NOTES

DISCLOSURE PROBLEMS IN SALE AND LEASEBACK TRANSACTIONS

During the past five years the sale and leaseback agreement, a novel financing device, has been employed as a method of securing working capital for various types of enterprises, especially merchandising corporations. The following list, a compilation of selected recent leaseback transactions, shows the amount
of cash received by companies that sold real property and simultaneously leased the same land and buildings from the purchaser on a long-term basis:

<table>
<thead>
<tr>
<th>Vendor-Lessee</th>
<th>Selling Price of Property</th>
<th>Vendor-Lessee</th>
<th>Selling Price of Property</th>
</tr>
</thead>
<tbody>
<tr>
<td>Abraham and Strauss,</td>
<td>$9,000,000</td>
<td>General Motors</td>
<td>$1,132,000</td>
</tr>
<tr>
<td>Brooklyn</td>
<td></td>
<td>Gimbel, Philadelphia</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Allied Stores</td>
<td>16,000,000</td>
<td>Gimbel, Pittsburgh</td>
<td>5,000,000</td>
</tr>
<tr>
<td>American Machine and</td>
<td>3,000,000</td>
<td>Goldblatt, Chicago</td>
<td>4,000,000</td>
</tr>
<tr>
<td>Foundry</td>
<td></td>
<td>Koppers Co.</td>
<td>6,000,000</td>
</tr>
<tr>
<td>Bamberger, Newark</td>
<td>6,750,000</td>
<td>Liquid Carbonic</td>
<td>2,700,000</td>
</tr>
<tr>
<td>Bonwit Teller</td>
<td>6,250,000</td>
<td>Lit, Philadelphia</td>
<td>4,100,000</td>
</tr>
<tr>
<td>Bullock's, Los Angeles</td>
<td>10,000,000</td>
<td>Marshall Field</td>
<td>1,400,000</td>
</tr>
<tr>
<td>Continental Can</td>
<td>10,000,000</td>
<td>Sears, Roebuck</td>
<td>46,850,000</td>
</tr>
<tr>
<td>Foley, Houston</td>
<td>13,600,000</td>
<td>Western Union</td>
<td>12,500,000</td>
</tr>
</tbody>
</table>

This note will consider the problems relevant to the establishment of an appropriate method of adequate disclosure for sale and leaseback transactions in the annual reports of corporations to their stockholders. Accounting principles indicate different means of disclosure depending upon the assumption made about the nature of the transactions. If it is assumed that the transaction consists of nothing more than a sale and a lease, the usual methods of accounting disclosure may suffice: Lease commitments ordinarily receive footnote treatment in the balance sheet at most. On the other hand, if it is assumed that the transaction is in essence a loan, then it may follow that the sale and leaseback transaction is to occupy a prominent position in the liability section of the balance sheet along with other loan obligations. But the legal status of the transaction has not been determined. Therefore, any method of disclosure of leaseback arrangements suggested at the present by the security analyst, accountant, attorney or the Securities and Exchange Commission—the parties who serve management, investors, and creditors—should give due prominence to essential information about the transactions without suggesting an implicit or explicit conclusion as to their legal nature. The problem of appropriate disclosure may be stated as two separate questions: What ought to be required by way of disclosure in the published annual reports in the year in which a leaseback is contracted, and what ought to be required in all subsequent years it is in effect?

In the typical sale and leaseback transaction, the vendor sells real property to an institutional investor, and immediately leases back the identical property for a long term of years. The leaseback provides for annual "net rent" payments, which are computed at the outset so as to provide amortization of the purchase price over the term of the lease plus a fixed return on the purchaser's investment. The tenant contracts to pay taxes, insurance, maintenance and remodeling costs, and retains fully as much control over the property as a mortgagor would. Some of the agreements contain renewal clauses which provide for a rental payment of a small percentage—in some cases as low as two per
cent—of the appraised value of the land, while others contain options to repurchase at nominal sums after full amortization of the purchase price.

A representative leaseback transaction consummated in 1947 was that in which the American Machine and Foundry Company sold all its land and buildings to The Equitable Life Assurance Society of the United States for $3,000,000. Simultaneously, American leased the same land and plants from Equitable for a period of twenty-three years with four renewal options of ten years each. Following accepted conventions and conservative principles of accounting, the firm of certified public accountants that regularly audits American's books of record and account gave no accounting recognition to the lease agreement in the annual report of American to the stockholders, except for a brief, ordinary footnote to the balance sheet. It should be noted that "window-dressing" of the balance sheet follows automatically for a sale and leaseback transaction whenever current accounting conventions are used, for they serve to distort some of the financial ratios used for purposes of security analysis. This result can be emphasized through comparison of one actual and two hypothetical balance sheets of the American Machine and Foundry Company. The company's condensed balance sheet at June 30, 1947, prior to the sale of property, was as follows:

<table>
<thead>
<tr>
<th>BALANCE SHEET A</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Assets</td>
</tr>
<tr>
<td>Investments</td>
</tr>
<tr>
<td>Fixed Assets, net</td>
</tr>
<tr>
<td>Prepaid and Deferred Items</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

If the company had accounted for the sale and leaseback transaction without revealing the lease obligation in the liability section, the balance sheet would have been presented thus:

2 American Machine & Foundry Co., Annual Report (1947), Note C. Some information about lease arrangements was given the stockholders by means of a comparative balance sheet for December 31, 1947 and 1946, the property section of which was as follows:

<table>
<thead>
<tr>
<th></th>
<th>1947</th>
<th>1946</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$340,099</td>
<td></td>
</tr>
<tr>
<td>Buildings</td>
<td>2,958,759</td>
<td>4,257,676</td>
</tr>
<tr>
<td>Machinery and Equipment</td>
<td>$5,675,532</td>
<td>4,157,434</td>
</tr>
<tr>
<td>Total</td>
<td>$5,675,532</td>
<td>7,457,434</td>
</tr>
<tr>
<td>Less reserves for depreciation</td>
<td>1,588,321</td>
<td>2,414,231</td>
</tr>
<tr>
<td>Net property, Plant and Equipment</td>
<td>$4,087,211</td>
<td>$5,043,203</td>
</tr>
</tbody>
</table>

2 For purposes of simplification, the entire amount of the sale has been deducted from net fixed assets. Actually, there was a book profit on the sale of $605,399, after taxes of $231,803, which resulted from the sale of the property at a price in excess of book value.
### BALANCE SHEET B

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Assets</td>
<td>$16,247,667</td>
</tr>
<tr>
<td>Investments</td>
<td>4,125,953</td>
</tr>
<tr>
<td>Fixed Assets, net</td>
<td>2,991,479</td>
</tr>
<tr>
<td>Prepaid and Deferred Items</td>
<td>1,819,544</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$25,184,043</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Liabilities</td>
<td>$4,286,825</td>
</tr>
<tr>
<td>Preferred Stock</td>
<td>8,000,000</td>
</tr>
<tr>
<td>Common Stock and Surplus</td>
<td>12,897,218</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$25,184,043</strong></td>
</tr>
</tbody>
</table>

If financing had been secured by the more traditional methods of mortgaging the property or obtaining a loan on the general credit of the corporation, a pro forma balance sheet would have been as follows:

### BALANCE SHEET C

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Assets</td>
<td>$16,247,667</td>
</tr>
<tr>
<td>Investments</td>
<td>4,125,953</td>
</tr>
<tr>
<td>Fixed Assets, net</td>
<td>5,991,479</td>
</tr>
<tr>
<td>Prepaid and Deferred Items</td>
<td>1,819,544</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$28,184,043</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Liabilities</td>
<td>$4,286,825</td>
</tr>
<tr>
<td>Funded Debt</td>
<td>3,000,000</td>
</tr>
<tr>
<td>Preferred Stock</td>
<td>8,000,000</td>
</tr>
<tr>
<td>Common Stock and Surplus</td>
<td>12,897,218</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$28,184,043</strong></td>
</tr>
</tbody>
</table>

A computation of the ratio of total assets to total liabilities for Balance Sheets B and C present strikingly different results: The ratio for Balance Sheet B (and Balance Sheet A) is approximately 5.87 to 1, while that for Balance Sheet C is only 3.87 to 1. The mere choice of sales and leaseback financing rather than mortgage or debenture financing adds to the appearance of strength on the balance sheet if conventional accounting technique is used.

While the leaseback may serve to “window-dress” the balance sheet, it has an opposite effect upon subsequent income statements. The annual operating expenses of a leaseback lessee are rent, taxes, insurance, and maintenance under a net rent lease, while those of a mortgagor are depreciation, interest, taxes, insurance, and maintenance. The last three items of expense are present under both forms of financing, but the rent payment, being an amortization of principal plus interest, will be higher than the total of depreciation and interest for a number of reasons. First, in the event that a corporation selects sale and leaseback financing rather than a mortgage or a debenture issue to secure a given sum of working capital, it will be charged a higher rate of interest. Explanations of the differential in rates are not entirely satisfactory, but a number of persons engaged in handling leaseback transactions have found empirically that it does exist. Second, for income tax purposes the owner of land may not charge depreciation against the land, while the leaseback lessee in effect depreciates the

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3 “In general, insurance company executives seem to believe that the differential amounts to approximately ½ to ¾ of one per cent.” Cary, Corporate Financing Through the Sale and Lease-Back of Property: Business, Tax, and Policy Considerations, 62 Harv. L. Rev. 1, 9 (1948).

4 Reg. 111, § 29.23 (l)-2 (1943).
land by gauging the rent payments so as to amortize the purchase price of both the land and buildings. This may be done even if the property has been completely depreciated by the seller for federal income tax purposes. In this latter instance no charge against income could have been made for depreciation before the sale nor would the Treasury Regulations have permitted write-up to reflect the present value of the asset, and then permitted depreciation over the remaining life of the asset. Unless corporations take the trouble to make two sets of calculations, it is probable that the same figures will find their way into published reports as appear in tax returns.

Thus it may be seen that the special effects of sale and leaseback financing on the income statements of lessees are so extensive that adequate disclosure is required for the protection of investors and creditors. The need is particularly evident in the case of those corporations for which the funds procured by sale and leaseback financing constitute a large proportion of the capital structure, since the presence of heavy fixed rent payments has the usual effect of too much leverage upon the earnings of the equity interest.

The uncertain legal status of the leaseback transaction makes it important that there be adequate disclosure so as to place investors and creditors on guard. It would be fair to assume that the management of the vendor-lessee would take the position that if disclosure must be made, it should be made in a legally neutral form. Management does not wish the contents of financial statements to influence adversely the decision on the conceptual plane concerning the legal status of the parties to the leaseback transaction. However, the ultimate decision by the courts will depend upon the view that is taken of the real risks of the parties involved: Are they those of lessor and lessee, or those of mortgagee and mortgagor?

There are three types of litigation in which the question will arise: tax cases involving the deduction of rent or depreciation by the vendor-lessee as an operating expense; tax cases in which the propriety of registering a substantial capital gain or loss on the sale of property being leased back is questioned, and bankruptcy proceedings involving corporations which are vendor-lessees under sale and leaseback agreements. In all three situations the status of the parties to the leaseback transaction will be considered, but deciding the real risks in tax cases will involve considering such things as the positions of the parties in bankruptcy, while bankruptcy litigation will involve a direct determination of

5 Reg. 111, § 29.23(b)-5 (1943).

6 Current accounting convention is opposed to depreciation of land. Paton, Advanced Accounting 373 (1941). It is not considered conservative accounting practice to permit appreciation of property to effect any change in the income accounting. Ibid., at 349. However, if it is determined that an error was made in estimating the life of a depreciable asset, in order to provide a check on the efficiency of management, current accounting theory prescribes that the reserve for depreciation be debited, the amount be shown as an item of extraordinary income in the year in which the error is recognized, and the asset be depreciated over the new estimated life. This cannot be done for income tax purposes because original cost is a limitation on the total amount of depreciation allowed.
the real risks of the parties in the light of the doctrine of fairness and full compensation.

The first situation has already received judicial treatment. In the only Supreme Court decision concerned with a sale and leaseback transaction, the Court confined itself to the point at issue and did not determine the status of the leaseback lessee. In that case, Helvering v. Lazarus, the Court construed federal income tax law as permitting a taxpayer, who had sold property to a bank and taken back a long-term lease, to make a deduction from income for depreciation on the property. If the Court had denied the taxpayer the opportunity of taking the depreciation expense, presumably the taxpayer would have been required to treat the rent payment as an operating expense, which is precisely what the typical leaseback lessee desires.

Determination of whether the transaction is a lease or a mortgage is also important in terms of Section 112(b)(1) of the Internal Revenue Code which provides that no gain or loss can be recognized if the taxpayer exchanges property for property of like kind. Consideration of this provision by the courts may result in a denial to the vendor-lessee of the opportunity for registering a capital gain or loss on the sale of the property being leased back. Implicit in such a decision may be the thought that the relationship between the parties to a leaseback transaction is something other than the normal landlord and tenant relationship.

The definitive ruling on the real risks of the parties to a leaseback transaction will be made when a large corporation with such an agreement faces reorganization under Chapter X of the National Bankruptcy Act. If the vendor-lessee had chosen to mortgage the property, (or if the courts treat the sale and

7 308 U.S. 252 (1939).
8 It is not essential that the taxpayer claiming a deduction for depreciation be the owner of legal title to the property. Duffy v. Central R. Co. of New Jersey, 268 U.S. 55 (1925) (lessee occupying under 99 year lease permitted to take depreciation on betterments having a useful life less than the term of the lease); Cogar v. Com'r of Internal Revenue, 44 F. 2d 554 (C.C.A. 6th, 1930) (purchaser of the interest in 99 year lease entitled to take depreciation on improvements erected by his predecessor in interest); Rankin v. Com'r of Internal Revenue, 60 F. 2d 76 (C.C.A. 6th, 1932) (depreciation may be taken if use or occupancy by lessee will exceed life of the improvement).
10 See Cary, op. cit. supra note 3, for an extended discussion.
11 The sale of property by American Machine and Foundry Company resulted in a large book profit. If the company can pay the 25 per cent capital gains tax on this amount and treat the rent payments as expenses, the savings in taxes will be substantial. This may be a partial solution for the problems of those business men who have been complaining that the profits reported by business today are higher than they are in actuality because allowable depreciation expense is inadequate. They point out that at present prices it may cost twice as much to replace property that is being worn out as the depreciation charge permitted by the Bureau of Internal Revenue.
12 SEC v. United States Realty and Improvement Co., 310 U.S. 434 (1940) (insolvent large corporation must reorganize under Chapter X provisions).
leaseback agreement as a disguised loan and fraudulent conveyance) in reorganization the claim of the lender against the other assets of the vendor-lessee would be limited to the difference between the claim and the appraised value of the security.\textsuperscript{13} Whether this would be more onerous to the management or the equity interest than a claim limited to three years' rent\textsuperscript{14} would depend upon the market price and marketability of the property at the time of insolvency. Since insolvency is likely to occur at a time when real property is marketable only at a sacrifice because of general business depression, it is probable that the market price at the time of insolvency would be so much less than the unrecovered principal of the vendee-lessor that the general claim would exceed the total of three years' rent. In such a situation the vendor-lessee and its equity interest would be in more strategic positions if the leaseback transaction were considered a lease rather than a loan. Moreover, from the standpoint of flexibility and bargaining in reorganization proceedings the choice between affirmation and disaffirmance of a lease may be better alternatives for the management and the equity interest than the satisfaction of claims of mortgagees on an absolute priority basis.\textsuperscript{15}

Management's concern that the commercial community will not conclude that the leaseback transaction is a loan as a result of the accounting treatment given it must be balanced with the investor's desire for disclosure that will permit meaningful comparisons to be made between the financial condition and prospective earnings of one corporation with those of others. The methods of treatment advanced by an investors' service, the accounting profession, the Securities and Exchange Commission, and by attorneys will now be scrutinized to see if they satisfy the requirements of both the primarily interest groups.

Only the most sophisticated investors and professional security analysts would be able to make adjustments to financial statements for the purpose of making financial comparisons between companies using the leaseback method of financing and those using debt financing, even where there was knowledge of the existence of commitments under long-term leases. In his effort to determine the financial condition of a corporation, the security analyst must obtain data to supplement the financial statement whenever there is inadequate disclosure. In this role he is perhaps the severest critic of the present form of disclosure accorded sale and leaseback agreements in annual reports to stockholders.

Confronted with the similar problem of adjusting the financial data of railroads using leased facilities with the financial data of railroads using their own facilities, Moody's Investors Service instituted the following procedure as an aid to investors:

\textit{Capitalization Factors}: A tabulation is presented under "Capitalization and Other Factors." This table shows not only bonds, stock and capitalized rentals on a per mile

\begin{itemize}
  \item \textsuperscript{13} 52 Stat. 896 (1938), 11 U.S.C.A. § 616(7) (1946).
  \item \textsuperscript{14} 52 Stat. 893 (1938), 11 U.S.C.A. § 602 (1946).
  \item \textsuperscript{15} Case v. Los Angeles Lumber Products Co., 308 U.S. 106 (1939); Northern Pacific Ry. Co. v. Boyd, 228 U.S. 482 (1913).
\end{itemize}
NOTES

basis but also equipment and joint facility rent net debit or credit and other income less miscellaneous deductions capitalized at five per cent on a per mile road basis. The total of all the above are presented as adjusted capital.

This tabulation shows the "effective" capitalization on a per mile basis and is presented for more direct comparison of the capitalization factors of the various railroad companies. Unless such factors as joint facility rents, equipment rents, non-operating income and miscellaneous deductions are considered, capitalization comparisons may be misleading. Other things being equal, a large rental debit for joint facilities offsets low funded debt and large non-operating income offsets funded debt, etc.\textsuperscript{6}

Implicit in this uniform capitalization of leases at five per cent is the assumption that all the leases are equally advantageous or disadvantageous at all times. The procedure outlined by Moody's was undertaken because of the need for a feasible solution to the problem of providing comparable data. But since it is aware that the procedure adopted is not entirely satisfactory, Moody's has continued to study the problem, as the following statement by an official of Moody's will reveal:

For the past two years, we have given considerable thought as to the proper figure to use in capitalizing rentals. . . . We realize that (the 5\% rate) has not been changed with changed conditions, and for this reason we have been reviewing it. We are not yet prepared to change the 5\% figure, but may make some modification before the next Railroad manual appears.

We have hesitated to use a similar procedure, that is, capitalizing rentals in respect to companies other than railroads, for the reason that standardized accounting has not been followed to the same degree as in railroads. We are considering, however, adding a footnote to the income accounts of industrials and utilities, showing the amount of rental included in operating expenses.\textsuperscript{7}

In a leaseback transaction the primary security is the general credit of the vendor-lessee, and not the property being sold.\textsuperscript{8} This points to another inherent weakness in attempting to apply Moody's technique to sale and leaseback transactions. In the case of railroad leases the rent of leased facilities is objectively determined by arms-length bargaining, but the net rent payments under a leaseback need not necessarily bear a relationship to the value of the proper-

\textsuperscript{6} Moody's Manual of Railroad Securities—1948, p. x.

\textsuperscript{7} Letter from Mr. Edmund L. Vogelius, Manager of Ratings, Moody's Investors Service, dated November 24, 1948.

\textsuperscript{8} In hopes of profiting from the expected increase in demand for frozen food after the war, Liquid Carbonic Corporation constructed a plant at Morrison, Illinois, for the manufacture of boxes for deep-freeze coolers. The plant was sold to Northwestern Mutual Life Insurance Company, and Liquid Carbonic became the tenant under a long-term lease. Since the expected demand for frozen food has not materialized, Liquid Carbonic has virtually abandoned the plant. Opportunities for sub-letting are relatively poor in the community, and Liquid Carbonic will have to endure the burdens of the lease for a long period to come. Despite the lack of marketability of the property, the insurance company anticipates no difficulty in the continued collection of rental payments because of the sound financial condition of Liquid Carbonic.
The rental payments reflect the sale price agreed upon and not the price at which the property could have been sold in the market. Thus, it can be said that the sale price and rental payments reflect the relative strength or weakness of the general credit of the vendor-lessee.

This may be illustrated by a hypothetical example. An institutional investor might be willing to pay a large corporation with excellent credit $3,000,000 for a warehouse, whose value was $2,000,000, if the net rent payments of the leaseback agreement provided for amortization of the amount plus a fixed rate of return over the fairly short period of twenty years. The obvious reason is confidence in the ability of the corporation to repay the amount in due course. The investor probably would be willing to pay only $1,500,000 for the same property with the same type of leaseback arrangement to a company in a weaker financial condition. The institutional investor would require at least the protection it would have as a mortgagee. A company with a relatively weak financial condition might not be able to secure financing by sale and leaseback at all. Certainly, the less the confidence of the investor in the general credit of the prospective vendor-lessee, the smaller would be the price that would be set for the property. But, whether the vendor-lessee is a corporation with a very strong financial position or one with a somewhat weaker position, it could increase the amount of funds realized from the property being sold by decreasing the length of the lease during which the purchase price, or at least that part of the purchase price which represents excess over the market price, is being amortized. That is, a corporation might be able to sell the same property referred to above at $5,000,000 if the net rent payment under the lease taken back was $1,000,000 “plus” for a period of three years and something like the market rental thereafter.

There are at least three pressures tending to keep the sale price at something like the price that would prevail in an unencumbered sale. First, there is the lack of inclination by the institutional investor to speculate on the credit of the

Particularly would this be the case if the purchaser were a subsidiary or a charitable trust controlled by the vendor. Under such circumstances, the price would be agreed upon between the directors of the vendor, acting qua vendors, and the directors of the vendor, acting qua trustees or as directors of the subsidiary.

The term “institutional investor” is used because insurance companies, charitable foundations, and tax-exempt educational institutions have been the major investors in leaseback transactions. The impossible tax position that would result is a bar to participation by investors that do not enjoy tax advantages: The net rent payments received would have to be treated as income, and depreciation of the building, not the land, would be the only expense, thus resulting in a large net income. These facts have led some critics to assert that the sale and leaseback transaction is only a method by which a tax-exempt institution can “sell” its exemption.

See N.Y. Times, p. 29, col. 5 (Dec. 13, 1948), quoting Dr. Vincent S. Hart, investment executive of Oberlin College: “It is true that you can always run into a hazard. That is why we pick our investments so carefully. We look primarily to the credit of the organization, and not the value of the property we buy. If the concern cannot pay the money due on its lease, then of course we would get stuck. There might be some difficulty during a depression, but we pick and choose extremely carefully.”
vendor. Second, a sale at $3,000,000 or $5,000,000 in the hypothetical situation would probably be considered a write-up by the Bureau of Internal Revenue, and the supposed tax advantages of the transaction would not be permitted.22 Third, there is the ever-present fear that if the transaction should be scrutinized by a court, an inflated sales price would serve to characterize the transaction as a loan rather than a lease. If the sale were made at the market price, which depends upon the effectiveness of these pressures, and the rate of capitalization of the leaseback were an appropriate one, then it may be that the method used by Moody's for railroad leases might be applied to leaseback transactions to secure comparable data that might be satisfactory for security analysts. But the technique would still leave unsolved the problem of balance sheet disclosure, and the balance sheet is a financial statement upon which many investors rely.

The accounting profession has been stirred to recognition of the inadequacy of current treatment of long-term leases in the balance sheet by the criticism that one of the main reasons for resort to the sale and leaseback financing technique is the "window-dressing" of the balance sheet.23 This criticism and the proposed remedies can be evaluated in terms of the function of the balance sheet and the information that statement should serve to disclose according to accepted principles of accounting. One certified public accountant has pointed directly at the crux of the problem the leaseback presents for the accountant in his efforts to furnish essential data to management, investors, and creditors:

Another argument against accounting recognition of the lease is the difficulty of determining the amount at which to record the asset and obligation, and the subsequent treatment which should be followed.

The difficulty alone is not sufficient reason for omission. As Paton and Littleton say in discussing the problem of donated assets, "Every economic facility employed by the enterprise, regardless of its origin, should be carefully administered, and recognition in the accounts of all such facilities is necessary to a proper computation of earning power."24

Although the accounting profession has recognized the problem of disclosure of sale and leaseback arrangements, it has proposed few solutions, presumably because of doubt concerning the legal nature of the transaction. However, there is a segment of the profession which has sought acceptance of "special purpose" financial statements as a solution to this new problem and many older problems of financial reporting. Despite increasing emphasis on the income statement as the primary financial report, the necessity for presentation of the financial condition (that is, the balance sheet) of an enterprise has persisted. Yet, there is a great deal of inaccuracy in adding, with a semblance of mathematical certainty,

\[ \text{Reg. 111, § 29.23 (l)-5 (1943).} \]

\[ \text{See Myers, Presentation of Long-Term Lease Liabilities in the Balance Sheet, 23 Accounting Rev. 289 (1948); Blough, Current Accounting Problems, 86 J. Accountancy 247 (1948); Cannon, Danger Signals to Accountants in "Net Lease" Financing, 85 J. Accountancy 312 (1948); Kircher, Long Term Leases and the Balance Sheet, 16 Controller 388 (1948).} \]

\[ \text{Kircher, op. cit. supra note 23, at 389.} \]
assets whose value can be absolutely (Cash and its equivalent) or reasonably accurately determined (Receivables) with other assets whose valuation is fairly accurate in the short run and a guess in the long run (Inventories) or whose valuation is simply a guess in either the short run or long run (Fixed Assets). Ordinarily, no attempt is made to adjust the vagaries of valuation of the latter assets to the fluctuations of the price level as is attempted in the valuation of inventories at the lower of “cost or market.” Since there is this basic defect in the balance sheet, this segment of the accounting profession declares that the individual needs of short-term creditors, long-term creditors, short-term investors and long-term investors can not be satisfied unless special financial reports are prepared for each.

The special statement is an appropriate solution only for the year in which a leaseback transaction is originated. It is a method of calling attention to the existence of long-term lease commitments, but it can not be as helpful as some other method that will incorporate the information into the regular financial statements customarily inspected by investors and permit comparisons to be made.

The Securities and Exchange Commission, in performance of its duty to require full disclosure and accuracy in financial reports under the provisions of the Securities Act of 1933\(^25\) and the Securities Exchange Act of 1934\(^26\), has been studying the leaseback transaction. An official of the Commission has made the following statement on the subject:

With respect to “sale and lease-back agreements” and long-term leases our studies so far seem to suggest two possible solutions:

1. Accounting treatment comparable to that accorded equipment trust obligations which would result in reflection of the leasehold as a fixed asset subject to amortization and the rent obligation as a fixed liability.

2. Footnote disclosure concerning all facts pertinent to the “sale and lease-back agreement” in a manner which will clearly set forth the significance of such an agreement in the capitalization structure.

It is our policy at the present time to require disclosure in an appropriate footnote to the balance sheet as to the following facts:

(a) Proceeds of sale of property and carrying amount on the vendor company’s books prior to sale;

(b) A brief summary of the terms of the “lease-back agreement,” e.g., period of years covered, rental, option to repurchase and option to renew leases;

(c) A grouping of all such leases according to the year of expiration, indicating with respect to each such grouping the number of leases expiring and the aggregate minimum annual rental with respect thereto;

(d) The inclusion of a caption on the liability side of the balance sheet such as “Long-term Lease Obligations,” with a reference to the footnote disclosing the above information.

If the “Lease-back agreement” includes an option to repurchase, the company is


NOTES

requested to consider, in the light of its present intentions, the desirability of reflecting the purchase price of the property as a liability on the balance sheet with a corresponding asset descriptively captioned such, for example, as "Contract to purchase plant.'

The two possible accounting treatments of the leaseback transaction being considered by the Securities and Exchange Commission, have been utilized by the corporations employing the device in their prospectuses circulated at the time new security issues are offered for sale. But none has chosen to give accounting treatment to the sale and leaseback transaction in the annual reports to stockholders comparable to that accorded the equipment trust obligation, and few have given the abundance of facts contemplated in the footnote method of treatment.

The suggestion of accounting treatment for the sale and leaseback transaction, identical to that accorded equipment trust obligations of railroads subject to regulation by the Interstate Commerce Commission probably flows from the familiar mental process of reasoning by analogy. Is the analogy persuasive? To answer this question it is necessary to have an understanding of the specific accounting technique employed for recording equipment obligations and of the similarities and differences between the two methods of financing.

The Interstate Commerce Commission requires that the cost of the equipment, less payments applicable to principal, be carried as an asset either in the general equipment account or in a special leased equipment account, and that a corresponding liability, "Equipment trust notes," be set up on the balance sheet. The most popular legal form used for railroad equipment obligations is the Philadelphia Plan, a type of conditional sales agreement in which title to the rolling stock or other equipment passes at the time of the last payment. Payments are made in the form of fixed net rent payments just as they are in the leaseback arrangement, and the "lenders" in both cases are likely to be institutional investors. In both types of transactions, the security is the property bolstered by the general credit of the lessee. The parties to both the Philadelphia Plan type of equipment obligation and to a sale and leaseback agreement containing an option to repurchase intend that the transfer of title be withheld until the final payment is made or the option exercised.

27 Letter from Mr. J. K. McClare, Assistant Chief Accountant, Division of Corporate Finance, SEC, dated November 4, 1948.

28 The following example of the treatment given leaseback transactions in prospectuses illustrates the amount of information disclosed to investors because of the policy of the Commission:

"On March 1, 1948, the Company sold the Koppers Building in Pittsburgh, Pa., to The Equitable Life Assurance Society of the United States for $6,000,000 and took back a net lease. The first year's rental under the lease is $375,000 and each succeeding year's net rental for the initial thirty-year term is $3,750 less than the last preceding year. The net rental for the first renewal period is $3,750 per annum and for each additional renewal period is $120,000 per annum. In addition, the Company is to pay taxes, insurance, repairs, maintenance and alterations. At the expiration of the twentieth lease year, the Company has the option of terminating the lease by making an offer, which the lessor is free to reject, to purchase the leased property at a price of $3,000,000." Notes to Financial Statements, Koppers Company, Inc., Prospectus Offering $10 par Common Stock, at 28 (Jan. 10, 1949).
But the fact that investment in a sale and leaseback produces a different yield from that realized on equipment trust certificates indicates that there are underlying differences between the two forms of financing. These differences form the basis for an argument against identical accounting treatment. Equipment obligations sell at yields to maturity which are less than those of any other class of corporate bonds, while leaseback agreements ordinarily provide a higher yield than would be afforded by debentures of the same issuer. There are several possible explanations for the difference in yields. The high cost of tailoring each agreement to the individual needs of a vendor-lessee is one of the factors to which the high interest rates on leaseback transactions have been ascribed, but it is difficult to see how this cost can exceed that occasioned in the process of preparation and public sale of debentures, although it will exceed the preparation costs of the standardized equipment trust issue. It is true that the physical security for the leaseback is not as good as that for the equipment obligation in that rolling stock is movable and may be sold readily for use on another railroad, while land and buildings may require additional investment to make them suitable for other tenancy or ownership even if there is a market for the property. On the other hand, the financial condition and general credit of the typical leaseback lessee is far stronger than that of the railroad obligor, who often is a chronically ailing member of an industry subject to violent cyclical fluctuation and the competition of new methods of transportation.

In the discussion of railroad leases it was noted that in contrast to the leaseback the rental is objectively determined. A similar point can be made in regard to the differences between the equipment trust obligation and the sale and leaseback transaction: for the cost of the railroad equipment financed is also objectively determined because it is sold to the lessor by a third party, instead of being sold by the vendor-lessee. There would be no advantage to the lessor or lessee in paying a price to the third party that is higher than the market price of the property; the same cannot be said in the situation where the lessor is buying the property from the lessee. There is still another difference: Unless there is an option to repurchase in the leaseback agreement, the vendor-lessee will not be the ultimate owner of the property; on the other hand, it is always contemplated that the equipment trust obligor will acquire title.

Despite the existence of these differences between the two forms of financing, a tentative guess is advanced that the higher rate of return afforded by the leaseback is not due to anything inherent in the transaction, but to the current uncertainty of the business world as to the legal and tax status of the arrangement.29 The primary reasons for the popularity and low yield of equipment trust obligations have been the relatively small dollar amount of the usual issue in comparison with the total capital structure of the obligor, the short-term nature (five to ten years) of most issues, and the general belief in their strong

29 Until about 1900 a similar statement could have been made about equipment trust obligations because of diverse treatment by the state and federal courts. See Duncan, Equipment Obligations 97–175 (1924).
security position because of the favorable treatment accorded these obligations in reorganization proceedings. In few reorganizations have equipment trust holders incurred any loss.\textsuperscript{30} On the other hand, funds derived from sale and leaseback arrangements may constitute a large proportion of the capital structure of a vendor-lessee, and the typical leaseback is a long-term (forty years or more) obligation. Only the passage of time can reveal the relative strength of the bargaining position of leaseback lessors for the device is so new that it has not been subjected to the stress of a depression period or other financial tension. The investment world can only draw its conclusions about the security position of leaseback lessor-vendees from considered guesses and current experience with the device.

The enumerated differences between the sale and leaseback transactions and the equipment trust obligation indicate that the needs of investors and creditors require that even more attention be directed in the balance sheet toward the presence of the leaseback than to the presence of the equipment obligation because all the differences that have been discussed disclosed possible weaknesses of the leaseback device. A practical method of accomplishing this aim would be a three-fold treatment in the balance sheet that can best be illustrated by a return to the data for the American Machine and Foundry Company, and presentation of a new hypothetical balance sheet:

| BALANCE SHEET D |
|-----------------|-----------------|
| Current Assets  | $16,247,067     |
| Investments     | 4,125,953       |
| Fixed Assets, net. | 2,991,479     |
| Prepaid and Deferred Items | 1,819,544 |
| Current Liabilities | $4,286,825     |
| Long-term Lease Obligations | $3,000,000    |
| Less: Value of Leasehold | 3,000,000* |
| Preferred Stock | 8,000,000       |
| Common Stock and Surplus | 12,897,218     |
| Total           | $25,184,043     |

* In 1947 the Company sold all its plants and land, having a book value of $2,200,000 to an insurance company for $3,000,000, and leased the property back for a period of twenty-three years with four renewal options of ten years each.

If the problem of adequate disclosure of leaseback transactions is, as has been suggested, that of giving due prominence to the transaction in a neutral manner so that there will be no presumption created as to the legal nature of the ar-

\textsuperscript{30} In 1931 in the case of the Series D issue of Florida East Coast Railway Equipment Trust Obligations, the lease was disaffirmed by the receiver, and the security holders realized only 43 cents on the dollar from the sale. This is the only case in over fifty years in which there were any appreciable losses by equipment trust holders. See Graham and Dodd, Security Analysis 739-42 (1940). So strong is the position of this type of issue that in November 1939 the Chicago and North Western Railroad was able to issue new equipment trust obligations at prices to yield only from 0.45 per cent to 2.35 per cent despite the fact that all mortgage issues of the road were in default.
rangement, then the method used in Balance Sheet D is a feasible solution. Management may be placated by the treatment since it does not use the conventional methods of recording lease commitments or loan obligations, and so carries no legal inference. The wealth of detail that is revealed will serve as a warning to the small investor as well as the institutional investor. For purposes of making financial comparisons, it is necessary only to move the account "Value of Leasehold" to the fixed asset section.

Balance Sheet D is an appropriate method of solution to the problem of disclosure of leaseback arrangements, but there are some less drastic methods of disclosure in the annual reports to stockholders that might be effective for conveying information about the leaseback agreement in the year in which it is contracted. A narrative paragraph, preceding the financial statements in the annual report, is one method of presenting the information without changing conventional patterns in financial statements. The defect of this treatment alone is that it does not afford a method of making financial comparisons with the data of the previous year or with the financial data of other corporations in the same industry. A second possible solution is the presentation to stockholders of a special statement, such as a comparative statement of funds.

A narrative statement. This ideal may be compared with the information that has been included in narrative statements in annual reports to stockholders. An example of the latter follows:

"To avoid having too much of the Company's capital invested in land and property improvements, as well as to provide funds for new expansion, selected store properties were sold to insurance companies and other institutions and the properties were leased back at moderate rentals by the Company on long-term leases. Sears, Roebuck & Co., Annual Report (1947). at 3."

A sample presentation of a comparative statement of funds follows:

<table>
<thead>
<tr>
<th>Source of Funds:</th>
<th>1947</th>
<th>1948</th>
<th>Increase and Decrease*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net operating income</td>
<td>$140,000</td>
<td>$120,000</td>
<td>$20,000*</td>
</tr>
<tr>
<td>Depreciation</td>
<td>20,000</td>
<td>—</td>
<td>20,000*</td>
</tr>
<tr>
<td>Sale of fixed assets</td>
<td>—</td>
<td>1,000,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Total</td>
<td>$220,000</td>
<td>$1,120,000</td>
<td>$900,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Application of Funds:</th>
<th>1947</th>
<th>1948</th>
<th>Increase and Decrease*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends</td>
<td>$30,000</td>
<td>$30,000</td>
<td>—</td>
</tr>
<tr>
<td>Interest expense</td>
<td>30,000</td>
<td>—</td>
<td>30,000*</td>
</tr>
<tr>
<td>Retirement of mortgage bonds</td>
<td>—</td>
<td>300,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Rent</td>
<td>—</td>
<td>120,000</td>
<td>120,000</td>
</tr>
<tr>
<td>Taxes</td>
<td>60,000</td>
<td>40,000</td>
<td>20,000*</td>
</tr>
<tr>
<td>Additions to machinery and equipment</td>
<td>50,000</td>
<td>250,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Leasehold improvements</td>
<td>—</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Increase in inventories</td>
<td>10,000</td>
<td>60,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Increase in working capital</td>
<td>10,000</td>
<td>230,000</td>
<td>220,000</td>
</tr>
<tr>
<td>Total</td>
<td>$220,000</td>
<td>$1,120,000</td>
<td>$900,000</td>
</tr>
</tbody>
</table>

Inspection would reveal the change in the method of financing, the sale price of the fixed assets, the financial burdens of leasing property, and other useful information. This type of statement would disclose adequately the facts concerning the leaseback arrangement entered
ment would allow the investor or creditor to make detailed comparisons between the company's prospective earnings and those results he might have forecasted at the end of the previous fiscal year. It does not afford him a method of comparison of the anticipated profits and financial condition of the company with that data for other corporations. A third solution is a combination of the first and second methods, but this, too, gives no basis for comparison of results with those of other corporations that do not resort to financing by the sale and leaseback method.

This note has considered the importance of adequate disclosure of leaseback-transactions in financial statements; it has explored the areas of legal uncertainty that have a bearing upon the accounting treatment; and it has suggested methods of adequate disclosure. There remains the problem of insuring management's acquiescence in a full disclosure policy for sale and leaseback transactions. To date dollar and cent forces have not succeeded in compelling changes in annual financial reports to stockholders. But such forces have led to the drafting of special security provisions in the indentures of new bond issues at the insistence of underwriters.

In one case, an indenture was drafted which provided that in the event properties were sold the proceeds must be used for the retirement of the debenture issue. In the indenture of another issue, a modification of the Securities and Exchange Commission's first solution, treatment comparable to that accorded equipment trust obligations, was adopted as a method of providing an additional feature of strength. The corporation, which does not plan to re-

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33 A recent example of the use of a narrative-special statement form of presentation follows: "It has long been the policy of the Company to keep the amount of its own funds invested in fixed asset or property accounts on a conservative basis. This is best shown by reference to the ten year comparative balance sheet included as a part of this report. This policy will be continued in order to maintain the Company's finances in a relatively liquid position." Allied Stores Corp., Annual Report (1947), at 23. Investors might draw some interesting conclusions from the following excerpt condensed from the ten year statement:

<table>
<thead>
<tr>
<th></th>
<th>1943</th>
<th>1948</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Assets</td>
<td>$54,277,928</td>
<td>$117,049,292</td>
</tr>
<tr>
<td>Land</td>
<td>$17,695,669</td>
<td>$4,449,472</td>
</tr>
<tr>
<td>Buildings and equipment, net</td>
<td>8,135,704</td>
<td>4,958,677</td>
</tr>
<tr>
<td>Store fixtures and equipment, net</td>
<td>4,792,668</td>
<td>11,392,148</td>
</tr>
<tr>
<td>Improvements to leased property, net</td>
<td>1,369,075</td>
<td>12,086,796</td>
</tr>
<tr>
<td>Total, Land, Buildings, and Equipment</td>
<td>$31,993,116</td>
<td>$32,885,092</td>
</tr>
</tbody>
</table>

The comparative income statement also revealed that Allied Stores had a loss total of $5,173,783 in 1943, 1944, and 1945 on the sale of land and buildings. Only a minute percentage of corporations present ten year comparative balance sheets and income statements as a part of their annual reports.

34 American Optical Company Twenty-Year 3½ per cent Debentures due March 1, 1968.

35 Bristol-Myers Company Twenty-Year 3 per cent Debentures due April 1, 1968.
sort to sale and leaseback financing arrangements, accepted a covenant pro-
posed by the attorneys for the underwriter that will adjust the financial ratios
to what they would have been if the accounting treatment proposed by the
Commission had been used. Specifically, the indenture contained a provision
that no further funded indebtedness could be created unless on a pro forma
basis the net assets of the company were equal to at least 250 per cent of the
funded debt, and the net current assets were equal to at least 150 per cent of
the funded indebtedness. To this provision was added the following novel cov-
enant:

The company covenants that, so long as any of the Debentures remain outstanding,
it will not sell, or cause or suffer or permit any North American Subsidiary to sell,
any manufacturing plant or other fixed asset if, as a part of the same transaction, the
Company or any North American Subsidiary shall acquire the right to possession or
use of such plant or other fixed asset under any lease, agreement, or other arrangement
which obligates the Company or such North American Subsidiary to pay for such
possession or use for more than one year from the date of such sale unless either (a)
the provisions hereinabove set forth . . . shall be fully complied with after (i) giving
effect to such sale and (ii) adjusting Consolidated Funded Indebtedness of the Com-
pany and its North American Subsidiaries by adding to each thereof an amount
equal to the total sales price, or (b) forthwith upon such sale, the Company shall give
notice of redemption . . . and shall redeem or otherwise acquire and surrender to the
Trustee for cancellation Debentures . . . of an aggregate principal amount equal to the
total sales price. . . .36

A covenant like this one will afford protection to creditors against the con-
ventional accounting treatment of long-term lease contracts, and the effect of
that treatment upon the ratios prescribed for the protection of creditors. Con-
sider again the three balance sheets previously presented for the American
Machine and Foundry Company. If the preferred stock contract contained a
covenant prohibiting the incurrence of funded debt without the consent of the
preferred stockholders unless the ratio of total assets to liabilities was greater
than 4 to 1 after the sale of bonds was reflected on the balance sheet, the sale
and leaseback device would have afforded a method for securing new financing
without the consent of the preferred: The company would not have been able
to mortgage the plant or sell $3,000,000 of debentures since the ratio of total
assets to liabilities would drop to 3.87 to 1 on a pro forma basis;37 but the com-
pany could sell the property for $3,000,000, lease it back for a term of years
equal in length to that of the proposed bond issue, and insert an option to re-
purchase the property in the lease.38 By means of the sale and leaseback, the
company could secure all the benefits of the funding operation, and the only
difference would be that title to the property would be separated from the
company temporarily.

36 Indenture, at 36.
37 See Balance Sheet C, p. 485 supra.
38 See Balance Sheet B, p. 485 supra.
The quoted covenant avoids this result by requiring, in effect, that resort to financing by sale and leaseback be had only when the company might incur more funded indebtedness as an alternative. But if the business world shows its intention to treat the sale and leaseback agreement as a loan for one purpose, it ought not to be shocked if the Bureau of Internal Revenue formulated the policy of so treating the transaction for tax purposes. Similarly, since management has been willing to permit the treatment of the leaseback as a loan for one purpose, an inference may be drawn as to acceptable methods of accounting disclosure. The special security clauses in bond indentures stand as condemnations of the present balance sheet treatment of sale and leaseback transactions.

Full disclosure of information about leaseback arrangements in the annual reports to stockholders will give them the opportunity of making informed judgments for themselves. However, since there is no regulating agency with the power to prescribe uniform accounting practices for industrial and merchandising corporations, it is likely that a considerable length of time will pass before the needs of investors and creditors will be able to effect adequate balance sheet presentation for leaseback arrangements in the annual reports to stockholders through the medium of concerted pressure upon corporations by the Securities and Exchange Commission, investors' services, the accounting profession and the bar.

LEGAL BARRIERS CONFRONTING THIRD PARTIES: THE PROGRESSIVE PARTY IN ILLINOIS

Recent events have produced considerable controversy as to whether or not statutory provisions in the various states present a serious obstacle to the success of minority political parties. To the traditional view that existing statutes have a controlling adverse effect has been opposed the view of a small number of political scientists who contend that the purported lack of success of minority parties is due, in the main, to factors more deeply imbedded in our political structure. This latter view seems to have received at least some confirmation from the elections of November 1948 in which the newest of the "third parties," the Progressive Party, was able to obtain a place on the ballot in forty-five states, but received surprisingly little support.

Illinois was the scene of the most heated fight with respect to the right of the Progressive Party to appear on the ballot. Candidates for offices within Cook County were able to secure their places only after protracted litigation in the state courts, and candidates for national and state-wide offices were barred al-

1 A tabulation of the statutory provisions governing minor political parties is provided in Legal Obstacles to Minority Party Success, 57 Yale L.J. 1276, 1292-97 (1948).

2 Brooks, Political Parties and Electoral Problems 122, 265 (3d ed., 1933); Odegard and Helms, American Politics 782 (1938).