or subordinated to the Notes. At August 31, 1971 the Company's tangible net worth, as defined in the Note Agreements, exceeded the requirements of these agreements.

UNDERWRITING

The Underwriters named below, acting through their Representatives, Merrill Lynch, Pierce, Fenner & Smith Incorporated and Sutro & Co. Incorporated, have severally agreed to purchase from the Company and the Selling Shareholders the aggregate number of shares of Common Stock set forth below opposite their respective names. The Underwriters are committed to purchase all of such shares if any are purchased. Under certain circumstances the commitments of non-defaulting Underwriters may be increased. In the event of default by the Company none of the shares of Common Stock will be sold. In the event of default by one or more of the Selling Shareholders, less than all of the shares of Common Stock may be sold.

Name	Address	Aggregate Number of Shares
Merrill Lynch, Pierce, Fenner & Smith Incorporated	70 Pine Street, New York, N. Y. 10005	262,000
Sutro & Co. Incorporated	460 Montgomery Street, San Francisco, California 94104	262,000
Blyth & Co., Inc.	14 Wall Street, New York, N. Y. 10005	18,000
Lehman Brothers Incorporated	One William Street, New York, N. Y. 10004	18,000
Stone & Webster Securities Corporation	90 Broad Street, New York, N. Y. 10004	18,000
Bache & Co. Incorporated	100 Gold Street, New York, N. Y. 10038	18,000
CBWL-Hayden, Stone Inc.	767 Fifth Avenue, New York, N. Y. 10022	18,000
E. F. Hutton & Company Inc.	One Battery Park Plaza, New York, N. Y. 10004	18,000
Shearson, Hammill & Co. Incorporated	14 Wall Street, New York, N. Y. 10005	18,000
Bear, Stearns & Co.	One Wall Street, New York, N. Y. 10005	13,000
A. G. Becker & Co. Incorporated	60 Broad Street, New York, N. Y. 10004	13,000
Alex. Brown & Sons	135 East Baltimore Street, Baltimore, Maryland 21202	13,000
Clark, Dodge & Co. Incorporated	140 Broadway, New York, N. Y. 10005	13,000
Dominick & Dominick, Incorporated	14 Wall Street, New York, N. Y. 10005	13,000
Estabrook & Co., Inc.	80 Pine Street, New York, N. Y. 10005	13,000
Equitable Securities, Morton & Co. Incorporated	65 Broadway, New York, N. Y. 10006	13,000
EuroPartners Securities Corporation	767 Fifth Avenue, New York, N. Y. 10022	13,000
Robert Fleming Incorporated	100 Wall Street, New York, N. Y. 10005	13,000
Hill Samuel Securities Corporation	375 Park Avenue, New York, N. Y. 10022	13,000
W. E. Hutton & Co.	14 Wall Street, New York, N. Y. 10005	13,000
Ladenburg, Thalmann & Co.	25 Broad Street, New York, N. Y. 10004	13,000
F. S. Moseley & Co.	60 Broad Street, New York, N. Y. 10004	13,000
Paribas Corporation	40 Wall Street, New York, N. Y. 10005	13,000
R. W. Pressprich & Co. Incorporated	80 Pine Street, New York, N. Y. 10005	13,000
L. F. Rothschild & Co.	99 William Street, New York, N. Y. 10038	13,000
Shields & Company Incorporated	44 Wall Street, New York, N. Y. 10005	13,000
F. S. Smithers & Co., Inc.	One Battery Park Plaza, New York, N. Y. 10004	13,000

ACCOUNTANTS' REPORT

The Board of Directors
Computer Machinery Corporation:

We have examined the consolidated balance sheet of Computer Machinery Corporation and subsidiaries as of December 31, 1970 and the related statements of operations, stockholders' equity and source and application of funds and changes in working capital for the period July 17, 1968 (inception) to December 31, 1968 and the two years ended December 31, 1970. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, such financial statements present fairly the consolidated financial position of Computer Machinery Corporation and subsidiaries at December 31, 1970, and the results of their operations and source and use of funds for the period July 17, 1968 to December 31, 1968 and the two years ended December 31, 1970, in conformity with generally accepted accounting principles applied on a consistent basis, as restated (see Note A to Statement of Consolidated Operations).

PEAT, MARWICK, MITCHELL & CO.

Los Angeles, California
April 14, 1971 (except as to the change in accounting method described in Note A to Statement of Consolidated Operations which is as of May 19, 1971)

PROSPECTUS

1,376,000 Shares

Computer Machinery Corporation

Common Stock
(Par Value $0.10 per Share)

THE SHARES OFFERED HEREBY INVOLVE A HIGH DEGREE OF RISK

The Company is selling 900,000 shares and certain shareholders (see "Selling Shareholders") are selling 476,000 shares. The Company will receive no part of the proceeds from the sale of shares offered by the Selling Shareholders. The Underwriters have agreed with the Company to reserve not in excess of 60,000 shares for offering at the public offering price to certain employees of the Company. Any of such shares not purchased by such employees by the close of business on the day the public offering commences will be included in the shares offered to the public; to the extent the shares reserved are purchased by employees, the number of shares available to the public will be reduced.

Prior to this offering, there has been no public market for the Common Stock of the Company and there is no assurance that a public market will develop upon completion of this offering. The offering price of the Common Stock was determined by negotiations among the Company, the Selling Shareholders and the Underwriters, and bears no relation to the operating results or book value of the Company.

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

	Price to Public	Underwriting Discount(1)	Proceeds to Company(2)	Proceeds to Selling Shareholders(2)
Per Share	$12.00	$0.84	$11.16	$11.16
Total	$16,512,000	$1,155,840	$10,044,000	$5,312,160

(1) The Company and the Selling Shareholders have agreed to indemnify the Underwriters against certain liabilities. See "Underwriting."

(2) Before deducting expenses payable by the Company estimated at $228,900 and expenses payable by certain of the Selling Shareholders estimated at $4,100.

This offering involves:

1. ***A high degree of risk concerning the Company. See "Introductory Statement" on page 3; and***
2. ***Immediate substantial dilution to the public investors of the book value of the Common Stock from the public offering price. See "Dilution" on page 4.***

The Common Stock is offered subject to prior sale and when, as and if delivered to and accepted by the Underwriters, and subject to the approval of certain legal matters by Messrs. Nossaman, Waters, Scott, Krueger & Riordan, counsel for the Company and the Selling Shareholders, and Messrs. Brown, Wood, Fuller, Caldwell & Ivey, counsel for the Underwriters. The Underwriters reserve the right to withdraw, cancel or modify such offer and reject orders in whole or in part.

Merrill Lynch, Pierce, Fenner & Smith
Incorporated

Sutro & Co.
Incorporated

September 23, 1971

IN CONNECTION WITH THIS OFFERING, THE UNDERWRITERS MAY OVER-ALLOT OR EFFECT TRANSACTIONS WHICH STABILIZE OR MAINTAIN THE MARKET PRICE OF THE COMMON STOCK OF THE COMPANY AT A LEVEL ABOVE THAT WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. SUCH TRANSACTIONS MAY BE EFFECTED IN THE OVER THE COUNTER MARKET OR OTHERWISE. SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.

THE COMPANY

INFOREX, INC. (the "Company"), a Delaware corporation, was organized on June 14, 1968 to design, develop, manufacture and market computer peripheral equipment. Since its organization, the Company has devoted its efforts primarily to its first product, the *Intelligent Key Entry System* (the "Inforex System" or the "System"), a multiple keystation, centrally-controlled, data entry system used to prepare data for computer processing.

The Company manufactures substantially all the sub-assemblies of the System. The Company shipped the first production models of the System to customers in March, 1970. Through August 27, 1971 the Company had sold or rented 473 Systems which are being used by 191 customers. An additional 55 Systems are being installed or are in transit.

From its organization through July 2, 1971, the Company incurred operating losses of $9,102,638 and during the six months ended July 2, 1971, it operated at an average loss of approximately $400,000 per month. See "Consolidated Statement of Operations". The Company's revenue is derived primarily from the rental of Systems and costs related to rented Systems must be recovered over an extended rental period. From its organization through July 2, 1971, the Company's net cash outflow was approximately $13,500,000 and the Company's present rate of net cash outflow is approximately $600,000 per month.

The Company's executive offices and manufacturing plant are located at 21 North Avenue, Burlington, Massachusetts 01803 (Tel.: 617-272-6470).

Change in Method of Accounting

On September 14, 1971, with the concurrence of its independent public accountants, the Company decided to change its method of accounting to defer revenue on its long-term leases of Systems and on its sales of Systems to Inforex Leasing Company ("Inforex Leasing"). This action was taken after the Company was advised that the Accounting Principles Board intends to issue an interpretation which, when issued, would require the Company to make this change. The Company's relationship with Inforex Leasing and the terms of the Company's sales to Inforex Leasing are described under "Business — *Sales to Inforex Leasing Company*". Under the new method, the Company will recognize revenue on long-term leases over the terms of such leases and will recognize revenue on sales to Inforex Leasing over five years. As a result of the restatement of the Company's operating results to reflect this change, the Company's previously reported losses for the year ended January 3, 1971, and the six months ended July 2, 1971, were increased from $3,434,069 to $4,074,433 and from $1,293,699 to $2,396,162, respectively. See "Consolidated Statement of Operations".

INFOREX, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED STATEMENT OF OPERATIONS
(Including notes applicable to periods not examined by independent public accountants)

(A) — Accounting for Sales and Leases

The Company manufactures equipment for sale or lease. Through January 3, 1971, substantially all of the equipment leased by the Company was leased under the Company's standard rental contract which provides for an initial term of one year and is cancelable thereafter by either party upon 90 days written notice. The Company follows the "operating method" of accounting for such leases, recognizing rental income over the lease term. During the six months ended July 2, 1971, the Company also leased certain equipment under noncancelable contracts for terms of 36 months or more. Such contracts had previously been accounted for under the "financing method" and accordingly the Company had included in sales in such six month period the aggregate rentals due under these contracts, less unearned finance income. In the accompanying financial statements the accounting for such contracts has been restated to the "operating method".

The Company also sells Systems to Inforex Leasing Company under a purchase agreement described in Note 3. In the financial statements initially released for the year ended January 3, 1971, the Company recorded as sales the full selling price of Inforex Systems sold to Inforex Leasing. This included the 20% portion evidenced by notes receivable which are payable at future dates provided the rental revenue from the equipment meets a predetermined rent quota. A reserve was provided which in management's opinion was adequate to cover future rent quota deficiencies which might arise. Subsequently, the Company retroactively adopted what was considered to be a preferable method of recording income on sales to Inforex Leasing and deferred the portion of the selling price represented by the notes receivable. The Company also retroactively adopted the practice of deferring a percentage of the gross profit recognized on sales to Inforex Leasing equivalent to the Company's percentage capital investment in the partnership's purchase price of each System.

On September 13, 1971, the Company was advised that the Accounting Principles Board of the American Institute of Certified Public Accountants intends to publish an interpretation of its Opinion No. 7 on Accounting for Leases in Financial Statements of Lessors. It is expected that such interpretation will require the Company to defer all income from its transactions with Inforex Leasing. Therefore, the Company has retroactively changed its method of accounting to defer all income from transactions with Inforex Leasing and to recognize such income in the following manner:

The cash received (80% of the selling price) at the time of transfer of equipment to Inforex Leasing is carried as Unamortized Advance Payments in the accompanying balance sheet and is being taken into income as Revenues from Inforex Leasing Company over a sixty-month period. Costs attributable to such equipment are also being amortized over a sixty-month period.

The portion represented by notes receivable (20% of the selling price) and accrued interest thereon is also being deferred to be taken into income if collected under their terms as described in Note 3.

The effect of these changes in accounting for transactions with Inforex Leasing and long-term leases on the consolidated statement of operations for the year ended January 3, 1971, and the six months ended July 2, 1971, is as follows:

INFOREX, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED STATEMENT OF OPERATIONS — Continued
(Including notes applicable to periods not examined by independent public accountants)

(A) — Accounting for Sales and Leases (Continued)

Year Ended January 3, 1971

	As Originally Reported	Effect of Deferral of A Portion of the Selling Price	Effect of Deferral of Gross Profit	As Previously Restated	Effect of Deferral of Advance Payments from Inforex Leasing	As Restated
Revenue	$ 2,854,808	$(424,528)	$(47,453)	$ 2,382,827	$(1,591,242)	$ 791,585
Net (Loss)	$(3,174,352)	$(212,264)	$(47,453)	$(3,434,069)	$ (640,364)	$(4,074,433)
Net (Loss) Per Share	$(2.55)	$(.17)	$(.04)	$(2.76)	$(.51)	$(3.27)

Six Months Ended July 2, 1971
(Unaudited)

	As Originally Reported	Effect of Deferral of Advance Payments from Inforex Leasing	Effect of Change to "Operating Method" for Long-Term Leases	As Restated
Revenue	$ 3,858,496	$(2,044,609)	$(294,398)	$ 1,519,489
Net (Loss)	$(1,293,699)	$ (979,407)	$(123,056)	$(2,396,162)
Net (Loss) Per Share	$(.96)	$(.73)	$(.09)	$(1.78)

For information with respect to accounting for sales to Randolph Boston Leasing GmbH see Note 5.

(B) — Net Loss Per Share

Net loss per share is computed based on the weighted average number of shares outstanding during each period. Common equivalent shares (outstanding stock options and stock purchase warrants) are not included in the computations since the effect would be to decrease the loss per share. Fully diluted loss per share data is not presented since the effect of contingent conversions of convertible debt or other contingent issues of stock would be to decrease the loss per share.

(C) — Amortization Relating to Stock Purchase Agreements and Stock Purchase Warrants

The Company amortized to operations the amount by which the fair value of common stock issued to employees and officers under stock purchase agreements exceeded the cash purchase price. In October 1970 the Company began amortizing to expense the fair value of stock purchase warrants issued at that time to the other partners in Inforex Leasing Company. Additional information relating to these transactions is set forth in Notes 3 and 4 to the consolidated financial statements.

(D) — Field Engineering Expenses

Field engineering expenses include the costs of installing Systems sold to Inforex Leasing. Costs applicable to such installations are not shown separately as it is not practical to determine the amounts.

The Company has not paid any cash dividends.

The results of consolidated operations for the six months ended July 2, 1971, are not necessarily indicative of the results of consolidated operations that may be expected for the entire current fiscal year.

INFOREX, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Including notes applicable to periods not examined by independent public accountants.)

NOTE 1 — *Principles of Consolidation*

The financial statements include the accounts of the Company and its three wholly-owned foreign subsidiaries, since the dates of their incorporation in 1970. All material intercompany balances and transactions have been eliminated in consolidation. The investments in subsidiaries are carried at underlying book value as shown by the accounts of the subsidiaries. The net assets ($709,178 at January 3, 1971 and $1,733,685 at July 2, 1971) and the loss from operations ($172,713 for the year ended January 3, 1971 and $360,001 for the six months ended July 2, 1971) are included at appropriate rates of exchange.

In January, 1971, the Company formed Infobond Corporation and as of July 2, 1971 owned 64% of Infobond's common stock. This subsidiary has not been consolidated since it is anticipated that the Company will become a minority stockholder as Infobond develops its own capital sources. The Company accounts for its investment in Infobond on the equity method.

NOTE 2 — *Accounting for Sales and Leases*

The Company manufactures equipment for sale or lease. Through January 3, 1971, substantially all of the equipment leased by the Company was leased under the Company's standard rental contract which provides for an initial term of one year and is cancelable thereafter by either party upon 90 days written notice. The Company follows the "operating method" of accounting for such leases, recognizing rental income over the lease term. During the six months ended July 2, 1971, the Company also leased certain equipment under noncancelable contracts for terms of 36 months or more. Such contracts had previously been accounted for under the "financing method" and accordingly the Company had included in sales in such six month period the aggregate rentals due under these contracts, less unearned finance income. In the accompanying financial statements the accounting for such contracts has been restated to the "operating method".

The Company also sells Systems to Inforex Leasing Company under a purchase agreement described in Note 3. In the financial statements initially released for the year ended January 3, 1971, the Company recorded as sales the full selling price of Inforex Systems sold to Inforex Leasing. This included the 20% portion evidenced by notes receivable which are payable at future dates provided the rental revenue from the equipment meets a predetermined rent quota. A reserve was provided which in management's opinion was adequate to cover future rent quota deficiencies which might arise. Subsequently, the Company retroactively adopted what was considered to be a preferable method of recording income on sales to Inforex Leasing and deferred the portion of the selling price represented by the notes receivable. The Company also retroactively adopted the practice of deferring a percentage of the gross profit recognized on sales to Inforex Leasing equivalent to the Company's percentage capital investment in the partnership's purchase price of each System.

On September 13, 1971, the Company was advised that the Accounting Principles Board of the American Institute of Certified Public Accountants intends to publish an interpretation of its Opinion No. 7 on Accounting for Leases in Financial Statements of Lessors. It is expected that

INFOREX, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — Continued
(Including notes applicable to periods not examined by independent public accountants.)

NOTE 2 — *Accounting for Sales and Leases* (Continued)
such interpretation will require the Company to defer all income from its transactions with Inforex Leasing. Therefore, the Company has retroactively changed its method of accounting to defer all income from transactions with Inforex Leasing and to recognize such income in the following manner:

The cash received (80% of the selling price) at the time of transfer of equipment to Inforex Leasing is carried as Unamortized Advance Payments in the accompanying balance sheet and is being taken into income as Revenues from Inforex Leasing Company over a sixty-month period. Costs attributable to such equipment are also being amortized over a sixty-month period.

The portion represented by notes receivable (20% of the selling price) and accrued interest thereon is also being deferred to be taken into income if collected under their terms as described in Note 3.

The effect of these changes in accounting for transactions with Inforex Leasing and long-term lease contracts on the consolidated statement of operations for the year ended January 3, 1971, and the six months ended July 2, 1971, is as follows:

Year Ended January 3, 1971

	As Originally Reported	Effect of: Deferral of A Portion of the Selling Price	Effect of: Deferral of Gross Profit	As Previously Restated	Effect of Deferral of Advance Payments from Inforex Leasing	As Restated
Revenue	$ 2,854,808	$(424,528)	$(47,453)	$ 2,382,827	$(1,591,242)	$ 791,585
Net (Loss)	$(3,174,352)	$(212,264)	$(47,453)	$(3,434,069)	$ (640,364)	$(4,074,433)
Net (Loss) Per Share	$(2.55)	$(.17)	$(.04)	$(2.76)	$(.51)	$(3.27)

Six Months Ended July 2, 1971 (Unaudited)

	As Originally Reported	Effect of: Deferral of Advance Payments from Inforex Leasing	Effect of: Change to "Operating Method" for Long-Term Leases	As Restated
Revenue	$ 3,858,496	$(2,044,609)	$(294,398)	$ 1,519,489
Net (Loss)	$(1,293,699)	$ (979,407)	$(123,056)	$(2,396,162)
Net (Loss) Per Share	$(.96)	$(.73)	$(.09)	$(1.78)

For information with respect to accounting for sales to Randolph Boston Leasing GmbH see Note 5.

INFOREX, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEET
January 3, 1971 and July 2, 1971
ASSETS

	January 3, 1971	July 2, 1971 (Unaudited)
CURRENT ASSETS:		
Cash	$ 299,211	$ 793,030
Accounts receivable —		
Trade, net of $18,000 reserve for doubtful accounts at July 2, 1971	332,423	574,189
Inforex Leasing	729,982	300,495
Employees	77,700	60,095
Inventories, at the lower of cost (first-in, first-out) or market (Note 8) —		
Raw materials and finished parts	1,358,330	1,493,602
Work in process	846,648	1,596,374
Prepaid expenses	168,358	326,961
Total current assets	$3,812,652	$ 5,144,746
INVESTMENT IN INFOREX LEASING, at cost plus equity in net income (Note 3)	$ 133,073	$ 306,081
NOTES AND ACCRUED INTEREST RECEIVABLE FROM INFOREX LEASING	$ 424,528	$ 1,026,331
Less — Unearned portion (Notes 2 and 3)	(424,528)	(1,026,331)
	$ —	$ —
RENTAL EQUIPMENT, at cost (Notes 5 and 9)	$1,660,652	$ 3,660,913
Less — Accumulated depreciation	71,924	307,599
	$1,588,728	$ 3,353,314
PROPERTY AND EQUIPMENT, at cost (Note 9):		
Machinery and equipment	$ 622,767	$ 935,016
Furniture and fixtures	73,876	125,789
Leasehold improvements	84,944	125,547
	$ 781,587	$ 1,186,352
Less — Accumulated depreciation and amortization	56,802	112,449
	$ 724,785	$ 1,073,903
COST ATTRIBUTABLE TO SYSTEMS TRANSFERRED TO INFOREX LEASING, net of amortization of $35,442 at January 3, 1971 and $198,309 at July 2, 1971 (Notes 2 and 3)	$ 950,878	$ 1,912,499
OTHER ASSETS:		
Deferred debt expense, net of amortization	$ —	$ 60,060
Investment in Infobond Corporation, at underlying book value (Note 1)	—	32,053
Other	—	14,365
	$ —	$ 106,478
	$7,210,116	$11,897,021

The accompanying notes are an integral part of these financial statements.

INFOREX, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

January 3, 1971 and July 2, 1971

LIABILITIES AND STOCKHOLDERS' INVESTMENT

	January 3, 1971	July 2, 1971 (Unaudited)
CURRENT LIABILITIES:		
Notes payable — banks (Note 5)	$1,700,000	$ 2,900,000
Lease obligations, current portion	—	39,446
Accounts payable	1,129,478	1,210,986
Accrued expenses —		
Payroll and commissions	111,837	191,632
Taxes, other than Federal income taxes	68,676	60,056
Other	45,463	10,035
Total current liabilities	$3,055,454	$ 4,412,155
UNAMORTIZED ADVANCE PAYMENTS ON SYSTEMS TRANSFERRED TO INFOREX LEASING (Notes 2 and 3)	$1,638,695	$ 3,659,541
NOTES PAYABLE (Note 3)	$ 133,073	$ 206,454
6% CONVERTIBLE SUBORDINATED DEBENTURES (Note 5)	$ —	$ 3,250,000
LEASE OBLIGATIONS (Note 5)	$ —	$ 247,668
COMMITMENTS (Note 6)		
STOCKHOLDERS' INVESTMENT (Notes 3, 4 and 5):		
Common stock $.25 par value —		
Authorized 5,000,000 shares at both dates		
Outstanding 1,348,705 shares at January 3, 1971 (excluding 1,725 treasury shares) and 1,345,105 at July 2, 1971 (excluding 5,325 treasury shares)	$ 337,176	$ 336,276
Capital in excess of par value	8,752,194	8,887,565
Retained earnings (deficit)	(6,706,476)	(9,102,638)
	$2,382,894	$ 121,203
	$7,210,116	$11,897,021

The accompanying notes are an integral part of these financial statements.

Financing Arrangements

The Company has entered into a Financing Agreement dated as of September 1, 1971 (the "Agreement") pursuant to which the Company is entitled to borrow up to the lesser of $8,000,000 or a Borrowing Base described below to finance the Systems manufactured by the Company and leased to customers. Under the Agreement, The First National Bank of Boston acts as Agent for itself and for The Chase Manhattan Bank N.A. and State Street Bank and Trust Company. All loans from the banks are secured by a security interest in all Systems owned by the Company and located in the United States and by an assignment of all related rental contracts. The Company's present indebtedness to these banks will be repaid from the proceeds of the offering made hereby.

A copy of the Agreement as executed has been filed as an Exhibit to the Registration Statement of which this Prospectus is a part. The following statements summarize certain provisions contained in the Agreement and are subject to the detailed provisions of the Agreement, to which reference is hereby made for a complete statement of such provisions.

The Company is entitled to borrow and have outstanding at any time an amount which does not exceed the lesser of $8,000,000 or the Borrowing Base. The Borrowing Base is an aggregate of base amounts determined for each System securing the loan and on rent to an approved customer under an approved rental agreement. The base amount for each System equals the first 12 months' rental for such System, reduced by 1/36 each month for 36 months after the date of the first acceptance of such System by a customer. Any System off rent for 60 days is removed from the Borrowing Base until placed on rent again. If the Agreement had been in effect, the Borrowing Base at August 27, 1971 would have been approximately $1,326,000. All loans from the banks bear interest at a rate 2% over the prime interest rate prevailing from time to time. The Company is required to pay a fee of ½% per annum of the loaned amount to the Agent. The banks are also entitled to a commitment fee of ½% per annum on the difference between $8,000,000 and the loaned amount. Each borrowing from the banks is payable in 36 equal monthly installments. However, if in any 90-day period the aggregate monthly rental of Systems included in the Borrowing Base under leases terminated in such period is greater than an amount equivalent to the aggregate monthly rental of Systems sold or put on lease during such period, monthly amortization of loans outstanding will be doubled and the Company will not be entitled to borrow additional funds under the Agreement.

The Agreement also provides for a number of negative covenants. The Company may not pay any cash dividends, and neither the Company nor any domestic subsidiary may make additional borrowings except as follows: up to $1,000,000 of long-term indebtedness; indebtedness subordinated to bank debt; and indebtedness, not exceeding $2,080,000 in the aggregate, to The St. Paul Leasing Company and United States Leasing International, Inc. for capital contributions to Inforex Leasing. The Agreement limits mortgaging or pledging of the assets of the Company and domestic subsidiaries and prohibits them from entering into sale and lease-back agreements. The Company and all subsidiaries are prohibited from disposing of any of their assets (except in the ordinary course of business). In addition, the Company may not make any amendments to the Inforex Leasing Partnership and Purchase Agreements or repurchase any Systems sold to Inforex Leasing, except the Company may repurchase up to $100,000 of Systems in any twelve month period and may repurchase Systems for resale. The Company also agrees to maintain consolidated net working capital of not less than $3,000,000, consolidated current assets of at least 1.8 times consolidated current liabilities, a one-to-one ratio of consolidated unsubordinated liabilities, not including deferred federal income taxes, to the sum of consolidated tangible net worth, consolidated subordinated debt and 40% of deferred income or its equivalent on transactions with Inforex Leasing and a one-to-one ratio for the Company and domestic subsidiaries of consolidated unsubordinated liabilities to the sum of consolidated tangible net worth, subordinated debt and 40% of deferred income or its equivalent on transactions with Inforex Leasing.

The Agreement is terminable either by the banks or by the Company once each year on 90 days notice. In the event of any such termination outstanding balances will continue to be amortized in accordance with the amortization schedule. In addition, in the event of default by the Company the banks have the right to accelerate the maturity of the loans.

In May 1971 the Company and its German subsidiary (the "Subsidiary") entered into an arrangement with Randolph Boston Leasing GmbH ("RBL") under which RBL has purchased from the Subsidiary Systems having an aggregate purchase price of DM 1,118,000 (approximately $300,000). The Subsidiary is required, within 12 months after the date of this Prospectus, to offer to RBL for purchase additional Systems having an aggregate purchase price of at least DM 2.2 million (approximately $645,000). RBL is not required to purchase the Systems offered to it. The Subsidiary is required to lease back from RBL, for a four-year term, all Systems purchased by RBL. The Subsidiary may offer RBL a System only if the System is in Germany and is the subject of a sublease agreement between the Subsidiary and a customer whose credit has not been disapproved by RBL and which agreement (i) has at least 10½ months of its term remaining at the time the System is sold to RBL and (ii) provides a monthly rental at least equal to the monthly rental to be paid by the Subsidiary to RBL for the System under the lease-back agreement. If a sublease is terminated for any reason before the expiration of the four-year term of the lease-back agreement, the Subsidiary is required either to (1) substitute a new sublease agreement meeting the tests set forth above, (2) take back title to such System and sell to RBL and lease back another System under a sublease which meets the above requirements, or (3) to purchase such terminated System from RBL. After the four-year period of the lease-back, the Subsidiary has no obligation under the agreement but may arrange a sale of the System, in which case it receives 75% of the purchase price, or may arrange a lease for the System, in which case it receives 75% of the income from such lease. The Company has guaranteed the obligations of the Subsidiary under the foregoing arrangement.

The Company intends, subject to the ability of the Subsidiary to keep a satisfactory sublease in effect, to recognize the profit on sales of Systems to RBL over the four-year lease period.

EDISON ELECTRIC INSTITUTE
90 PARK AVENUE • NEW YORK 10016 • (212) 986-4100

October 1, 1971

Mr. Richard C. Lytle, Administrative Director
Accounting Principles Board
American Institute of Certified Public Accountants
666 Fifth Avenue
New York, New York 10019

Dear Mr. Lytle:

The Edison Electric Institute submits for your consideration the attached memorandum with respect to Proposed Changes in Accounting of Lessees and Lessors.

The Institute also requests time to present a brief oral statement and to respond to questions with respect to the written memorandum at the public hearing to be held on October 14 and 15 in the offices of the Accounting Principles Board.

Sincerely yours,

W. Donham Crawford

W. Donham Crawford
President

Attachment

MEMORANDUM OF EDISON ELECTRIC INSTITUTE
on
Proposed Changes in Accounting of Lessees and Lessors

to the

ACCOUNTING PRINCIPLES BOARD
of the
American Institute of Certified Public Accountants

As an organization whose membership has become increasingly involved in leasing portions of its plant and equipment, the Edison Electric Institute has a practical interest in the proposals that have been made for changes in the accounting for leases. Although the accounting of our members is prescribed by various regulatory authorities, those authorities are influenced by the pronouncements of the Accounting Principles Board which may have a detrimental effect upon the financial statements of the utilities in the financial community.

If utilities were required to capitalize leases, the effect would also be detrimental and because of the very large financing problems faced by the industry in meeting its legally imposed obligations to serve its customers, we must strongly oppose any such requirement that does not meet any need, consistently applied, of meaningful financial statements. We think that the need for capitalization has not been demonstrated and that some proposals under consideration are not consistent with each other and with the reporting of liabilities in other areas.

We, as an industry group, are not directly concerned to any significant degree with the accounting problems of lessors; however, we are greatly concerned with any theory that accounting principles established to allocate the income of lessors properly between periods should govern the reporting of assets and liabilities by lessees. To apply the solution of one problem to another problem may result in absurdities, as would be the case if the characteristics which make a lease a "financing lease" or not a financing lease for the lessor were to govern capitalization by the lessee. Although the purpose of this hearing is to help determine those characteristics, it appears to be suggested that, for example, if a building were leased from a financial institution the lessee should capitalize the lease and report a very large liability, whereas, if the lessor were a real estate operator the lessee need not capitalize and need not record any liability although his rentals might well be larger in the second case than in the first. This invites the question of what is a liability and what is the purpose or use of reporting liabilities. Other examples could be given, in which the characteristics that are proposed for making a lease a "financing lease" for a lessor seem to have little or nothing to do with liability on the part of a lessee. It should be clear that interdependence of accounting is not the proper basis for the establishment of generally accepted accounting principles.

There are many indications that the pressure for capitalization of leases is fueled by a purpose of requiring lessees to report a liability. The American Institute of Certified Public Accountants has established a Study Group under the chairmanship of Robert M. Trueblood to refine the objectives of financial statements. Its charter stresses, among other things, that consideration is required of criteria to determine what resources and obligations should be recorded. It seems to us that if the AICPA recognizes the need for establishment of objectives in this area, and our comments on interdependence of accounting of lessors and lessees suggest that some confusion does indeed exist, false starts and wrong turnings are invited by attempts to establish rules before it has been determined what purpose they are intended to serve.

We think one of the major determinations that will have to be made by the AICPA's Study Group is with regard to the relationship between commitments and obligations to be recorded. We think that many leases which meet some of the criteria for capitalization proposed in the memorandum of Proposed Changes in Accounting of Lessees and Lessors are commitments and should be reported by the means appropriate to commitments. Electric utilities have many large commitments, greater in many cases than their commitments under leases, and we think it is pertinent to ask what purpose is served by reporting one but not the other as a liability. One, as much as the other, will impose a demand on the company's resources over a period of time.

The use of the phrase "in substance an installment purchase" is one of the principal factors in the controversy over leases because it fosters proposals to establish accounting rules for one thing on the basis that it is "in substance" something else. On that basis if an electric utility should enter into a long-term firm contract for a supply of coal it could be proposed that "in substance" it has purchased a coal field and a mining plant, or a portion of each, and should record an installment purchase.

Instead of coal the utility could burn natural gas, entering into a long-term firm contract for gas which the supplier might deliver at the burners of the boilers. Payment would be based on the BTU content of the gas and in effect the utility would be paying for BTU's. Under present accounting rules no liability would be recorded. Instead of gas the utility might turn to nuclear fuel and enter into a long-term firm contract for another party to own and furnish the nuclear material, payment being made on the basis of BTU's of heat produced in the reactor. This seems to be the same thing as another party furnishing BTU's of heat by means of gas and should not require the recording of a liability. If that arrangement could not be made, the utility might lease the nuclear fuel and pay rent on the basis of BTU's. This seems scarcely distinguishable from paying for BTU's without leasing but under some proposals the utility would have to capitalize the lease and record a very large liability. This might have such an unfavorable effect on its balance sheet that the utility would be discouraged from using nuclear fuel, and a choice possibly having important economic and environmental consequences might be determined on the basis of rules requiring capitalization of leases.

If utilities were required to capitalize leases, one result, in addition to any effect on net income, would be to segregate an assumed interest component of the rent, which would be required to be reported "below the line" and would not be recoverable as an operating expense. This could be a severe blow unless the capitalized amount were allowed as part of the rate base. Whether the regulatory commissions would require or permit one without the other is not predictable at this time. It is possible that they would not permit capitalization and would require published financial statements to conform with the prescribed systems of accounts. We think that because of the possible effect of any requirement of capitalization of leases on both net income and on the presentation of expenses in financial statements explicit recognition should be given to applicability of the statement of the Accounting Principles Board cited in the addendum to Opinion No. 2.

Opinion No. 5 of the Accounting Principles Board, which bases capitalization of leases on criteria of material equity, seems to us to encompass the cases of leases which are clearly installment purchases and we think that there should be no increase in the scope until there has been a more general determination of the objectives and the criteria to be applied in recording liabilities.

October 1, 1971

The Financial Analysts Federation

Tower Suite, 219 East 42nd Street, New York, N. Y. 10017, (212) 687-3882

October 8, 1971

TO: Committee on Accounting for Leases by Lessees
and
Committee on Accounting for Leases by Lessors
of the
Accounting Principles Board

SUBJECT: Proposed Changes in Accounting of Lessees and Lessors

PURPOSE: Position of the Financial Analysts Federation

1. Scope of the FAF Position

The Federation position pertains specifically to the Draft Opinion on Accounting for Leases by Lessees sections 4c, 8a, 8b, 8c, and 9f. Additionally, it makes general recommendations applicable throughout its text to interpretation of the opinion.

2. Accounting Principles

2.1. General

The Federation believes that proper accounting for leases under generally accepted principles should be reflected in the financial statements as follows:

- Balance sheets of lessees and lessors should include the substantive arrangements between parties rather than the legal form (particularly on third party leases).
- Future obligations arising from leases and capitalized should be stated on equivalent terms to other types of capital.
- The appropriate capitalization rate used to value lease obligations at the time of capitalization should reflect total company credit circumstance and differences between leasing and other types of obligations.
- Consistent and comparable application of these principles should apply equally to lessees and lessors.

2.2. Comparability

To the extent that lease obligations constitute an alternative form of capital, comparability and consistency require published financial statements disclosing economic ownership and obligations rather than legal forms. The same principles that govern reporting of equivalent alternative forms of capital should govern reporting of lease obligations.

2.3. Form of Presentation

2.31 Financial Statement

The application of the principles must be made to lessors as well as leasees. Consistently applying the general principles recommended would avoid ambiguity arising from such situations as paragraphs 8a or 8b of the draft opinion where disclosure requirements for leases are less stringent than those of direct debt obligations.

Capitalization rates used to define stated lease values should be disclosed in the balance sheet. Contingent payments and/or contract provisions should be noted. Estimated future obligations when reported should note the method used for estimation.

2.32 Income Statement

The same comparability cited above should apply to the accounting for gains and losses in leasing transactions as well as for annual charges to income.

3. Disclosure

We believe the financial statements should disclose all material information regarding lease obligations including rates used for capitalization and salvage value. Segregation of direct and indirect obligations in the balance sheet and income statement with supporting notation for contingencies and estimation procedures is appropriate. While management determines the foregoing, procedures should be reviewed by independent auditors for consistency and suitability.

4. Conclusion

The draft opinion is considerably more suited to the requirements of financial analysts than APB Opinion 5 and the sections of APB Opinion 7 and APB Statement No. 4 which it amends. However, it is not sufficiently definitive in the respects cited to eliminate significant inconsistencies between companies and industries. We would like to emphasize our interest in the treatment of third-party leases. These have the greatest potential for abuse. The standards of risk-reward responsibility should be liberally interpreted so that new loopholes are not created. Since such inconsistencies can lead to inappropriate value judgments regarding company securities and therefore to inefficient allocation of resources in the economy, we believe there is sufficient reason to make lease reporting requirements more stringent and comparable than called for under present provisions of the draft opinion.

Financial Accounting Policy Committee
Sub-Committee on Accounting for Leases
David A. Baker, C.F.A., Chairman
For the full Committee:
Frances Stone, C.F.A. Chairman

October 1, 1971

COMMITTEE ON CORPORATE REPORTING
FINANCIAL EXECUTIVES INSTITUTE

Presentation of Views
at
Public Hearing on Accounting for Leases
held by
Accounting Principles Board
October 14-15, 1971

The Committee on Corporate Reporting of the Financial Executives Institute welcomes the opportunity to present its views on proposals for certain changes in the Opinions of the Accounting Principles Board of the American Institute of Certified Public Accountants relating to accounting by lessors and lessees. The proposed changes could have very material effects not only on lessors and lessees but on the entire economy, and we believe that careful consideration should be given both to what changes might be made and to whether any changes should be made.

We have reservations about the desirability of establishing principles governing the accounting for certain named classes of transactions, such as "financing type" and "in substance installment purchases of property" and then, at a later date, expanding the scope of those names. There is some danger that the expanded scope may be accepted as appropriate to the name without sufficient regard for the basis for the original application of the principles. We think that generally accepted accounting principles cannot usefully be established without reference to objectives and that the application of any principle to a particular case requires consideration of whether the appropriate objective thereby will be attained. Marshall S. Armstrong, President of the AICPA, announced on April 5, 1971, the appointment of a Study Group on Objectives of Financial Statements. The charter of this group emphasizes the importance of objectives and includes the following statement:

> "The study will require consideration of criteria for determining what resources and obligations should be recorded, when they should be recorded, how they should be measured, and how the changes in recorded amounts should be reported. The study should distinguish between objectives and mechanisms for achieving objectives."

In view of this clear evidence that the leadership of the AICPA believes that a study is required to determine, among other things, what resources and obligations should be recorded, a valid question may be raised (without implying any subordination of the function or authority of the Accounting Principles Board) as to whether it may not be premature and less than orderly for another organ of the AICPA to proceed independently and without awaiting the result of the study to consider the establishment of new criteria in areas in which there are established criteria. To our knowledge, current lessee accounting practices have not caused any significant reporting problems that would require immediate action on the part of the APB. We think that the conclusions of the Study Group should be awaited in order that the further development of accounting principles, especially in so highly controversial a field as the accounting for leases, may be based on agreed objectives, and the following presentation of our views on the proposed changes is subject to that basic caveat.

Although the APB Committees on Accounting for Leases have attempted to limit the scope of the inquiry by excluding, among other things, the substitution of disclosure for capitalization and the accounting for executory contracts generally or commitments generally, we cannot accept those liminations because we think it is necessary to present them as alternatives to some of the proposed changes.

With regard to interdependence of lessee and lessor, the question that has been posed, "whether the same characteristics that make a lease a financing lease of a lessor also make it in substance an installment purchase of a lessee," is premature and, in any case, unnecessary. The Memorandum of Proposed Changes which contains over seven pages of questions and discussion directed toward determining what is a financing lease, and to ask, before a decision on that point has been made, whether the same characteristics that make a financing lease also make an installment purchase and, inferentially, should govern the accounting of the lessee, suggests a disposition to establish generally accepted accounting principles without due consideration of objectives.

Since there are so many open questions, we can only base our comments on the criteria for financing leases set forth in Opinion No. 7, and on that basis we think that the criteria that may be controlling for the lessor should not be controlling for the lessee. Among the criteria established for financing leases in Opinion No. 7 are that the lessor recovers his capital cost, that he receives no more than a reasonable return on his investment, and that all or most of the usual ownership risks and rewards are passed to the lessee. These characteristics imply a lease for substantially the full useful life of the property. We submit that these characteristics have little to do with the reasons for recording assets and liabilities in the balance sheet of the lessee, which is the real point of the debate over "installment purchase."

Whether an asset is regarded, philosophically, as an item of value or as a deferred charge to income, the character of a lease on the books of the lessee is not affected by whether or not the lessor recovers his investment, whether he receives a reasonable or unreasonable return on his investment, whether the lessee assumes a risk, or whether the term of the lease approximates the full useful life of the leased property or is for only half that long. Similarly, the lessee's liability, if any, is unaffected by these factors. If a lessee signs a lease for a rent of $100,000 a year, for example, it would seem illogical to say that he must immediately record a liability of $1,250,000 if the lease is for thirty years, but need not record any liability at all if a lease of the same property were for only twenty years, or to say that he must record a liability of $1,250,000 if the property is expected to be worthless at the end of the lease but need record nothing if the property is expected to have substantial value to the lessor at that time.

The reason for these contradictions was well indicated in Opinion No. 7 when the Board stated that in that Opinion it was dealing with the problem of allocating the revenues and expenses of lessors to accounting periods. That was a specific objective and it should not be at all surprising that the criteria that might serve that objective might have nothing to do with the different objective of presenting financial position in the balance sheet of the lessee. Generally accepted accounting principles should be established to serve defined objectives. If this results in symmetry in accounting by two parties to the same transaction in some cases, well and good, but if difference in objectives results in difference in accounting, no disquiet should be felt. We think that interdependence of accounting by lessors and lessees is irrelevant and that any attempt to determine one by reference to the other may result in error.

With regard to definition of a lease that is in substance an installment purchase of an asset, it is possible that too much unthinking acceptance has been given to that phrase. There is no question that substantial equivalence to purchase is true of some so-called leases. For example, when rent payments are inordinately high over the first five years, and very low or nominal over the remaining useful life, which may be fifteen years. However, some persons, including those who would discard material equity as a criterion, would expand the scope of the phrase to include leases in which the rents remain level over the entire useful life of the property and there is no provision for passing title to the lessee at any time. We think that it is fair to ask those people what they mean by "substance." Why would it not be equally reasonable to say that when the payments under a so-called installment purchase contract remain level over the expected full useful life of the property, the arrangement is in economic substance a lease? There is a very wide range of provisions for payment under both installment purchase contracts and leases, but we think that, as a general rule, payments under installment purchase contracts tend to be limited to a period substantially less than the expected useful life of the property, while under leases the payments tend to remain level over the entire useful life or to correspond to expected changes in the usefulness of the property. Therefore, we think that the payment schedule is an important part of the substance and that arrangements which purport to be leases should be accepted and accounted for as such unless the terms of the lease create a material equity in the lessee as defined in Opinion No. 5. We think that the conditions contained in paragraph 11 of Opinion No. 5 should continue to be regarded only as supplementary indications when there is some question of material equity.

A principal objective of some who urge the equivalence of leases and installment purchases is to require a liability to be recorded in the balance sheet of the lessee, but we think that this misinterprets both the nature of a liability and the function of the balance sheet. A lessee does not have a present liability because rents become payable only period by period and then only if the lessor performs his express or implied covenants of giving quiet enjoyment and furnishing whatever services he may be required to furnish under the lease. The lessee does not have a fixed liability because in the event of bankruptcy or reorganization his liability under a lease might be greatly limited, and it is the liability under those circumstances rather than the liability when all is well that is of concern to creditors and investors.

If the liabilities recorded in the balance sheet are looked to not as an indication of the amount payable in the event of financial difficulty, but as an indication of whether a company's commitments might lead to that condition, it must be considered that the commitment under leases may be a relatively small part of a company's commitments under executory contracts. Contracts for purchase of materials and services may involve very large amounts, often much larger than the commitments under leases. Many of them are firm and even if it should be argued that they are not altogether firm because it is theoretically possible that the other parties will default, this would only mean in most cases that similar contracts would have to be entered into with other parties because the materials or services are essential to the company's continued operation.

Therefore, if the balance sheet is to be looked to as a source of information regarding future cash flows and demands upon a company's revenues, it would be necessary for it to include not only all substantial commitments in the usual sense, but other demands, such as labor, that may be fixed with regard to price, if not with regard to quantity, by binding agreements. In this connection, it may be pointed out that railroads, as one example, have had a very serious problem with contracts or customs which have had the effect of fixing the "quantity" of labor. These executory contracts and other commitments are not now reported in the balance sheet and there is little prospect that they will be. Even if they were, they would reflect the commitments for such varying periods that the amount reported would be an incommensurable jumble that would be meaningless without detailed analysis of information that hopefully would be supplied in the footnotes. It is clear that the disclosure of future cash flows is not the proper or possible function of the balance sheet.

The proper place for disclosing commitments and their effect on cash flows is in the footnotes or in schedules supplementing the financial statements. Acceptance of this principle would make unnecessary most of the tortuous debate over what characteristics of a particular lease may be seized upon to construe it as "in substance an installment purchase." A characteristic of all great principles is their simplicity; when it becomes necessary to patch and shore them up, when it becomes necessary to deal with one thing by saying that it is in substance something else, it is usually an indication that something has gone wrong. When that happens it is advisable to stop and reconsider the objective.

We think that in the case of leases the objective is to disclose the demands that may be made upon a company's resources in the future, not what the company's liabilities would be if it were to be liquidated today. If that is so, we are dealing with a commitment and for the reasons stated above we think that commitments cannot be shown meaningfully in the balance sheet; however, they can and should be disclosed adequately in the footnotes or in supplementary schedules.

Repeated readings of the Memorandum of Proposed Changes reinforce a feeling that consideration of the matter is being, or may be, approached as an academic exercise without regard for the practical consequences. To base a requirement to record or not to record a so-called liability of possibly millions of dollars on such accidents as whether a lease is with a financial institution or not with a financial institution, whether the residual value of the leased property is estimated to be more or less than 10% of its cost, etc., may be acceptable as a method of wrapping up an accounting problem in a neat package, but becomes unacceptable when viewed in relation to the seriously detrimental effect on many enterprises and the public interest.

Bond indentures and credit agreements often impose restrictions on the amount of debt that may be incurred, the ratio of debt to equity capital, interest coverage, etc. In some cases provision is made for the effect of leases, but in others it is not and in the latter cases a change in accounting that would make leases similar to debt might create very serious difficulty, ranging from limitations on additional debt to, in some cases, immediate default with a possible minimum consequence that the lender might have the power to force a renegotiation of terms. Regulatory authorities consider the same factors in passing on applications for the issuance of new debt and equity securities. Other effects would be felt in taxes based on reported assets and liabilities and situations in which rents, but not interest, are directly recoverable expenses. Lenders and security analysts are influenced to some degree by the reported amounts of liabilities without looking behind them for what they represent. In many of these cases, but not all, the parties could agree to treat leases as other than debt regardless of how they are reported, just as they have the contrary power now, but reported amounts have a presumptive effect that is often difficult to overcome, especially when the presumption favors one party.

The effects of treating leases as debt would extend beyond lessees to consumers and other parts of the economy. Increases in reported debt would tend to lead to an increase in interest rates and require an increased investment of equity capital requiring an even greater rate of return. This could contribute to inflationary pressures and act as a deterrent to investment in modernized or expanded plant and equipment. These considerations affecting the public interest make it important to be sure that accounting changes are directed toward sound objectives.

We think that no changes are necessary in the provisions of Opinion No. 5 relating to the capitalization of leases on the basis of material equity. We think that the present provisions identify the true cases of equivalence to installment purchase and that expansion would invade the area of commitments, both as they relate to liabilities and as they relate to assets. In our opinion, commitments can and should be disclosed by footnotes to the financial statements and, where appropriate, in supplementary schedules.

In essense, we endorse the statement of the American Petroleum Institute*:

> "If assets included in balance sheets are based on legal ownership and liabilities represent claims thereto, then leases do not result in asset acquisition, but rather are commitments which under current accounting principles, give rise to neither assets nor liabilities. If, on the other hand, assets are defined in more subjective economic terms, then leases are only one of many items not presently reflected in the balance sheet which should be included."

*Excerpt from API letter of December 30, 1970 to AICPA.

FIRSTBANK FINANCIAL CORPORATION

Affiliated with

THE FIRST NATIONAL BANK OF BOSTON

September 30, 1971

Mr. Richard C. Lytle
Administrative Director
Accounting Principles Board
American Institute of Certified Public Accountants
666 Fifth Avenue
New York, New York 10019

Dear Mr. Lytle:

We have studied at great length the proposed changes in Accounting for Leases and plan to have representatives in attendance at the hearings on October 14 and 15, 1971. It is not our intention to outline in detail in this letter our objections in the changes proposed as we feel there are many in the leasing industry that are covering this subject in considerable detail. Our position has been to discuss many of these points with senior accountants throughout the country expressing our opinions quite candidly.

We are in full agreement that disclosure on the balance sheet must be set forth in proper detail so that an adequate credit analysis is available. However, our opinion is that your concern for proper disclosure should not lead you into the area of capitalizing every executory contract that exists in our business world today. We think your statement that every lessee dealing with a financial institution that is engaged in leasing automatically disqualifies the transaction as a lease, is not a proper position for the Principles Board to take. The 1970 One-Bank Holding Company Act passed by Congress permitted the banking industry to continue in the leasing area, and it does not now appear that actions by the accounting fraternity should create considerable obstacles for us to compete in this type of financing. We again would like to emphasize that we fully support the disclosure of leases, and the proper accounting for any instrument that is not legally considered a lease.

A copy of my letter is being forwarded to all members of the Accounting Principles Board so that they are fully aware of our position on this most important subject.

Very truly yours

George E. Phalen

George E. Phalen
President

100 FEDERAL STREET, BOSTON, MASSACHUSETTS 02110 TELEPHONE (617) 434-4033

GREEN CONSTRUCTION COMPANY
General Contractors
1321 WALNUT STREET, DES MOINES, IOWA 50309, PHONE 244-7251

September 23, 1971

Mr. Richard C. Lytle, Administrative Director
Accounting Principles Board
American Institute of Certified Public Accountants
666 Fifth Avenue
New York, New York 10019

Dear Sir:

It is our understanding that your Board will soon hold hearings on "Opinion No. 5--Reporting of Leases in Financial Statements of Lessees."

Our Company performs an annual construction volume varying from, say, \$35 million to \$60 million, depending upon the contractor's organization and nature of contract, viz; joint venture with one partner or several partners; fixed price vs. "cost-plus" or "turn key" or like contractual arrangement or performed by our own company alone. We serve clients/ owners from Coast to Coast (except South Central) and Alaska.

In addition, we are interested in affiliated businesses in industry other than construction.

Our central management and field staff includes many highly competent, professional accountants. We have had many years' experience in financing major construction projects and vast equipment pools. Accordingly, we suggest some competence to speak on this subject.

Some construction contracts are of but a few months' duration---some span several years. Our company (and joint venture partners) often leases heavy construction equipment. Leasing is particularly adaptable to many projects. Say a given project is scheduled for a 3 or 4-year completion, absorbing, say, 85% of the useful life of given machines.

Leasing those machines for their period of need offers several advantages to the contractor involving, often, reduced costs and increased productivity, (assuming new equipment be leased vs. the use of older machines that might be capitalized which, in turn, encourages or demands useage simply because of capital structure), manageable cash flow, relief from disposal at termination, increased credit image---and so on, and on.

We believe that leasing of equipment is often a production stimulant. But if the accounting fraternity becomes so technically academic as to establish a trend of capitalizing leases, per se, within the balance sheets of clients, it could well have an adverse effect on the very goal that industry is striving for.

If accountants propose to "clutter" financial statements with this and like capitalization (why not "capitalize" new spark plugs in the company car? They last 2 or 3 years), they may seriously affect a nerve center that American industry may desperately need to compete in the market place of the world.

We recognize that there may be particular or unusual leasing arrangements of such substance, make-up, or longevity that practical as well as theoretical accounting suggests "capitalization" on a financial statement, that the reader be precisely informed. But it is our opinion that the thousands upon thousands of "routine" leases covering just about any item "under the sun" can be brought to the attention of the reader of a financial statement by reasonable, brief, but to-the-point footnote to a statement. Perhaps as to hundreds upon hundreds of leases there is even little justification for footnoting.

We are not advocating less than reasonable and pertinent disclosure of financial information. We are simply concerned that accounting theorists may "over sell" a viewpoint that may be adverse to the national interest.

Thank you.

GREEN CONSTRUCTION COMPANY

By W C Kimm

W. C. Kimm, Secretary-Vice President

By L S Olsen

L. S. Olsen, Treasurer-Vice President

xc's: Members of Accounting Principles Board.

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GREYHOUND
LEASING &
FINANCIAL
Corporation

445 Park Avenue, New York, New York 10022 (212) 752-2720

October 7, 1971.

Mr. Richard C. Lytle,
Administrative Director,
Accounting Principles Board,
666 Fifth Avenue,
New York, New York 10019

Dear Mr. Lytle:

In response to your request, we are setting forth herein the comments of Greyhound Leasing & Financial Corporation ("GLFC") with respect to the current study of the Accounting Principles Board of proposed changes in accounting of Lessees and Lessors as presently set forth in Opinions Nos. 5 and 7 of the Board. GLFC is an independent lessor engaged principally in the business of equipment financing. The Company, a pioneer in the leasing business, has seventeen years of experience and is one of the largest leasing companies in the industry. The following comments are, therefore, the views of an independent lessor as to the proposed changes in APB Opinions Nos. 5 and 7.

The recent interpretation of Opinion No. 7 by the APB was very disturbing to GLFC because it risks equating a sale with the financing method of accounting and a rental agreement with the operating method of accounting. It should be made clear that the APB has no intention of attempting to change current law regarding the difference between a sale and a lease, but that the sole purpose is to prescribe generally accepted accounting principles for lessors for financial reporting purposes.

Billions of dollars of aircraft and railroad rolling stock have been financed for the U. S. airline and railroad industries respectively by the use of leases which are "true" leases for U. S. Federal Income Tax purposes. If the APB does not make clear that its characterization of a financing lease as a sale is only for purposes of accounting for income in the financial accounts of the lessor, such a characterization will cause confusion in, if not the reversal of, all of the tax law which has required decades to develop, and perhaps cause the termination of the lease as a device for financing aircraft and rolling stock. Such a result will be extremely expensive for the airlines and railroads and will virtually prohibit many of them from acquiring new capital equipment in quantities sufficient to serve the country's needs.

Greyhound Leasing & Financial Corporation

The damages which could be caused to title and security interest recording laws could be equally devastating since owners/ lessors will find themselves to be without title to their property and also without any perfected security interest and with no chance to protect themselves from liens of intervening creditors of its lessees.

Comments on Opinion No. 5:

In our opinion, the present criteria for capitalization of leases in the financial statements of lessees are adequate. The accounting for a lease in the financial statement of lessees should not be influenced by the nature of the independent lessor's business, operations, method of financing or any other matters which are unique to an independent lessor. In addition, the criteria for capitalizing a lease in the accounts of a lessee should not be dependent upon the lessor's method of accounting for the lease transaction. For example, an independent lessor may book a financing lease with a 15% residual value (estimated fair market value at the inception of the lease) but the lessee may only have the right to purchase the equipment at fair market value at the termination of the lease. The lessee should not capitalize the lease because he is not building up a material equity in the property. The lessor is justified in recording a financing lease because he is not looking solely to the lessee for the recovery of his residual value. Too, it would not be feasible or practical for the lessee to determine the accounting treatment by the lessor, and it would be impossible to police the situation.

However, if the Board feels that revisions of Opinion No. 5 are required, GLFC endorses the position paper of United States Leasing International, Inc. on APB Opinion No. 5.

Comments on Opinion No. 7:

Generally speaking, it is our opinion that APB Opinion No. 7 as it relates to independent lessors, is sound and that it sets forth reasonable criteria for determining whether an independent lessor should use the financing method of accounting.

Today's sophisticated finance lessor evaluates the desirability and profitability of proposed leases on an after-tax basis, applying discounted cash flow techniques to the rentals, the residuals, the tax benefits from accelerated depreciation, and, where applicable, investment tax credits. Any set of guidelines which tried to cope specifically with all these variables might well prove unworkable -- and possibly damaging to the lessors.

Greyhound Leasing & Financial Corporation

Assuming more specific standards must be promulgated by the APB with regard to how independent lessors should take up income on their books for leases, the major question left to be discussed her is what those standards should be. We feel that the simplest and most realistic approach would be to deem a lease to be a financing lease if the present value of the sum of

(a) the lease payments during the fixed non-cancellable term, including the value of any investment tax credit as adjusted to its pre-tax equivalent plus

(b) a reasonable residual value not to exceed 20% of total lease payments, as defined in (a) above, during the fixed non-cancellable term or 25% of purchase cost (fair value), whichever is lower,

equals or exceeds the purchase cost to the independent lessor of the equipment. Leases which do not meet the above criteria should be accounted for under the operating method.

In determining the present value of lease payments, the discount rate to be used should be the rate applicable to loans secured by the lease rentals and/or the leased equipment. If no specific lease-by-lease rate can be determined, the discount factor should be the lessor's average borrowing rate for debt outstanding at the end of the prior month, but not less than the bank prime rate in effect at the inception of the lease plus an appropriate amount to adjust for the lessor's required compensating balances and miscellaneous loan fees. This last criterion may appear somewhat arbitrary, but it has the merit of establishing a minimum rate, it is simple, and it can be uniformly applied.

When an independent lessor, whose primary contribution to the lessee is a means of financing the long-term utilization of the property, enters into a lease agreement, he does so with the intent that the rentals will bear a close relationship to his chief expense of debt service. Since this matching of revenue and expense is an integral part of any yield calculation, would it not be an anomaly if the accounting profession, by use of unrealistic criteria, made the lessor account for the lease in a manner contrary to the financial intent of the parties involved?

In determining whether a particular lease transaction should be considered a financing lease or an operating lease, the pre-tax equivalent of the investment tax credit ("ITC") should be included as an addition to the rental payments due over the non-cancellable lease term. If a lessor retains the ITC and allows rental credits equal to all or a portion of the ITC and thereby maintains or increases his yield, thus perhaps reducing his

GREYHOUND LEASING & FINANCIAL Corporation

discounted rentals below the purchase price, he should not be subjected to any standards which might transform his transaction from a financing lease to an operating lease. In such an event, the lessor would be forced to treat the more profitable lease as an operating lease and the less profitable lease as a financing transaction. Obviously, if the investment tax credit is claimed by the lessor, the benefit derived from doing so becomes part of the lessor's yield and should be considered as part of the receipts from the lease in any comparison of discounted rentals to the cost of the equipment. Inasmuch as the ITC is an after-tax item and is compared to pre-tax items, it should be adjusted to its pre-tax equivalent in order to be properly considered as an element of return.

If a lease agreement is for a fixed non-cancellable term and the lessor anticipates recovering his investment, the magnitude of the residual value, unless it is clearly unreasonably high, should be of limited significance to the accounting method used over the fixed term of the lease. This is because the total income during the period of the lease is the same irrespective of whether the financing or operating method is used. The estimated amount to be recovered from the sale of the property at the end of the lease term should also be the same amount in either case and, under both the financing and operating methods, should be recorded as an asset to be recovered.

In our opinion, residual (or salvage) values should be recorded at the estimated fair market value at the date the lease is entered into. However, if the estimated residual value exceeds 15% of the original purchase cost of the equipment and is a material amount, we believe it should be supported by an independent appraisal.

GLFC has never in any year of its existence experienced a net loss on dispositions of equipment at the expiration of the lease terms; that is, GLFC has each year disposed of all of its equipment at the expiration of its leases for an aggregate amount which exceeded those aggregate residual figures on such equipment. This record should demonstrate the limited importance of the residual value in a full payout lease which covers a long or intermediate term. It appears therefore that recovery of the investment plus a return on invested funds should be the principal consideration in whether or not a lease qualifies for the financing method. A relatively high residual on a lease in which the rental payments, including the pre-tax equivalent of the ITC, recovers the purchase cost of the equipment plus a yield over the fixed non-cancellable term, would be indicative of a good return on investment and should not bar the use of the financing method. It is GLFC's experience that misjudgment of residual values does not constitute a major

Greyhound Leasing & Financial Corporation

risk of its business. We realize, however, that estimates of residual values can be highly subjective and could be influenced by the need to fall within prescribed parameters. In order to prevent distortion and to formalize guidelines, we have recommended a maximum residual value of 20% of the gross aggregate rentals due under the non-cancellable term or 25% of the purchase cost, whichever is lower, as the criterion for accounting under the financing method. We recommend the added safeguard that any residual higher than 15% of purchase cost must be supported by an independent appraisal.

When a lessor enters into a lease agreement which passes on all or most of the usual ownership risks to the lessee and the lessor is assured of recovering his investment over a non-cancellable lease term, he has a minimum determinable gross profit with reasonable assurance of full recovery of his investment plus profit. Under such a lease, the total gross profit over a fixed non-cancellable term thereby remains the same whether it is accounted for under the financing or operating method. The method of accounting chosen merely shifts income between periods and does not relate to any unkown expenses which could have a detrimental effect on income at a later time. In such cases, the financing method is clearly preferable because it is consistent with the intent of the lessor and the lessee and because it allows the lessor to take up income in an undistorted and realistic manner.

An example of a typical lease transaction (a copy of which is attached as Exhibit A) with an eight-year term and a 15% estimated residual value indicates that, under the financing method, the after-tax income to the lessor would increase from approximately $40,000 in the first year to $54,000 in the eight year. By accounting for this same lease under the operating method, the lessor would receive net income after tax of only $6,000 in the first year, increasing to $88,000 during the last year. Inasmuch as all expenses are determinable within a reasonable range at the inception of the lease, with a possible minor variance in the residual value (which should be determined by expert appraisal if material), the financing method would be the most realistic for "full pay out" leases because of the leveling effect on net income, taking into consideration reinvestment of after tax cash flows.

It is our opinion that APB Opinion No. 7 should relate only to the method of accounting for leases in the financial statements of independent lessors and, accordingly, should not include the treatment of sales by a manufacturer or dealer to captive lessee companies or others.

GREYHOUND
LEASING &
FINANCIAL
Corporation

The special accounting problems of a manufacturer or dealer in equipment as well as the related manufacturer/lessor are for the most part completely unrelated to those of the independent lessor and, therefore, it would be better to cover these matters in a separate Opinion. Much of the confusion in accounting for leases in the accounts of the lessor would be eliminated if the portions of APB Opinion No. 7 dealing with the manufacturer were eliminated. For example, where the manufacturer retains material risks of ownership, a sale should not be recorded. However, where the manufacturer does retain these ownership risks, the independent lessor is better protected and, therefore, has greater assurance of recovering his investment; consequently, the financing method of accounting is appropriate. The separate opinion for recording sales of manufacturers and dealers should not only deal with the problems of the sales to independent lessors but should also give consideration to other situations where installment sales are recorded but the manufacturer or dealer retains substantial credit risks or there are other important uncertainties which would require that income be recorded as payments are made.

Very truly yours,

GREYHOUND LEASING & FINANCIAL
CORPORATION

W Carroll Bumpers

By W. Carroll Bumpers, President

Exhibit

GREYHOUND LEASING & FINANCIAL Corporation

GREYHOUND LEASING & FINANCIAL CORPORATION

STATEMENT OF NET INCOME BY YEAR - FINANCING vs. OPERATING METHODS

TYPICAL LEASE TRANSACTION

	1971	1972	1973	1974	1975	1976	1977	1978	Total
FINANCING METHOD:									
Income:									
Rental income (amortization of gross profit)	$141,263	$122,535	$103,804	$ 85,072	$ 66,341	$ 47,609	$ 28,878	$ 10,146	$605,648
Interest income return on re-investment of funds (net of tax)	6,215	18,177	29,286	39,795	50,004	60,206	70,843	82,225	356,751
Total income	147,478	140,712	133,090	124,867	116,345	107,815	99,721	92,371	962,399
Expenses:									
Interest	62,250	62,250	62,250	62,250	62,250	62,250	62,250	62,250	498,000
Expenses	9,000	900	900	900	900	900	900	900	15,300
Provision for losses	4,238	3,676	3,114	2,552	1,990	1,428	866	304	18,168
Total expenses	75,488	66,826	66,264	65,702	65,140	64,578	64,016	63,454	531,468
INCOME BEFORE TAXES	71,990	73,886	66,826	59,165	51,205	43,237	35,705	28,917	430,931
Taxes (48%)	31,572	26,740	18,019	9,298	576	(8,145)	(16,886)	(25,588)	35,606
NET INCOME - FINANCING METHOD	$ 40,418	$ 47,146	$ 48,807	$ 49,867	$ 50,629	$ 51,382	$ 52,571	$ 54,505	$395,325
OPERATING METHOD:									
Income:									
Rental income, less depreciation	$ 75,706	$ 75,706	$ 75,706	$ 75,706	$ 75,706	$ 75,706	$ 75,706	$ 75,706	$605,648
Other income (return on reinvestment of funds - net of tax)	6,215	18,177	29,286	39,795	50,004	60,206	70,843	82,225	356,751
Total income	81,921	93,883	104,992	115,501	125,710	135,912	146,549	157,931	962,399
Total expenses - per above	75,488	66,826	66,264	65,702	65,140	64,578	64,016	63,454	531,468
INCOME BEFORE TAXES	6,433	27,057	38,728	49,799	60,570	71,334	82,533	94,477	430,931
Taxes (48%)	105	4,262	4,532	4,802	5,071	5,342	5,611	5,881	35,606
NET INCOME - OPERATING METHOD	$ 6,328	$ 22,795	$ 34,196	$ 44,997	$ 55,499	$ 65,992	$ 76,922	$ 88,596	$395,325

See assumptions attached.

GREYHOUND LEASING & FINANCIAL Corporation

Exhibit A

GREYHOUND LEASING & FINANCIAL CORPORATION

ASSUMPTIONS FOR DETERMINATION OF NET INCOME BY YEAR

FOR A TYPICAL LEASE TRANSACTION

1. Cost of equipment	$1,000,000
2. Notes payable	$750,000
3. Term of lease	8 years
4. Pre-tax yield	12%
5. Cost of debt	8.30%
6. Reinvestment rate	7% after tax
7. Residual	15%
8. Tax rate	48%
9. Provision for losses	3% of rental income

10. G & A: First year reflects sales and legal fees associated with closing transaction and administrative costs for balance of transaction.

JOHN R. HUEBNER

THE CASE FOR CAPITALIZING LONG-TERM LEASES

One of the objectives of financial analysis is an appraisal of a corporation's stewardship of all its assets. Under current accounting rules and practices for reporting long-term leases in financial statements, this kind of appraisal becomes exceedingly difficult where "leasehold assets" account for a material portion of total assets, as they do among many distribution (retail, wholesale) companies.

Accounting theory does not recognize property rights "acquired" under long-term leases as "assets," considering such arrangements as executory in nature, similar to employment contracts. Unfortunately, their exclusion from the balance sheet significantly affects some important financial ratios, among which are: return on invested capital, debt to equity, times interest charges earned, etc.

One may properly inquire at this point whether a corporation's accountability to its stockholders is any less with respect to leased property than property owned in fee because of the footnote disclosure relegation given such leases. Can management tell its stockholders that it need not account for its earnings on its leaseholds because the latter do not constitute a part of its total investment or assets?

This writer believes that requiring all long-term (three years or more in length), non-cancellable leases to be capitalized would be merely an extension of the fact that management is accountable for <u>all</u> "assets" used in its business, whatever their origin. Leasing is simply another form of financing and the accounting treatment accorded "property rights" acquired thereunder should not be distinguished from property rights acquired through outright purchase, mortgage financing, etc. Capitalizing such long-term leases recognizes them for what they are, namely, a form of indirect debt or debt equivalent.

This does not necessarily mean that such capitalized values should be lumped into the long-term debt account; although, in most cases, the lease may represent a form of indebtedness that is senior to all other corporate obligations, as in the cases of subsidiary leases "guaranteed" by the parent or leases where the parent is the direct obligor. Where the lease represents only the debt of a consolidated subsidiary and not the parent, then some segregation should be made so that the analyst can obtain a better idea of the true financial liability and capital leverage of the parent. In any event, it is suggested that a separate caption should be used to identify the capitalized lease liabilities and assets from other assets and direct debt.

The purport of such balance sheet recognition is to show that investment return, capital leverage, future financial planning and financial flexibility, cash flow and the like are all affected by long-term lease commitments and that without their recognition as assets and liabilities an incomplete financial statement condition is projected.

Adherence to a strict legal definition of an "asset" and "liability" can sometimes lead to anomalous results. For example, consider a company which builds and owns its own factory or warehouse. In the succeeding year it decides to finance other capital projects through a sale and leaseback of that factory or warehouse. In the year of construction and ownership, the factory or warehouse shows up as a "fixed asset" but in the following year it "disappears" from the balance sheets and appears, instead, in a footnote disclosure as a lease. Now can it be argued that the company's "asset position" has been "economically" altered by the sale - leaseback arrangement? Aren't the same property rights being enjoyed but in slightly different legal form (i.e., lease instead of ownership)? Is the return on investment in the year in which the property is sold under a sale-leaseback arrangement any greater by virtue of the property's elimination from the fixed asset account?

The financial analyst, seeking a more complete and meaningful appraisal of how effectively a corporation is managing its assets, is confronted with two equally unacceptable choices when trying to account for long-term leases. He may choose to ignore these leases as part of the corporation's total assets and liabilities, but in so doing he distorts a number of important financial ratios. Alternately, the analyst may use his own rudimentary methods or techniques for establishing the "present values" of rental payments (or the sum of rental payments derived through a capitalization rate technique of lease rentals that takes into account an interest rate factor).

In this latter effort, he may find all-too-brief footnote disclosures on the terms, length, expiration dates, inclusion or non-inclusion of taxes, insurance, etc. pertaining to the lease rentals.

The writer undertook a study of some eighteen major retailing companies — where leases typically account for a high percentage of fixed assets — with a view toward measuring the effect, on the balance sheet, of lease capitalization. Unfortunately the discounted value of the lease rental payments could not be computed because information sufficient to arrive at present value calculations was not available. Footnote disclosures and even SEC 10-K reports were largely limited to fixed annual rental figures and a classification of the average minimums by five-year periods for succeeding 20 to 30 year periods. No indication of the remaining life of the leases, underlying interest rates, etc. were indicated. In some cases, it was not clear whether annual rentals included such expenses as maintenance, insurance, taxes and the like.

To quantify the impact in some meaningful way, this writer used an 8 times multiple of the indicated minimum annual rentals to arrive at debt equivalents for three leading retail companies. The capital leverage effect, as well as the impact on two key ratios, is set forth below:

	Company A		Company B		Company C	
	BC	AC	BC	AC	BC	AC
Debt to total capital	30%	64%	25%	32%	13%	62%
Current ratio	1.6x	1.4x	2.4x	1.8x	1.6x	1.4x
Return on total capital	9.8%	6.2%	5.6%	5.0%	11.3%	9.6%
Leases as % net fixed assets		88%		15%		82%

BC - before capitalization
AC - after capitalization

Note: The "8" capitalization rate is the low end of the range of estimations (8-12 1/2).
See Axelson article footnote (2)

It may be observed that company A and Company C, which lease a high percentage of their assets, were affected more unfavorably than Company B which did not. The financial analyst looking only at present balance sheet presentations would get a misleading picture of capital leverage and investment return.

One writer on this subject (1) found that among eleven lessee companies whose financial statements were examined, capitalization substantially affected some of the more important financial ratios — presenting a less favorable financial position than conventional accounting methods.

Regrettably, the analyst is forced to substitute guesswork for some of the missing key data including, among other things, the implied average interest cost under the leases. The result: a wide divergency of views among financial analysts and room for substantial errors in judgment because of the inadequacy of the data presented (2).

The answer would appear to be not merely greater disclosure of the lease commitments—although that is certainly desirable— but some standard or uniform guidelines for the measurement of lease commitments that will enable the financial analyst to appraise more accurately and completely a company's liquidity, debt borrowing capacity and true investment return.

One major retailing company, J. C. Penney, has developed a "set of principles for calculating the debt equivalent of (its) lease commitments." Penney management employs the capitalized leases (present value of all future minimum payments excluding property taxes, maintenance, insurance and other executory expenses) as an integral part of its internal financing planning. This is done in an effort to keep a proper mix or balance between direct and indirect (lease) debt and thus "maintain a reserve borrowing capacity" and liquidity that will be consonant with a prime credit rating. The Penney Company has publicly acknowledged its indirect debt (lease) values in a footnote disclosure in its 1969 and 1970 annual reports.

Another major retailer, the Dayton-Hudson Company, also uses capitalized leases for internal financial planning purposes. In its 1970 Annual Report, under its Financial Philosophy Section, it alludes to leases as a debt-equivalent in the following statement:

> "For the retail operations, the eventual goal is an even balance between the <u>use of debt, including leases,</u> and equity. This goal will be attained as permitted by satisfactory earnings coverage of fixed charges."

Opposition from financial executives has been heated with catastrophic and dire predictions voiced if such a change were to be made. Existing covenants against additional debt creation would be breached (do leases have to be categorized as debt in the legal sense?); credit ratings and debt borrowing capacity unfavorably affected, it is alleged. There is further concern that reported profits would be substantially lowered because annual amortization payments (under the discounted value of the lease rentals) will exceed the level annual rental payments, reflecting the interest expense factor on the unamortized principal. The latter, of course, declines as the principal is reduced.

In connection with this latter view (lowered profits), the indicated impact upon the income statement is probably unavoidable, as a matter of sound and consistent accounting theory and application, if long-term leases are to be considered as debt equivalents.

While some of the above voiced objections may be valid and not to be dismissed lightly, it should be observed that the financial community has long been aware of the financial statements' shortcomings in excluding long-term leases from "asset" and "liability" recognition. Thus to continue to perpetuate the current status or to modify current accounting practice by merely extending the capitalization concept to financing leases or leases that are, in substance, acquisitions of property only serves to proliferate the confusion and uncertainty, not resolve it. What is needed is not an ad hoc, piecemeal discussion of specific leases, but a broader overview of the whole concept of leasing.

It is not the purpose of this paper to discuss and appraise the various approaches to a measurement or calculation of leases, their "present value," derivation, etc. This is indeed a separate study in itself. For example, what kind of leases should be excluded from capitalization? Should straight percentage leases be excluded? Note: Penney excludes them. Should renewal option periods exercisable at the lessee's discretion be excluded? How should imputed interest be calculated? Are satisfactory disclosures being made so as to form a reasonable basis for capitalization? The complexities are endless and the details obviously time consuming. But this should not be a barrier to doing what is necessary to present a more complete and revealing statement of corporate financial condition.

(1) Tom Nelson "Capitalizing Leases--The Effect on Financial Ratios," The Journal of Accountancy, July, 1963, Page 49.

(2) Kenneth S. Axelson "Needed: A Generally Accepted Method for Measuring Lease Commitments, Executive Magazine, July, 1971.

JOHN R. HUEBNER

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John R. Huebner is associated with the First Manhattan Co. as a security analyst specializing in retail trade securities. He holds B.S., M.B.A. and L.L.B. degrees and is a chartered financial analyst. He is currently the President of the Retail Analysts, Inc. The latter is an independent New York group of investment firm analysts specializing in Retail Trade Securities.

IDS
LEASING
CORPORATION
INVESTORS BUILDING
MINNEAPOLIS, MINN. 55402

January 20, 1971

Mr. Richard Lytle
Administrative Director
Accounting Principles Board
c/o The American Institute of
Certified Public Accountants
666 Fifth Avenue
New York, New York 10019

Dear Mr. Lytle:

It is our understanding that the Board of the APB has instructed the Committee on Leases to proceed to draft an opinion that will amend Opinion No. 5 to require lessees to capitalize those financing leases that are required to be treated as financing transactions under Opinion No. 7. We are concerned about the adverse effects that this will have upon the leasing industry. We would like to take this opportunity to make some general comments concerning this matter:

1. Generally, most personal property leasing companies use the finance method of accounting for book purposes and the operating method of accounting for tax purposes. The reasons are obvious, in that it allows the lessor to maximize earnings for book purposes and minimize earnings for tax purposes. Generally, most lessees prefer to expense lease payments in their financial statements rather than capitalize equipment under lease for depreciation purposes. This generally becomes a matter of convenience rather than accounting principle. It is felt that if the accounting rules require lessees to capitalize equipment under lease, the lease method of financing would become somewhat less attractive and potential lessees would seek more orthodox or alternative methods of financing. The final results of one bank holding company legislation would tend to aggravate the problem considerably.

2. Hospitals and certain other agencies that are reimbursed under the provisions of Medicare can, in certain cases, be reimbursed for lease payments only if they are expensed in the financial statements of the lessee. If these entities were required by accounting rules to capitalize the leases they might run the risk of losing reimbursement for the expenditures and, in that case, might seek alternative methods of financing.

Mr. Richard Lytle

January 20, 1971

3. Generally, broker-dealers (as an example) do not wish to capitalize leases in their financial statements, as the lease liability may have to be included in aggregate indebtedness for purposes of computing net capital and the asset would generally be excluded when computing net worth of the broker-dealer. Other institutions could be similarly affected.

From a standpoint of accounting theory, we cannot take too much exception to the amendment of the Opinions 5 and 7. However, from a practical standpoint we recognize that such an amendment could have some very dramatically adverse effects upon the leasing industry for the reasons cited above as well as others. We trust that the practical aspects of the problem will also be given consideration in your deliberations.

Respectfully submitted,

IDS LEASING CORPORATION

Gordon Olsen

Gordon C. Olsen
Vice President

GCO/lji

Irvine | Builders of Tomorrow's Cities... Today

October 1, 1971

Accounting Principles Board
American Institute of CPAs
666 Fifth Avenue
New York, New York 10019

Attention: Mr. Richard C. Lytle, Administrative Director

Gentlemen:

Proposed Changes in Accounting of Lessees and Lessors

The Irvine Company is primarily a land development company developing new communities on the largest privately financed master planned area in the world. The Company assets includes 80,000 acres in Orange County, California. Inherent in this development is the opportunity to own and manage income-producing properties such as shopping centers, office buildings, and apartment projects. During the past eight years the Company has selected some eighteen such projects totaling $82 M for its own account. Each one of these investments have been analyzed thoroughly and have proven to be profitable real estate transactions.

Unfortunately, generally accepted accounting principles materially misstate the annual results of operations for that portion of the Company's business relating to income-producing properties financed by mortgage notes. The purpose of this letter is to advocate that the accounting profession adopt a method of accounting which will result in a matching the cost of ownership (depreciation and interest) with the related operating income. In analyzing income-producing real estate projects it becomes apparent that the annual operating income (rental, less expenses of operations) generally increase over the life of the project, while under G.A.A.P. we are matching the cost of ownership on a declining method.

To illustrate our position, we have projected the effect of various alternative methods of accounting for interest and depreciation on income-producing properties which are reflected on the attached Exhibit "A" for the Company as a whole, and to a specific project, Exhibit "B".

The accounting methods illustrated in the exhibits are:

1. Straight line depreciation and interest expense as incurred

   This method is the one generally followed under generally accepted accounting principles and results in heavy book losses in the early years of the project, even though the project is fully leased.

2. Straight line depreciation and straight line interest

   This method meets the objective of leveling the cost of ownership over the life of the project and more closely matches that cost with the operating income over the life of the project.

3. Lease Financing

   This method also has the effect of leveling income from income-producing properties, but has limited use because of strict accounting requirements and lender reluctance.

4. Sinking fund depreciation

   This method not only levels the income over the life of the project but more closely reflects the physical deterioration and economic usefulness of the project during its useful life.

Although all three latter methods results in reporting income on a more level basis consistent with the desire of matching costs to revenue, only the last method appears to better reflect the actual depreciation with the economic usefulness of the project cost.

It is important that the accounting profession adopt methods of reporting annual results of operations from income-producing real estate transactions that will more clearly reflect performance. This is especially true today with the growing number of companies entering into land development activities and our need to be able to communicate with the financial community in order to expand our financing alternatives.

We wish to thank the Committee for this opportunity to state our view, and I am prepared to be present at the hearings and will be willing to furnish any additional information that will be helpful to this Committee.

Sincerely,

L. E. Eberling

L. E. Eberling
Vice President

Attachments:

Exhibit "A"
Exhibit "B"

THE IRVINE COMPANY
Pro Forma "Net Income" Resulting Under
Alternate Accounting Treatments for Cost
Of Ownership of Income Producing Properties
Financed by Mortgage Notes

	For the year ended April 30: 1967	1968	1969	1970	1971
Total revenue	$ 23 750 869	$16 841 138	$28 595 512	$34 239 121	$35 325 568
Percent of revenue attributable to income producing property financed by mortgage notes	2%	8%	8%	10%	14%
Net income, utilizing the following accounting treatments:					
.Straight line depreciation and interest expense as incurred	$ 8 718 563*	$ 2 988 843*	$ 5 496 251*	$ 6 485 677*	$ 6 297 367*
.Straight line depreciation and straight line interest over the loan term	8 745 000	3 025 000	5 680 000	6 740 000	6 585 000
.Lease financing	8 745 000	3 026 000	5 670 000	6 750 000	6 600 000
.Sinking fund depreciation and interest expenses as incurred	8 755 000	3 040 000	5 730 000	6 815 000	6 680 000

*As reported in the Company's audited statements

EXHIBIT "A"

THE IRVINE COMPANY
Pro Forma "Net Income" Resulting Under
Alternate Accounting Treatments for Cost
Of Ownership of Income Producing Properties
Financed by Mortgage Notes

	For the year ending April 30: 1972	1973	1974	1975	1976
Total revenue	$43 360 000	$49 273 000	$60 845 000	$66 820 000	$75 965 000
Percent of revenue attributable to income producing property financed by mortgage notes	16%	23%	26%	31%	34%
Net income, utilizing the following accounting treatments:					
.Straight line depreciation and interest expense as incurred	$ 7 450 000	$10 430 000	$13 235 000	$15 500 000	$18 000 000
.Straight line depreciation and straight line interest over the loan term	7 990 000	11 335 000	15 300 000	18 470 000	21 940 000
.Lease financing	8 025 000	11 355 000	15 353 000	18 615 000	22 140 000
.Sinking fund depreciation and interest expenses as incurred	8 175 000	11 592 000	15 810 000	19 210 000	22 925 000

EXHIBIT "A"

2 of 2

THE IRVINE COMPANY
FINANCIAL ANALYSIS
OF
FASHION ISLAND

Prepared by
The Finance Department
of
The Irvine Company
October 1, 1971

EXHIBIT "B"

THE IRVINE COMPANY
FINANCIAL ANALYSIS
OF
FASHION ISLAND

DESCRIPTION OF PROJECT

Fashion Island is a 915,000 sq. ft. regional shopping center located on 75 acres in Newport Beach, California. The center contains four major department stores and 56 mall stores. The fully-leased center opened for business in September of 1967. In this financial analysis we have used actual results of operations for the first three full years of operations, plus projections for the remaining 27 years of the analysis.

Project Investment

Improvements by component depreciation lives:		
50 years	$4 082 408	
30 "	2 272 805	
20 "	3 528 299	
15 "	1 244 328	
10 "	420 568	
	11 551 408 *	
Leasing commission	462 511	
Interim financing	109 561	
	12 123 480	
Add, Market value of land at inception of project	1 520 000	
Total investment	$13 643 480	(a)
Mortgage loan 25 year - 6 % loan from Prudential Life Insurance, payable in annual installments of $972,298, incl.inter.	$12 000 000	(b)
Project equity	$ 1 643 480	(a-b)

*The Irvine Company constructed 493,000 sq. ft. of the center, while the remaining 422,000 was constructed by two of the major department stores on ground leases

THE IRVINE COMPANY
FINANCIAL ANALYSIS
OF
FASHION ISLAND

DESCRIPTION OF PROJECT

(Continued)

Leases

The two ground leases are for a period of 32 years with option to extend for an additional 64 years. Two other department stores occupying 288,000 sq. ft. have leases for 25 and 30 year periods. Mall store leases range from 5 to 10 years.

All leases with the exception of ground lease tenants pay a minimum rent, plus percentage rent based upon annual gross sales volumes.

Summary of 1971 rental:

Minimum rental	$1 128 828
Percentage rental	70 193
	$1 199 021

THE IRVINE COMPANY
FINANCIAL ANALYSIS
OF
FASHION ISLAND

Pro forma Contribution to "Net Income" Resulting Under Alternate Accounting Treatments for Cost of Ownership

Year	Alternatives* #1	#2	#3	#4	After Tax Cash Flow
1	$ (126 201)	$ 14 733	$ 3 120	$ 44 520	$ 360 826
2	(104 218)	30 082	18 468	62 755	324 537
3	(92 149)	35 071	23 458	70 831	158 468
4	(65 010)	54 657	43 044	93 718	259 685
5	(45 072)	66 537	54 923	109 129	232 376
6	(30 956)	72 054	60 440	118 423	201 619
7	(16 693)	77 143	65 529	127 551	175 574
8	(5 911)	78 136	66 522	132 863	146 906
9	4 534	78 136	66 522	137 483	120 245
10	15 678	78 136	66 522	142 423	96 109
11	75 862	126 430	94 151	175 336	86 372
12	88 549	126 430	94 151	180 987	68 982
13	102 085	126 430	94 151	187 030	50 997
14	116 528	126 430	94 151	193 492	32 346
15	131 938	126 430	94 151	200 403	12 955
16	216 631	194 681	123 151	236 793	(5 026)
17	234 175	194 681	123 151	244 697	(24 339)
18	252 893	194 681	123 151	253 148	(44 758)
19	272 865	194 681	123 151	262 186	(66 360)
20	294 174	194 681	123 151	271 851	(89 236)
21	406 676	284 447	123 151	282 186	(176 075)
22	430 936	284 447	508 999	293 238	(201 778)
23	456 820	284 447	508 999	305 055	(229 048)
24	484 437	284 447	508 999	317 692	(257 996)
25	513 904	284 447	508 999	331 205	(288 739)
26	530 596	530 596	508 999	330 906	665 641
27	530 596	530 596	508 999	312 811	665 641
28	530 596	530 596	508 999	293 539	665 641
29	530 596	530 596	508 999	273 014	665 641
30	530 596	530 596	508 999	251 156	665 641
	$6 265 455	$6 265 455	$6 259 205	$6 236 421	4 272 847
				Book value of project at end of year 30 using straight line depreciation	2 753 343
					$7 026 190

* Description of alternatives:

1. Utilizing straight line depreciation and interest as incurred.
2. Utilizing straight line depreciation and straight line interest over the loan term.
3. Utilizing lease financing.
4. Utilizing sinking fund depreciation and interest expense as incurred.

THE IRVINE COMPANY
FINANCIAL ANALYSIS
OF
FASHION ISLAND
STATEMENT OF PROJECTED NET INCOME
UTILIZING STRAIGHT LINE DEPRECIATION AND INTEREST EXPENSE AS INCURRED

YEAR	GROSS REVENUE	OPERATING EXPENSES	OPERATING INCOME	STRAIGHT-LINE DEPRECIATION	CONTRIBUTION TO EARNINGS	INTEREST EXPENSE	INCOME BEFORE TAXES	FEDERAL AND STATE TAXES ON INCOME	NET INCOME
1	1,157,769	179,232	978,537	456,772	521,765	774,166	-252,401	-126,200	-126,201
2	1,207,017	197,783	1,009,234	456,772	552,462	760,897	-208,435	-104,217	-104,218
3	1,199,021	179,808	1,019,213	456,772	562,441	746,739	-184,298	-92,149	-92,149
4	1,269,600	211,215	1,058,385	456,772	601,613	731,633	-130,020	-65,010	-65,010
5	1,302,900	220,756	1,082,144	456,772	625,372	715,515	-90,143	-45,071	-45,072
6	1,320,300	227,122	1,093,178	456,772	636,406	698,318	-61,912	-30,956	-30,956
7	1,336,700	233,344	1,103,356	456,772	646,584	679,969	-33,385	-16,692	-16,693
8	1,346,700	241,359	1,105,341	456,772	648,569	660,391	-11,822	-5,911	-5,911
9	1,346,700	241,359	1,105,341	456,772	648,569	639,502	9,067	4,533	4,534
10	1,346,700	241,359	1,105,341	456,772	648,569	617,214	31,355	15,677	15,678
11	1,414,000	253,400	1,160,600	415,442	745,158	593,434	151,724	75,862	75,862
12	1,414,000	253,400	1,160,600	415,442	745,158	568,060	177,098	88,549	88,549
13	1,414,000	253,400	1,160,600	415,442	745,158	540,988	204,170	102,085	102,085
14	1,414,000	253,400	1,160,600	415,442	745,158	512,102	233,056	116,528	116,528
15	1,414,000	253,400	1,160,600	415,442	745,158	481,282	263,876	131,938	131,938
16	1,484,700	266,100	1,218,600	336,940	881,660	448,398	433,262	216,631	216,631
17	1,484,700	266,100	1,218,600	336,940	881,660	413,311	468,349	234,174	234,175
18	1,484,700	266,100	1,218,600	336,940	881,660	375,875	505,785	252,892	252,893
19	1,484,700	266,100	1,218,600	336,940	881,660	335,931	545,729	272,864	272,865
20	1,484,700	266,100	1,218,600	336,940	881,660	293,312	588,348	294,174	294,174
21	1,484,700	266,100	1,218,600	157,408	1,061,192	247,840	813,3M2	406,676	406,676
22	1,484,700	266,100	1,218,600	157,408	1,061,192	199,321	861,871	430,935	430,936
23	1,484,700	266,100	1,218,600	157,408	1,061,192	147,553	913,639	456,819	456,820
24	1,484,700	266,100	1,218,600	157,408	1,061,192	92,319	968,873	484,436	484,437
25	1,484,700	266,100	1,218,600	157,408	1,061,192	33,385	1,027,807	513,903	513,904
26	1,484,700	266,100	1,218,600	157,408	1,061,192		1,061,192	530,596	530,596
27	1,484,700	266,100	1,218,600	157,408	1,061,192		1,061,192	530,596	530,596
28	1,484,700	266,100	1,218,600	157,408	1,061,192		1,061,192	530,596	530,596
29	1,484,700	266,100	1,218,600	157,408	1,061,192		1,061,192	530,596	530,596
30	1,484,700	266,100	1,218,600	157,408	1,061,192		1,061,192	530,596	530,596
	42,173,907	7,431,837	34,742,070	9,903,710	24,838,360	12,307,455	12,530,905	6,265,450	6,265,455

THE IRVINE COMPANY
FINANCIAL ANALYSIS
OF
FASHION ISLAND
STATEMENT OF PROJECTED NET INCOME
UTILIZING STRAIGHT LINE DEPRECIATION AND STRAIGHT LINE INTEREST OVER THE LOAN TERM

Year	Gross Revenue	Operating Expenses	Operating Income	Straight Line Depreciation	Contribution to Earnings	Interest Expense	Income Before Taxes	Federal and State Taxes on Income	Net Income
1	$ 1 157 769	$ 179 232	$ 978 537	$ 456 772	$ 521 765	492 299	$ 29 466	$ 14 733	$ 14 733
2	1 207 017	197 783	1 009 234	456 772	552 462	492 299	60 163	30 081	30 082
3	1 199 021	179 808	1 019 213	456 772	562 441	492 299	70 142	35 071	35 071
4	1 269 600	211 215	1 058 385	456 772	601 613	492 299	109 314	54 657	54 657
5	1 302 900	220 756	1 082 144	456 772	625 372	492 299	133 073	66 536	66 537
6	1 320 300	227 122	1 093 178	456 772	636 406	492 298	144 108	72 054	72 054
7	1 336 700	233 344	1 103 356	456 772	646 584	492 298	154 286	77 143	77 143
8	1 346 700	241 359	1 105 341	456 772	648 569	492 298	156 271	78 135	78 136
9	1 346 700	241 359	1 105 341	456 772	648 569	492 298	156 271	78 135	78 136
10	1 346 700	241 359	1 105 341	456 772	648 569	492 298	156 271	78 135	78 136
11	1 414 000	253 400	1 160 600	415 442	745 158	492 298	252 860	126 430	126 430
12	1 414 000	253 400	1 160 600	415 442	745 158	492 298	252 860	126 430	126 430
13	1 414 000	253 400	1 160 600	415 442	745 158	492 298	252 860	126 430	126 430
14	1 414 000	253 400	1 160 600	415 442	745 158	492 298	252 860	126 430	126 430
15	1 414 000	253 400	1 160 600	415 442	745 158	492 298	252 860	126 430	126 430
16	1 484 700	266 100	1 218 600	336 940	881 660	492 298	389 362	194 681	194 681
17	1 484 700	266 100	1 218 600	336 940	881 660	492 298	389 362	194 681	194 681
18	1 484 700	266 100	1 218 600	336 940	881 660	492 298	389 362	194 681	194 681
19	1 484 700	266 100	1 218 600	336 940	881 660	492 298	389 362	194 681	194 681
20	1 484 700	266 100	1 218 600	336 940	881 660	492 298	389 362	194 681	194 681
21	1 484 700	266 100	1 218 600	157 408	1 061 192	492 298	568 894	284 447	284 447
22	1 484 700	266 100	1 218 600	157 408	1 061 192	492 298	568 894	284 447	284 447
23	1 484 700	266 100	1 218 600	157 408	1 061 192	492 298	568 894	284 447	284 447
24	1 484 700	266 100	1 218 600	157 408	1 061 192	492 298	568 894	284 447	284 447
25	1 484 700	266 100	1 218 600	157 408	1 061 192	492 298	568 894	284 447	284 447
26	1 484 700	266 100	1 218 600	157 408	1 061 192		1 061 192	530 596	530 596
27	1 484 700	266 100	1 218 600	157 408	1 061 192		1 061 192	530 596	530 596
28	1 484 700	266 100	1 218 600	157 408	1 061 192		1 061 192	530 596	530 596
29	1 484 700	266 100	1 218 600	157 408	1 061 192		1 061 192	530 596	530 596
30	1 484 700	266 100	1 218 600	157 408	1 061 192		1 061 192	530 596	530 596
	$42 173 907	$7 431 837	$34 742 070	$9 903 710	$24 838 360	$12 307 455	$12 530 905	$6 265 450	$6 265 455

THE IRVINE COMPANY
FINANCIAL ANALYSIS
OF
FASHION ISLAND
STATEMENT OF PROJECTED NET INCOME
UTILIZING LEASE FINANCING

Year	Gross Revenue	Operating Expenses	Operating Income	Lease Payments	Income Before Taxes	Federal and State Taxes on Income	Net Income
1	$ 1 157 769	179 232	$ 978 537	$ 972 298	$ 6 239	$ 3 119	$ 3 120
2	1 207 017	197 783	1 009 234	972 298	36 936	18 468	18 468
3	1 199 021	179 808	1 019 213	972 298	46 915	23 457	23 458
4	1 269 600	211 215	1 058 385	972 298	86 087	43 043	43 044
5	1 302 900	220 756	1 082 144	972 298	109 846	54 923	54 923
6	1 320 300	227 122	1 093 178	972 298	120 880	60 440	60 440
7	1 336 700	233 344	1 103 356	972 298	131 058	65 529	65 529
8	1 346 700	241 359	1 105 341	972 298	133 043	66 521	66 522
9	1 346 700	241 359	1 105 341	972 298	133 043	66 521	66 522
10	1 346 700	241 359	1 105 341	972 298	133 043	66 521	66 522
11	1 414 000	253 400	1 160 600	972 298	188 302	94 151	94 151
12	1 414 000	253 400	1 160 600	972 298	188 302	94 151	94 151
13	1 414 000	253 400	1 160 600	972 298	188 302	94 151	94 151
14	1 414 000	253 400	1 160 600	972 298	188 302	94 151	94 151
15	1 414 000	253 400	1 160 600	972 298	188 302	94 151	94 151
16	1 484 700	266 100	1 218 600	972 298	246 302	123 151	123 151
17	1 484 700	266 100	1 218 600	972 298	246 302	123 151	123 151
18	1 484 700	266 100	1 218 600	972 298	246 302	123 151	123 151
19	1 484 700	266 100	1 218 600	972 298	246 302	123 151	123 151
20	1 484 700	266 100	1 218 600	972 298	246 302	123 151	123 151
21	1 484 700	266 100	1 218 600	972 298	246 302	123 151	123 151
22	1 484 700	266 100	1 218 600	*200 602	1 017 998	508 999	508 999
23	1 484 700	266 100	1 218 600	200 602	1 017 998	508 999	508 999
24	1 484 700	266 100	1 218 600	200 602	1 017 998	508 999	508 999
25	1 484 700	266 100	1 218 600	200 602	1 017 998	508 999	508 999
26	1 484 700	266 100	1 218 600	200 602	1 017 998	508 999	508 999
27	1 484 700	266 100	1 218 600	200 602	1 017 998	508 999	508 999
28	1 484 700	266 100	1 218 600	200 602	1 017 998	508 999	508 999
29	1 484 700	266 100	1 218 600	200 602	1 017 998	508 999	508 999
30	1 484 700	266 100	1 218 600	200 602	1 017 998	508 999	508 999
	$42 173 907	$7 431 837	$34 742 070	$22 223 671	$12 518 399	$6 259 194	$6 259 205

*In year 22, the project is repurchased and depreciated over the remaining life.

THE IRVINE COMPANY
FINANCIAL ANALYSIS
OF
FASHION ISLAND
STATEMENT OF PROJECTED NET INCOME
UTILIZING SINKING FUND DEPRECIATION AND INTEREST EXPENSE AS INCURRED

Year	Gross Revenue	Operating Expenses	Operating Income	Sinking Fund* Depreciation	Contribution to Earnings	Interest Expense	Income Before Taxes	Federal and State Taxes on Income	Net Income
1	$ 1 157 769	$ 179 232	$ 978 537	$ 115 332	$ 863 205	$ 774 166	$ 89 039	$ 44 519	$ 44 520
2	1 207 017	197 783	1 009 234	122 828	886 406	760 897	125 509	62 754	62 755
3	1 199 021	179 808	1 019 213	130 812	888 401	746 739	141 662	70 831	70 831
4	1 269 600	211 215	1 058 385	139 316	919 069	731 633	187 436	93 718	93 718
5	1 302 900	220 756	1 082 144	148 371	933 773	715 515	218 258	109 129	109 129
6	1 320 300	227 122	1 093 178	158 015	935 163	698 318	236 845	118 422	118 423
7	1 336 700	233 344	1 103 356	168 286	935 070	679 969	255 101	127 550	127 551
8	1 346 700	241 359	1 105 341	179 224	926 117	660 391	265 726	132 863	132 863
9	1 346 700	241 359	1 105 341	190 874	914 467	639 502	274 965	137 482	137 483
10	1 346 700	241 359	1 105 341	203 281	902 060	617 214	284 846	142 423	142 423
11	1 414 000	253 400	1 160 600	216 494	944 106	593 434	350 672	175 336	175 336
12	1 414 000	253 400	1 160 600	230 566	930 034	568 060	361 974	180 987	180 987
13	1 414 000	253 400	1 160 600	245 553	915 047	540 988	374 059	187 029	187 030
14	1 414 000	253 400	1 160 600	261 514	899 086	512 102	386 984	193 492	193 492
15	1 414 000	253 400	1 160 600	278 512	882 088	481 282	400 806	200 403	200 403
16	1 484 700	266 100	1 218 600	296 616	921 984	448 398	473 586	236 793	236 793
17	1 484 700	266 100	1 218 600	315 896	902 704	413 311	489 393	244 696	244 697
18	1 484 700	266 100	1 218 600	336 429	882 171	375 875	506 296	253 148	253 148
19	1 484 700	266 100	1 218 600	358 297	860 303	335 931	524 372	262 186	262 186
20	1 484 700	266 100	1 218 600	381 586	837 014	293 312	543 702	271 851	271 851
21	1 484 700	266 100	1 218 600	406 389	812 211	247 840	564 371	282 185	282 186
22	1 484 700	266 100	1 218 600	432 804	785 796	199 321	586 475	293 237	293 238
23	1 484 700	266 100	1 218 600	460 937	757 663	147 553	610 110	305 055	305 055
24	1 484 700	266 100	1 218 600	490 898	727 702	92 319	635 383	317 691	317 692
25	1 484 700	266 100	1 218 600	522 806	695 794	33 385	662 409	331 204	331 205
26	1 484 700	266 100	1 218 600	556 788	661 812		661 812	330 906	330 906
27	1 484 700	266 100	1 218 600	592 979	625 621		625 621	312 810	312 811
28	1 484 700	266 100	1 218 600	631 523	587 077		587 077	293 538	293 539
29	1 484 700	266 100	1 218 600	672 572	546 028		546 028	273 014	273 014
30	1 484 700	266 100	1 218 600	716 289	502 311		502 311	351 155	251 156
	$42 173 907	$7 431 837	$34 742 070	$9 961 787	$24 780 283	$12 307 455	$12 472 828	$6 236 407	$6 236 421

*Depreciation is calculated under the sinking fund method utilizing a 6-1/2% interest rate which is equivalent to the interest rate on the mortgage.

THE IRVINE COMPANY
FINANCIAL ANALYSIS
OF
FASHION ISLAND
STATEMENT OF PROJECTED CASH FLOW AFTER TAXES

YR	OPERATING INCOME	ACCELERATED DEPRECIATION	TAXABLE INCOME	FEDERAL AND STATE TAXES ON INCOME	CASH FROM OPERATIONS (COL 1-COL 4)	DEBT SERVICE INTEREST	DEBT SERVICE PRINCIPAL	DEBT SERVICE TAX CREDIT	NET CASH FLOW
1	978,537	913,545	64,992	32,496	946,041	774,166	198,132	387,083	360,826
2	1,009,234	823,539	185,695	92,847	916,387	760,897	211,401	380,448	324,537
3	1,019,213	744,157	275,056	137,528	881,685	746,739	225,559	373,369	282,756
(CAPITAL ITEM)									-124,288
4	1,058,385	673,949	384,436	192,218	866,167	731,633	240,665	365,816	259,685
5	1,082,144	611,690	470,454	235,227	846,917	715,515	256,783	357,757	232,376
6	1,093,178	556,337	536,841	268,420	824,758	698,318	273,980	349,159	201,619
7	1,103,356	512,419	590,937	295,468	807,888	679,969	292,329	339,984	175,574
8	1,105,341	472,676	632,665	316,332	789,009	660,391	311,907	330,195	146,906
9	1,105,341	440,243	665,098	332,549	772,792	639,502	332,796	319,751	120,245
10	1,105,341	414,258	691,083	345,541	759,800	617,214	355,084	308,607	96,109
11	1,160,600	363,308	797,292	398,646	761,954	593,434	378,865	296,717	86,372
12	1,160,600	353,899	806,701	403,350	757,250	568,060	404,238	284,030	68,982
13	1,160,600	345,001	815,599	407,799	752,801	540,988	431,310	270,494	50,997
14	1,160,600	336,585	824,015	412,007	748,593	512,102	460,196	256,051	32,346
15	1,160,600	328,623	831,977	415,988	744,612	481,282	491,016	240,641	12,955
16	1,218,600	267,548	951,052	475,526	743,074	448,398	523,901	224,199	-5,026
17	1,218,600	264,007	954,593	477,296	741,304	413,311	558,987	206,655	-24,339
18	1,218,600	260,608	957,992	478,996	739,604	375,875	596,424	187,937	-44,758
19	1,218,600	257,345	961,255	480,627	737,973	335,931	636,367	167,965	-66,360
20	1,218,600	254,212	964,388	482,194	736,406	293,312	678,986	146,656	-89,236
21	1,218,600	126,007	1,092,593	546,296	672,304	247,840	724,459	123,920	-176,075
22	1,218,600	123,120	1,095,480	547,740	670,860	199,321	772,977	99,660	-201,778
23	1,218,600	120,348	1,098,252	549,126	669,474	147,553	824,745	73,776	-229,048
24	1,218,600	117,688	1,100,912	550,456	668,144	92,319	879,980	46,159	-257,996
25	1,218,600	115,133	1,103,467	551,733	666,867	33,385	938,913	16,692	-288,739
26	1,218,600	112,681	1,105,919	552,959	665,641				665,641
27	1,218,600	112,681	1,105,919	552,959	665,641				665,641
28	1,218,600	112,681	1,105,919	552,959	665,641				665,641
29	1,218,600	112,681	1,105,919	552,959	665,641				665,641
30	1,218,600	112,681	1,105,919	552,959	665,641				665,641
	34,742,070	10,359,650	24,382,420	12,191,201	22,550,869	12,307,455	12,000,000	6,153,721	4,272,847

BOOK VALUE OF PROJECT IN YEAR 30 — 2,753,343

BASED ON THE DISCOUNTED CASH FLOW METHOD OF ANALYSIS.
THE RATE OF RETURN ON EQUITY IS 16.43% — 7,026,190

OLDS, BRUNEL & CO.
INCORPORATED
375 PARK AVENUE
NEW YORK, NEW YORK 10022

KRAMBO CORPORATION
375 PARK AVENUE
NEW YORK, N. Y. 10022

PURE LEASE CHARACTERISTICS

AND THE NEED FOR

MORE EXTENSIVE DISCLOSURE

We are not accountants, lawyers, or tax experts and therefore endeavor to tread carefully in such professional areas. We are investment bankers specializing in contract finance (especially net lease transactions) and are familiar with many of the accounting issues listed for consideration at the Accounting Principles Board's Proposed Changes in Accounting by Lessees and Lessors hearing. In particular we wish to discuss the following:

1. The features of a leasing transaction which distinguish its nature or substance as either a pure lease or a financing arrangement, and

2. the objectives of financial analysis which, we believe, can best be accomplished through greater disclosure of pure lease obligations and other fixed charges, rather than through mere capitalization of such items.

1. Features Determining Substance of a Lease Transaction

APB Opinion No. 5 acknowledges certain general lease characteristics which would determine that a transaction should be considered, in substance, as a purchase or a financing arrangement with beneficial ownership of the asset constructively belonging to the lessee. In ascertaining the appropriateness for capitalization of certain lease obligations the background material for the instant hearings requests analyses which would more carefully distinguish a pure lease from a financing arrangement characterized as a lease.

In reply, we suggest that for any assets under lease there are certain clear incidents of ownership apart from possessory rights (which possessory rights substantially all lessees obtain in substantially all leases). If the lessor has substantial incidents of ownership, we believe a lease should be deemed a pure lease, notwithstanding its "net-ness" and even though the lease grants the lessee certain privileges and responsibilities parallel to other incidents of ownership. We consider the incidents of ownership in the lessor to include the following:

A. Benefit of Refinancing: If, without jeopardizing the rent set forth in the lease, the lessor has the right to prepay long-term debt at a later time when interest rates in the capital market may be lower, the lessor has a potentially valuable right.

B. Freedom of Disposition: The freedom to sell, exchange, etc. at will the equity of a leased property (subject to its lease and its debt) has a profit potential which, while conjectural, may be particularly significant in the case of realty.

C. Right to Unencumbered Fee or Extended Leasehold Estate: While again conjectural, the historical record of incremental increases in property values suggests that the owner of a fee estate or leasehold estate in land (after the lease, or sublease, including renewals, expires) has an asset of substantial prospective value.

D. Rentals in Excess of Debt Service: The right to supplemental rentals (e.g., overage rentals as a percentage of sales or potentially significant rentals during the basic or optional extended terms) over and above the debt service requirements of an unaffiliated lessor should distinguish that lessor from categorization as a mere financing conduit and denote genuine substance to the lessor as owner and the lease as a pure lease.

E. Benefit of Surplus Insurance or Condemnation Awards: While conjectural, the lessor's right to insurance or condemnation awards in excess of indebtedness is a potentially valuable ownership incident, in contrast with situations wherein the lessee undertakes to acquire properties subject to casualty and condemnation (together with such proceeds or awards) at a fixed price that cannot be rejected by the lessor.

F. Ruling for Tax Purposes: To the extent that lessor's favorable tax ruling or tax treatment establishes the intentions of the lessor as owner, the substance of the transaction should be recognized as a pure lease rather than as a financing arrangement on behalf of the lessee.

The lessor's having one or more of the above items lends substance to the argument that the transaction is a pure lease. However, the absence of one or more of the above clearly does not make the transaction fail to be a pure lease. We believe the lessor's interests (the presence in the lessor of substantial incidents of ownership, or not) should determine for both the lessor and lessee whether the transaction is a pure lease or not.

2. Objectives of Analysis: Our Suggestion of an Alternative to Capitalizing Pure Leases

We suggest that capitalizing pure leases is a substantial departure from fundamental accounting principles and, more importantly, is detrimental to financial analysis. While the balance sheet and the sources and uses of funds statement are, of course, significant, we believe that earnings are the dominant concern of financial analysts and investors (and prospective investors). This is true for investors in equity securities, for long- and short-term lenders, as well as for lessors and their lenders. Primary emphasis of the analysis of such investors and other interested parties may be summarized as follows:

A. Equity: earnings prospects (quality, security, growth), operating leverage, financial leverage

B. Long-Term Fixed Income: the ability to pay obligations measured by earnings coverage of interest, minimum annual rentals, and other contractual fixed charges

C. Internal Management: earnings on investment

D. Government (Taxes), Insurance Companies (Insurance), Employee Interests (Wages, Fringe Benefits, Profit Sharing): earnings, revenues, value of property--a variety of yardsticks

E. Short-Term Lenders, Trade Creditors: earnings and the current ratio

We conclude that detailed disclosure of fixed charges in the income statement (and/or exhibits) would be a very desirable alternative to capitalizing long-term contracts (such as leases).

Fixed charges, quasi-fixed charges, and similar items thought necessary to evaluate earnings, operating leverage, fixed charge coverage, etc. would include such items as:

(a) Gross interest paid (not interest paid less interest earned)
(b) Amortization of bond discount
(c) Principal payments
(d) Rents
(e) Property taxes (owned and leased properties)
(f) Insurance
(g) Maintenance and repairs (owned and leased properties)
(h) Licenses, franchises, royalty payments
(i) Contracts--long term
(j) Utilities
(k) Depreciation and amortization of assets

Abstract distinctions between primary responsibility and secondary responsibility for such charges do not seem to lend to analysis. For example, with respect to property taxes, maintenance and insurance, it makes little difference whether a corporate occupant:

(a) (pursuant to a gross lease without escalation) pays rent over to the landlord and the landlord pays such items out of rent (and if squeezed by expenses into worse than profitless ownership, landlord might default, in which case a corporate tenant desiring continuing occupancy of premises would have to take over);

(b) (pursuant to a gross lease with escalation) pays rent to landlord;

(c) (pursuant to a completely net lease) pays such items directly;

(d) (pursuant to covenants in a mortgage loan) pays such items directly;

(e) (pursuant to covenants in unsecured notes or debentures) pays such items directly.

Obviously, in all the above, maintenance, taxes, and insurance are paid by the occupant and are quasi-fixed charges and, as such, should be of concern to the serious analyst.

Accordingly, we believe it would be desirable to have available ten years' past history as well as properly disclaimered projections for ten years or more into the future, with the full terms of long-term contracts (in aggregate) set forth in five-year groups from the first year to the distant future. We feel that items now required as supplementary information in registration statements and 10-K's should be included in annual reports so that various equity, fixed income, trade and other special purpose analysts could use analytical formulae designed for their respective interests.

Finally, the income statement and fixed charge coverage would be distorted by capitalizing pure leases and showing interest and depreciation expenses instead of rents. Not only might the depreciation method employed be vastly different from the schedule of required rents, but also the land, in a real estate lease, would never run through the income statement as an expense, resulting thereby in a distortion of coverage by earnings of various fixed charges.

Summary

The characterization of a transaction as a pure lease should depend on whether the lessor or the lessee has the bulk of the most significant nonpossessory incidents of ownership, such as benefits of refinancing, freedom of disposition, rights to unencumbered future estates of value, possibilities for supplemental rentals, benefits of surplus insurance or condemnation awards, and existence of favorable tax rulings.

Capitalizing long-term pure leases is disclosure of a kind, but it does not lend itself to analysis where it counts and, moreover, seems to be a departure from accountancy. Whether a lease is "come hell or high water" (but short of a guarantee of the lessor's indebtedness) or is executory with a variety of lessor responsibilities does not seem to be relevant. Whether the contract is onerous or advantageous, the positive and negative leverage therein and its fixed nature over its term in a changing world are what we believe should be available for analysis.

OLDS, BRUNEL & CO.
Incorporated

KRAMBO CORPORATION

CONTENTS

Written Presentation to the Accounting Principles Board

dated September 30, 1971

LEASE CONSULTANTS

OF PHILADELPHIA INC.

SCOPE This paper will comment upon the subject -

"Profit on Sale to Lessor and Assignment of Lease"*

REFERENCES

A. "Proposed Changes in Accounting of Lessees and Lessors" (August 1971), pp 19-20.

B. Lease Consultants of Philadelphia Inc. letter of September 17, 1971 to AICPA.

C. Enclosure to Robert N. Sempier letter of September 24, 1971, called "Accounting Interpretation to APB Opinion Number 7"**.

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*Reference A

**This reference was received on September 27, 1971, and was not used as a basis for comment in this paper.

RECOMMENDATION

My position on this issue is as follows:

1. There is significant economic, legal and even political consequence resulting from the accounting question of whether a manufacturer or dealer has made a sale when he has conveyed title to his product subject to a lease which is assigned to the buyer.

2. The timing of the Accounting Principles Board Accounting Interpretation of APB Opinion 7 (Reference C) appears to be inconsistent with the intended purposes of public hearings by the Accounting Principles Board in October.

3. There appears to be a tendency to make Accounting Principles Board Opinion 7 serve as the authority for settlement of this issue, whereas it is entirely possible that this Opinion is being stretched onto an issue for which the fit is awkward to say the least.

4. There is ample and acceptable accounting precedent for the form of accounting recommended by this paper.

My specific recommendation in regard to the accounting question is:

When a manufacturer or dealer sells depreciable property to an unaffiliated investor firm or individual (re APB Opinion 18), with or without an assigned lease, the accounting for the transaction by the manufacturer will be consistent with the economic intent of the buyer and manufacturer, and if a sale is intended and appropriately documented, sale accounting will reflect these facts with any estimated liabilities accompanying the manufacturer's warranties to be accounted for as a reserve for warranties. Subsequently when and if the manufacturer incurs an expense because of his obligations, the reserve is to be charged for that amount. Upon the expiration of the warranty period the balance of the reserve, if any, is to be charged to the current cost of sales account if the manufacturer is producing the same or similar products, or if he is not, to extraordinary income.

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Despite the uncertainties that are involved, the warranty obligations of the seller should be carefully estimated with the benefit of prior experience whenever possible. In some transactions the amount of the reserve may well result in a loss on the sale. The estimated liabilities or warranty may include several or more of the following or others not mentioned:

a) remarketing obligations

b) substituting equipment

c) rental payments

d) renovation

e) re-installation of equipment

f) repair of equipment

Adoption of this method of accounting will more accurately reflect the manufacturer's performance and will simplify the accounting for a manufacturer or dealer who makes a sale to a buyer accompanied by protection for the buyer's investment - whether extensive or minimal, but as necessary to arrange the sale.

GENERAL

I would like to deal with the accounting question on a generalized basis first and then I shall deal in detail with a specific example from the peripheral equipment manufacturing industry. The latter industry has largely been responsible for the accounting controversy over this issue.

Sample Transactions

Two sample transactions representing extremes are shown below with the briefest of entries to illustrate the recommended method of accounting.

Example A

A manufacturer sells his product for cash to a buyer who is unaffiliated with the manufacturer. The estimated liabilities for manufacturers' warranties are inconsequential for reasons which are not germane at this point in this example.

Debit	Cash		100,000	
Credit		Sales Revenue		100,000
Debit	Cost of Sales		32,000	
Credit		Inventory-Equipment		32,000
Credit		Reserve for Warranties		-

Example B

A manufacturer sells his product for cash to a buyer who is unaffiliated with the manufacturer. The estimated liabilities for this manufacturer's warranties are significant in that they represent an amount equal to the sales price. Again, the reasoning is not germane at this point in this example.

Debit	Cash		100,000	
Credit		Sales Revenue		100,000
Debit	Cost of Sales		132,000	
Credit		Inventory-Equipment		32,000
Credit		Reserve for Warranties		100,000

Assume that in Examples A & B there were conditions that directly affected the amount of the Reserve for Warranties for each manufacturer. Assume further that in Examples A & B both manufacturers guaranteed repurchase of the product should any one of certain events occur. Assume still further that although the guarantee to repurchase remained with each manufacturer, other conditions were more influential as to the amount of the reserve:

Manufacturer

> A has been providing similar guaranties for ten years and has never had to repurchase one unit of his product. An argument could logically be made that he need not have a reserve for warranty; however, because B is new in business he should.

Manufacturer

> A limits his warranty to an event which can't happen; however, B's warranty extends to an event that could happen. Again, there is good reason for A not to provide for a reserve for warranty; however, B should.

Reasoning

The principal fact that emerges from Examples A & B is that both manufacturers are making a sale. That fact is not governed by APB Opinions 5 or 7. If both these manufacturers had leased their products to users and had assigned or sold those leases concurrently with the passage of title to their products, that issue is not covered by APB Opinions 5 or 7 either. In general, APB Opinions 5 and 7 govern the accounting consequences of the relationships between lessors and lessees. They do not cover the relationship which is at issue; that of a seller and buyer. However, because of an assigned lease that accompanies the passage of title from the seller to the buyer, Opinion 7 is being made applicable in a way that the lease is the determining factor as to how the sale is to be accounted for. That appears to be convoluting the subject matter.

The question is: should the manufacturer account for a transaction as a sale modified by the peculiar conditions accompanying the transaction, or should one, or any combination of conditions, dictate the method of accounting to be used.

In general terms, I opt for treating the transaction as a sale when

a) the economic intent of both the buyer and seller is to effect a sale and

b) they observe the generally recognized and accepted means of making a sale.

If a transaction meets these prerequisites, there has been a sale as there was in both of the above examples. One was a profitable sale; one resulted in a loss - both were sales, however. Adoption of such recommended tests is logical since accountants would then treat the transaction as the participants intended and is consistent with how members of other professions interpret the intentions of the participants.

To do otherwise - to allow the attendant negotiated conditions to a sale determine whether a sale has been made from an accounting standpoint - leads to confusion in determining which condition is overruling:

Which circumstance is so vital that its significance outweighs that of the economic intentions of the parties to the agreement? Is it circumstance one? Is it circumstance two; or, is it finally circumstance twelve? Make it simple, was a sale intended? Were there evidences that the intentions resulted in a sale? If so, record the transaction as a sale and then look to the negotiated conditions for how they influenced the net reportable revenue resulting from the sale.

Assume further from the examples above that the products sold were subject to leases and that these leases were assigned to the purchasers. The existence of leases is not material as to whether a sale occurred. Leases may be material in computing the reserve for warranties; not because they are"operating" or "financing" leases but because of the amount of the estimated liability that was retained by the seller.

In conclusion, the parties to a sale should determine whether a sale took place,and if the resulting transaction meets the test of intention and evidence, the accountants should treat it as a sale with appropriate reserves to be established for estimated liabilities resulting from negotiated terms to that sale.

SPECIFIC INDUSTRY EXAMPLE

Description

Background Information: Since around 1956 an industry has developed - the peripheral equipment manufacturing industry - that both supplements and complements the computer manufacturing industry - which industry is characterized by the term "IBM" (International Business Machines Corporation). Members of this fledging peripheral equipment manufacturing industry produce data processing equipment that is used with computers, principally "main frames", and some produce equipment that can be used in lieu of computers. Some of these manufacturers even produce small computers, mini computers. Collectively these manufacturers are referred to as "peripheral equipment manufacturers" and they represent the focus of this paper hereinafter.

Several of these manufacturers are referred to by name for example purposes:

Mohawk Data Sciences Corp.
Microform Data Systems, Inc.
Scan-Data Corp.

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The market which these peripheral manufacturers serve is one for which the regulatory authority is IBM through either its share of the market, or its marketing practices. One of these more important marketing practices is the use of the operating lease by IBM. The terms of the IBM lease commits the user to a minimum thirty-day term with termination possible thereafter with thirty-day notice to IBM on the equipment.* ** In the lease IBM also assumes the responsibility for significant risks and costs, i.e., personal property taxes, all risk insurance, etc. Additionally, the user is required by IBM to use IBM-provided maintenance if he leases the equipment from IBM.

As a continued matter of background, the peripheral equipment manufacturers have won some variations to this IBM pattern in that most of the peripheral equipment manufacturers have been able to obtain a twelve month minimum initial term; some have passed the responsibility for payment of personal property taxes to the users; some have made the user responsible for a ninety day, or even a hundred and twenty day, notice before being able to terminate the lease. Despite these changes however, the contractual instrument used in this industry is found in the terms and conditions of the Agreement for IBM Machine Service.

The significance to this rather detailed background reporting on the industry standard is found in its effect on the financial condition of the peripheral equipment manufacturer. Although many of these peripheral equipment manufacturers are successful in installing their products, they do not have the evidences of success - most are not profitable and most are extremely short on cash resources. In fact, those who have shipped the most products are sometimes the worst in appearance. Given an unrealistic combination of conditions they could be cash-rich and profitable; however, in the dynamic market place no such combination is possible.

Therefore, the peripheral equipment manufacturer has adopted the IBM life style; but also he has had to wrench himself free of its' consequences. He has had to satisfy his corporate purposes of

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*There are variations to this condition but they are not so influential on the peripheral equipment manufacturing industry as the basic practice.

**The Agreement for IBM Machine Service provides for a twelve-month minimum term,but the above described practice is observed more often than the contractual terms on peripheral equipment.

a) profit and b) positive cash flow through the use of the uncommon practice of selling to others the equipment that is used by his customers. Therefore, in recent years, in direct response to the peripheral manufacturer's needs, a new type third-party lessor has emerged.

Briefly, this type third-party lessor must be compared to the third-party computer lessor in order to differentiate between them; although in a very few instances they are one and the same. The third-party computer lessor has been in business longer, typically responds to users' needs rather than the manufacturers', and has a user-oriented marketing organization. Further, the third-party computer lessor characteristically leases IBM equipment including computers and peripherals and has as its principal competitor IBM. In contrast the third-party lessor I refer to in this paper does not have a marketing force, does not lease IBM equipment, and is responding to the peripheral equipment manufacturer's need, not the user's needs.

Therefore, through the combination of

a) the user,who is willing to obligate himself to at least a twelve-month use period on equipment delivered, maintained and otherwise serviced by a peripheral equipment manufacturer,

b) a peripheral manufacturer faced with the dire consequences of conventional financing,and

c) a third-party lessor willing to gamble on the manufacturer's ability to service the user, the likelihood of the user to renew, and the future value of the equipment,

a new type agreement has resulted that provides the manufacturer with a "lease line of credit".

Accounting Consequence

The consequence of this form of financing has resulted in there being

> profit and positive cash flow for the peripheral manufacturers that employ it, expected profit for the lessors, and a choice of manufacturers for the users.

Another result has been a controversy over whether the peripheral equipment manufacturer can report the receipt of cash from the lessor as a sale (less appropriate reserves), or should it be reported as a loan with income recognized under the operating method. The controversy seems to be of recent origin, and appears to have been developed because of the Memorex Corporation sales to a firm begun by Memorex, ILC Peripherals Leasing Corporation.

Example Transaction

Each transaction that I have reviewed or participated in may have been unlike in pattern or on some there were at least nuances of difference. For the purpose of this paper there is reason to coalesce a number of diversities into one transaction.

The peripheral equipment manufacturer (Manufacturer) develops a unique product having the likelihood of penetrating a certain sub-market in the data processing world. He obtains venture capital financing*. He develops a manufacturing, marketing, maintenance and software capability second to none**, and places a few machines in use - by means of a lease of course; and the Manufacturer has a future second to none** - but he is broke. Thus he issues more of his common stock usually with the implied promise that he will secure a lease line of credit. In specific terms then he negotiates with a Lessor or several Lessors until he is a party to a purchase agreement, wherein the terms are as shown in Attachment 1, with ancillary information contained in Attachments 2,3,4 and 5.

Proposed Method Of Accounting for Example Transaction

The proposed method of accounting attempts to illustrate all type situations that may develop from a single purchase agreement, putting exphasis

First, on the to-be-expected situation wherein a Lessee acquires use of the Equipment and uses it for most, if not all, of its economic life at the

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*or too often he dies in the womb
**They all are "second to none".

original lease rate*;

Second, a Lessee terminates his lease, the Equipment is re-leased, and the effect is shown as if it occurred for varying time periods in both the Recovery Period and the Residual Period**;

Third, conditions that continue whether the Equipment is subject to a lease or not***; and

Fourth, sale of the Equipment at various points in time****.

Reasoning

Each entry in Attachment 6 - 9 possibly should be justified but because many are so obviously acceptable and follow from the acceptance of others I shall address myself to only those that are the most controversial.

Sale Entries*****

Prior to there being any or much contact between the Manufacturer and the Lessor, or any lessor, the Manufacturer decides what he needs and the following paraphrasing is characteristically his decision.

A large amount of sales that result in current profit and cash.

"Profit and cash"; this is what motivates the Manufacturer. He then has a choice in fulfilling these requirements; he can either sell his equipment OEM****** or according to terms of a lease line

*See Attachment No. 6
**See Attachment No. 7
***See Attachment No. 8
****See Attachment No. 9
*****See Attachment No. 6 - Entry 1

******"OEM" is jargon for an agreement in which a Manufacturer agrees to sell his Equipment in quantity over a period of time to another Manufacturer, which Manufacturer assembles the purchased product into his own, and an agreement wherein the selling Manufacturer has to allow a discount from list price in the range of twenty to fifty percent.

of credit. Typically the sophisticated Manufacturer will attempt to use both techniques until one or the other begins to firm up and then he will concentrate on the more likely prospect.

It is at this point that it is important to examine the Lessor's characteristics, motivations for and risks involved in this type transaction. The characteristics of the Lessor that is in this business is that he is diversifying his leasing business, and he is nonregulated. He is motivated by the potential profit in the cash return from the Equipment and that return likely from the warrant he obtains for some of the common stock of the Manufacturer. His basic risks are whether the Manufacturer's Equipment will be successful over its planned economic life, whether the Manufacturer, typically a new and one-product firm, will make it, credit standing of the Lessees, and finally what will competition do, most particularly IBM, not only in product announcements but in delivery price and other marketing maneuvers. Therefore, the Lessor is most likely not to be a commercial bank, savings institution or insurance company*, but in fact the Manufacturer doesn't really consider them, but instead he starts conversations with some of the twenty or more Lessors that are in this industry.

Prior to there being an agreement reached between the Lessor and Manufacturer there is a negotiating environment that is characterized by the Manufacturer conducting himself as a seller, not as a borrower, and the Lessor conducting himself as a buyer, not as a lender. Both parties are hopeful of reaching an agreement, but in a way that does not compromise their basic desires. Their intentions, tactics and appearances label them as "antagonists" in the truest sense of the word. Finally, after a protracted period of time they reach agreement.

Thereafter, and prior to the transfer of title on Equipment from the Manufacturer to the Lessor, the Manufacturer has to pass several rigid tests, to wit:

> continued evidence of his competence to service his product,
>
> acceptance by the Lessor of the Lessee's credit, and
>
> acceptance by the Lessee of the Equipment

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*although at least one is a limited partner in a limited partnership functioning as a Lessor.

If the Manufacturer fails to perform, the Lessor will not buy the Equipment.

Subsequent to the sale the Lessor conducts his business as an owner by

a) accounting for the Equipment as if it were his rather than accounting for the disbursement of cash as if it were a loan, and

b) protecting his interests like that of an owner rather than a secured lender.

Also, subsequent to the sale, the Manufacturer conducts his business as if he has sold the Equipment according to the marketing agreement in that he accounts for the Equipment as if there had been a sale and accounts for his subsequent role as a collection agent for the rental payments. When Equipment is moved he notifies the Lessor, or requests his permission, whichever he is required to do; when a new Lessee is obtained he must obtain credit approval and approval of the lease terms from the Lessor and upon redelivery of the Equipment he has to obtain an acceptance by the new Lessee for the benefit of the Lessor. In summary, it is the economic intent of both Lessor and Manufacturer to make a sale. The manifestations of their intentions are obviously what any buyer and seller do involving large purchases over an extended period of time:

a purchase or sale agreement

an invoice by the seller

a delivery of the bill of sale by the seller to the buyer upon the delivery of consideration

a payment by cash, or cash and notes, by the buyer

an attempt by the seller to meet his warranties,and

a policing by the buyer to assure that he obtains the benefits of such warranties.

There must have been a sale:

the buyer and seller intended that there be a sale

- consideration has passed from the buyer to the seller for transfer of title

- the normal forms associated with a sale are used, and

- there is ample economic, legal and accounting precedent to consider that all reasonable tests of a sale have been met.

There is sufficient accounting precedent and acceptance of that precedent to label the accounting entries shown for the sale in the Attachment Number 6 as being conventional rather than controversial.

> "WARRANTIES. Products are often sold with warranties under which the warrantor, within time limits and without charge, agrees to replace defective units or parts and to furnish labor or service required to make repairs. The sales prices usually include an amount to cover anticipated costs to be incurred in discharging warranty obligations...Provision for these allowances should be made in the accounts of the producer when the original sale is recorded by a deduction from sales or a charge to operating expense."*

Therefore, the question remains how much in earnings can the seller book at the time of invoicing or the acceptance of the Equipment by the Lessee. Clearly this depends upon what is the estimated liabilities resulting from the warranties that were extended by the seller to the buyer. Since the warranties vary by type, term and amount, the amount of these liabilities becomes questionable in each case.**

In addition to the questionable amount of these estimated liabilities is the form in which they should be accounted. I believe that the

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*"Accountants' Handbook - Fourth Edition" New York: The Ronald Press Company 1963, p 5.23

**If the consideration by the buyer is a promissory note then clearly there is a credit question and, if necessary, in reply to that question, an amount should be deducted from the sales revenue as a credit reserve, but because that is not the issue here, I'll not return to the subject of the buyer's credit worthiness.

accounting profession has already decided that estimated liabilities as resulting from warranties are reserves.

> "ESTIMATED LIABILITIES. A known obligation of an uncertain amount, such as the rendering of free service and the replacement of defective merchandise, is termed an estimated liability. Under a guaranty or warranty agreement a company is obligated to comply with the terms of the contract. The only question is the aggregate sum to which they ultimately will be liable.
>
> In such case it is considered proper to charge an appropriate expense account and to credit an appropriate liability account for the estimated amount of the obligation based on the past experience of the company. This procedure permits the matching of costs and related revenues and the recognition of the obligation that is outstanding. Subsequently, costs of fulfilling guaranties are charged to the liability account."*

Often there is little or no past experience of the seller in regard to the amounts of his obligations since these Manufacturers are either new themselves or the subject of the reserve is a new product. Consequently,again we are faced with the question of the amount of the reserve.** Therefore, the amount of the reserve has to be conservatively estimated and the amount has to be reviewed periodically and adjusted accordingly.

Collection Agent Entries***

In general practice there are collection agencies that make collec-

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*Ibid, p.,20.9

**Therefore, in the Proposed Method of Accounting for Example Transaction, in the interest of being conservative, I have used as a reserve the full amount of the estimated liability for rent, the largest portion of the liability for warranty. In addition, I have applied the same conservatism to the other estimated liabilities for inclusion in the reserve; however, I concede that others equally experienced could use higher or lower amounts.

***See Attachment No. 6 - Entries 2,3 and 4 tions of cashfrom accounts receivable for the owners of such cash items and it is customary for the collection agent to deduct a fee for doing so from the received proceeds.

As owner of the Equipment, the Lessor determines whether he, or the Manfacturer, will invoice the Lessees, collect on these invoices, and prepare the appropriate reporting forms. Some Lessors prefer to perform this administrative function, but the other system of having the Manufacturer perform the funciton for a fee is preferable for these reasons:

The Manufacturer is already organized to prepare invoices for the Equipment he has retained for his own account and which is on lease.

The Manufacturer prefers to maximize his contacts with a Lessee even though it is a Lessee for Equipment owned by the Lessor and even though the nature of his contact is administrative.

The Manufacturer and the Lessor each could have one system on lease with the same Lessee and one invoice, rather than two possibly with different terms,is preferable.

The Manufacturer considers that the Lessor may become his competitor in time and that the Lessor's contacts with prospects should be minimized.

The Manufacturer has to be compensated by all Lessees for the maintenance service provided by the Manufacturer or his agent, if one is employed.

In summary, the Manufacturer is in a better position to collect rents than the Lessor, and it is therefore a logical course of action for both parties to do what is best for them as part of effecting a sale.

Remarketing Agent Entries*

There is ample precedent for one firm which has a marketing staff to market the product of another firm.

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*See Attachment No. 7 - Entries 1 - 4

In this type of transaction the Manufacturer almost always remarkets the Lessor's product. The Manufacturer must have a sales force in order to obtain the initial Lessee for the Lessor and to obtain leases for his own Equipment. His is in fact the only sales force for that specific type Equipment. The Lessor who is the most likely entity, other than the Manufacturer, to have a sales force chooses not to do so until it is absolutely necessary and in the interim period* uses the Manufacturer's. He does so because:

The Manufacturer's sales force is unquestionably the best.

During the negotiations that precede the signing of the Purchase Agreement the Lessor can obtain concessions from the Manufacturer not otherwise obtainable, and one of these concessions is an economic marketing arrangement wherein the Lessor pays -

1. A low rate of commission, or none at all, during the Recovery Period but

2. a higher rate of commission after the Recovery Period when the Lessor has recovered its investment and when the Equipment will have less of the automatic acceptance it may have had approximately five years before.

The Lessor does not want to develop a specialized sales force for each product it owns.

The Manufacturer is willing to market the Lessor's Equipment because:

The Manufacturer is qualified, prepared and already has sold the Lessee on use of that Equipment.

The Manufacturer's marketing force wants to maintain contact with the Lessee to sell him on the use of additional systems or additional features and in time replacement systems.

---

*which may be for the economic life of the Equipment.

The Manufacturer's normal practice is to maintain contact with any user of his product, whether that user is a purchaser or a Lessee, and whether such Lessee is leasing Manufacturer-owned or Lessor-owned Equipment.

The Manufacturer has to provide maintenance.

The Manufacturer, as a positive act, wants to offset competitive advances from other Manufacturers.

The consequence of the desires of these two parties is unquestionably the business-like way to handle marketing. Therefore, an agreement for marketing results that is typically included as part of the purchase agreement. However, the Lessor in giving the Manufacturer exclusive marketing rights to the Lessor's Equipment has to protect himself; he includes within this Purchase Agreement or Marketing Agreement preferential, or at least equal, treatment for himself from the Manufacturer in marketing the Equipment owned by the Lessor.

The preferential treatment desired by the Lessor, and which is applicable whenever the Lessor has Equipment not in a revenue status, usually takes the form of head of backlog, and is applicable during the Recovery Period.

The equal treatment desired by the Lessor, and which is applicable whenever the Lessor has Equipment not in a revenue status, usually takes the form of -

best efforts, or

pro rata fulfillment of orders

and is applicable during the Residual Period.

Should the Manufacturer not be successful in re-leasing the Lessor's Equipment during the Recovery Period the Manufacturer is characteristically penalized by the Lessor in order to keep him honest, so to speak. The punitive measures are named below and usually are applied singularly or in limited combination.

Rental Payments

Substitution

Repurchase of Equipment

Order fulfillment should be briefly discussed before the effects of these protective and punitive measures are expressed. When the Manufacturer receives an order he can either fill the order from what he is building (or what he has built when the Equipment is a "shelf item") or from Equipment that has returned from an initial or subsequent Lessee. He will likely, where practical, fill orders from returned Equipment. Such warehoused Equipment always has first call on backlog. During the initial years of the life cycle of the Equipment the source for order fulfillment is from the production line with some of the Equipment being sold to the Lessor and some being retained by the Manufacturer. During the subsequent time period, the outstanding orders will be filled from the production line and some orders from Equipment available from discontinued use by the initial Lessee and the ownership of such discontinued Equipment may be either that of the Lessor or the Manufacturer. During the next and final period, the incoming orders are fulfilled from the Equipment returned by Lessees, which Equipment is owned by both Lessor and Manufacturer. The entire time period, which I have divided into three sub-periods, can vary from six through ten years depending upon the product's success.

Use of the head of backlog for the Lessor has this practical effect on the Manufacturer; the Manufacturer loses an order to the Lessor as much as if he had lost an order to competition and consequently over the long run he closes the production line one unit sooner and suffers a lost opportunity then. So long as there is a backlog he does not suffer an economic loss at the time the Lessor's Equipment is advanced to head of backlog. The next order in backlog is advanced and is satisfied from the next available Equipment.

If the Lessor's Equipment were used to fulfill the last unfilled order, it is likely that the production line had been closed much sooner and therefore the Manufacturer has a unit off lease that he could have had on lease if it had not been for the Lessor's Equipment being at the head of backlog.

"Best efforts" is a marketing effort by the Manufacturer on behalf of the Lessor for which there is no breech if the Manufacturer is prevented by causes wholly beyond his control and without any default on his part. The Manufacturer agrees to do his best for the Lessor.

"Pro rata fulfillment of orders" is a formulized way of describing how Lessor-owned Equipment that is available will be re-leased in relationship to Manufacturer-owned Equipment.

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Should the Manufacturer agree to any one or more of the below listed conditions,

head of backlog, or

best efforts, or

pro rata fulfillment of orders,

the reserve that should be set up at the time of the sale should be directly related to the expense incurred by the Manufacturer in fulfillment of that requirement. However, there is no reason not to book a sale when the Manufacturer agrees to help protect the Lessor's investment.

In contrast it is any punitive condition that the Manufacturer agrees to that should represent the basic reason for a reserve for warranty, but even so these punitive measures are not reasons to attack the validity of there having been a sale.

Should the Manufacturer agree to make Rental Payments to the Lessor, should the Lessor-owned Equipment be off lease for at least a two or three-month period, he will normally agree to pay in the range of two through ten payments, after which his obligation to make further payments ceases. Unless past experience indicates that a reserve is not called for these Rental Payments would likely be reserved for in part or in total.

Use of substitution as a possible punitive measure has this practical effect on the Manufacturer; the Manufacturer will lose the rental revenue on that unit that is replaced by the Lessor's unit and, at the time the substitution occurs the Manufacturer discontinues reporting that revenue but continues to report the depreciation expense. There appears to be no reason to penalize a Manufacturer in advance for that future contingency when his method of reporting revenue on the Equipment owned by the Manufacturer, "the operating method", is used for that contingency anyway.

Use of the repurchase requirement for Equipment by the two parties to a lease line of credit agreement should not alter the recommended method of booking sales revenue. However, the maximum potential repurchase price will likely substantially influence the amount of reserve for warranties. Should the maximum potential repurchase price result in a very high reserve for warranties, the Manufacturer will garner little or no current gross profit from the sale. In fact, when the reserve is combined with the applicable cost of sales the Manufacturer may report a loss on that sale - , but nonetheless a sale occurred.

Aside from marketing the Lessor's Equipment to Leasees on a lease basis the Manufacturer attempts to sell Equipment to Leasees and other users. Selling this type Equipment is quite difficult as compared to leasing it. It is also more difficult to sell this type of Equipment further on in its life cycle. Therefore, there is reason for increased compensation or commission rates for Manufacturers later on in the life cycle of the Equipment. This may be called "residual sharing".

Aside from this commission, the Manufacturer has an additional inducement to sell the Lessor's Equipment prior to the completion of the Residual Period in that with success he is able to charge off the remaining reserve for warranties into income or as an offset to cost of sales.

The significance to this discussion on remarketing is for the reader to recognize that the Lessor and Manufacturer determine that it is fundamental to both parties interest

a) for the Manufacturer to have the exclusive right and obligation to remarket the Lessor's Equipment

b) the Manufacturer should be penalized for failure to do so, and

c) there is cause for establishing or adding to a reserve for warranty.

However, despite the remarketing arrangement <u>there has been a sale</u>.

Other Relational Aspects

It is thought that the other entries are sufficiently conventional, therefore acceptable and not necessary of explanation.

•
The Proposed method of accounting is done with these assumptions resulting from the Purchase Agreement between the Lessor and Manufacturer. All other conditions are generally as previously discussed.

Lessor: A non-manufacturer who characteristically leases equipment.

Manufacturer: An engineering, manufacturing (principally assembling), marketing and most often a provider of maintenance services for a data processing or communication product.

Lessee: A user who is obligated to the terms of a lease negotiated with the Manufacturer. (See Attachment Number 2, Purchase Agreement Terms.)

Equipment: The Manufacturer's product which is usually classified as "limited life equipment".

Commitment - Amount: Minimum dollar amount usually in annual increments over a period of several years.
Example: $10,000,000 total over the purchase period.

Commitment - Percentage: That percentage of the Manufacturer's production that the Lessor will purchase. It usually varies from twenty-five to seventy-five percent (25-75%).

Purchase Period: Period of time following the execution of the Purchase Agreement during which period the Lessor will purchase Equipment.
Example: Three (3) years.

Purchase Price: The price paid by the Lessor to the Manufacturer which almost always is with a volume discount from list price.
Example: $100,000

Rental Payments: The monthly payment required of the Lessee by the Lessor and Manufacturer during the initial term of the lease.
Example: $3,000 of which $500 is payable to the Manufacturer for prime shift maintenance.

• ATTACHMENT Number 1 - Purchase Agreement Terms

• Recovery Period: The period of time during which amortization of the Lessor's investment takes place.

Example: Fifty (50) months.

Residual Period: The period of time following the Recovery Period.

Example: After fifty (50) months.

Administration: The responsibility for invoicing and collecting Rental Payments from the Lessee.

Administration Fee: Percentage of Rental Payment (less maintenance) or Gross Sales Proceeds, deductible upon receipt.

Example: One percent (1%).

Commission: Percentage of Purchase Price, payable to the Manufacturer, each time the Equipment is re-leased or percentage of net proceeds of subsequently received proceeds from rent or sale of the Equipment after the Recovery Period has elapsed or after the Lessor receives some part of the Purchase Price, whichever occurs first.

Example: a) One percent (1%) of Purchase Price or
b) Twenty-five percent (25%) of net proceeds after
(1) Recovery Period or
(2) Lessor receives one hundred twenty-five percent (125%) of Purchase Price
whichever [b(1) or b(2)] occurs first.

Rental Penalty: Should the Manufacturer not be able to re-lease or sell the Lessor's Equipment, the Manufacturer sometimes incurs a penalty.

Example: Manufacturer is to pay four (4) months @ $2,500 per month, or $10,000 in total starting three (3) months after Lessor's equipment is off rent but this provision is not effective during the initial term of the lease for the initial Lessee or subsequent Lessee's initial term thereafter.

Insurance All Risk: Lessor.

Personal Property Tax: Manufacturer (See Attachment Number 2, Lease Agreement Terms.)

• ATTACHMENT Number 1 - Purchase Agreement Terms

- **Warrants***: The Manufacturer will commonly give the Lessor a warrant on the common stock of the Manufacturer according to other Agreement terms.

  Example: A warrant for 70,000 shares of common stock which will represent at the time of purchase seven percent (7%) of the then outstanding shares.

  Economic Life: The period of time during which the Lessor is depreciating the Equipment and after which time the Purchase Agreement terminates as to that Equipment.

  Example: Seventy-two (72) months.

*The accounting for this transaction is not shown as it is not relevant.

The Proposed method of accounting is done with these assumptions resulting from the Lease Agreement between the Lessee and Manufacturer using a form of lease pre-approved by the Lessor.

Term: The Initial Term commences with the day of acceptance and continues thereafter usually for twelve (12) months.
Example: Twelve (12) months.

Renewal Term: Commences following the Initial Term and is automatic month-to-month with a notice of termination equal to one to three (1-3) months.
Example: Month-to-month with three (3) month notice.

Use: Unlimited use is given the Lessee.

Personal Property Tax: The responsibility for making payment to the municipality in which the Equipment is located for ad valorem taxes.
Example: Lessee. (See Attachment Number 1, Purchase Agreement Terms.)

Insurance "All Risk": The responsibility for replacement value coverage of the Equipment.
Example: Manufacturer's responsibility which the Lessor assumes in the Purchase Agreement.

Shipping Costs: To and from the Manufacturer's plant.
Example: Lessee's responsibility.

Purchase Option: The Lessee may exercise an option to purchase the Equipment so long as the Equipment is subject to the Lease Agreement with there usually being a reduction in purchase price by some portion of net rent paid per month to a minimum percentage of List Price.
Example: Reduction in Purchase Price by thirty percent (30%) of net rent. Minimum percentage of List Price is sixty percent (60%).

List Price: The price at which one unit of the Equipment is normally purchased.
Example: $112,500.

The proposed method of accounting is done with these Manufacturer estimates of Reserve for Warranties concurred to by its public accounting firm.

$32,000: Cost of Sales

$ 1,000: Rennovation (assuming that rennovation is necessary once during the Recovery Period and that rennovation costs will be one percent (1%) of the Purchase Price).

$ 1,250: Personal Property Taxes (assuming that of all the leases to be written there is a probability of one out of ten (1/10) wherein the Lessee refuses to pay the Personal Property Tax. The average Personal Property Tax over the Recovery Period for all fifty (50) of the United States plus Washington, D.C. is presumed to be ten percent (10%) of Rental Revenue after deduction of prime shift maintenance).

$ 1,000: Shipping (assuming that one out of two (1/2) Lessees will refuse the responsibility for shipping expense).

$ 1,750: Miscellaneous. This amount provides for remarketing costs incurred by the Manufacturer in remarketing a Lessor's Equipment prior to payment of the commission by the Lessor when its equipment is successfully relocated.

The Reserve for Warranties is made up of:

$10,000	- Rental Penalty*
1,000	- Rennovation**
1,250	- Personal Property Taxes**
1,000	- Shipping**
1,750	- Miscellaneous**
$15,000	TOTAL

*The Rental Penalty is reserved for in total. The Reserve for Warranties is to be charged when, and if, paid and the balance, if any, is to be charged to the current cost of sales account in the last month of the Recovery Period; and, if any remains, in the second to last month of

• (*) continued...

the Recovery Period; and, if any remains, in the third to last month of the Recovery Period; and finally, if any remains, in the fourth to last month of the Recovery Period. (Months are measured from the commencement day of the initial lease.)

**The Reserve for Warranty is to be charged in the month when rennovation is completed, or when the Personal Property Taxes are paid or when the income due and payable, or the shipping costs are paid or remarketing costs are incurred and the balance, if any, is to be charged to the then current cost of sales account in the seventy-third (73rd) month.

The proposed method of accounting is done with estimates made by the Lessor with the concurrence of his public accounting firm.

<u>Depreciation Method</u>: Straight line.

<u>Salvage Value</u>: Zero.

<u>Economic Life</u>: Seventy-two (72) months.

<u>Depreciation Rate</u>: $1,388.88 per month.

<u>Insurance All Risk Premium</u>: $600 per $100,000 of replacement value coverage per year or $50 per month.

ATTACHMENT Number 4 - Lessor Estimates

The Chart of Account used for the proposed method of accounting is shown below:

LESSEE

ASSETS

Cash
Fixed Assets

EXPENSES

Rent Expense

LESSOR

ASSETS

Cash
Fixed Assets
Reserve for Depreciation

INCOME

Rental Revenue
Equipment Sales

LIABILITIES

Premium Payable

EXPENSES

Administrative Expense
Commission Expense
Depreciation Expense
Discounts Allowed
Insurance Expense

MANUFACTURER

ASSETS

Cash

INCOME

Administrative Revenue
Commission Revenue
Maintenance Revenue
Sales Revenue

LIABILITIES

Rental Payable

Sales Price Payable

Reserve for Warranties

- ATTACHMENT Number 5 - Chart of Accounts

1. Sale of Equipment made by Manufacturer to Lessor:

Manufacturer:	Debit -	Cash	$100,000.00	
	Credit -	Sales Revenue		$100,000.00
	Debit -	Cost of Sales	$ 47,000.00	
	Credit -	Inventory - Equipment		$ 32,000.00
		Reserve for Warranties		15,000.00
Lessor:	Debit -	Fixed Assets	$100,000.00	
	Credit -	Cash		$100,000.00

2. Rental Payments made by Lessee to Manufacturer:

a. Each month during Recovery Period
b. Each month during Residual Period

a. Each month during Recovery Period:

Lessee:	Debit -	Rent Expense	$3,000.00	
	Credit -	Cash		$3,000.00
Manufacturer:	Debit -	Cash	$3,000.00	
	Credit -	Rental Payable		$2,475.00
		Maintenance Revenue		500.00
		Administrative Revenue		25.00

b. Each month during Residual Period:

Lessee:	Debit -	Rent Expense	$3,000.00	
	Credit -	Cash		$3,000.00
Manufacturer:	Debit -	Cash	$3,000.00	
	Credit -	Rental Payable		$1,856.25
		Commission Revenue*		618.75
		Maintenance Revenue		500.00
		Administrative Revenue		25.00

*.25 x $2,475

ATTACHMENT Number 6

LEASE CONSULTANTS

OF PHILADELPHIA INC.

3. Remittance of Rental Payments to Lessor by Manufacturer:

   a. Each month during Recovery Period
   b. Each month during Residual Period

a. Each month during Recovery Period:

Manufacturer:	Debit -	Rental Payable	$2,475.00	
	Credit -	Cash		$2,475.00
Lessor:	Debit -	Cash	$2,475.00	
		Administrative Expense	25.00	
	Credit -	Rental Revenue		$2,500.00

b. Each month during Residual Period:

Manufacturer:	Debit -	Rental Payable	$1,856.25	
	Credit -	Cash		$1,856.25
Lessor:	Debit -	Cash	$1,856.25	
		Administrative Expense	25.00	
		Commission Expense	618.75	
	Credit -	Rental Revenue		$2,500.00

4. Entries when Warranty Period lapses:

   a. Recovery Period and assuming no charges have been made to the Reserve for Warranties

Manufacturer:	Debit -	Reserve for Warranties	$2,500.00	
	Credit -	Cost of Sales*		$2,500.00

(In each of Months 47,48,49 & 50)

   b. Residual Period and assuming no charges have been made to the Reserve for Warranties

Manufacturer:	Debit -	Reserve for Warranties	$5,000.00	
	Credit -	Cost of Sales*		$5,000.00

(Month 73)

*If the Manufacturer is no longer producing the same or similar product Other Income or Extraordinary Income account should be credited in lieu of Cost.

ATTACHMENT Number 6

1. Equipment Off-lease:

   a. During Recovery Period in month 25
   b. During Residual Period in month 55

a. Month 25 during Recovery Period:

Manufacturer:	Debit -	Reserve for Warranties	$100.00	
	Credit -	Cash		$100.00

(Costs incurred directly attributable to remarketing of Lessor Equipment.)

b. Month 55 during Residual Period:

Manufacturer:	Debit -	Reserve for Warranties	$100.00	
	Credit -	Cash		$100.00

(Costs incurred directly attributable to remarketing of Lessor Equipment.)

2. Equipment Relocated for lease:

   a. During Recovery Period month 26 after being off-lease during month 25
   b. During Residual Period month 56 after being off-lease during month 55

a. During Recovery Period month 26:

Lessee:	Debit -	Rent Expense	$3,000.00	
	Credit -	Cash		$3,000.00
Manufacturer:	Debit -	Cash	$3,000.00	
	Credit -	Rental Payable		$1,475.00
		Commission Revenue		1,000.00
		Maintenance Revenue		500.00
		Administrative Revenue		25.00

• Manufacturer:	Debit -	Rental Payable	$1,475.00	
	Credit -	Cash		$1,475.00
Lessor:	Debit -	Cash	$1,475.00	
		Administrative Expense	25.00	
		Commission Expense	1,000.00	
	Credit -	Rental Revenue		$2,500.00

b. During Residual Period month 56:

Lessee:	Debit -	Rent Expense	$3,000.00	
	Credit -	Cash		$3,000.00
Manufacturer:	Debit -	Cash	$3,000.00	
	Credit -	Rental Payable		$1,856.25
		Commission Revenue		618.75
		Maintenance Revenue		500.00
		Administrative Revenue		25.00
Manufacturer:	Debit -	Rental Payable	$1,856.25	
	Credit -	Cash		$1,856.25
Lessor:	Debit -	Cash	$1,856.25	
		Commission Expense	618.75	
		Administrative Expense	25.00	
	Credit -	Rental Revenue		$2,500.00

3. Equipment Off-lease:

a. During Recovery Period - months 25-28
b. During Residual Period - months 55-58

a. During Recovery Period Months 25-28:

Manufacturer:	Debit -	Reserve for Warranties	$100.00	
	Credit -	Cash		$100.00

(Each month 25-27 for costs incurred directly attributable to remarketing of Lessor Equipment.)

• ATTACHMENT Number 7

	Debit -	Reserve for Warranties	$2,600.00	
	Credit -	Cash		$2,575.00
		Administrative Revenue		25.00

(Month 28 for costs incurred directly attributable to remarketing of Lessor's Equipment. [$100 and rental payment due to Lessor of $2,500.00].)

Lessor:	Debit -	Cash	$2,475.00	
		Administrative Expense	25.00	
	Credit -	Rental Revenue		$2,500.00

(For month 28)

b. During Residual Period Months 55-58:

Manufacturer:	Debit -	Reserve for Warranties	$200.00	
	Credit -	Cash		$200.00

(Each month 55-58 for costs incurred and directly attributable to remarketing of Lessor Equipment.)

4. Equipment Off-lease:

   a. During Recovery Period - months 25-33
   b. During Residual Period - months 55-63

a. During Recovery Period Months 25-33:

Manufacturer:	Debit -	Reserve for Warranties	$100.00	
	Credit -	Cash		$100.00

(Each month 25-27 for costs incurred directly attributable to remarketing of Lessor's Equipment.)

Debit -	Reserve for Warranties	$2,600.00	
Credit -	Cash		$2,575.00
	Administrative Revenue		25.00

(Each month 28-31 for costs incurred directly attributable to remarketing of Lessor's Equipment [$100 and rental payment due to Lessor, $2,500].)

<u>Lessor</u>:

Debit -	Cash	$2,475.00	
	Administrative Expense	25.00	
Credit -	Rental Revenue		$2,500.00

(Each month 28-31)

<u>Manufacturer</u>:

Debit -	Reserve for Warranties	$100.00	
Credit -	Cash		$100.00

(Each month 32-33 for costs incurred directly attributable to remarketing of Lessor's Equipment.)

<u>b. During Residual Period Months 55-63</u>:

Manufacturer:

Debit -	Reserve for Warranties	$200.00	
Credit -	Cash		$200.00

(Each month 55-63 for costs incurred directly attributable to remarketing of Lessor's Equipment.)

1. **Depreciation of Equipment by Lessor without considering the one-time effect of depreciation and the likelihood of investment credit:**

Lessor:	Debit - Depreciation Expense	$1,388.88	
	Credit - Reserve for Depreciation		$1,388.88

(Each month 1-72)

2. **Charging for Insurance:**

Lessor:	Debit - Insurance Expense	$50.00	
	Credit - Premium Payable		$50.00

(Months 1 and thereafter)

- Purchase by Lessee after the sixth month and before Lessee makes the seventh Rental Payment:

Lessee:	Debit -	Fixed Assets*	$108,000.00	
	Credit -	Cash		$108,000.00
Manufacturer:	Debit -	Cash	$108,000.00	
	Credit -	Sales Price Payable**		$106,920.00
		Administrative Revenue		1,080.00
	Debit -	Reserve for Warranty	15,000.00	
	Credit -	Cost of Sales		15,000.00

Manufacturer simultaneously pays the Lessor.

Manufacturer:	Debit -	Sales Price Payable	$106,920.00	
	Credit -	Cash		$106,920.00
Lessor:	Debit -	Cash	$106,920.00	
		Administrative Expense	1,080.00	
	Credit -	Equipment Sales		$108,000.00

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*	Price is equal to List Price	$112,500.00
	(less .30 x $2500/mo. x 6 mo.)	(4,500.00)
		$108,000.00
**	125% of Purchase Price is	$125,000.00
	Receipts to date are $2475/mo. x 6 mo.	14,850.00
	Amount necessary for Lessor to receive before Manufacturer is paid a commission for reselling the Equipment	$110,150.00

- ATTACHMENT Number 9

- **Purchase by Lessee after the twenty-fourth month and before Lessee makes the twenty-fifth Rental Payment:**

Lessee:	Debit -	Fixed Assets*	$94,500.00	
	Credit -	Cash		$94,500.00
Manufacturer:	Debit -	Cash	$94,500.00	
	Credit -	Sales Price Payable**		$86,566.25
		Commission Revenue		6,988.75
		Administrative Revenue		945.00
	Debit -	Reserve for Warranty	$15,000.00	
	Credit -	Cost of Sales		$15,000.00

Manufacturer simultaneously pays the Lessor.

Manufacturer:	Debit -	Sales Price Payable	$86,566.25	
	Credit -	Cash		$86,566.25
Lessor:	Debit -	Cash	$86,566.25	
		Commission Expense	6,988.75	
		Administrative Expense	945.00	
	Credit -	Equipment Sales		$94,500.00

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* Price is equal to List Price		$112,500.00
(less .30 x $2500/mo. x 24 mo.)		(18,000.00)
		$ 94,500.00
** 125% of Purchase Price is		$125,000.00
Receipts to date are $2475/mo. x 24 mo.		59,400.00
Amount necessary for Lessor to receive before Manufacturer is compensated for remarketing		$ 65,600.00
Gross Sale Proceeds	$94,500.00	
(Less amount necessary to reach $125,000)	(65,600.00)	
(Less Administrative Revenue)	(945.00)	
Net Amount subject to commission		$ 27,955.00
Commission to Manufacturer .25 x $27,955		6,988.75

- ATTACHMENT Number 9

LEASE CONSULTANTS

OF PHILADELPHIA INC.

LEASING INTERNATIONAL, INC.
3242 PEACHTREE ROAD. N. E.
ATLANTA, GEORGIA 30305
TELEPHONE (404) 261-0990

October 7, 1971

Mr. Robert N. Sempier
American Institute of Certified Public Accountants
666 Fifth Avenue
New York, New York 10019

Dear Mr. Sempier:

This letter will further outline my company's position with regard to risks involved in finance (Open End) and operating (Closed End) automotive leases and will give our reasons for believing that open end and closed end automotive leases should be accounted for by the same accounting method.

When a lessee chooses an "Open End" lease, his responsibility is for "X" payments and that the residual value sells for at least as much as projected. He has the option to premature this lease upon payment of a penalty computed similarly to the rule of 78's.

A lessee's responsibility on a "Closed End" lease is different but protects the value of the vehicle for the lessor just the same. The lessee's mileage is restricted and he must pay a penalty for any excess miles over the limit. He also must bring the vehicle back with only "fair wear and tear". That is; if a tire is slick or the car needs a tune-up or valve job, or has body damage or any abuse, the lessee must pay the lessor an amount equal to the cost of these repairs. These responsibilities are spelled out in the lease. The lessee may premature his closed end lease at any time after six payments at which time the "Closed End" lease automatically becomes "Open" and the same penalties apply as if he had started out "Open End".

I believe what the APB needs to recognize more than anything is that automotive leasing is a completely different ball game from computer or other types of "equipment leases". In view of the fact that there is always a receptive market for used vehicles, your suggested 10% of cost as a guideline for automotive lessors to determine accounting on the finance or operating method, I think, is completely out of line. We at Leasing International, Inc. think that a fairer residual percentage, if one is needed at all, in automotive leasing is 70% for 12 month, 50% for 24 month, 35% for 36 month, and 25% for 48 month leases.

Mr. Robert N. Sempier October 7, 1971

Someone may question the lessor's risk of residual value in an economic recession. Generally speaking, the value of used cars increases in a recession due to the public "tightening their belts". In a strong economy used vehicles hold their prices due to the inflationary trends. So you see, the automotive lessor does not stand to lose money on residual values as equipment lessors might.

I hope that I may help clear up some of the problems confronting the APB on October 14, 1971. I look forward to an oral presentation at that time.

Yours very truly,

LEASING INTERNATIONAL, INC.

F. W. Briscoe
Vice President

FWB/sp

LEASING INTERNATIONAL, INC.

3242 PEACHTREE ROAD, N. E.
ATLANTA, GEORGIA 30305
TELEPHONE (404) 261-0990

LEASE TYPE	☐ OPEN END ☒ CLOSED END
LEASE NO.	2861
UNIT NO.	5636
DELIVERY DATE	10/5/71
NEW X ADDITIONAL	
EXPIRED NO.	

VEHICLE LEASE ORDER

LESSEE JOHN B. DOE — BUSINESS PHONE 404/892-8499 — HOME PHONE

ADDRESS 130 The Prado, N.E., Atlanta, Georgia 30309

OPERATORS NAME (Lessee) — ADDRESS (Same as Above)

YEAR	MAKE	MODEL	BODY TYPE	COLOR	SERIAL NO.
1972	Chevrolet	Impala Custom	2/Door Hardtop	Dr.Blue	1M47H2D108573

ACCESSORIES AND SPECIAL EQUIPMENT

☒ V-8 CYL. ENGINE	☒ POWER STEERING	☒ WHEEL COVERS	☒ Remote Control Mirror
☒ AUTOMATIC TRANS.	☒ POWER BRAKES	☐ POWER WINDOWS	☐
☒ RADIO FM	☒ AIR CONDITIONING	☐ POWER SEAT	☐
☒ VINYL ROOF	☒ TINTED GLASS	☒ Rear Seat Spkr.	☐
☒ VINYL TRIM	☒ WHITEWALL TIRES	☒ Floor Mats	☐

INITIAL TERM 36 Months

RATE $ 105.27 PER MONTH

SALES TAX $ 3.16 PER MONTH

TOTAL PAYMENT $ 108.43 PER MONTH

DEPRECIATION VALUE AT END OF INITIAL TERM $ 1,450.06

PREMATURE TERMINATION FACTOR $ 90.14

SECURITY DEPOSIT RECEIPT NUMBER ______ $ 200.00

ANNUAL MILEAGE ALLOWANCE 20,000 — EXCESS MILEAGE CHARGE PER MILE .02 ¢

LEASE RATE BASED ON LESSEE ANNUAL MILEAGE ESTIMATE OF 20,000

RENTAL TO BE PAID ON 1st DAY OF EACH MONTH BEGINNING October 1, 1971 TO:

LEASING INTERNATIONAL, INC.
ATLANTA, GEORGIA

AT TERMINATION VEHICLE TO BE RETURNED TO ATLANTA, GEORGIA UNLESS OTHERWISE SPECIFIED UNDER SPECIAL PROVISIONS.

SPECIAL PROVISIONS (IF ANY)

PAYMENTS MADE 15 DAYS AFTER DUE DATE SUBJECT TO 5% LATE CHARGE

LICENSE AND TAXES

PROVIDED BY LESSOR ______ PROVIDED BY LESSEE 4,1,2,3

1. STATE LICENSE
2. SALES TAX
3. PROPERTY TAXES
4. ALL OTHER TAXES

MINIMUM INSURANCE REQUIRED

PROVIDED BY LESSOR ______ PROVIDED BY LESSEE 5, 6 1,2,3,4

1. COMPREHENSIVE ($50.00 DEDUCTIBLE)
2. COLLISION ($100.00 DEDUCTIBLE)
3. PUBLIC LIABILITY ($100,000 / $300,000)
4. PROPERTY DAMAGE ($25,000)
5. FIRST $ 100.00 OF ANY COLLISION DAMAGE +
6. FIRST $ 50.00 OF ANY COMPREHENSIVE DAMAGE

AGENT NAME Duncan Peek, Inc. - Robert Reardon, Agent

ADDRESS 1270 Techwood Drive, Atlanta, Ga.

404/ PHONE 873-1092

MAINTENANCE

PROVIDED BY LESSOR ______ PROVIDED BY LESSEE 1,2,3,4

1. MECH. MAINTENANCE REPAIRS
2. FRONT END ALIGNMENT & WHEEL BALANCE
3. OIL & FILTER CHANGES & LUBRICATION
4. TIRES (MAXIMUM ______)
5.

NORMAL MAINTENANCE REPAIRS TO BE PERFORMED AT Dealer of Lessee's Choice

MONTHLY MAINTENANCE RESERVE CREDIT $ -0-

IT IS HEREBY AGREED THAT MAINTENANCE WILL BE PROVIDED AS SPECIFIED ABOVE BY LESSOR AND/OR LESSEE. IN EVENT LESSOR PROVIDES MAINTENANCE, LESSOR AGREES TO RETURN TO LESSEE ANY UNUSED PORTION OF THE ACCUMULATED MAINTENANCE RESERVE CREDIT, AND LESSEE AGREES TO PAY TO LESSOR ANY MAINTENANCE COSTS IN EXCESS OF THE ACCUMULATED RESERVE CREDIT, ON TERMINATION OF THIS LEASE ORDER.

I/WE HEREBY ORDER FOR LEASE UNDER THE TERMS OF LESSOR'S LEASE AGREEMENT, WHICH IS INCORPORATED HEREIN BY REFERENCE, THE ABOVE VEHICLE TO BE DELIVERED AT

Atlanta, (CITY) Georgia (STATE)

THIS VEHICLE LEASE ORDER IS APPROVED AND ACCEPTED THIS 5th DAY OF October 1971

LEASING INTERNATIONAL, INC.

BY Paul D. Jones

TITLE

JOHN B. DOE
LESSEE

BY John B. Doe — TITLE

PAYMENTS GUARANTEED BY

LEASING INTERNATIONAL, INC.

3242 PEACHTREE ROAD, N. E.
ATLANTA, GEORGIA 30305
TELEPHONE (404) 261-0990

LEASE TYPE	[X] OPEN END [ ] CLOSED END
LEASE NO.	10,088
UNIT NO.	15,098
DELIVERY DATE	9/27/71
NEW	X
ADDITIONAL	
EXPIRED NO.	

VEHICLE LEASE ORDER

LESSEE JOHN B. DOE

BUSINESS PHONE 404/636-0137 HOME PHONE

ADDRESS 2514 Brookdale Drive, N.E., Atlanta, Georgia

OPERATORS NAME (Lessee) ADDRESS (Same as Above)

YEAR	MAKE	MODEL	BODY TYPE	COLOR	SERIAL NO.
1972	Mercury	Monterey Custom	4/Door Hardtop	Brown	2Z58S509682

ACCESSORIES AND SPECIAL EQUIPMENT

- [X] V-8 CYL. ENGINE
- [X] AUTOMATIC TRANS.
- [X] RADIO FM STEREO
- [X] VINYL ROOF
- [X] VINYL TRIM
- [X] POWER STEERING
- [X] POWER BRAKES
- [X] AIR CONDITIONING
- [X] TINTED GLASS
- [X] WHITEWALL TIRES
- [X] WHEEL COVERS
- [ ] POWER WINDOWS
- [ ] POWER SEAT
- [X] Split Paint
- [X] Clock
- [X] Remote Mirror
- [X] Bumper Guards
- [X] Fender Skirts
- [ ]
- [ ]

INITIAL TERM 28 Months

RATE $ 136.51 PER MONTH

SALES TAX $ 4.10 PER MONTH

TOTAL PAYMENT $ 140.61 PER MONTH

DEPRECIATION VALUE AT END OF INITIAL TERM $ 1,799.98

PREMATURE TERMINATION FACTOR $ 108.69

SECURITY DEPOSIT RECEIPT NUMBER ______ $ -0-

ANNUAL MILEAGE ALLOWANCE ______ EXCESS MILEAGE CHARGE PER MILE ______ ¢

LEASE RATE BASED ON LESSEE ANNUAL MILEAGE ESTIMATE OF 25,000

RENTAL TO BE PAID ON 1st DAY OF EACH MONTH BEGINNING October 1, 1971 TO:

LEASING INTERNATIONAL, INC.
ATLANTA, GEORGIA

AT TERMINATION VEHICLE TO BE RETURNED TO ATLANTA, GEORGIA UNLESS OTHERWISE SPECIFIED UNDER SPECIAL PROVISIONS.

SPECIAL PROVISIONS (IF ANY)

PAYMENTS MADE 15 DAYS AFTER DUE DATE SUBJECT TO 5% LATE CHARGE

LICENSE AND TAXES

PROVIDED BY LESSOR ______ PROVIDED BY LESSEE 4,1,2,3

1. STATE LICENSE
2. SALES TAX
3. PROPERTY TAXES
4. ALL OTHER TAXES

MINIMUM INSURANCE REQUIRED

PROVIDED BY LESSOR ______ PROVIDED BY LESSEE 5, 6, 1, 2, 3, 4

1. COMPREHENSIVE ($50.00 DEDUCTIBLE)
2. COLLISION ($100.00 DEDUCTIBLE)
3. PUBLIC LIABILITY ($100,000 / $300,000)
4. PROPERTY DAMAGE ($25,000)
5. FIRST $ 100.00 OF ANY COLLISION DAMAGE +
6. FIRST $ 50.00 OF ANY COMPREHENSIVE DAMAGE

AGENT NAME Allstate Insurance Co. - Don Boyer, Agent
ADDRESS 3585 Northside Parkway, N.W., Atlanta, Ga.
PHONE 404/ 237-3361

MAINTENANCE

PROVIDED BY LESSOR ______ PROVIDED BY LESSEE 1,2,3,4

1. MECH. MAINTENANCE REPAIRS 2. FRONT END ALIGNMENT & WHEEL BALANCE
3. OIL & FILTER CHANGES & LUBRICATION 4. TIRES (MAXIMUM ______)
5.

NORMAL MAINTENANCE REPAIRS TO BE PERFORMED AT Dealer of Lessee's Choice

MONTHLY MAINTENANCE RESERVE CREDIT $ -0-

IT IS HEREBY AGREED THAT MAINTENANCE WILL BE PROVIDED AS SPECIFIED ABOVE BY LESSOR AND/OR LESSEE. IN EVENT LESSOR PROVIDES MAINTENANCE, LESSOR AGREES TO RETURN TO LESSEE ANY UNUSED PORTION OF THE ACCUMULATED MAINTENANCE RESERVE CREDIT, AND LESSEE AGREES TO PAY TO LESSOR ANY MAINTENANCE COSTS IN EXCESS OF THE ACCUMULATED RESERVE CREDIT, ON TERMINATION OF THIS LEASE ORDER.

I/WE HEREBY ORDER FOR LEASE UNDER THE TERMS OF LESSOR'S LEASE AGREEMENT, WHICH IS INCORPORATED HEREIN BY REFERENCE, THE ABOVE VEHICLE TO BE DELIVERED AT

Atlanta, (CITY) Georgia (STATE)

THIS VEHICLE LEASE ORDER IS APPROVED AND ACCEPTED THIS 27th DAY OF Sept. 1971

LEASING INTERNATIONAL, INC.

BY ______

TITLE ______

JOHN B. DOE
LESSEE

BY ______ TITLE ______

PAYMENTS GUARANTEED BY ______

INSPECTION OF LEASED VEHICLES

The following is intended as a guide for use in evaluating "normal wear and tear" of leased vehicles turned in for disposal as used cars. In general, normal wear and tear proportionate to the mileage is to be expected; conditions resulting from operator neglect or abuse become the responsibility of Lessee.

General Condition

Lessee is responsible for the following items at the time of release: interior must be clean; all equipment such as jack and spare wheel, and all equipment included in Lease Agreement, etc., must be present.

Body - Exterior

Acceptable: Stone chips, bumper scratches and minor dents (from parking), paint chips on sides and front of hood, minimal rust and paint oxidation, and minor scratches.

Non-Acceptable: Body dents requiring sheetmetal work to make the vehicle acceptable for resale as a late model used car, bumper damage of collision severity, damaged windshield or other glass, severe scratches, and alterations (hole drilling, etc.) due to Lessee installation of accessories, such as trailer hitches, telephone antenna, etc.

Body - Interior

Acceptable: Wear of trim and carpets proportionate to mileage, substandard manufacturing conditions such as split seams or sagged cushions, minor scratches and removable stains.

Non-Acceptable: Permanently stained or damaged trim or carpets, severely scratched or damaged garnish mouldings or instrument panel, damage caused by installation of accessories other than original equipment.

Tires

Acceptable: Free from cuts and bruises requiring patches or boots. Tread must be clearly visible and of sufficient depth to pass state safety inspection.

Mechanical Conditions

Lessee is responsible for proper maintenance of the vehicle in accordance with the appropriate Certified Car Care schedule or equivalent, and for satisfactory operating performance of the vehicle at time of release, including engine, drive train, brakes and steering.

SUMMARY

Some of the items designated "non-acceptable" may be classified as comprehensive damage, in which case the Lessee would have recourse through insurance coverage. However, such items must be corrected prior to release of the vehicle.

LEASING INTERNATIONAL, INC.

SIGNED: ______________________________
LESSEE

SIGNED BY: ______________________________
LESSOR

Comparison of operating statements for a 36 month lease using the operating and financing methods:

	Operating	Financing
Year 1:		
Gross income	$1,179	$ 730
Less depreciation expense	750	-
Less acquisition cost	61	101
Gross profit	$ 368	$ 629
Year 2:		
Gross income	$1,179	$ 408
Less depreciation expense	750	$ -
Less acquisition costs	61	60
Gross profit	$ 368	$ 348
Year 3:		
Gross income	$1,179	$ 149
Less depreciation expense	750	-
Less acquisition costs	61	22
Gross profit	$1,104	$1104

The above example is representative of both the company's long-term closed-end and open-end leases. Gross income under the financing method recognizes unearned lease income using the sum-of-the-months-digits method. Acquisition costs are amortized using the straight-line and the sum-of-the-months-digits methods for the operating and financing methods, respectively.

Both closed-end and open-end lease agreements contain premature termination clauses which provide for termination penalties which are based on the sum-of-the-months-digits method of amortization. Consequently, if in the above example the agreement were terminated after two years no gain or loss would result, if the financing method were being used. Conversely, if the operating method were being used the company would realize or gain on termination of the lease of approximately $241.

Using the same example as above the company's balance sheet would appear as follows:

	Beginning of Year 1	Year 1	End of Year 2	Year 3
Operating Method:				
Leased vehicles	$3,709	$3,709	$3,709	$3,709
Accumulated depreciation	-	750	1,500	2,250
	$3,709	$2,959	$2,209	$1,459
Deferred acquisition cost	183	122	61	-
Total	$3,892	$3,081	$2,370	$1,459
Financing method:				
Lease receivable	$3,537	$2,358	$1,179	-
Unearned lease income	1,287	557	149	-
	$2,250	$1,801	$1,030	-
Deferred acquisition cost	183	82	22	-
Residual value	1,459	1,459	1,459	1,459
Total	$3,892	$3,342	$2,511	$1,459

Libby, McNeill & Libby
200 South Michigan Avenue • Chicago, Illinois 60604

C. F. AXELSON
Vice President &
Controller

September 22, 1971

Mr. Richard C. Lytle
Administrative Director
Accounting Principles Board
American Institute of Certified Public Accountants
666 Fifth Avenue
New York, NY 10019

Dear Mr. Lytle:

It has come to our attention that on October 14 and 15, 1971 the Accounting Principles Board will hold hearings on changing Opinion No. 5, "Reporting of Leases in Financial Statements of Lessees."

It is our further understanding that consideration will be given to capitalization of certain kinds of leases with the simultaneous offsetting accrual of liabilities.

We are gravely concerned about the implications of such a change, if it should come to pass, because it would have many unseen ramifications in the traditional ways of doing business in America. For example, a company with long term debentures might have an indenture restricting the total assets, or increase in assets, which the corporation should have. To increase a corporation's assets by means of the capitalization of leases might not only cause a default in the bond indenture, but could have unascertainable effects on future financing arrangements.

We do not believe that an accounting policy should be adopted which is impractical in its application, although perhaps

Mr. Richard C. Lytle
September 22, 1971

theoretically justifiable, and we feel that recognizing outstanding commitments against a corporation can better be done by footnotes or supplementary information than by bringing such commitments onto the face of the balance sheets as assets and offsetting liabilities.

Yours very truly,

Libby, McNeill & Libby

C. F. Axelson

C. F. Axelson
Vice President & Controller

cc: Members of Accounting Principles Board

Mr. Richard G. Shuma
Touche Ross & Co.

NATIONAL RETAIL MERCHANTS ASSOCIATION

ALLIED STORES CORPORATION
401 FIFTH AVENUE
NEW YORK

EXECUTIVE OFFICES

September 28, 1971

Accounting Principles Board
American Institute of Certified
Public Accountants
666 Fifth Avenue
New York, New York 10019

Gentlemen:

The Committee on Accounting Principles of the National Retail Merchants Association has carefully considered the matter of accounting for leases. We have offered comments on APB Opinions 5 and 7, and submitted a position paper dated December 15, 1970, together with a detailed 15 page answer to a questionnaire on the subject. We presently submit this summarization of our comments for your consideration.

Our position with respect to Opinions 5 and 7 is that whatever is proper accounting for the lessee need not necessarily be proper accounting for the lessor. We do feel, however, that the development of clearly stated generally accepted accounting principles applicable to leasing transactions would eliminate most of the differences in interpretation as between the lessee and lessor. Differences in interpretation do not appear to be significant in the real estate area, since the vast majority of real estate leases are accounted for on a consistent basis by both lessors and lessees. Thus, the present method of accounting for real estate leases is generally accepted and consistently applied and, therefore, should not be changed.

We have consistently maintained that there should be no capitalization of leases beyond the current policy as postualted in Opinion No. 5. It follows, therefore, that leases which are essentially installment purchases should be capitalized as should leases through controlled shell corporations or subsidiaries unless such subsidiaries or controlled shell corporations are included in consolidated financial statements.

The commitment for leases other than those which would require capitalization under Opinion No. 5 should be disclosed in an appropriate footnote to the financial statements of the lessee. It is the consensus (not the unanimous opinion) of the Committee that the current method of disclosing lease commitments can lead to confusion and should be revised. The disclosure, if revised, should contain information with respect to only those leases having primary terms of more than three years. Once included, a lease should continue to be reported until termination. We believe that in computing the initial lease commitment, renewal option periods should be omitted. The commitment should be calculated based on the present value of the minimum rental payments to be paid over the basic term of a lease. It is also the consensus of the Committee that minimum rental payments should be determined on a "net" lease basis. The lease commitment should exclude any additional rental based upon percentages of sales. In addition, the footnote should provide disclosure of the methods used to develop information contained therein.

The Committee feels that it is vital that the Accounting Principles Board, in its deliberations, give recognition to the great number of leases involved. One member of the Committee represents a company with more than 4,000 leases, and the average number of leases for each of the companies directly represented by the Committee is close to 1,000. We feel that the need for setting parameters for tests and disclosures must recognize the practicalities of the situation. It is assumed that normal tests for materiality would apply.

We believe it extremely important that the AICPA recognize the clear distinction between equipment leases and real estate leases. Equipment has a limited life, while real estate does not. Problems in accounting for leases by equipment lessors should not be used to confuse accounting for valid real estate leases. The term financing lease should, therefore, be more clearly defined. In the case of real estate leases, the fact that a financial institution is the landlord, or the fact that the lease is assigned as collateral is frequently beyond the control of the tenant and, therefore, is not significant in evaluation of the lease. What is significant is that the residual value lies with the owner. Land, and frequently buildings, have an unquestioned residual value. The fiction that the lessor does not consider residual value should be recognized as fiction. Anyone close to real estate leasing cannot deny the lessor's interest in depreciation, renewal terms, sales participation and title - all clear and obvious signs of ownership. Accounting theory must not ignore the facts in a given situation.

We respectfully submit our position and we will be pleased to present further comments at the Public Hearing on Leases scheduled to be held on October 14-15, 1971.

Very truly yours,

Howard E. Hassler

Howard E. Hassler
Chairman, NRMA
Committee on
Accounting Principles

PNB THE PHILADELPHIA NATIONAL BANK
PHILADELPHIA, PA. 19101 PHONE 215 LO 9-2100

WILLIAM T. RISKIE
VICE PRESIDENT

October 4, 1971

Mr. Richard C. Lytle
Administrative Director
Accounting Principles Board
American Institute of Certified
Public Accountants
666 Fifth Avenue
New York, New York 10019

Dear Mr. Lytle:

We would like to set forth some comments for consideration by the Accounting Principles Board in connection with the hearings to be held on October 14 and 15 concerning the possibility of changing Opinion No. 5 "Reporting of Leases in Financial Statements of Lessees." The following thoughts might be of assistance to members of the Board as they deliberate on this vital question:

1. Leases should not be capitalized and considered "debt" unless the terms are such that a document actually represents an installment purchase.

2. The draft of the proposed opinion indicates that leases should be capitalized by the lessee if the lease "contains favorable renewal or purchase options calling for a <u>small</u> residual at the end of the primary term." We think this wording could present the accounting profession with very complicated and difficult matters of interpretation. It might well be that unless a clear position is taken at this time the present uncertainties would only be compounded rather than cleared up somewhat.

THE PHILADELPHIA NATIONAL BANK

Mr. Richard C. Lytle

October 4, 1971

3. Regardless of whether a lease is actually to be considered "debt" due to the nature of its terms, we feel that full disclosure, in any event, through footnotes or otherwise, should be made in all cases.

4. We feel strongly that since "leverage lease financing" is expanding very rapidly and in view of the fact that many banks and other lessors have developed certain techniques in the accounting for such activities, the Accounting Principles Board should include in its present study a review of this type of lease accounting and come up with some definite guidelines. In our opinion, it would be a terrible mistake not to take up this matter during the current proceedings.

We would appreciate your consideration of the views expressed above and assure you of our desire to assist in any way possible.

Very truly yours,

W. T. Rankin

Vice President

WTR:L

Public Service Electric and Gas Company

80 Park Place, Newark, New Jersey 07101

Telephone (201) 622-7000

September 21, 1971

Mr. A. L. Peterson
Director of Accounting
Edison Electric Institute
90 Park Avenue
New York, New York 10016

Dear Sir:

We have reviewed the proposed memorandum on leasing to be submitted to the American Institute of Certified Public Accountants. Although we have not seen the AICPA proposal on changes to Opinion 5 - Reporting of Leases in Financial Statements of Lessee, we agree with the EEI proposed memorandum. Please list our vote as approved.

The change in Opinion No. 5 will require capitalization of leases in the balance sheet which is not now required unless a material equity is created in the property lease. We oppose such a requirement because it would be detrimental to a utility and cause financing problems.

It appears inappropriate that characteristics that determine accounting for lessors should govern capitalization by the lessee. Such interdependence of accounting is not the proper basis for the establishment of generally accepted accounting principles.

There is some doubt whether regulatory commissions would permit capitalization of leases and their inclusion in the rate making process. In the event leases are required to be capitalized, recognition should be given to the applicability cited in the addendum to AICPA Opinion No. 2 concerning accounting principles for regulated industries.

One of the reasons given for capitalization of leases is to require lessees to report a liability. We think there should first be a determination of the objectives and the criteria to be applied in recording liabilities.

L. R. Fay
Vice President and
Comptroller

PUGET SOUND POWER & LIGHT COMPANY

PUGET POWER BUILDING - GLENCOURT 4-6363
BELLEVUE, WASHINGTON
98009

September 23, 1971

Mr. Richard C. Lytle
Administrative Director
Accounting Principles Board
American Institute of Certified
Public Accountants
666 Fifth Avenue
New York, N. Y. 10019

Dear Mr. Lytle:

Since I am unable to personally appear before the Accounting Principles Board of the American Institute of Certified Public Accountants on October 14 and 15, 1971, I am taking this opportunity to express the concern of this Company with regard to changes in accounting for leaseholds being considered by the Board.

It would be presumptuous on my part to suggest to the Board what decision good accounting theory would dictate in this matter. However, I can tell you as chief financial officer of this Company that any move toward a requirement for capitalization of leases by the lessee would have a damaging effect on the ability of this Company and the electric utility industry generally to raise capital funds needed to supply anticipated customer energy requirements. We are particularly concerned with the upward pressure on electric rates that would be created by the higher revenue requirements necessary to support additional equity capital.

We urge the Accounting Principles Board to give full weight to the crippling effect its decision may have on this and other business enterprises.

Yours very truly,

JHKing

J. H. ~~King~~
Vice President-Finance

RCC RANDOLPH COMPUTER CORPORATION
A MEMBER COMPANY OF THE TRAVELERS

CORNELIUS T. RYAN
PRESIDENT

September 30, 1971

Mr. Richard C. Lytle
Administrative Director
Accounting Principles Board
American Institute of
Certified Public Accountants
666 Fifth Avenue
New York, New York 10019

Dear Mr. Lytle:

The following statement is presented for consideration by the Accounting Principles Board on Proposed Changes in Accounting by Lessees and Lessors; and in particular to present the views of Randolph Computer Corporation (RCC) on the Interpretation of APB Opinion No. 7 for the public hearing on leases scheduled for October 14-15, 1971. RCC's position is that the purchase of equipment from independent computer equipment manufacturers in the manner described below should be accounted for as a sale by the manufacturer.

RCC, a wholly-owned subsidiary of Travelers Corporation, is engaged in computer equipment operating leases and full payout leases covering general equipment in various industries such as transportation and manufacturing. The computer equipment operating leases cover total computer systems, including a $175 million RCC investment in IBM systems and investments in equipment manufactured by independent computer equipment manufacturers.

It is the purchase of the equipment of independent computer equipment manufacturers to which this statement

537 STEAMBOAT ROAD / GREENWICH, CONNECTICUT 06830 / (203) 661-4200 / IN NEW YORK CITY: (212) 931-1177

is addressed. Typically, RCC purchases the equipment outright for cash from the manufacturers. In addition, RCC obtains a warrant position in the manufacturing company which results in a minor equity position. Companies are selected for such a purchase program only after careful evaluation of all aspects of the company and its product line.

A purchase agreement is drawn up wherein, over a period of several years of the purchase program, RCC buys one half of the total number of units of individual pieces of equipment newly going on rent (typically for an initial lease term of one year, which is much shorter than the expected useful life of the equipment). By agreement, the manufacturer retains title to the other half of similar equipment newly going on rent, thereby providing equal exposure to risks and opportunity for rewards for RCC and the manufacturer for their respective pools of similar equipment. The agreement with the manufacturer in no way precludes his selling outright equipment to end users or to OEM customers, or his obtaining financing of receivables from a bank or similar institution on his equipment on rent.

As part of the agreement, RCC pays the manufacturer a fee for remarketing the RCC-owned equipment on a parity basis, wherein the manufacturer remarkets the RCC-owned equipment and similar equipment owned by the manufacturer on a one-for-one basis. The manufacturer remarkets RCC-owned equipment only so long as he can remarket similar equipment owned by the manufacturing company. Equal ownership by RCC and the manufacturer of similar equipment thus provides a sound business limit on the term that the manufacturer is obligated to remarket RCC-owned equipment. It should be noted that it is in the sole judgment of the manufacturer to decide when it is no longer practicable, economic or otherwise, to remarket such equipment.

It should be further noted that the arrangement whereby the manufacturer remarkets RCC-owned equipment eliminates the need for RCC to establish its own sales force to remarket equipment in direct competition to identical equipment owned by the manufacturer. This provides for a nondisorderly market for the manufacturer's equipment, and at the same time strengthens his ability to compete with other manufacturers offering the same class of equipment.

RCC in purchasing the equipment assumes risks of ownership not only including credit risk of lessees and payment of insurance premiums, but most importantly, the risk of technological obsolescense or any other reason that the manufacturer is unable to remarket RCC-owned equipment. RCC does not require repurchase of RCC-owned equipment or guarantee of full recovery of RCC investment by the manufacturer should the manufacturer be unable to or decide not to remarket similar equipment owned by the manufacturer.

Under the purchase agreement described in the foregoing, the manufacturer does not retain substantial risks of ownership since there are no commitments to RCC that guarantee recovery of RCC investment. RCC interprets that it must account for equipment purchased from the manufacturer as equipment owned by RCC, having acquired title without recourse, and thus to be depreciated by RCC over a reasonable expected useful life of the equipment and account for lease rentals on the operating method. It then follows that the manufacturer would not account for the RCC-owned equipment as also owned by the manufacturer. We are informed that some accountants have interpreted the recently released Interpretation of APB Opinion No. 7 to require that the manufacturer retain title to the RCC-owned equipment if the only commitment by the manufacturer to RCC is "to secure a replacement lessee or a buyer for the property."

It is RCC's opinion that as related to the form of agreement between RCC and a manufacturer as described herein, the obligation by the manufacturer to make a reasonable effort (for a reasonable price) to secure a replacement lease or buyer for RCC-owned equipment does not constitute a substantial or onerous burden and should not upset the manufacturer's accounting for a sale to RCC.

RCC is of the opinion that the outright purchase of equipment for cash is vital to the development of a proper capital structure of the independent computer equipment manufacturers. Without such an equipment purchase program, adequate equity financing could be so limited as to make it impossible for the independent manufacturers to grow or even survive in the capital intensive rental business which is the standard form of transaction expected by end users for all types of computer equipment. The net effect would be to enhance rather than diminish the overpowering position of certain few manufacturers in the computer industry by severely limiting competition by the smaller independent computer equipment manufacturers.

Sincerely yours,

Cornelius T. Ryan

Cornelius T. Ryan

CTR:MZ

RELIANCE
ELECTRIC COMPANY

ELLIS W. SMITH
VICE PRESIDENT-FINANCE AND TREASURER

September 16, 1971

Mr. Richard C. Lytle
Administrative Director
Accounting Principles Board
American Institute of Certified Public Accountants
666 Fifth Avenue
New York, New York 10019

Dear Mr. Lytle:

In connection with the hearings on changing Opinion No. 5, "Reporting of Leases in Financial Statements of Lessees," this will state the position of our company.

Long-term leases of significant fixed assets with clearly demonstrable and significant residual values to the lessor at the expiration of the lease should be capitalized and the corresponding liability shown on the balance sheet.

However, we strongly believe short-term leases should not be indiscriminately capitalized. Many such leases of computer equipment, automobiles, sales offices, etc., are real rentals for valid business reasons and capitalization would distort the true business nature of such arrangements and would unwisely inflate the capital asset base and the debt position of many companies.

We believe appropriate disclosure of such leases can properly be made through analysis of the trends of rental expenses and explanation of material changes from year to year in the amount of such expenses.

Sincerely yours,

EWSmith

EWS:dp

cc: Richard T. Baker, Managing Partner, Ernst & Ernst

Members of Accounting Principles Board

5 7 2 7 0 0
AREA CODE 21

Joseph E. Seagram & Sons, Inc.

EXECUTIVE OFFICES

375 PARK AVENUE • NEW YORK, N. Y. 10022

Distillers Since 1857

September 23, 1971

Mr. Richard C. Lytle
Administrative Director
Accounting Principles Board
American Institute of CPAs
666 Fifth Avenue
New York, New York 10019

Dear Mr. Lytle:

Our public accountants, Price-Waterhouse, sent us a copy of the materials that will be discussed at your public hearings on accounting for leases.

We urge you to carefully consider any changes to APB Opinions 5 or 7. From our viewpoint, these opinions are adequate in their present form and achieve the objective of capitalizing leases that are equivalent to installment purchases.

It is absolutely essential that the criteria for capitalizing a lease remain whether the lessee obtains a material equity in the assets. If they do not, the lease is equivalent to hundreds of other long term commitments incurred in the normal course of business. These commitments would distort the balance sheet and are best disclosed as footnotes. For whatever their shortcoming, the present concepts of assets and liabilities for accounting purpose are well understood in the business and financial communities; a change would lead more to confusion than illumination.

I am sure the APB appreciates the tremendous impact that additional capitalization of leases would have on American industry. Many companies would find themselves in violation of their indenture agreements. Analysts would have to revise their rules of thumb on equity ratios and other credit standards.

If the Board feels that clarification of these opinions is necessary, we suggest they issue another unofficial interpretations.

We hope these points will be brought out and considered by the Board in the public hearings.

Very truly yours,

Harold Fieldsteel
Vice President-Finance

APB PUBLIC HEARING, OCTOBER 14-15, 1971

POSITION OF THE SECURITIES AND EXCHANGE COMMISSION ON ACCOUNTING FOR LEASES

Financing by use of lease agreements has become progressively more important since Accounting Research Bulletin No. 38 was issued by the Committee on Accounting Procedure in October 1949 and various actions have been taken by the profession in developing accounting principles applicable to this growing activity. The Commission, through its Chief Accountant, has participated in these actions by commenting on the actions to be taken. The following paragraphs relate to some of those responses.

On January 17, 1964, the Chief Accountant of the Commission, in conveying to the AICPA's Director of Accounting Research the Commission's general agreement with proposed Opinion 5, stated, _inter alia_:

"_Paragraphs 11 and 12_

It is my understanding that these paragraphs are intended to strengthen the similar recommendation expressed in paragraphs 6 and 7 of ARB No. 38 in 1949 and reasserted in Chapter 14 of ARB No. 43. The intent of these paragraphs should not be evaded on grounds of immateriality or strict adherence to legal interpretations of the lease. The existing bulletin deals specifically with this latter point--perhaps it should be reemphasized. I have in mind particularly the use of 'phantom' or satellite corporations to hold legal title to property. Perhaps paragraph 11b could be expanded to cover this point. If paragraph 12d is intended to do this it should be clarified.

* * *

"_Paragraph 13_

This paragraph recommending against capitalization of leases should be qualified to permit disclosure in the face of the balance sheet but without extension into totals. See...our letter of May 14, 1963....

On June 11, 1964, the Chief Accountant of the Commission, in advising the AICPA of the Commission's acceptance of the revised draft of Opinion 5, suggested that paragraph 1 of that draft Opinion should be expanded to include what is now the first sentence of that Opinion.

With the issuance of Opinion 5 in September 1964, generally accepted accounting principles became congruent with the Commission's policy with respect to the recordation, as purchases, of leases which are "clearly in substance installment purchases of property." The Commission, on the other hand, withdrew its former insistence of "short" balance sheet presentation by lessees of other lease commitments, in the light of the tighter disclosure requirements and guidelines provided in Opinion 5.

APB Opinions 7 (1966) and 10 (1966)

On March 21, 1966, with the approval of the Commission, the Chief Accountant, in advising general agreement with proposed Opinion 7, suggested that Opinion 7 should "comment on the gap between this Opinion and No. 5 regarding the treatment of personal property leases which are in substance purchases to the lessee," and that in paragraph 8 primary emphasis should be placed "on the substance of the transaction and secondary emphasis on the type of business as the basis for selection of the financing method."

The Commission concurred in the promulgation of paragraph 4 of Opinion 10 (December 1966) requiring consolidation of the "accounts of all subsidiaries (regardless of when organized or acquired) whose principal business activity is leasing property or facilities to their parents or other affiliates." The thrust of that paragraph was that the "equity" method of accounting "which directs its emphasis primarily to recognizing results of operations of the enterprise as a whole, is not adequate for fair presentation in the case of these subsidiaries because of the significance of their assets and liabilities to the consolidated financial position of the enterprise." The Commission took particular cognizance of footnote 5 to the cited paragraph, which read:

> "The Board is giving further consideration to the accounting treatment of lease transactions. In the meantime, it has deferred expressing an opinion on the inclusion in consolidated financial statements of companies organized in connection with leasing transactions in which the equity interest, usually nominal at the time of organization, is held by third parties, but in which the principal lessee, through options or by similar devices, possesses or has the power to obtain the economic benefits of ownership from the lease arrangements. (This deferment does not affect the applicability of paragraph 12 of APB Opinion No. 5.)

In dissenting to paragraph 4 of Opinion 10, two members of the APB indicated that a "subsidiary of the type referred to...represents one of several possible approaches to financing by means of leases..." and considered that "the better solution...would be for Opinion No. 5 to be revised to provide that material amounts under noncancellable leases should be shown as obligations (discounted to present value) in the balance sheets of all lessee companies."

SEC position

The Commission's position to Part I of the APB's Discussion Outline of August 1970 on the proposed revision of Opinion No. 5 was communicated to the Institute on November 24, 1970, as follows:

"1. Material equity - Paragraphs 10 and 11 should be harmonized to preclude any further misconceptions. I believe that paragraph 11 was intended to amplify and strengthen paragraph 10. In practice, the test of 'material equity' has been overworked in cases where the tests cited in paragraph 11 should dictate capitalization. Perhaps the combination of these paragraphs into a single paragraph would help.

"2. 'Equivalent to installment purchases of property' - It seems reasonably clear at this phase of this particular subject that it is inappropriate to continue permitting a different presentation by a lessee who is a party to the same lease which the lessor is required to include in the lessor's financial statements in conformity with the finance method prescribed by Opinion 7. There is some feeling here that Opinion 7 will also have to be reconsidered in order to accomplish this reconciliation.

"3. Significance of 'residual values' and depreciation methods - The 'different interpretations' mentioned should be spelled out and should be reconciled.

"4. Method of amortizing leased asset - Specific guidance should be provided consistent with other actions of the Board in dealing with compound interest. We accepted paragraph 17 of APBO 12. On the other hand, see paragraph 6 of APBO 10 and the related dissent of Messrs. Davidson and Weston.

"5. Applicability of long or short-term leases - We note that the view has been expressed that '[a]lthough this period of three years may serve as a useful "rule of thumb," it can hardly be accepted as a sound basis for determination. There may be relatively substantial lease obligations with less than three years to run, and they should be capitalized in order to obtain a fair and informative presentation.' It would accordingly appear to be desirable to consider whether the underlying characteristics of the agreement can be enumerated on a more satisfactory test rather than any artificial time span.

"6. Related parties - It is my understanding that paragraph 12 was intended to solve the phantom corporation problem. The failure to do so was cured in part by paragraph 4 of APBO 10 to which Messrs. Catlett and Davidson dissented. The problem needs a firm solution.

"7. Sale and leaseback - We agree that this subject requires further examination."

On June 18, 1971, with the approval of the Commission, the Chief Accountant furnished the following comments on the APB's communication of April 20, 1971:

> "...We note that the February 5, 1971 draft...Opinion...would require many lease transactions which are, in substance, purchases, but are not accounted for as such under Opinion No. 5, to be accounted for as acquisitions of assets. This would permit consistent accounting on transactions between lessees and lessors.
>
> "We are in general agreement with your conclusions that no serious question need be raised as to the soundness of the accounting principles described in Opinion No. 7. However, it appears that...'Sales of property under lease,' covers a subject which should be dealt with in any new opinion. It should be made clear that 'sales' to a third party of equipment under lease or to be leased should not generate recorded sales and income if the leases would not qualify for use of the finance method and the 'seller,' through various arrangements, retains certain risks of ownership. The necessity of passing title or making other legal arrangements to meet the demands of the third party should not be controlling as to the proper accounting.
>
> "...another problem...not directly covered by APB Opinion No. 7...the lessor involved is neither a financing institution nor a manufacturer of the equipment leased. A good example is the franchisor who leases purchased equipment to his franchisee. In such cases it is very difficult to arrive at an appropriate discount rate, particularly since collection may depend on successful operation of the franchise. The case of a discount rate of nine or ten percent can result in the recording of a sale and related receivable substantially higher than the sales price of the franchisor's supplier. Serious consideration should be given to including in the opinion a conclusion that such 'sales,' if they qualify for the financing method, should be limited to the amount of the lessor's direct costs plus any other clearly related costs to the lessor. Profits on such 'sales' would thus be taken up as financing income over the life of the lease."

The Commission reaffirms the position communicated by its Chief Accountant on November 24, 1970 and April 20, 1971, as cited above.

ACCOUNTING FOR LEASES

VIEWS OF UNIVAC DIVISION OF SPERRY RAND CORPORATION

Introduction

The Proposed Interpretation 7-1, Draft 12 (9/17/71), of "Accounting for Leases by Lessors" states: "When there are no significant uncertainties as discussed in this Accounting Interpretation, the lessor should account for the lease under the financing method if the present value (excluding any residual or salvage value) of the required payments under the lease (excluding any renewal or purchase option) during the fixed, non-cancellable term is equal to or greater than the selling price for an outright sale or the fair value (either of which may be less than cost) of the property."

There is a basic inadequacy in this criterion, especially for a manufacturer, and particularly for a manufacturer in the computer industry. The purpose of this paper is to demonstrate the inadequacy in two major aspects, and then to recommend revised criteria.

What are the two major aspects of inadequacy?

1. Results of operations will not be properly reflected.

2. The criterion is not consonant with any rational competitive pricing philosophy in a manufacturer-customer relationship.

Presentation of Results of Operations

We think it extremely significant that in the proposed interpretation there is no reference to a fair presentation of the results of operations. APB No. 7 presently states unequivocally that "The objective of fairly stating the lessor's net income during each of the periods covered by the leasing activities is the most important consideration in differentiating between the use of the financing or operating methods." "The most important consideration" is now not even being recognized in this latest Accounting Interpretation.

We have been faced in our internal measurement program with some of the same problems, on a much smaller scale, that the board has undoubtedly been faced with. We must measure the results of a number of profit centers and must be sure that this measurement is a fair representation of operations. In our business, we have three basic contractual relationships with our customers.

1. We sell outright.

2. We lease to a customer for a term at least equivalent to the estimated useful life or depreciation life of the property (five years).

3. We rent for a period shorter than the useful life of the property (one year contracts).

We, in management, feel that the first two of these three contractual relationships are roughly equivalent in value to the company. The lease for the useful life may be of slightly less value than the outright sale because of some uncertainty as to the minimal salvage or residual expected, but this type of lease is necessary in an industry where renting has become a way of life. The shorter than useful-life rental contract is purely a marketing need in an industry dominated by IBM which has set the pattern for this type of contract. The business risks in this type of contract are, of course, tremendous.

We previously recorded all leases under the operating method in our internal measurement system. This recording was not achieving the results which management desired because it distorted the results of operations. Let us look at the following example in the handling of the contracting of one of our smaller computers.

<u>Assumptions</u>

Selling price	\$100,000
Capitalized value (cost)	30,000
Monthly equipment charge:	
1 year rental contract	2,299
5 year lease contract	1,839

<u>Gross Profit Generated For One Year</u>

	Sale	1 Year Rental Contract	5 Year Lease
Revenue	100,000	27,588	22,068
Cost	30,000	6,000	6,000
Contribution to Gross Profit	70,000	21,588	16,068

If profitability can be looked at as a test of operating results, the outright sale would then appear to be ranked first, the one-year rental contract second, and the five-year lease (which has a monthly charge 20% less than a one-year contract) third. This was not the hierarchy of values that management placed on these three contracting media. We came to the conclusion that a measurement founded on the principle of the financing method was the only proper method for reflecting the results of operations, since it corresponded with management's view that a sale and a five-year lease were approximately the same in value, with both of them far superior to the one-year rental contract.

In this measurement system, and in the compensation structure throughout our organization for general managers down to salesmen, we see a philosophy throughout our company that takes this hierarchy of values into account: The outright sale and the five-year lease are roughly equivalent, and the one-year contract is of far less value.

We cannot see where the fairest presentation of the results of operations internally within our division should differ from the fairest presentation of results of operations to our stockholders and to the investment community. To the shareholder, the use of the criterion as proposed in the Accounting Interpretation would significantly distort the results of operations of our division.

Since the long-term lease and the outright sale are approximately equivalent in value to the corporation, the use of the operating method could distort, for the shareholder, vital comparative results of operations over the years if there were large swings from year to year in the proportion of sales and long-term leases. In the following example, we have assumed a 20% growth rate from year to year in the shipments of new products which are either being sold outright or being placed on five-year lease contracts. We have assumed also a constant "cost of sales" relationship (30%).

For a proper reflection of operations, the gross profit should increase 20% per year. This would be the most accurate representation to the shareholder of the true health of the operation. Instead we have the result you see in the table below where in some years there is even a decrease in profitability, and in others it more than doubles.

(Table on following page)

Shipments at Sales Value
Millions of $

	Year 1	Year 2	Year 3	Year 4	Year 5
Total Shipments	500	600	720	864	1037
Sold Outright	300 (60%)	200 (33%)	500 (69%)	288 (33%)	726 (70%)
Leased for 5 Yrs.	200 (40%)	400 (67%)	220 (31%)	576 (67%)	311 (30%)
Revenue Under Operating Method					
Sale	300	200	500	288	726
Lease	44	132	180	307	376
	344	332	680	595	1102
Cost of Sales Under Operating Method					
Cost of Sale	90	60	150	86	218
Depreciation (5 Yr. Straight Line)	12	36	49	84	103
	102	96	199	170	321
Gross Profit	242	236 (-2%)	481 (+104%)	425 (-12%)	781 (+84%)

Relationship of Accounting Treatment to Pricing Philosophy

In the computer industry the pattern for leasing has been set by the industry leader, IBM. It is necessary, therefore, for any corporation striving for any sizable market to offer leasing to its customers. Because of the immense investment necessary in this industry for research and development; for training a marketing force, which has to be highly technically skilled; and for training of an extensive field engineering force, it would probably be fair to state that all companies, with the probable exception of IBM, would welcome it if all rental transactions with necessary large investments were eliminated and all procurement was made via the sale contract. A large part of the reason for the demise of General Electric and RCA was the extensive investment necessary in rental equipment.

For these reasons, we would prefer to sell the equipment outright rather than rent it. However, it is necessary to offer rental plans. Five years ago we decided to offer two different lease plans and have continued to do so. The first is for a five-year period, which is our depreciation life of the equipment. The second is for a one-year period. In our five-year lease, we obtain, on the average, 80% of the revenue each month that we do on the one-year rental contract. If we attempted to have a lease price strictly in accordance with the new criterion being proposed, it would be non-competitive. The present value of this lease revenue does return to us a substantial portion of the sales price. We anticipate a minimal residual or salvage value.

We, in effect, are financing the user in his use of the equipment and gambling on the achievement of the minimal residual or salvage value to realize a profitability equal to that achieved on a sale. We also recognize the basic reality that even the minimal residual value of computer equipment can only be obtained by a knowledgeable technical firm such as the manufacturer. Most users would not be able to realize any residual value because the equipment itself is not marketable without customer support ability.

This pricing philosophy, which has a premise that we shall recover, during the useful life of the equipment without any material risk, a substantial portion of the purchase price, is the foundation for the suggested revision in this paper.

In fact, we see a grave danger in the quantification formula proposed in the Interpretation - "the present value...of the required payments under the lease...is equal to or greater than the selling price." Official selling prices could be promulgated, but no outright sales made, merely as a means of living within the letter of the opinion. It is far more significant that the lease be at least equal to the depreciation or useful life of the equipment.

Recommendation

We recognize that the APB must establish standards to control and prevent the misuse of accounting principles. In establishing standards, we believe the useful life of the property should be the primary criterion for using the financing method. This belief is based on the fact that the usual risks and rewards of ownership (e.g. obsolescence, unsatisfactory performance, idle capacity, profitable/unprofitable revenue) related to the property is in the hands of the lessee during the property's useful life. We, therefore, suggest that a long term non-cancellable lease, which covers substantially all of the useful life of the equipment, should qualify a transaction for the use of the financing method. This should be the primary emphasis. Other quantitative tests in qualifying for the financing method should be secondary. These tests would only help evaluate whether the lease in fact covers the useful life of the property.

Our experience with regard to accounting for leases is limited to the computer manufacturer's position and our proposed solution may not be appropriate for all possible situations. We believe that wording regarding manufacturing operations should be similar to the following:

> "When there are no significant uncertainties, the lessor (a manufacturer) should account for the lease under the financing method if the lease's non-cancellable term (excluding any renewal options) is at least equal to the depreciable life or the estimated useful life of the leased property. Other criteria which may assist in supporting the use of the financing method are (1) the rental payments are defined as to timing and total amount, and (2) the present value of the rental payments is comparable with the outright sale price of similar property."

We wish to express our appreciation for the opportunity to present our views on a subject that is highly important to our corporation and its stockholders.

THE TELEX CORPORATION / P. O. BOX 1526 / PHONE NATIONAL 7-2333 / TULSA, OKLAHOMA 74101

STEPHEN J. JATRAS
PRESIDENT

October 1, 1971

Accounting Principles Board
The American Institute of Certified
Public Accountants.
666 Fifth Avenue
New York, New York 10019

Gentlemen:

We appreciate the opportunity of presenting to the Accounting Principles Board our thoughts concerning the subject of accounting for sales of leased equipment to third party leasing companies by manufacturers. Our Company is vitally interested in this subject, since the matter involves the very life blood of our existence. The adoption of inappropriate accounting principles which do not adequately recognize the economic substance of the transactions in which our Company has and will enter could, under most adverse assumptions eliminate our firm from competition in the computer peripheral field.

Our comments in this letter are limited to those relating to accounting for leased equipment sales by manufacturers to third party leasing companies and financial institutions. We believe the Board should consider particularly the following points in its deliberation on this subject:

1. All third party transactions are not alike and pronouncements which are based on the premise that they are all alike will result in incorrect accounting for certain companies.

2. The Board should be specific in its treatment of the subject so that company management has the framework for decisions which cannot be challenged by its auditors or the Securities and Exchange Commission.

3. The Board should avoid over-reacting because of its concern triggered by a few publicized examples.

4. The principles adopted should allow reasonable and realistic evaluations of risks and rewards.

5. Principles adopted should recognize there are two separate aspects of the question - recognition of a sale and recognition of profit.

6. Unreasonable and inconsistent accounting could result from positions suggested by the recent interpretation of Opinion No. 7.

Before discussing these points, we would like to make one general observation. We are most concerned that the Board does not overlook the real substance of the transactions in its effort to classify them as - a sale, a lease or a loan. In our opinion such transactions are clearly sales transactions. We do recognize that there may be some unusual aspects to the sales which could create other accounting problems.

1. <u>All third party transactions are not alike and pronouncements which are based on the premise that they are all alike will result in incorrect accounting for certain companies.</u>

   Inour recent experience, it has become quite apparent to us that there is a tendency for people to group all third party transactions together in their thinking. In reality, there is usually only one thing which is common in third party transactions - that is, there is a third party involved in addition to the initial lessor and the lessee. The particular aspects of individual agreements are quite different, and the resultant transfer of ownership risks and rewards can be quite different from one transaction to the next. We find these differences both in agreements we have negotiated among different third parties and within different agreements with the same third party. From public information which is available on third party transactions of other manufacturers, we have noted significant differences in their transactions as compared to ours.

In order for the Board to prepare an adequate Opinion relating to these transactions, it appears to us that it would be mandatory for the Board to review in detail documents supporting a myriad of these transactions - perhaps hundreds - and to discuss them with the principals who were involved in their initial negotiations. In absence of this, the Board can hardly hope to avoid the error of generalizing from a review of specific cases which are not representative of the total subject on which they intend to express their opinion. A thorough understanding of these individual transactions will give the Board a better basis for expressing a knowledgeable opinion.

2. The Board should be specific in its treatment on the subject so that company management has the framework for decisions which cannot be challenged by its auditors or the Securities and Exchange Commission.

Although we support in theory an approach which generalizes on accounting principles and allows a specific adaptation of principles to meet fact circumstances relating to individual companies, our experience in the past several years leaves us no choice in the present circumstances but to strongly urge that any opinion issued on this subject be a specific opinion. Too often there have been instances where second guessing by the Securities and Exchange Commission occurred after public reporting of operating results to stockholders. Recently we were seriously delayed in our efforts to develop a financing program to support our operations for the next several years because of the ambiguity in Opinion No. 7 and the Securities and Exchange Commission's linking of third party transaction with Opinion No. 7, when we believe in fact, Opinion No. 7 makes no reference to third party transactions. In short, based on our experience we feel we must abandon a theoretical position we feel is sound in favor of a hard pragmatic approach we believe is necessary in order for us to run our business. Again, a specific opinion cannot be drafted without a basic specific understanding of the transactions in question.

3. <u>The Board should avoid over-reacting because of its concern triggered by a few publicized examples.</u>

We are fully cognizant of recent situations in which certain manufacturers have been required to support certain "guarantees" relating to their third part transactions. We hope that the Board will not over-emphasize the importance of these specific instances in relationship to the total volume of transactions of this type, and adopt accounting principles to prevent the future recognition of losses such as those which may be experienced by a few manufacturers and over-look the appropriate accounting for the majority of the cases. To carry this type of thinking to an extreme would involve the adopting of cash basis accounting for all sales transactions in order to avoid the future recognition of some bad debts of which the company is not presently aware. Providing reserves for such future bad debt losses would not be adequate under a line of reasoning similar to that which has been proposed by some persons for accounting for third party transactions. In order to avoid the mistake of adopting principles which are not applicable to the majority of such transactions, the Board should make some survey concerning the volume of transactions in existence and the experience of individual manufacturers relating to such transactions.

4. <u>The principles adopted should allow reasonable and realistic evaluations of risks and rewards.</u>

There appears to be a tendency on the part of some people to look only at a potential dollar exposure based upon strict legal interpretations of the underlying documents, without giving adequate consideration to the real facts of the market place or to give recognition to a company's actual experience with respect to its transactions. There has also been a tendency by some to insert the question of "value accounting" into this issue, when that is not involved at all.

For any accounting principle adopted to be valid, we believe it must give recognition to realities of the market place. In our industry, for example, the market place involves the following significant factors:

- It is dominated by one giant company (IBM) which establishes the basic rules of the marketing game.

- IBM has chosen to use the lease as a means of marketing its products, and its competitors are forced to use the same type document.

- From a business viewpoint IBM has a substantial investment in its equipment on lease, and is not going to make instantaneous business decisions which will make such equipment obsolete overnight.

- There is a relatively long period between the first announcement of a new product and its final introduction into the market place.

- A manufacturer can make relatively good estimates of total markets for its products based upon the IBM field population and can limit its production to avoid an excess of its own field population.

- Most "risks of ownership" can be insured against or otherwise disposed of by the manufacturer.

The foregoing items were listed because, in the final evaluation, when the basic risks and rewards of ownership are considered in our industry, the only significant potential risk is that of potential obsolescence and oversupply of the equipment. Other risks retained in the basic lease document to the lessee are insurable or are of no greater significance than normal warranties involved in most sales. We believe strongly that the potential risks of obsolescence and oversupply have been overemphasized and are well within the control of a well-managed company, and accordingly should not prevent the recognition of sale and related profit in its transactions with third party leasing companies.

We believe the Board has taken a parallel position in its Opinion No. 10 when it states in paragraph 12 "profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured. The Board reaffirms its statement; it believes that revenue should ordinarily be accounted for at the time a transaction is completed, with appropriate provision for uncollectible accounts. Accordingly, it concludes that, in the absence of the circumstances referred to above, the installment method of recognizing revenue is not acceptable."

Finally, there has been some indication on the part of some people that the retention of a right to certain residuals by the manufactuer constitutes such a significant reward that the sales transaction should not be recognized. This can only occur in instances in which the underlying assumptions concerning the equipment's likelihood of staying on lease are entirely in contradiction with the assumption that the risks are so great that a sale cannot be recognized.

5. Principles adopted should recognize there are two separate aspects of the question - recognition of a sale and recognition of a profit.

It seems to us that the Board should first examine the question as to whether a sale has in fact occurred. If the determination is made that a sale has occurred, then a separate determination is required concerning the necessity of reserving all or a portion of the related profits. The transfer of the rewards of ownership is of prime importance in determining whether there is a sale. The transfer of risks of ownership is of prime importance in determining whether a profit should be recognized. We are not proposing that a transfer of all benefits with the retention of all risks constitutes a sale. That is not the issue. Rather, a sale is the transfer of ownership, and it occurs when the seller gives up his rights, privileges, benefits or rewards. The retention of some risk doesn't alter the overriding nature of the transaction.

We believe it is reasonable that aside from the matters of form, the question of whether a sale has taken place is closely related to the question of who owns the property after the transaction. In the usual instance in third party transactions, the manufacturer no longer owns the property after it is sold to the third party. There should be no question as to whether or not a sale has taken place. Title has passed, consideration has been given, virtually all rewards have been transferred and substantial risks have been transferred. The new owner has an asset for his balance sheet, frequently pledges it as collateral for a loan, insures it, pays personal property taxes on it and assumes credit risks. In the case of our transactions, the third party (with minor exceptions) assumes 100% of the risk of lease cancellation or default by the user.

We have contracted with the third party in our agreements to perform certain of the management functions with respect to the property he has purchased for which we are additionally compensated. This in no way negates that a sales has taken place, since this type of management arrangement occurs frequently in other transactions. Real estate sales of income producing property are excellent examples of this type of arrangement. In our transactions, it is quite clear that a sale has in fact taken place.

The remaining question then is whether the terms of the transaction require any deferral of the profit on the transaction. Again, in the case of our transactions, the following circumstances generally exist after the time of sale:

- We agree to perform maintenance and service on the equipment for which we are reimbursed by the lessee.

- We agree to attempt to find a new lessee for the third party, in the event that a lease is cancelled. Although our agreements provide that we will be reimbursed for this effort (either separately or as a portion of a "residual" amount), we are in no way financially obligated to the purchaser to see that the equipment is placed with a new lessee. The third party's equipment which may come off lease has no priority in releasing over any of our own equipment.

- We perform the bookkeeping and collection functions for the third party.

We know of no authority for a contention that a contract for the continued rendering of managerial or marketing services on a cost reimbursement or better basis is a bar to recording sales. No one has questioned the propriety of recording a sale of an IBM typewriter just because there is a concurrently executed maintenance agreement.

The burden of releasing might be measured in terms of out-of-pocket costs. In our own circumstances, these amounts are relatively insignificant and are to be reimbursed as mentioned above. The burden might also be argued in terms that marketing is all that we do and are being paid for. Again, the fact is that marketing cost as compared to total sales value is a nominal amount as compared to manufacturing costs in relation to sales value. Clearly, the manufacturing effort is much greater and is the major factor to which our profit relates.

It might further be argued that the burden of releasing is a "liability" because such obligation diminishes the opportunity to market our own equipment. We know of no accounting principle that requires or permits accounting for opportunity costs. There is, however, no reason to suppose that we are any worse off in an orderly arrangement in which we control the total rental market for our products than we would be in a situation where we were competing with others who own our products. It is difficult to understand how the fact that we sell a product which will then compete in the market place for other products which we may sell or lease in the future is any reason for deferring the profit on the original sale. On the same theory a real estate developer should defer the profit on all the houses he sells until he stops selling houses.

Under the most adverse circumstances the common releasing arrangement is an advantage rather than a burden to us. So long as the present situation exists and there are enough users to absorb all the equipment, the whole subject is rather trivial and academic. If, however, the market shrinks and there are not enough users, then we are at least spared the burden of competition with our third party customers which could otherwise be anticipated. In short, the alleged burden is a mutually advantageous arrangement without adverse consequences to us.

In summary, in relation to our own transactions we know of no conditions which would negate the recognition of a sale or require the deferral of profits.

6. Unreasonable and inconsistent accounting could result from positions suggested by the recent interpretation of Opinion No. 7.

If suggestions indicated in a recent interpretation of Opinion No. 7 are inappropriately applied to our transactions, then the following inaccurate misleading financial presentations would result:

- We would show an asset on our balance sheet as though we owned it when, in fact, we did not have the rewards or benefits of ownership because they had been conveyed to our third party customers.

- Our balance sheet would show a liability to the third party customers for all money received, even though we owed them nothing and were going to pay them nothing.

- If our third party customers continued their present accounting, the same asset (the equipment) would appear on both our balance sheet and their balance sheets.

- Alternatively, if to avoid the unreasonable situation in the preceding item, our third parties were to conform their accounting to our accounting, then they would show on their balance sheet receivables, though no one owed them money and they did not expect to collect. This would have the ironic result of forcing them to balance sheet presentations substantially the same as though they were accounting for the equipment as though they were on the financing leases when, in fact, they should be accounting for the equipment as being on operating leases.

From the foregoing comments it is clear to us that the only reasonable approach is to account for the transactions as sales and to recognize the profit at the time of sale. We do recognize there may be certain minor contingencies for which a reserve may be appropriate.

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Again, we appreciate the opportunity of expressing our views to the Board. If the Accounting Principles Board committee feels our oral testimony is desirable we would welcome the opportunity of appearing in person before the Board during the public hearing.

Yours very truly,

THE TELEX CORPORATION

S J Jatras

S. J. Jatras

SJJ:cb

Trust Company Bank

Bradley Currey, Jr.
Senior Vice President
and Controller

September 15, 1971

Mr. Richard C. Lytle, Administrative Director
Accounting Principles Board
American Institute of Certified Public Accountants
666 Fifth Avenue
New York, New York 10019

Dear Mr. Lytle:

At the request of Bankers Leasing Corporation, we are responding to the proposed changes on Opinion No. 5, "Reporting of Leases in Financial Statements of Lessees."

As a banker, a lessee, and a lessor, we think that lease obligations over a fixed term are capital liabilities and should be reported as such, either on the balance sheet or by reference on the balance sheet. We believe that the accounting for non-cancellable leases will inevitably give rise to interpretation to the best advantage of the company reporting, so do not have a strong view of the manner of capitalizing, prefering to leave it to business people as to whether a liability should be set up on the balance sheet or referred to on the balance sheet and detailed in the notes to the balance sheet.

We are all aware that this is an area where corporate financial statements have been incomplete. Steps to remedy that situation and to recognize as a liability something which a lessor recognizes as an asset are entirely appropriate and consistent with good financial reporting.

Very truly yours,

Bradley Currey Jr

BC:eh

WRITTEN STATEMENT OF VIEWS
ON

ACCOUNTING FOR LEASES

BY

BROOKS WALKER, JR.
CHAIRMAN OF THE BOARD
UNITED STATES LEASING INTERNATIONAL, INC.

The following views are submitted in accordance with procedures outlined by the Accounting Principles Board prior to public hearings to be conducted on October 14-15, 1971 on the subject of Accounting for Leases.

It is our contention that certain important changes should be made to APB #5 in order to have a definable and consistently applicable definition of the difference between an operating lease and a finance lease and that certain less major changes should be made in APB #7 in order to make it consistent with the suggested changes in APB #5. It is further our contention that the current position of the Board regarding the treatment of certain transactions between manufacturers and third party lessors should be modified. Our basic underlying beliefs in developing these suggested changes are as follows:

1. ALL LEASE CONTRACTS SHOULD NOT BE CAPITALIZED - to do so would be to alter the balance sheet presentation of almost every company in the United States with regard to only one of many executory type contracts and the net effect would be to create

drastic changes while at the same time coping only with a small part of the question of the purpose of a balance sheet and the items that should be included thereon.

2. APB #5 AND APB #7 SHOULD AND CAN BE IMPROVED IN A MANNER WHICH WILL DEVELOP A CLEAR, CONCISE AND RELATIVELY SIMPLE DISTINCTION BETWEEN A FINANCE AND OPERATING LEASE.

3. APB #5 AND APB #7 SHOULD UTILIZE THE SAME CRITERIA IN DEFINING FINANCE AND OPERATING LEASES. It should be recognized, however, that the economic situation and impact of a given transaction to the lessor and the lessee may differ even though the same basic criteria are applied and that, therefore, the different treatment of the same transaction may be applicable.

4. TWO MAJOR FEATURES CAN BE USED TO DETERMINE THE SUBSTANCE OF A LEASING TRANSACTION. These two features comprise the backbone of our suggested changes to APB #5 and APB #7.

5. THE NATURE OF A LEASE, EITHER ON THE BOOKS OF A LESSEE OR ON THE BOOKS OF A LESSOR SHOULD NOT BE DETERMINED BY THE NATURE OF A LESSOR'S BUSINESS, OPERATIONS, METHOD OF FINANCING OR ANY OTHER ASPECT OF THE LESSOR. We believe that a transaction should be judged solely by the nature of the obligations between the two parties, both contractual and implied.

Based upon these underlying beliefs, we recommend changes to both APB #5 and APB #7.

A P B # 5

Paragraphs 10 and 11 should be eliminated and a new paragraph written as follows:

1. A LEASE SHOULD BE CONSIDERED TO BE A FINANCE LEASE AND, IN SUBSTANCE, A PURCHASE IF:

   A. THE INITIAL NON-CANCELLABLE TERM COVERS SUBSTANTIALLY THE USEFUL LIFE OF THE EQUIPMENT; OR

   B. IF, AT THE TERMINATION OF THE INITIAL NON-CANCELLABLE TERM THE LESSEE HAS ACQUIRED A MATERIAL EQUITY IN THE PROPERTY.

2. ALL OTHER LEASES SHOULD BE CONSIDERED TO BE OPERATING LEASES.

In order to be meaningful, some important terms used in this definition will have to be defined. We suggest the following definitions:

1. "Useful life" should be the useful life to the lessee and should relate to the expected useful life of similar equipment if owned by the lessee. In other words, the useful life could extend beyond the lease term even though the lessee had no specific rights under the lease to continue to use the equipment after the initial term.

2. "Lessee acquires a material equity." This definition will require two parts.

First, "material equity" should relate the expected value of the property at termination of the initial term in relation to its original value. (We suggest that a precise attempt to put an absolute numerical definition of "material" in this case would be overly arbitrary and that it should be left to the discretion of the company and its auditors to determine materiality with regard to the nature and the substance of each individual transaction.) A property of such specialized nature as to probably be usable only by the lessee, or a property on which the lessee has given the lessor a "put" covering the property at any time, casts grave doubts on the question of the property's market value to the lessor and, therefore, doubts as to the materiality of the equity retained by the lessor.

Secondly, "lessee acquires" must be defined. It must first be determined whether or not the property at the expiration of the initial non-cancellable term is expected to have a material value in relation to its original value. If it is, the question still remains as to whether the lessor or the lessee will have, in substance, the rights to this material value. The presence of a lessee's right to purchase the equipment for a nominal amount in relation to its expected "fair market value" (at the time of exercise of the option) or the presence of a lessee's option to renew the lease at a nominal rental in relation to its expected "fair market rental" should clearly indicate that the lessee will have retained a material equity. The transaction should, therefore, be treated as a purchase.

In addition to this basic alteration in the definition of a lease, we also suggest certain specific changes in APB #5.

Paragraph 11(c): "The lessee has guaranteed the obligations of lessor with respect to the property leased." This test, present in Bulletin 5, was not listed as a test in the Staff Outline draft. We take issue with the all encompassing concept that, simply by guaranteeing a lessor obligation, a lessee, under an otherwise operating lease, has in fact changed the lease into a financing lease. We do agree, however, that if the guarantee extends beyond the initial term of the lease and covers substantially the useful life of the equipment, or if the terms of the guarantee are such that by meeting the guarantee obligation the lessee acquires a material equity in the equipment, then the lease should be treated as a purchase.

Paragraph 12(l): "The lease payments are pledged to secure the debts of the lessor." This sentence should be removed in its entirety under our contention that the nature of the business of financing of the lessor should not affect the accounting treatment of a lease on the books of a lessee.

Suggested Addition: Paragraph 10 appropriately covers the question of a so-called "front end loaded lease" with bargain renewal options. However, APB #5 does not cope with the equally important question of the accounting treatment of a "rear end loaded lease". We submit that a lease which calls for lower payments in the early portion of its initial non-cancellable term and higher payments in the latter portion of the term could, if it met all other conditions, still be considered an operating lease, but that for income statement purposes average annual rentals during the initial term should be calculated and imputed additional rent in the early portion of the lease should be charged to income in addition to the actual rentals paid.

A P B # 7

Paragraphs 7 and 8 should be eliminated and a new paragraph written as follows:

1. A LEASE SHOULD BE CONSIDERED TO BE A FINANCE LEASE AND, IN SUBSTANCE, A SALE IF:

   A. THE INITIAL NON-CANCELLABLE TERM COVERS SUBSTANTIALLY THE USEFUL LIFE OF THE EQUIPMENT; OR

   B. THE ESTIMATED RESIDUAL VALUE OF THE PROPERTY TO THE LESSOR* IS NOT MATERIAL IN RELATION TO THE NON-CANCELLABLE RENTALS RECEIVABLE DURING THE INITIAL TERM (NET OF RELATED UNEARNED INCOME).

2. ALL OTHER LEASES SHOULD BE CONSIDERED TO BE OPERATING LEASES.

* "Estimated residual value" should include only the property valuation risk taken by the lessor and should exclude any contractual right that the lessor has to sell the property (at the expiration of the non-cancellable lease term) at the lessor's option to the lessee or any third party.

In suggesting the elimination of existing paragraphs 7 and 8, there are certain specific points we would like to make.

Paragraph 7: The nature of the contract written should be the governing factor in accounting for leases on the books of the lessor, not the nature of other businesses in which the lessor may be involved. In addition, we also submit that tests for the "unusual risks of ownership" (obsolescence, unprofitable operations, etc.) should be removed for reasons set forth in the attached Exhibit A.

Paragraph 8: This paragraph should either have major revision or perhaps be eliminated entirely since, again, it contends that the accounting treatment for a lease is governed by the nature of the other business of the lessor, while our contention is that the nature of the transaction itself should be the sole governing factor. We contend that it is, for example, perfectly possible for a lessor, basically in the business of "lending money at interest" to also engage in the business of writing both operating and finance leases and that the distinction must be made by looking to the lease contracts themselves.

In addition to the specific changes outlined above, we believe there is a strong need for specific accounting provisions for the lessor in a so-called leveraged lease transaction.

A lessor entering into a leveraged lease transaction generates positive cash flow through tax savings in the early years of the lease. This is attributable to (1) depreciation on 100% of the cost of the leased property whereas approximately 20% thereof is financed with equity capital and 80% by a loan and (2) by the receipt of level rental payments offset by level debt service payments, the greater portion thereof being interest expense. Therefore, he receives all of his equity investment and earnings thereon back in a relatively short period of time through positive net cash rental flows plus tax savings. Thereafter, he receives substantial cash flows from tax savings which will, in part, be used to pay for tax obligations in later years. The positive tax savings in the early years are equal to the present value of future tax obligations. The early tax savings and the future tax obligations can be computed with reasonable accuracy and constitute a major benefit which economically justifies the investment.

If such a transaction qualifies as a finance lease to the lessor under the criteria established in APB #7, it is submitted that, to report fairly the financial results of the transaction, (1) the current tax savings in excess of investment and return thereon should be recorded as a deferred tax liability and (2) this liability being the present value of future tax obligations should be accreted with the passage of time. APB #21 covers the mechanics although it is not clear whether it applied to deferred tax liability. If it does not, then APB #21 should be modified or specific exemption should be made for this type of transaction in APB #7. (See Exhibit B for a more complete explanation of this position.)

TREATMENT OF A LEASE UNDER APB #5 VERSUS TREATMENT OF THE SAME LEASE UNDER APB # 7

Considerable concern has been expressed over the current situation wherein a given transaction can be treated as an operating lease by the lessee and a finance lease by the lessor, or vice versa. We contend that this is not intrinsically evil. (From a practical point of view, the auditor for one party to a lease may have no way of determining how the other party to the lease has treated the transaction for accounting purposes.) Such a situation could occur under Bulletins #5 and #7 as we have suggested their revision and we contend that this would be proper accounting for both parties. As an example, suppose a non-cancellable lease on railroad rolling stock for an initial term of fifteen years. Further suppose that the equipment has a 20 year estimated useful life and that the lessee has no renewal or purchase options at the expiration of the initial term and also that the lessee has no penalty payments or other obligations at the end of the initial term. If the lessee railroad can establish to its own and its auditors' satisfaction that the equipment will have a market value of approximately 30% of original value 15 years hence, then under most commonly held accounting definitions of "material" the lessee would not have acquired a material equity in the property and therefore would treat the lease as an operating lease under APB #5.

If the lessor felt that it was prudent to carry a 30% residual value for the property at the commencement of the lease, again this would probably meet the definition of "material" in relation to the initial term rentals and under these circumstances the lessor would be required to treat the transaction as an operating lease. If, however, the lessor felt that it would be imprudent to carry a value of no more than, say, 10% for the property, this could well fall below a generally accepted definition of "material" in relation to the lease receivables that the lessor would book at the same time and, therefore, the lessor would handle the transaction as a financing lease.

There are many situations where a lessee could comfortably assume a "value" for property which will be in his possession at the end of the initial term considerably in excess of the "value" that a lessor might wish to assume on the same transaction. The difference, of course, stems from the fact that the lessee, as a user, will relate "value" to replacement cost, while the lessor will relate value to expected sales proceeds which he could obtain from other parties. These differences in value relate to the "in place" value the equipment has to the lessee which it does not have to the lessor. Replacement costs for the lessee could include freight, delivery, installation and down time costs, while the sales costs to the lessor could include removal, crating, transportation and remarketing costs in the case of personal property and real estate commissions, refurbishing and lost rental costs in the case of real property. Therefore, we do no believe that the different accounting in the example above is inconsistent with a concept of good accounting for either party involved.

THIRD PARTY LESSOR TRANSACTIONS

The Accounting Principles Board has issued a tentative release on Accounting for Leases by Lessors designed primarily to set forth the accounting treatment for a manufacturer who either offers his own equipment directly on a lease basis to his customers or who offers his equipment to his customers through a third party lessor. In this release a finance lease is defined as one in which the present value of future non-cancellable rentals must be equal to or greater than the selling price or fair value of the property under lease. We submit that the present value concept can be a useful tool in determining the amount to be capitalized on the books of the lessor, but that it is not a useful tool in developing a definition of finance versus operating leases.

Paragraph 12 of APB #7 states that the manufacturing revenues to be recognized in a financing lease transaction would be the amount obtained in a regular sale or the discounted amount of future rentals, whichever is lower. It is presumed that such discount would be sufficient to cover interest and overhead and to provide a reasonable return on the company's investment in the leasing portfolio. Generally, then, under the old opinion, the test of reasonableness of a discount rate would be whether or not the leasing portfolio, as discounted, would cover future interest and overhead expenses and generate a return on investment. The appropriate discount would therefore vary from company to company depending upon the respective costs of borrowed money and operating expenses; and, by the same token, the amount of manufacturing revenues that could be recognized would also vary from company to company.

The proposed release on accounting for leases by manufacturer-lessors states that a lease may be accounted for under the financing method only if the present value of the required payments under the lease (excluding any renewal option) during a fixed, non-cancellable term is equal to or greater than the selling price for an outright sale or the fair value of the property. This represents a substantial change from the accounting prescribed by APB #7 which stated that a sale could be recorded even though the present value of the future rental payments was less than the normal selling price. The effect of APB #7 was to limit the amount of manufacturing revenues that could be reported, whereas the new release would prevent the recording of any such revenues.

We do not believe that the revised criteria set forth in the latest proposed release is the proper method of curing the present abuses in the application of APB #7 by manufacturer-lessors. Generally, such abuses result from the manufacturer-lessor recording as financing leases relatively short term lease contracts (1 to 3 years), and establishing high residual values of equipment at the end of the respective lease terms. We believe that a high residual value is inconsistent with treatment of a lease as a financing lease as we have set forth elsewhere in this position paper. By limiting the residual, the present provisions of paragraph 12 of APB #7 would limit the amount of manufacturing revenues that could be recognized by manufacturer-lessors.

The recent APB release defining three types of transactions between a manufacturer and a third party lessor, states that all three types should, without qualification, be treated as operating leases. We contend that the requiring of the operating method for third party transactions where the manufacturer agrees to re-lease the equipment on a best efforts basis rather than on a substitution or repurchase agreement (described on page six of the draft) fails to make adequate distinction for the very different type of contingent obligation that a best efforts re-lease agreement places on the manufacturer.

1. Repurchase commitment in the event of default or termination obviously places the basic risk of the lessor back on the manufacturer to the full extent of the unamortized equipment value and to the full extent of the credit of the manufacturer and we therefore feel that the APB draft is appropriate in this regard.

2. Substitution of an existing lease places a different risk on the manufacturer and we believe that the agreement would have to be looked into individually in order to determine whether there was a general call on the credit of the manufacturer or simply a call on existing leases. If it is solely a call on existing leases, a case could be made for requiring a very fast and, therefore, conservative depreciation of the equipment cost under an existing lease or the establishment of a reserve against the income of existing leases, while still allowing the basic agreement to the third party to be treated as a sale.

3. A manufacturer re-lease agreement on a best efforts basis is, from the manufacturer's point of view, we believe, much nearer to an outright sale than it is to an operating lease where the manufacturer is the lessor. (The existence in many of these agreements of a priority right on property leased in the future is

really only a simple way of describing the real meaning of "best efforts", since it is hard to imagine how a manufacturer could be using best efforts to re-lease third party equipment if he were leasing his own equipment first.) If an agreement between a manufacturer and third party containing this provision provides for the receipt of a sum of money in cash or in other items of value (including securities, other property, notes, etc.) without any contingencies of manufacturer or lessee performance on the ultimate receipt of these items of value, then we contend that the transaction should be treated as a sale in those cases where a reasonable estimation of probable performance costs under the re-leasing agreement can be made. It seems to us that this type of transaction is much more analogous to a transaction in which a manufacturer writes a finance lease with maintenance included and is allowed to treat the transaction as a sale as long as he provides adequately for possible credit risk and future maintenance costs than it is to a manufacturer borrowing funds against his general credit and writing operating leases.

The most important factor that has been ignored by the APB draft in a transaction as I have described in #3 above is that the manufacturer is not obligated to repay or refund any of the funds obtained by original transfer of ownership of equipment and that the third party institution has no claim against the general credit of the manufacturer. He has, in fact, only a claim against the manufacturer for performing a best efforts service which seems to be very analogous to a customer's potential claim for reasonable maintenance. If the manufacturer can demonstrate that the equipment has become obsolete and no equipment of its type is being successfully marketed, then the third party institution would have no further claim against the manufacturer.

In summary, we believe that the current APB draft has taken an oversimplistic view to solving this problem and that it should be amended to provide that those third party transactions which cannot result in a general claim against the manufacturer in the event of return of equipment by the lessee should be looked at on an individual basis to determine whether they more nearly in total fall into the category of a manufacturer's operating lease or a manufacturer's finance lease with credit and maintenance contingent risk.

EXHIBIT A

In an early Staff Outline on Accounting for Leases, the basic emphasis on risk and rewards criteria inherent currently in APB #5 and #7 were restated for purposes of discussion. We contend that the list of risks and rewards is confusing, redundant and, in one case, inapplicable. The list of factors bearing on the determination of the nature of the lease is equally troublesome.

A. Risks

1. "Obsolescence", "unprofitable operation", "unsatisfactory performance" and "idle capacity" are all nothing more than a part of the broader question within a lease contract of the lessee's ability to return the property to the lessor for any reason whatsoever.

2. "Dubious residual value" is a separate and important risk/reward which will be discussed later in this memorandum.

B. Rewards

1. "Profitable operation for entire estimated economic life" does not seem to make much sense and seems to be inapplicable. Many true rental contracts (operating leases), such as IBM computer leases, offer the lessee this reward for an infinite period of time if the lessee chooses to continue exercising renewal options.

2. "Gain from appreciation in value." If this means possible

gain over original value, then from a practical point of view it would apply only to certain leases covering real property and would have little practicality to leases covering personal property. This point is essentially a small part of the underlying question of "material equity" which was covered earlier in this memorandum.

C. Factors bearing on the determination of the nature of a financing lease

1. "The non-cancellable term of the lease covers the <u>entire</u> economic life of the leased property." This language really avoids the basic concern regarding a lease term for <u>substantially</u> all of the economic life of the leased property.

2. "Title passes to the lessee after specified rental payments." This item is redundant in that it is covered more broadly in the succeeding paragraph.

3. "The lessee can pay a nominal price, either in future rental payments or in exercise of a purchase option, and obtain a significant residual benefit." We do not disagree with this definition, but feel that it more appropriately belongs in a section defining "material equity".

4. "The lessor is a financial institution or other organization that is engaged primarily in lending money at interest." <u>We submit that the question of whether or not a lease contract</u>

<u>should be capitalized on the books of a lessee should not in any way be influenced by the nature of the lessor's business, operations, method of financing or any other aspect of the lessor.</u> It seems to us that two identical lease transactions covering identical equipment in the hands of one lessee should not be treated differently on the lessee's books because some difference exists between the two lessors. The only exception to this is the case where the lessor has a relationship to the lessee and this situation is appropriately covered now in both APT #5 and #7.

5. "The lessor acquired title to the leased property from the lessee." Again, two exactly similar leases covering identical equipment in the hands of one lessee should not be treated differently because the equipment in one case was purchased from the lessee and in the other case was purchased from another party. If the lease covering equipment purchased from a third party is an operating lease, then under what accounting theory would the lease covering sale and lease-back equipment be a financing lease?

6. "The terms of the lease protect the lessor from adverse risk and limit his rewards." This point seems unhelpful in view of the fact that "adverse risk" is not defined and may well be undefinable. Even more important is the fact that by linking the concept of protection from risk <u>and</u> limiting rewards,

a strict reading would indicate that both factors must be in effect for the point to apply. We submit that most operating leases protect the lessor from adverse risk during their non-cancellable term. This is accomplished either by the lessor insuring against these risks and building the cost of the insurance into the rental contract or by direct contract between the lessor and the lessee requiring certain evidences of insurance and degree of care for the equipment. We also submit that the large number of rental contracts containing indefinite options for the lessee to renew (i. e. IBM) also limit the lessor's rewards. Actually, such rental contracts may limit the lessor's rewards more than a long term lease with no renewal or purchase options or with such options tied to fair market value.

7. "The rental payments under the term of the lease (and any nominal residual value) are sufficient to insure the lessor of and generally limit him to a full recovery of his normal selling price (or fair value of the property, if lower) together with a reasonable return for the use of the funds." We do not believe that the auditor for a lessee is in any position to make this determination regarding the lessor. Also, it should be obvious that a "reasonable return" for one lessor may not be a reasonable return for another lessor and, if this is accepted, then the arguments under #4 above apply.

8. "Guarantees or warranties of the lessor do not exceed those customarily given to the purchaser of similar property." This could have some meaning for a lease covering real property, but we are unable to see any applicability in practice to leases covering personal property and the whole point seems extremely unimportant in the marketplace.

9. "The property was acquired by the lessor to meet the special needs of the lessee and will probably be usable only for that purpose and only for the lessee." We do not disagree with this point, but feel that it could much more appropriately be embodied in a definition of "material equity".

10. "The lessee has treated the lease as a purchase for tax purposes." This is probably the most troublesome of all of the points listed, in view of the current debate as to whether good accounting should follow tax law or tax law should follow good accounting. If the tax treatment of a lease transaction has any bearing on the accounting treatment of the transaction, then the question must arise as to whether the Board can avoid the question of defining a finance lease entirely and simply state that any lease which a lessee treats as a true lease on his tax statement should not also be an operating lease on his accounting statement. Rather than get involved in the multitude of pros and cons on this point, we strongly suggest that neither the lessee's nor the lessor's treatment

of a lease on his tax return should be embodied in the definition of a finance lease under APB #5.

SUMMARY

This memorandum has dealt with the individual points raised in the Staff Outline in considerable detail solely in the hope of convincing the Board that the entire approach taken by the staff is inappropriate and that a better alternative exists.

EXHIBIT B

Accounting for the leveraged tax leases

APB #7 states that for finance leases, lease earnings (i.e. unearned income) should be recognized in decreasing amounts which relate to the unrecovered investment similar to the method used by lending institutions in accounting for level loan repayment plans. The Opinion, however, fails to recognize the significance of the tax deferment in lease profitability. The present Opinion assumes that the rental receivable plus the residual, net of unearned income, represents the unrecovered investment, it assumes that unearned income amortization is the only contribution to income, and it assumes that the investment recovery period is the term of the lease. None of these assumptions are necessarily true.

Although the failure to recognize the tax deferral characteristic of leases is a shortcoming in accounting for all leases, it is particularly apparent in the leveraged tax lease. In recent years, probably more dollars have been invested in leveraged tax leases than all other types of leasing transactions. Such leveraged tax leases include the majority of all financing leases of aircraft, railroad rolling stock, ships, and major real estate leases.

In the leveraged tax lease, the lessor's investment is limited to only a portion of the equipment cost (the remainder is financed by debt with no recourse to the lessor beyond his unrecovered investment in the lease); unearned income may be less than the aggregate interest charges on the senior debt; and the investment recovery period may be as little as 1/3 of the lease term.

To illustrate, assume the following actual lease of railroad cars to a major U.S. railroad:

Equipment Cost: $100,000

Lease Term: 15 years

Payment: 30 semiannual payments in arrears of $5,020

Residual Value at Lease Termination: $7,500

Financing: $20,000 equity and $80,000 debt, bearing interest at 8.5% and repayable in 30 equal semi-annual payments of $4,768

Depreciable Life: Straight line over 5 years (railroad cars are subject to 5-year rapid amortization)

Tax Rate of Lessor: 50%

Cost of Money to Lessor (or investment opportunity rate): 3.5% after tax (equivalent to 7% before tax)

The above lease will yield a 5.97% after tax rate of return to the lessor (11.94% pretax equivalent). This is illustrated in the attached schedule #1 which sets forth the resulting cash flows attributable to the lease transaction. These cash flows are described below:

Lease receipt: the semiannual rental received from the lessee.

Straight line depreciation: the semiannual depreciation computed on a straight-line basis over 10 semiannual periods.

Loan interest: the semiannual interest payment on the $80,000 of debt computed at 4.25% per période on the unpaid principal balance.

Taxable income: the lease receipts less the depreciation and interest expense.

Cash flow for taxes: 50% (the effective tax rate) of the taxable income or loss.

Loan principal: the amount of the semiannual loan payment ($4,768) less the amount of loan interest accrued during the period.

Cash flow after tax: the cash flow for taxes less the loan principal.

Reserve fund: the amount of cash necessary to offset future negative cash flows (resulting principally from tax payments) assuming that such funds would earn an after tax return of 3.5% per annum (7% pretax equivalent) from investment in securities or by prepayment of other outstanding debt.

Beginning reserve fund balance: the balance of the reserve at the beginning of each period represents the present value of the future negative cash flows assuming an after tax present value factor of 3.5% per annum.

Interest earned: the interest earned on the beginning reserve fund balance assuming an after tax interest rate of 3.5%.

Reserve fund cash flow: the amount of the cash flow after taxes added to or provided by the reserve fund. No payments are made to the reserve fund until the present value of future cash flows, assuming 3.5% interest after tax, exceeds zero.

Cash flow to recover investment: the return of cash to the lessor as a recovery of his investment and profit.

Present value factors: the present value factors (determined by trial and error) which when applied to "cash flow to recover investment" discounts such cash flows to the lessor's original investment. These factors correspond to a 5.97% after tax rate of return.

Present value of flows applied to investment: the present value of each of the cash flows received by the lessor. It is computed by multiplying the cash flow to the lessor by the present value factors.

Certain observations can be made about this leveraged tax lease which differentiate it from the type of finance leasing transactions contemplated by APB #7.

First, the lessor invested $20,000 and received only $17,534 in return. Unearned income computed in accordance with the Opinion is $58,100 (i.e. the aggregate lease receipts including residual less the cost) while the total interest payment on debt is $63,032. Ignoring the time value of money, the lease results in a pretax loss of $4,932 before deducting operating and other administrative expenses.

Second, all of the profits from the above lease are directly attributable to interest earned on the reserve fund; over the period of the lease the reserve fund earned $12,568 pretax. Of this $4,932 was used to fund the pretax loss on the lease, and the remainder ($7,636) represented the lessor's pretax profit.

Under present generally accepted accounting principles future interest to be earned as a result of deferring tax payments is not considered. Further, generally accepted accounting principles state that losses on transactions cannot be deferred and must be recognized immediately. Thus, such principles would require recognition of a $4,932 loss immediately on entering into the transaction. Yet in this case it has been demonstrated that rather than a loss, the lessor earns a total after-tax profit (ignoring administrative expenses) of $3,818 -- equivalent to a 5.97% after tax rate of return.

Assuming generally accepted accounting principles did not require immediate recognition of the loss and the finance lease accounting outlined in APB #7 were applied, profits would be recognized as shown in schedule #2.

The annual income statements shown on schedule #2 indicate an erratic pattern of profits and bear no relationship to the lessor's unrecovered investment in the lease transaction (i.e. the lessor's investment at the end of the third year has been reduced from $20,000 to $1,508).

The applicability of present accounting principles for financing leases to leveraged tax leases should be obvious; they produce results that are in direct contravention of the basic principle that lease income should be recognized in decreasing amounts which relate to the unrecovered investment.

The unrealistic results produced by present APB #7 principle stems in part from an improper definition of investment. The lessor, for purposes of economic analysis, defines his investment in a leveraged tax lease as his equity investment (in the above example $20,000). Therefore, applying the principle that earned income should be recognized in relation to unrecovered investment, income should be reported as shown in the amortization schedule contained in schedule #3. Using this method after tax earnings of $1,079 would be recognized in year 1, $610 in year 2, $174 in year 3, $109 in year 4, and in increasing amounts thereafter (reflecting the accretion (at 5.97% after tax) of the value of the residual). To accomplish this pattern of profit reporting requires basic changes in APB #7 in defining the lessor's unrecovered investment, and in APB #11 in the recognition of deferred taxes on income.

APB #7 assumes that the lessor's unrecovered investment is the lease receivable plus the residual less the unearned income. For leveraged tax leases the lessor's investment is his unrecovered equity investment.

APB #11 ignores the time value of money. It assumes that monies which are retained through the deferral of taxes will sit idle and earn no return. Such is not the case and the mere existence of the leveraged tax lease in itself is sufficient evidence of this.

We believe that all deferred taxes should be provided on a present value basis and interest imputed periodically to increase the deferred tax liability to the amounts that are assumed will be paid in the future. Were this theory applied in the above leasing transaction, changes in the deferred tax liability would be recorded in the same amounts as shown in the "Reserve Fund Cash Flow" column on schedule #1, and each period interest expense would be imputed and added to the deferred tax liability in the same amounts as shown in the "Interest Earned" column. This change, together with a redefinition of "the lessor's investment" in a leverage tax lease will result in financial statement reporting of lease income in relation to the lessor's unrecovered investment and conform accounting principles to a basis which is consistent with the economic facts surrounding the leveraged tax lease.

LESSEE:

EQUIPMENT:

LEASE TERM: 15 YEARS

DEPRECIATION BASIS: $ 100000.00 OVER 5 YEARS -- STRAIGHT LINE

Schedule #1

LEASE STRUCTURE: (A) 30 PAYMENTS (2 EACH YEAR) IN ARREAR
(B) LOAN @ 8.5000%
(C) 30 PAYMENTS TO REPAY LOAN OF 99.8000% OF COST
(D) TRUSTOR'S AGGREGATE TAX BRACKET = 50.0000%

YEAR	PYMT NO	LEASE RECEIT	ST LINE DEPREC		OTHER TAX DEDUCTABLE EXPENSE	LOAN INTEREST	TAXABLE INCOME	CASH FLOW TO TAXES	CASH FLOW TO LOAN PRINCIPAL	CASH FLOW AFTER TAX
0	1	0.	0.		0.	0.	0.	0.	0.	0.
0	2	5020.00	10000.00		0.	3400.00	-8380.00	-4190.00	1368.00	4442.00
1	3	5020.00	10000.00		0.	3341.86	-8321.86	-4160.93	1426.14	4412.93
1	4	5020.00	10000.00		0.	3281.25	-8261.25	-4130.63	1486.75	4382.63
2	5	5020.00	10000.00		0.	3218.06	-8198.06	-4099.03	1549.94	4351.03
2	6	5020.00	10000.00		0.	3152.19	-8132.19	-4066.09	1615.81	4318.09
3	7	5020.00	10000.00		0.	3083.52	-8063.52	-4031.76	1684.48	4283.76
3	8	5020.00	10000.00		0.	3011.93	-7991.93	-3995.96	1756.07	4247.96
4	9	5020.00	10000.00		0.	2937.29	-7917.29	-3953.64	1830.71	4210.64
4	10	5020.00	10000.00		0.	2859.49	-7839.49	-3919.74	1908.51	4171.74
5	11	5020.00	10000.00		0.	2778.38	-7758.38	-3879.19	1989.62	4131.19
5	12	5020.00	0.		0.	2693.82	2326.18	1163.09	2074.18	-911.09
6	13	5020.00	0.		0.	2605.67	2414.33	1207.16	2162.33	-955.16
6	14	5020.00	0.		0.	2513.77	2506.23	1253.11	2254.23	-1001.11
7	15	5020.00	0.		0.	2417.96	2602.04	1301.02	2350.04	-1049.02
7	16	5020.00	0.		0.	2318.09	2701.91	1350.95	2449.91	-1098.95
8	17	5020.00	0.		0.	2213.96	2806.04	1403.02	2554.04	-1151.02
8	18	5020.00	0.		0.	2105.42	2914.58	1457.29	2662.58	-1205.29
9	19	5020.00	0.		0.	1992.26	3027.74	1513.87	2775.74	-1261.87
9	20	5020.00	0.		0.	1874.29	3145.71	1572.85	2893.71	-1320.85
10	21	5020.00	0.		0.	1751.31	3268.69	1634.34	3016.69	-1382.34
10	22	5020.00	0.		0.	1623.10	3396.90	1698.45	3144.90	-1446.45
11	23	5020.00	0.		0.	1489.44	3530.56	1765.28	3278.56	-1513.28
11	24	5020.00	0.		0.	1350.10	3669.90	1834.95	3417.90	-1582.95
12	25	5020.00	0.		0.	1204.84	3815.16	1907.58	3563.16	-1655.58
12	26	5020.00	0.		0.	1053.40	3966.60	1983.30	3714.60	-1731.30
13	27	5020.00	0.		0.	895.53	4124.47	2062.23	3872.47	-1810.23
13	28	5020.00	0.		0.	730.95	4289.05	2144.52	4037.05	-1892.52
14	29	5020.00	0.		0.	559.38	4460.62	2230.31	4208.62	-1978.31
14	30	5020.00	0.		0.	380.51	4639.49	2319.74	4387.49	-2067.74
15	31	5020.00	0.		0.	194.05	4825.95	2412.97	4565.77	-2152.79
15	***	7500.00	0.		0.	0.	7500.00	-3750.00	0.	3750.00
							RECONCILIATION TOTALS			
		158100.00	100000.00		0.	63031.82	75932.15	34216.03	80000.00	46701.97
		0.	0.		0.	0.	-80863.97	-44181.97	0.	-29167.85
		158100.00	100000.00		0.	63031.82	-4931.82	-9965.94	80000.00	17534.12

YEAR	PYMT NO	BEGINING RESERVE FUND BALANCE	INTEREST EARNED ON RESERVE FUND @ 3.50%	CASH FLOW TO/FROM RESERVE FUND	ENDING RESERVE FUND BALANCE	SURTAX AND INVESTMENT TAX CREDIT	CASH FLOW TO RECOVER INVESTMENT	@ 5.97% PRESENT VALUE FACTORS	PRESENT VALUE OF FLOWS APPLIED TO INVESTMENT
0	1	0.	0.	0.	0.	0.	0.	1.0000	0.
0	2	0.	0.	0.	0.	0.	4442.00	.9710	4313.18
1	3	0.	0.	0.	0.	0.	4412.93	.9429	4160.95
1	4	0.	0.	0.	0.	0.	4382.83	.9156	4012.74
2	5	0.	0.	0.	0.	0.	4351.03	.8891	3868.50
2	6	0.	0.	1838.74	1838.74	0.	2479.35	.8633	2140.42
3	7	1838.74	32.18	4283.76	6154.68	0.	0.	.8383	0.
3	8	6154.68	107.71	4247.96	10510.35	0.	0.	.8140	0.
4	9	10510.35	183.94	4210.64	14904.93	0.	0.	.7904	0.
4	10	14904.93	260.85	4171.74	19337.52	0.	0.	.7675	0.
5	11	19337.52	338.43	4131.19	23807.14	0.	0.	.7453	0.
5	12	23807.14	416.65	-911.09	23312.70	0.	0.	.7237	0.
6	13	23312.70	408.00	-955.16	22765.54	0.	0.	.7027	0.
6	14	22765.54	398.42	-1001.11	22162.85	0.	0.	.6824	0.
7	15	22162.85	387.87	-1049.02	21501.70	0.	0.	.6626	0.
7	16	21501.70	376.30	-1098.95	20779.05	0.	0.	.6434	0.
8	17	20779.05	363.65	-1151.02	19991.68	0.	0.	.6248	0.
8	18	19991.68	349.87	-1205.29	19136.26	0.	0.	.6067	0.
9	19	19136.26	334.90	-1261.87	18209.29	0.	0.	.5891	0.
9	20	18209.29	318.68	-1320.85	17207.12	0.	0.	.5720	0.
10	21	17207.12	301.14	-1382.34	16125.92	0.	0.	.5555	0.
10	22	16125.92	282.22	-1446.45	14961.69	0.	0.	.5394	0.
11	23	14961.69	261.84	-1513.28	13710.25	0.	0.	.5237	0.
11	24	13710.25	239.94	-1582.95	12367.24	0.	0.	.5086	0.
12	25	12367.24	216.44	-1655.58	10928.10	0.	0.	.4938	0.
12	26	10928.10	191.25	-1731.30	9388.05	0.	0.	.4795	0.
13	27	9388.05	164.30	-1810.23	7742.12	0.	0.	.4656	0.
13	28	7742.12	135.50	-1892.52	5985.10	0.	0.	.4522	0.
14	29	5985.10	104.75	-1978.31	4111.54	0.	0.	.4391	0.
14	30	4111.54	71.96	-2067.74	2115.76	0.	0.	.4263	0.
15	31	2115.76	37.03	-2152.79	0.	0.	0.	.4140	0.
15	***	0.	0.	0.	0.	0.	3750.00	.4020	1507.50
			6283.82	22884.03			23817.94		20003.29
			0.	-29167.85			0.		0.
			6283.82	-6283.82			23817.94		20003.29

Schedule #2

ACCOUNTING UNDER APB #7

	Profit (Loss) Directly Attributable to Lease						
Year	Earned Income	Interest Expense	Profit (Loss) Before Tax	50% Tax	Profit (Loss) After Tax	After Tax Earning of Reserve Fund (1)	Total After Tax Profit (Loss)
1	$ 6,147	$ 6,742	$(595)	$ 297	$(298)	-	$(298)
2	5,902	6,499	(597)	298	(299)	-	(299)
3	5,641	6,236	(595)	298	(297)	$ 140	(157)
4	5,364	5,949	(585)	293	(292)	444	152
5	5,070	5,638	(568)	284	(284)	755	471
6	4,756	5,299	(543)	272	(271)	806	535
7	4,422	4,932	(510)	255	(255)	764	509
8	4,069	4,532	(463)	232	(231)	714	483
9	3,693	4,097	(404)	202	(202)	654	452
10	3,293	3,626	(333)	167	(166)	583	417
11	2,867	3,113	(246)	123	(123)	502	379
12	2,415	2,555	(140)	70	(70)	408	338
13	1,984	1,949	35	(18)	17	300	317
14	1,423	1,290	133	(67)	66	177	243
15	1,054	575	479	(240)	239	37	276
Total	$58,100	$63,032	$(4,932)	$2,466	$(2,466)	$6,284	$ 3,818

(1) represents the amount assumed to be earned at 3.5% after tax from the investment of surplus cash* resulting from deferring income tax. Such amounts would be reflected in the income statement on a pretax basis as either interest income (if invested in securities) or a reduction of interest expense (if applied to reduce the company's debt).

* The amount of cash available after providing for recovery of the original $20,000 investment ("Beginning Reserve Fund Balance" -- Schedule #1)

Schedule #3

Calculation of Semiannual Return on Original Investment

TOTAL PAYMENT ASSIGNED	PAYMENTS INTEREST (2.985%)	ALLOCATED TO PRINCIPAL	PRINCIPAL BALANCE 20000.00	AFTER 0
4442.00	597.00	3845.00	16155.00	1
4412.90	482.23	3930.67	12224.33	2
4382.60	364.90	4017.70	8206.63	3
4351.00	244.97	4106.03	4100.60	4
2479.20	122.40	2356.80	1743.80	5
0.	52.05	-52.05	1795.85	6
0.	53.61	-53.61	1849.46	7
0.	55.21	-55.21	1904.67	8
0.	56.85	-56.85	1961.52	9
0.	58.55	-58.55	2020.07	10
0.	60.30	-60.30	2080.37	11
0.	62.10	-62.10	2142.47	12
0.	63.95	-63.95	2206.42	13
0.	65.86	-65.86	2272.28	14
0.	67.83	-67.83	2340.11	15
0.	69.85	-69.85	2409.96	16
0.	71.94	-71.94	2481.90	17
0.	74.08	-74.08	2555.98	18
0.	76.30	-76.30	2632.28	19
0.	78.57	-78.57	2710.85	20
0.	80.92	-80.92	2791.77	21
0.	83.33	-83.33	2875.10	22
0.	85.82	-85.82	2960.92	23
0.	88.38	-88.38	3049.30	24
0.	91.02	-91.02	3140.32	25
0.	93.74	-93.74	3234.06	26
0.	96.54	-96.54	3330.60	27
0.	99.42	-99.42	3430.02	28
0.	102.39	-102.39	3532.41	29
0.	105.44	-105.44	3637.85	30
3746.44	108.59	3637.85	0.	31
23814.14	3814.14	20000.00		

THE LAST FULL PAYMENT WOULD OVER PAY THE PRINCIPAL BY $ 3.56

B.B.WALKER SHOE COMPANY

September 15, 1971

MARSHALL R. WILLIAMS
PRESIDENT

Mr. Richard Lytle
Administrative Director
Accounting Principles Board
American Institute of Certified Public Accountants
666 Fifth Avenue
New York, New York 10019

Dear Mr. Lytle:

Our Company, an industrial firm that uses leasing extensively, is concerned with the deliberations of the Accounting Principles Board, Opinion No. 5, "Reporting of Leases in Financial Statements of Lessees".

While it is mostly theorists who dispute the issues and raise questions, the practical solution should prevail. I would like to suggest that the economic well being of the business community should control and not the desires of theorists or uninformed members of the public.

It is my opinion that the economic conditions of our country are such that a change in the generally accepted accounting principles is not needed or desired at this time. A change would represent a hardship to most firms as well as the ability to finance operations. I know in our own firm we would have to curtail capital improvements if such changes are instituted. The problem, if any, does not lie with business, finance communities or accounting provisions, but the uninformed and any rule would be a problem to this group.

I would like for our Company to go on record as opposed to any changes in accounting principles with respect to leasing.

Yours very truly,

B. B. WALKER SHOE COMPANY

M R Williams

M. R.Williams
President

MRW:dwc

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