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*New York University, Graduate School of Business Administration* PH.D. 1985

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# A CRITICAL EVALUATION OF FASB STATEMENT NO. 13

Antonio L. Que

A thesis presented to the Faculty of the Graduate School of Business Administration, New York University, in partial fulfillment of the requirements for the degree of Doctor of Philosophy.

1985

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# ABSTRACT

"A Critical Evaluation of FASB Statement #13"

Antonio Que

An evaluation of FASB Statement #13 has shown that the theoretical controversy has raged for over twenty years between the property right and the legal liability concept.

The study replicates the conclusion of Sorter and Ronen, in that, it has created perceptible,if not significant, changes in many of the financial ratios. It has minimal impact on measures of profitability, the current ratio, the quick ratio, and sales to working capital ratio. It has also significant impact on the ratio of sales to fixed assets, and the ratio of operating income to interest expense. However, it has substantial impact on the ratio of debt to equity.

Also, the study indicates the existence of lease restructuring. Using trend analysis, comparison is made between the increment in new operating leases to that of increment in capital leases. Of the fifteen retailers, only two companies, Almy Stores, Inc. and Scoa Industries, Inc. have not exhibited lease restructuring. One corporation, Associated Dry Goods, and two others, have portrayed suggestions of restructuring. The substantial majority of retailers display conclusive evidence of lease restructuring.

The corollary impact of lease restructuring is the shift to greater ownership of operating assets. In addition, a comparison between the proportion of owned assets vis-a-vis

leased assets have provided behind the scene lease restructuring since the requirements for lease capitalization and the separate identification of capital lease and operating lease were given a transition period prior to full implementation. With the probable loss of some of the balance sheet benefits, the analysis seems to point toward apparent increase in owned assets as compared to leased assets in the great majority of cases.

## PREFACE

The selection of FASB Statement No. 13 for critical evaluation was considered appropriate because sufficient time had passed for the verification of the result of cookbook approach to accounting rule-making.

The purpose of this study is to substantiate opinion surveys on the existence of lease restructuring which may render lease capitalization ineffective for user of financial statement.

The research was both theoretical and empirical. The theoretical analysis provided a framework in which FASB No. 13 would be judged by. For empirical testing, 15 retailers were selected, and key financial ratios were compared on a before and after retroactive restatement basis. Further, in order to gauge lease restructuring, comparisons were made between incremental operating and capital leases over an extended period of time, supplemented by trend in gross addition of owned and leased assets.

I wish to express my eternal debt of gratitude to Professor Michael Schiff, chairman of the committee, who suggested the importance of the topic. I wish also to thank Professor George H. Sorter for suggesting the specific approach to the research, and to Professor Joseph Keiper for his assistance.

April 1985 Antonio L. Paz

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# CHAPTER I

## INTRODUCTION TO LEASE CAPITALIZATION

### Statement of the Problem

The balance sheet, long being considered secondary in importance to the income statement, has become center of reform following the disillusionment with the "go-go" years in the stock market. The reason is that the stagflation of 1974-75 has awakened the investing community to the relevance of the balance sheet.[1]

Business Week could not have phrased it more appropriately as it states that:

> A quiet, but potentially explosive, revolution is sweeping the U. S. business world as lenders, investors, regulators, accountants, and corporate mangers rediscover what should never have been lost: the balance sheet.[2]

The particular events that caused greater attention to the restoration of the balance sheet are the collapse of Penn Central and the demise of Equity Funding; and as it stands, the balance sheet has failed to reflect economic values.

Other conditions such as the matching of current costs against current revenue has given rise to the undervaluation

---

[1]"Focus on Balance Sheet," Business Week, June 7, 1976. p. 52.

[2]Idem.

of current assets, and the application of historical cost principle in times of persistent inflation has impaired the economic valuation of plant assets, which has the effect of understating shareholder's equity.[3]

The resulting deterioration of the debt to equity ratios, in the face of periodic weak stock market.[4] and with the help of tax laws to stimulate economic development, the financial market has created many innovative ways of financing business operation. Among the most popular financing device is the increase use of leasing arrangment, and there are also other techniques of off balance sheet financing which are used with frequent and significant regularity, such as the Take or Pay Contracts and its myriad forms. This pervasive change is reflected in the attitudes of Big Business in regard to what is considered respectable financing as Hershman explains that:

> Top-name companies ranging from American Airlines and Duke Power to General Motors and U. S. Steel are emulating the practices usually associated with sick or unseasoned companies and attaching 'bells and whistles' (Wall Street jargon for gimmicks) to their traditional securities offerings.[5]

Due to the changes in the economic and financial climates, it has prompted the Accounting Profession to redress the balance sheet credibility, which has been confirmed by

---

[3]Wyatt, Arthur R., "Efficient Market Theory: Its Impact on Accounting," Journal of Accountancy, February 1983, p. 58.

[4]Idem.

[5]Hershman, Arlene, Adkins, Lynn and Knecht, G. Bruce, "The Creative New Look in Corporate Finance," Dun's Review, July 1981, p. 28.

the then FASB Chairman Marshall S. Armstrong.[6] One of the resultant product of balance sheet reform was the issuance of FASB Statement No. 13 - Accounting for Leases.

It is, therefore, the purpose of this thesis to evaluate critically FASB No. 13 as amended and interpreted through May 1980. It is worth noting that since its issuance, FASB Statement No. 13 has been a subject of major controversy that has evoked passionate pleas from pro and con, not seen since the issuance of Accounting for Business Combination.[7]

On the one hand, Schachner had indicated that "the criteria for the classification of leases are explicit and appear to be less susceptible to varied interpretation than heretofore."[8] This cautious optimism appears to have been premature because subsequent experiences and events have been confusing to say the least.

On the other side, Baker had questioned the approach to the problem of leasing due to

> ... an inordinate amount of effect has been devoted to the topic; inordinate, that is, when compared with other complex topics in financial accounting such as business combination, income tax allocation, and earnings per share.[9]

---

[6]Business Week, <u>op. cit.</u>, p. 54.

[7]Baker, Richard C., "Leasing and the Setting of Accounting Standards: Mapping the Labyrinth," <u>Journal of Accounting, Auditing and Finance</u>, Spring 1980, p. 198.

[8]Schachner, Leopold, "The Accounting for Leases," <u>Financial Executive</u>, February 1978, p. 40.

[9]Baker, <u>op. cit.</u>, p. 198.

A similar view is also expressed by Coughlan who had commented that:

> ... it must be obvious that any quilt which requires 13 patches in three years must be rent beyond repair.[10]

As the debate rages, this is perhaps an opportune time to pause, study, and reflect on the consequences of Accounting for Leases from the perspective of hindsight; and besides, the Financial Accounting Standard Board seem to have placed a moratorium on further amendments and interpretations.[11]

Background History

It would be instructive to have a brief insight into the development of lease accounting rules on leasing arrangement, which is a very ancient form of contracts and could be traced back to Roman Law.[12] What is new is that lease contracts have been tailored to modern commercial and industrial conditions, and for the last twenty years or so, it has become a subject of major accounting controversy over the issue of alternative methods of presenting leases on the

The first mention regarding lease presentation on the balance sheet was Accounting Research Bulletin No. 38, which called for disclosure because some leases are nothing more

---

[10]Coughlan, John W., "Regulation, Rents and Residuals," Journal of Accountancy, February 1980, p. 58 footnote.

[11]AICPA, Late Development, Journal of Accountancy, March 1984.

[12]Cook, Donald, "The Case Against Capitalizing Leases," Harvard Business Review, Jan./Feb. 1963

than installment purchase in disguise, and stated that:

> ... where it is clearly evident that transaction involved is in substance a purchase, the 'leased' property should be included among the assets of the lessee with suitable accounting for corresponding liabilities and for the related charges to income statement.[13]

But during the intervening years as the volume of leasing activities increased, and the pronouncement resulted in relatively few instances of lease capitalization, the topic was brought to the attention of the Accounting Principles Board which issued a new guideline. It followed essentially ARB No. 38 which had stated that:

> ... to the extent then that leases give rise the distinction depends on the issue of whether or not the lease is in substance a purchase of the property rather than the issue of whether or not a property right exists.[14]

Furthermore, the Accounting Principles Board Opinion No. 5 suggested that to the extent that there is a creation of material equity, the transaction should be accounted for as in substance a purchase, and it mentioned that evidence of creation of material equity could be construed from the following situations:

> (1) The existence of noncancelable lease or the cancellation is a remote contingency.
>
> (2) The payment of rent is well ahead of any reasonable measure of the expiration of the service

---

[13] AICPA, "Disclosure of Longterm Leases in Financial Statement of Lessees," Accounting Research Bulletin No. 38, October 1949, paragraph 7.

[14] AICPA, "Reporting of Leases in Financial Statement of Lessee," Accounting Principles Board Opinion No. 5, 1964, paragraph 5.

value of the property.

> (3) The existence of either a bargain purchase option or the renewal of lease is made at bargain rentals.[15]

The apparent flaw is the Accounting Principles Board's emphasis on the creation of material equity, since most leases had been able to structured in such a way that there would be no indication of material equity. The method of circumvention was the use of level payment lease plus fair value options which would not build up material equity, as this had been brought out by Ferrera stating that:

> The nonsensical nature of the resultant accounting guideline is equivalent to suggesting that an installment purchase with heavy initial payments and one with even payments are so significantly different (even though both involve an identical rate of interest) that one should be reported in the balance sheet and the other only in the footnotes to the balance sheet.[16]

In May of 1966, the APB Board issued Accounting Principles Board Opinion No. 7 which prescribed rules on accounting for lessors where two methods of handling leases were described, that is, the operating and the financing method. The concept enunciated is that the lessors should account for the lease as a financing lease if it transfer

> ... all or most of the usual ownership or reward 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, subject only to the credit

---

[15] Ibid., paragraph 10

[16] Ferrera, William L., "The Case for Symmetry in Lease Reporting," Management Accounting, April 1978, p. 19

risks generally associated with secured loan.[17]

The problem is that the main concern of the Board in APB Opinion No. 7 is "the allocation of revenue and expense to accounting periods covered by the lease in manner that meets the objective of fairly stating the lessor's net income and therefore, the lack of symmetry between the lessors and lessees is not considered to be crucial.[18]

The last Statement issued in connection with leases was APB Opinion No. 10, which dealt with the problem of subsidiaries whose function was concerned primarily with the leasing of assets to the parent corporation. The Board concluded that the subsidiaries should not be consolidated under the equity method, but rather should be combined with the parent corporation, since the equity method was deemed to be inadequate to make the presentation fair due to the significance of the assets and liabilities of the subsidiaries.[19]

Scope and Limitation of This Study

This brings up the latest pronouncement under study - FASB Statement No. 13, Accounting for Leases - which is designed to bring on board items of expenditure that should have been capitalized, if in substance, the lessor has

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[17] AICPA, "Accounting for Leases in Financial Statements of Lessors," Accounting Principles Board Opinion No. 7, May 1966, paragraph 18.

[18] Idem.

[19] AICPA, "Omnibus Opinion - 1966," Accounting Principles Board Opinion No. 10, December 1966, paragraph 4.

transferred substantially all the risks and benefits of ownership to the lessee.

Chapter II will discuss selected qualitative and quantitative characteristics that leases should be judged by, the theoretical and pragmatic issues surrounding the lease capitalization controversy, and the current status of other executory contracts.

Chapter III will cover the development of FASB No. 13 from the perspective of lessee accounting, including the critiques on the redundancy of some lease capitalization criteria, the consequences of cookbook approach and the ease of circumvention.

Chapter IV will review the practical consequences of lease capitalization in the literature. The discussion will be in terms of its impact on key financial ratios, stock prices, bond ratings, users' preferences, technical violation of bond indentures, and the issue of the on-going process of lease restructuring in order to avoid capitalization.

Chapter V will present the central thrust to this thesis which is the replication of the existence of lease restructuring and the accounting-induced shift toward greater ownership.

Chapter VI will contain a brief summary of the findings and recommendations for future study.

## CHAPTER II

## CONCEPTUAL ISSUES SURROUNDING FASB STATEMENT NO. 13

This chapter will discuss selected qualitative and quantitative attributes, the conceptual and pragmatic issues surrounding the controversy over lease capitalization, and the current treatments of other executory contracts.

### Qualitative and Quantitative Attributes

Accounting is an information system, and as such, the worthwhileness of the accounting model, be it the historical or the current model, must satisfy certain basic qualitative and quantitative characteristics. Further, it should be noted that:

> Although conventionally referred to as qualitative characteristics, some of the more important of the characteristics of accounting information that make it useful, or whose absence limit its usefulness, turn out on closer inspection to be quantitative in nature.[1]

The following is a list of selected qualitative and quantitative characteristics that will be discussed, namely: relevance, reliability, neutrality, consistency and comparability, and materiality.

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[1] FASB, "Qualitative Characteristics of Accounting Information May 1980," Statement of Financial Accounting Concepts No. 2, paragraph 3.

The Statement of Financial Accounting Concepts No. 2 states the characteristic of relevance is that it should

> ... be capable of making a difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct expectations.[2]

In addition, an ancillary aspect of relevance is timeliness, which means that information should be available to users before it loses its ability to influence decisions.[3] For example, in the case of leasing issue, the critical question is whether expanded disclosures or lease capitalization with relevant disclosures can best satisfy the requirement of relevance.

Aside from the quality of relevance, the other primary qualitative attribute is reliability which does not require certainty or precision.[4] It means completeness to the extent possible subject to the constraint of cost-benefit criterion,[5] and should possess the ancillary attributes of freedom from bias and verifiability. The idea of freedom from bias or representational faithfulness means that there is assurance that information "validly represents the underlying events and conditions."[6] On the other hand, verifiability implies concensus that there is reasonable

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[2]Ibid., paragraph 47

[3]Ibid., paragraph 56

[4]Ibid., paragraph 72

[5]Ibid., paragraph 79

[6]Idem.

assurance that whatever measurement rule used, it has been applied carefully and free of any personal bias on the part of the measurer.[7]

Another secondary aspect of verifiability is neutrality which is primarily concerned with the setting of accounting standards. The rule-making authority should take cognizance of the fact that in formulating or implementing standards,

> ... the primary concern should be relevance and reliability of the information that results, not the effect that the new rule may have on a particular interest.[8]

Furthermore, one should be aware that oftentimes a trade-off is struck between relevance and reliability in the presentation of financial information.[9] For example, the capitalization of leases will require the determination of the appropriate rate of interest which

> ... may be affected by the credit standing of the issuer, restrictive convenants, the collateral, payment and other terms pertaining to the debt, and if appropriate, the tax consequences to the buyer and seller.[10]

The result of the need for estimation may decrease to some degree the quality of reliability as a measurement of what it tries to represent, but at the same time, it may enhance

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[7]Ibid., paragraph 83.

[8]Ibid., paragraph 98.

[9]Ibid., paragraph 90.

[10]AICPA, "Disclosure of Lease Commitments by Lessees," Accounting Principles Board Opinion No. 31, June 1973, paragraph 3.

the effectiveness of information in terms of quality of relevance.

Inasmuch as predictive value is one of the goals of accounting information, the quality of consistency is needed for comparisons of similar information within the same enterprise at different points in time; and the quality of comparability is desired for comparisons of similar information with another enterprise.

Historically, consistency refers to the application of methods of accounting from one year to the next, with the intention of applying to "a single entity over time."[11] Currently, the concept is best illustrated in the audit reports which state that financial statements have been prepared "on a basis consistent with that of preceding years."[12]

The authors have suggested that if consistency is to be a viable concept, the application in terms of consistency of method is not important; rather, its pertinence lies in the consistent application of accounting principles and concepts. Then and only then, "the doctrine have the flexibility necessary for a modern realistic revelation of the progress and status of an economic entity."[13]

The other closely related concept to consistency is

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[11]Bedford, Norton M. and Iino, Toshio, "Consistency Reexamined," The Accounting Review, July 1968, p. 453.

[12]Idem.

[13]Ibid., p. 457.

comparability, which may be defined as a "quality of the relationship between two or more pieces of information"[14] which have certain common characteristics. The problem is that the practical application is filled with difficulties which are caused by the diversity of business operations, the different risks and opportunities, and the influence of management policies. The result is that the desirability of achieving a semblance of comparability has become an illusive art, and the task has been complicated by the presence of different accounting procedures that described essentially similar activities which, in turn, has been partly caused by the lack of well-articulated financial objectives. In addition, there is the further challenge that "no accounting system can be devised that would lead all preparers to assess uncertainties alike,"[15] since risk and return will vary with each independent estimates.

In the leasing controversy, consistency is violated implicitly, when more and more off balance sheet financing is being used as device to acquire operating facilities of a firm, since the essence of leasing devices are nothing more than a way of financing plant assets after the decision to invest has been decided.[16] The implication is that two

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[14] FASB, op. cit., paragraph 115

[15] AICPA, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprise," Statement of the Accounting Principles Board, Oct. 1970, p. 59.

[16] Marrah, George L., "To Lease or Not to Lease," Financial Executive, October 1968. (Reprinted in Leasing and the Financial Executive, p. 7).

different methods of presentation are being applied to essentially the same types of transaction. Consequently, comparisons of similar information within the same enterprise will not be valid over a longer time span, with the undesirable side effect of creating the impression that management performance is more efficient than is warranted by reality.

The apparent distortion of comparisons of similar information within the same enterprise is only half the impact, because comparisons of similar information among business enterprise would also be impaired. It should be noted that consistency is a necessary attribute but is not sufficient by itself for the purpose of fullfilling the quality of comparability. For instance, if one firm's policy is to purchase operating assets, and the other firm's policy is to lease operating assets which is not subject to capitalization, comparability would be hampered unless the data are reflected in a similar way.

If accounting information has satisfied all the qualitative characteristics, still, it does not obviate the need to pass judgment upon the all-pervasive quantitative attribute of materiality. The usual question posed is whether an item is large enough to influence the decision of users of accounting information.[17] In other words, it operates as a

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[17]FASB, op. cit., paragraph 123

"screens or thresholds" for separating the material from inmaterial items in the light of surrounding circumstances, and the nature of the item.[18]

In the case of leases, FASB No. 13 has not set any materiality guideline in detail, which is based on the rationale that collective judgments are not always superior to professional individual judgment.[19] Besides, it states that:

> ... materiality judgment can properly be made by those who have all the facts. No general standards of materiality could be formulated that could hope to take account of all the considerations that enter into an experienced human judgment.[20]

The Board does not, however, preclude itself in setting materiality guidelines from time to time.[21] For example, FASB No. 13 has set breakpoints for capitalization of leases, such as when the lease term "is equal to 75 percent or more of the estimated economic life of the leased property."[22] In a nutshell, the current application of materiality attribute may be summarized as follows:

> Quantitative materiality guidelines generally specify minima only. They, therefore, leave room for individual judgment in at least one direction.[23]

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[18] Ibid., paragraph 126.

[19] Ibid., paragraph 131.

[20] Idem.

[21] Idem.

[22] FASB, "Accounting for Leases," May 1980, paragraph 7-C.

[23] FASB, "Statement of Financial Accounting Concepts No. 2," op. cit., paragraph 131.

Conceptual and Practical Issues of Lease Capitalization

The Accounting Principles Board Statement No. 4 defines executory contracts as:

> An exchange of promises between the contracting parties is an exchange of something of value, but the usual view in accounting is that the promises are offsetting and nothing need to be recorded until one or both parties at least partially perform(s) under the contract.[24]

The only two exceptions which call for recording in the book are some leases and losses on firm commitments.[25]

The controversy over the inclusion of leases on the balance sheet proper rests on the interpretations of executory contracts and the basic nature of assets and liabilities, aside from pragmatic arguments.

Arguments Against Lease Capitalization. Opponents to lease capitalization argue that leases are executory contracts, because the conveyance of the property does not constitute performance on the part of the lessor. This is so, due to the fact that under the doctrine of quiet enjoyment, there is an implied provision to guarantee the peaceful enjoyment of the leased property.[26]

Additionally, "liability accrues only period by period as the service is received. In many cases, the accrual may

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[24] AICPA, "Statement of the Accounting Principles Board No. 4," October 1970, paragraph 181 S-1E.

[25] Idem.

[26] Cook, Donald C., "The Case Against Capitalizing Leases," Harvard Business Review, Jan./Feb. 1963, p. 149.

be terminated or reduced substantially."[27] Therefore, the balance sheet should reflect only legal liability. Debt, unlike leases, is fixed and determinable; while the lease liability is indeterminate, and can be substantially smaller in amount in case of default or reorganization.[28]

Also, opponents argue that the consequences of lease capitalization should not be ignored. They cite the violation of bond indentures, deterioration of key financial ratios, particularly the distortion of historical debt to equity ratios, and the consequent burden in the increase costs of capital.[29]

An interesting anecdotal evidence is the flexibility of leasing over borrowing on ground of budgetary consideration. The writer states that plant managers can make quick decision without the need for approval from corporate headquarters, since many treasurers do not know the extent of leasing activities in their own company.[30]

Finally, the opponents to lease capitalization indicate that disclosure of leases would be just as effective as capitalization. They cite substantial supportive research

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[27]Whitman, Robert O., "Accounting Primer: A Lease is a Lease is a Lease," Financial Executive, December 1975, p. 23.

[28]Zises, Alvin, "Law and Order in Lease Accounting," Financial Executive, July 1970. (Reprinted in Leasing and the Financial Executive, p. 23).

[29]Hawkins, David F. and Wehle, Mary M., "Accounting for Leases," Financial Executive Institute, 1973, p. 32.

[30]Vanderwicken, Peter, "The Powerful Logic of the Leasing Boom," Fortune Magazine, November 1973, p. 154.

based on studies of Efficient Market Hypothesis, which apparently demonstrate that accounting information in foot-note form will be impounded in security prices as if it were on the main body of the financial statements.[31]

Arguments for Lease Capitalization. The proponents for lease capitalization argue that leases are essentially com-pleted transactions, and they emphasize the conveyance element of leases by lessor, in which there is unequal performance rather than unperformed executory contracts.[32]

In facing the issue regarding contingency of default or bankruptcy, the proponents admit that there is a statutory difference between leases and debts; however, it is not considered to be crucial under normal situation, when viewed from going concern assumption.

Moreover, in accordance with looking into the economic substance of leases over its legal form, proponents use analogy to justify capitalization. Wyatt argues that the nature of leases is similar to plant assets, for both the lease arrangement and the purchased property are economic resources. The essense is the control and use of economic resources that generate stream of cash flows, including the anticipated income tax benefit; and although the lessee is

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[31]Murray, Dennis, "The Irrelevance of Lease Capitalization," Journal of Accounting, Auditing and Finance, Winter 1982, p. 154.

[32]Myers, John H., "Reporting of Leases in Financial State-ments," Accounting Research Study No. 4, AICPA, 1962, p. 40.

not able to reap the benefit of residual value, it is not a critical reason for entering into the leasing arrangement.[33]

Also, Gant asserts that the commitment to make a series of future payments have the same effect as any fixed obligation, and the process of approval is dependent upon the general credit of the lessee, which is tantamount to a surrogate for debt financing.[34] Using similar argument, Huefner compares leases to cash loans. Both situations have received tangible assets, with the loan in the form of cash while the lease is in the use of a tangible asset; and both obligations have to be repaid for the asset itself and for its use over a period of time.[35]

In line with the expansion of the accrual concept, proponents for capitalization have placed its emphasis on the economic nature of asset. In Accounting Research Study No. 4, Myers has suggested the property rights concept as he states that:

> ... to the extent ... that leases give rise to property rights, those rights and related liabilities should be measured and incorporated in the balance sheet....[36]

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[33]Wyatt, Arthur R., "Leases Should be Capitalized," <u>CPA Journal</u>, September 1974, p. 36.

[34]Gant, Donald, "Illusion in Lease Financing," <u>Harvard Business Review</u>, March/April 1959, p. 123.

[35]Huefner, Ronald J., "A Debt Approach to Lease Accounting," <u>Financial Executive</u>, March 1970. (Reprinted in Leasing and the Financial Executive, p. 17).

[36]Myers, <u>op. cit.</u>, p. 4.

Sorter and Ingberman have expressed similar view as they state that asset is "an economic resource controlled by the firm and promising future benefits to it."[37]

Lastly, proponents for lease capitalization dispute the validity of Efficient Market Hypothesis. Wyatt has cited anecdotal evidences to refute EMH, on the ground that substantial number of companies have not adopted Lifo because of Income Tax conformity rules,[38] that significant efforts are devoted to meet the pooling criteria,[39] and that off balance sheet financing is more expensive when there is less costly financing alternative available.[40]

The implication of the anecdotal evidence suggests that the use of different accounting methods could produce accounting-induced behavior, which in turn, could cause the entering of transactions of dubious economic rationality except for the production of favorable accounting results. In other words,

> ... managers who make decisions don't act as if they understand or accept EMH. Since they are the structurers of transactions, and they act as if EMH doesn't exist, dilemmas are created. Is the market really efficient or does the research

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[37]Sorter, George H. and Ingberman, Monroe, "Comments on Exposure Draft (Revised) July 22, 1976 - Accounting for Leases," File Reference 1002-019P, p. 1838.

[38]Wyatt, Arthur R., "Efficient Market Theory: Its Impact on Accounting," *Journal of Accountancy*, February 1983, p. 57.

[39]*Ibid.*, p. 60.

[40]*Ibid.*, p. 65.

> supporting it have fundamental defects that have been recognized to data?"[41]

The moral of Wyatt's critical remarks about EMH is that the experience of the business world tends to give credence to the need for the replication of the existence of lease restructuring.

Literature Review of the Extension of Accrual Concept

The extension of capitalization to other executory contracts other than leases will require conceptual justification. It is therefore pertinent to review the literature on the progress made to date.

Myers has suggested the property rights concept be applied to lease capitalization;[42] while others like Burns, Jaedicke, and Sangster (1963) would include purchase contracts used to guarantee large investment, such as acquisition of raw materials, purchased power, and transportation facilities. The rationale is based on the Sprouse/Moonitz definitions of assets and liabilities.[43]

Rappaport (1965) argued that leases should be included because it would render the balance sheet more meaningful.[44] He viewed assets as "the right to use a bundle of service

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[41] Idem.

[42] Myers, op. cit., p. 4

[43] Burns, Joseph S., Jaedicke, Robert K., and Sangster, John M., "Financial Reporting of Purchase Contracts Used to Guarantee Large Investments," The Accounting Review, Jan. 1963, p. 6.

[44] Rappaport, Alfred, "Lease Capitalization and the Transaction Concept," The Accounting Review, April 1965, p. 373.

potentials."[45] While Birnberg (1965) assumed that the objective of financial statements should be its ability to predict future success of the firm, and he would therefore include contractual commitment such as the backlog of unfilled orders and yet to be performed long-term contracts.[46]

Wojdak (1969) also reiterated the need to include executory contracts which were assumed to be meritorious, he suggested that "entering into an executory contract constitutes an accounting transaction,"[47] because for all practical purpose "the parties exchange legal and economic rights."[48] Another writer, Nurnberg (1973) would call for the recognition of past service costs and leases on the basis similar to the definition of Sprouse/Moonitz that defined assets to represent future economic benefits.[49]

A more recent attempt to weave a comprehensive theory of executory contracts was presented by Cramer and Neyhart, Jr. (1979). The authors stated two critical attributes that encompass the general presentation:

(1) the exchange of promises on the part of

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[45] Ibid., p. 374.

[46] Birnberg, Jacob G., "The Reporting of Executory Contracts," The Accounting Review, October 1965, pp. 815-16.

[47] Wojdak, Joseph F., "A Theoretical Foundation for Leases and Other Executory Contracts," The Accounting Review, July 1969, p. 564.

[48] Idem.

[49] Nurnberg, Hugo, "Leases, Purchase Commitments, and Pension Revisited," The CPA Journal, May 1973, p. 378.

> each party is the form of consideration that creates the substance of a transaction at the moment of agreement.
>
> (2) To record an executory contract the cost or fair value of the respective promises must be determined as of the transaction date.[50]

The emphasis of Statement (1) is on the "exchange of promises," which will bind the parties to the contract, and Statement (2) is basically a measurement problem. In addition, a very significant element is the requirement of "continuning performance on the part of all parties involved for the full period of the contract."[51]

The framework developed would expand the recognition criteria to cover probably all executory contracts except accounting for human resources, and the condition under which recording is made is that there is "reasonable assurance that reciprocal promises will be fullfilled."[52] What constitute reasonable assurance in the case of non-cancellable lease would include:

> (1) The ability of the lessor to provide the leased facility.
>
> (2) ... the willingness of the lessor to transfer the property rights and to guarantee quiet enjoyment througout the duration of the contract.

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[50]Cramer, Joe J. and Neyhart, Jr., Charles A., "Comprehensive Accounting Framework for Evaluating Executory Contracts," Journal of Accounting, Auditing and Finance, Vol. 2, Winter 1979, p. 137.

[51]Ibid., p. 138.

[52]Ibid., p. 141.

> (3) ... rational expectations about lessee's ability to fulfill the financial commitment over the term of the lease.
>
> (4) ... the willingness of the lessee to use the facility specifically for the purpose for which it is leased.[53]

A common premise among the writers under review is that the extension of the accrual concept to one or more types of executory contracts will make the balance sheet more meaningful, or with the emphasis that assets have future economic benefits to the enterprise, with every reasonable expectation of fulfillment.

<u>Capitalization of Other Executory Contracts</u>

Perhaps one of the pragmatic "fear" of opponents of lease capitalization is the consequence of "domino" effect of requiring the capitalization of other executory contracts; nevertheless, it is time to examine some other forms of off balance sheet transactions, the current treatments of them, and the prospect for capitalization.

There are many forms of executory contracts, of which, two major types are selected for discussion, namely: product financing and project financing.

The basic feature of product financing is the undertaking of the financing of inventories prior to sale or conversion, with the provision that the sponsor's credit is excellent and the products financed are homogeneous in nature, such as liquor and coal, and in return, the utility company agrees to purchase back irrevocably the coal at a

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[53] *Ibid.*, p. 142

fixed price plus interest and storage costs from the other party.[54]

The predominant treatment of product financing is to consider the contract as executory rather than borrowing arrangement, although the Statement of Position 78-8 has made the recommendation that in substance, if the sponsor bears the risks and rewards of ownership, it "should be reported in the financial statements of the sponsor."[55]

From all indications, there is every reasonable expectation that product financing contracts will be fulfilled under normal business intercourse; and the sponsor will be in possession and control, and will derive future benefits from it. Therefore, the sponsor should capitalize the assets and the corresponding liabilities.

The second major type is project financing, which is perhaps one of the most difficult and intractable issues that FASB will have to resolve. Some of the forms and its variants are Take or Pay contracts, Throughput and Deficiency, and Bareboat Charters.

The Take or Pay Contracts

> ... guarantees that the taker will pay for for the project's output at a rate that will adequately service the debt of the project and moreover, that the taker will make these payments in a timely fashion even if the delivery

[54] Cason, Roger, "Off-Balance Sheet Financing Transactions," _Annual Accounting Review_, Vol. 2, 1980, p. 258.

[55] AICPA, "Accounting for Product Financing Arrangements," _Statement of Position 78-8_, December 26, 1978, p. 8.

of the output is interrupted.[56]

The second variation of project financing is the Throughput and Deficiency contract which is usually employed in pipeline project, whereby

> ... the taker agrees to accept oil shipment at a certain flow rate and at a price that will adequately serve the debt of the project, and, moreover, that the taker will make these payments in a timely fashion even if the delivery of the output is interrupted.[57]

The third variation is the Bareboat Charters whereby the contract

> ... permits the financing of the vessel upon the strength of a company which agrees to charter the vessel at a certain dollar rate for a definite period of time rather than upon the credit of the third-party equity owner. If the dollar rate and the length of the charter are sufficient to service the debt necessary to finance the vessel, long-term lenders are willing to make the necessary capital commitment.[58]

The current treatment of project financing is off balance sheet, but the expanded view is that it should be reported on the financial statement.

> Although many obligations rest generally on a foundation of legal rights, legal enforceability of a claim is not prerequisite to recommending it as a liability in financial statements if the future transfer is probable - discharging an obligation based on custom or moral responsiblity has the same effect on an enterprise's resources as

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[56]Kelly, Paul K., "Raising Corporate Capital, New Financing Techniques on Wall Street," Financial Executive, November 1974, p. 38.

[57]Idem.

[58]Idem.

discharging an enforceable claim.[59]

Also, the conclusion of the Issues Paper seems to lean toward capitalization as it advocates the recognition of assets and liabilities by identification of its specific characteristics.[60]

Despite the evolutionary character of accounting, the wind of change is for the expansion of the accrual concepts by emphasizing the economic nature of assets, and therefore, project financing should also be reported on the financial statements.

Summary

The reflection of economic reality on the financial statements is an elusive art, but the accounting profession is coming to grip with the economic relevancy of the balance sheet. The chapter has discussed selected qualitative and quantitative characteristics that lease capitalization should be judged by, and the controversial aspect of lease capitalization that ranges from the pragmatic to the conceptual from both sides of the debate. Still to be resolved is the capitalization of other executory contracts.

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[59] FASB, "Objectives of Financial Reporting and Elements of Financial Statements of Business Enterprises," Proposed Statement of Financial Accounting Concepts, paragraph 50.

[60] AICPA, "Accounting for Project Financing Arrangement," Issues Paper, Draft, February 26, 1979, p. 10.

# CHAPTER III

## DEVELOPMENT OF FASB STATEMENT NO. 13

The topic selection in the development of FASB No. 13 is eclectic in approach and is concerned with its impact on lessee's accounting, including some critical evaluation of the flaws and consequences resulting therefrom.

From the outset, the Discussion Memorandum sets the groundwork for a comprehensive analysis of the basic concepts and implemental issues attendant to the accounting for leases. The major sections are lessee accounting, lessor accounting, leverage leases, and the transitional problems of implementing new accounting standards. Among the critical issues that affect particularly on lessee's accounting are users' needs, capitalization concepts, accounting symmetry, selection of the discount rate, retroactive versus prospective restatement and implemental criteria.

### Users' Needs

There is consensus that the extent of any revision in accounting for leases must be justified ultimately on users' needs. The problem is that users are not very articulate

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[1]FASB, "Accounting for Leases - FASB Discussion Memorandun," July 2, 1974, Stamford: Conn..

about what informations are needed, nor are they vocal about what type of leases that ought to be capitalized.[2] For example, Donaldson expresses the view that the emphasis should be on gross cash outflows and should not be reduced by imputed interest nor executory expenses, and he considers the "do it yourself" job through disclosure a better choice than the misplaced emphasis on lease capitalization.[3]

The Financial Executive Institute has expressed the same view by stating that:

> ... information about projected cash flows is of more value to users of the financial statements and that, if comparisons are to be made, they may be made by converting debt information, ... in terms of cash flows.[4]

On the other side, Professor Anthony objects to the implication of the cash flow emphasis because it means that accountants do not know how to treat leases, "so we give you (users) the raw material and you can do what you want with it."[5]

Despite the lack of definitive study on users' needs, several basic concepts are presented as basis for the justification of lease capitalization.[6]

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[2]FASB, op. cit., pp. 17-18

[3]Ibid., p. 19

[4]Financial Executive Institute, Letter of Comment No. 157, File Reference No. 1002-015P, p. 863.

[5]FASB, op. cit., p. 32.

[6]Ibid, pp. 21-30

Lease Capitalization Concepts

The crucial concepts are that either leases should be capitalized if they give rise to debt in the strict legal sense or they give rise to property rights.[7]

The equating of leases with legal liabilities are that they possess certainty of legal enforcement and therefore they have no problem of measurement, while all other leases are reported satisfactorily by supplementary disclosures.[8]

Nevertheless, there is the apparent drawback that there will be situation where debt is less than the value of the property.[9] Moreover, the concept seems to lack precision due to the fact that the leasing arrangement is not a settled legal issue, inasmuch as the Uniform Commercial Code is not much help in explaining the nature of leases,[10] and Court's decisions are uncertain and uneven in their interpretation. For instance:

> If, on default, it is decided that a true lease exists, then the lessee of equipment with substantial market value is entitled only to the surplus from the sale of the remaining lease term ... and the lessor is awarded all the other proceeds - representing the residual which is now greatly increased in value. If, on the other hand, the transaction had created a security interest, no distinction would be made between the term and the residual, and the debtor would

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[7] Ibid., pp. 21-30.

[8] Ibid., p. 21

[9] Ibid., p. 30

[10] Ayer, John D., "On the Vacuity of the Sale/Lease Distinction," Iowa Law Review, May 1983, p. 669

> receive all the surplus in excess of the deficiency.[11]

In opposition to purely legal consideration, the property right concept emphasizes possession and control with all the likelihood that the lease contract would be honored in the normal course of business operation.[12] Besides, lease capitalization will result in a more complete balance sheet although it has to be supplemented by relevant disclosures.[13]

Weighing the polarity of economic versus legal concepts of assets and liabilities, the Board has stopped short of adopting the property right concept by enunciating the basic premise of capitalization in the following quotation, thus:

> ... that a lease that transfers substantially all of the benefits and risks incident to the ownership of property should be accounted for as the acquisition of an asset and the incurrence of an obligation by the lessee, and as a sale or financing by the lessor.[14]

<u>Accounting Symmetry Between Lessee and Lessor</u>

The acceptance of any lease capitalization concept will require presumably symmetrical accounting treatment between lessee and lessor. As a matter of fact, one of the unresolved issue of the Accounting Principles Board is that different criteria were applied between lessee and lessor

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[11] Coogan, Peter F., "Is There a Difference Between a Long-Term Lease and an Installment Sale of Personal Property?" <u>New York University Law Review</u>, Nov./Dec. 1981, p. 1055.

[12] FASB, <u>op. cit.</u>, p. 22.

[13] <u>Ibid</u>., p. 29.

[14] FASB, "<u>Accounting for Leases</u>," May 1980, p. 67.

resulting in asymmetrical accounting treatment.

Opinions regarding the achievement of accounting symmetry between lessee and lessor seem to be favorable but with certain reservation. For example, the American Accounting Association has said that:

> ... it seems impractical and illogical to insist on symmetry for its own sake. Instead symmetry should be related to the criteria used in judging how leases will be reported.[15]

While the New York Certified Public Accountants have offered a different perspective which states that:

> Symmetry is conceptually appealing ideal ... it implies that lessors and lessee look to the same facts and interprete those facts identically ... . It may be unreal view of the two parts of a transaction. The lessee views the lease arrangement from the impact it has upon his own operating and financial position while the lessor interprets it from his position. For example, a leased property to the lessee may have a limited productive period of five years, whereas for the lessor, the property may have productive period of twenty years, ... each has a different stake in the leased property; consequently, the accounting for tht two parties may differ.[16]

After due deliberation, the Board has taken the position that the attributes of the leasing transaction should govern the classification, and therefore, the same criteria should be used for both the lessee and the lessor with the

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[15]American Accounting Association, Letter of Comment No. 114, October 21, 1974, File Reference No. 1002-015P, p. 520.

[16]New York Certified Public Accountants, Letter of Comment No. 104, October 21, 1974, File Reference No. 1002-015P, p. 432.

exception of leverage leases.[17] In any event, the nature of the business of lessee or lessor should not warrant different classification.[18]

Selection of the Discount Rate

Another factor that influences accounting symmetry between lessee and lessor is the selection of the discount rate for capitalization purpose.

A common opposition to capitalization is that the procedure of discounting is arbitrary. For instance, Budd Company states that:

> The lease rate is made up of a composite of factors such as the size of the commitment, credit rating of the lessee, ITC (investment tax credit), tax timing depreciation, residuals, etc., all of which can produce a misleading inference as to the cost of lease financing.[19]

If the lessee incremental borrowing rate is used, the Association of Bank Holding Companies object to the result because it would discriminate against companies with AAA credit ratings. The reason is that when the lessee incremental borrowing rate is applied to discount the future minimum payments, it would tend to non-capitalization for companies with BBB credit ratings.

> Thus, comparing a Standard & Poor's AAA credit with an eight percent borrowing rate and

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[17]FASB, "Accounting for Leases - FASB Statement No. 13 as amended and interpreted through May 1980," Stamford: Conn., paragraph 65.

[18]Ibid., paragraph 64.

[19]The Budd Company, Letter of Comment No. 93, October 21, 1974, File Reference No. 1002-015P, p. 408.

> and a BBB credit with an 11 percent borrowing rate by evaluating the lease payments to determine whether capitalization is required, results in many cases in having the AAA credit capitalize leases, while the BBB credit would have an operating lease for the same type of equipment, the same dollar cost, and for the same lease term. For example, a seven year lease with Investment Tax Credit (ITC) to the lessor, which we believe reduces the minimum lease rental test to 81 percent of fair market value, with lease payments of $13,668.85 per month for $1 million of equipment discounted at eight percent (AAA credit) and 11 percent (BBB credit) results in $876,983 and $798,301, respectively. The AAA credit discount factor is 87.70 percent of equipment cost, while the BBB factor is 79.83 percent of equipment cost.[20]

On the other hand, if the rate implicit in the lease is chosen, Professor Bierman questions the appropriateness on technical ground. He states that:

> The use of the interest rate implicit in the lease to any discounting for time for a lease is a mistake, .... It is <u>not</u> a rate of return, it is not a cost of money, it does not apply to the lessee and is an artificial calculation of very limited usefulness. Why not just have the lessee use its incremental borrowing rate?[21]

The Board has concluded that lessee should use the incremental borrowing rate in computing the present value of the minimum lease payments,

> ... unless (i) it is practicable for him to learn the implicit rate computed by the lessor and (ii) the implicit rate computed by the lessor is less than the lessee's incremental borrowing

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[20] Association of Bank Holding Companies, <u>Letter of Comment No. 79</u>, Sept. 26, 1976, File Ref. No. 1002-019P, pp. 1269-1270.

[21] Bierman, Jr., Harold, <u>Letter of Comment No. 13</u>, September 6, 1976, File Ref. No. 1002-019P, p. 1072.

> rate. If both of those conditions are met, the lessee shall use the implicit rate.[22]

Subsequently, the Board has attempted to amend the use of lessee's incremental borrowing rate by requiring the lessee to use the rate of interest implicit in the lease, but on further deliberation, it has decided to withdraw the amendment and has concluded that:

> ... the improved symmetry would not justify the additional effort that would be imposed on lessee to estimate the implicit rate.[23]

Prospective Versus Retroactive Restatement

Having decided to require lease capitalization, there is the further issue of whether to require prospective or retroactive restatement.

A basic opposition to retroactive restatement is based on the fact that management has acted in good faith and has framed business decision on the basis of the then generally accepted accounting standards; besides, certain business decisions would have been different if it were to know in advance that new sets of accounting rules would have to be applied.[24]

However, Arthur Andersen & Co. states that retroactive restatement is only proper course of action because

> ... comparative financial statements (will) be (more) meaningful. This conclusion is

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[22]FASB, op. cit., paragraph 7.

[23]FASB, Action Alert No. 79-52, December 20, 1979.

[24]The Bibb Company, Letter of Comment No. 118, October 17, 1974, File Ref. No. 1002-015P.

> particularly true with respect to accounting for leases because of the long time period of many existing leases. Prospective application would mean that financial statements would embody differing accounting standards for lease transactions for many years.[25]

Due to tremendous opposition to retroactive restatement, the Board has compromised to allow a four-year transition period.[26]

Implemental Criteria

After all the debate, in order to render lease capitalization concept operational, the Board has selected four criteria for implementation purpose.

> a. The lease transfers ownership of the property to the lessee by the end of the lease term.
>
> b. The lease contains a bargain purchase option.
>
> c. The lease term is equal to 75 percent or more of the estimated economic life of the leased property.
>
> d. The present value at the beginning of the lease term of the minimum lease payments ... equals or exceeds 90 percent of the excess of the fair value of the property to the lessor at the inception of the lease over any related investment tax credit retained by the lessor and expected to be realized by him.[27]

Moreover, if the lease term is within the remaining 25 percent of the total economic life, the 75 percent of economic life and the 90 percent recovery criteria will not be

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[25] Arthur Andersen & Co., Letter of Comment No. 132, October 21, 1974, File Ref. No. 1002-015P, p. 1179.

[26] FASB, "Accounting for Leases," Stamford: Conn., 1980, paragraph 48-2.

[27] Ibid., paragraph 7.

applicable, with the result that it will be classified as operating leases.[28]

There are other special provisions that must be observed when it comes to leases involving real estate. The transfer of ownership and bargain purchase option criteria are applied to land leases only.[29] Whereas in situation involving land and building, it is to be accounted as a single unit, if the fair value of land element is less than 25 percent of the total fair value of the leased property at inception, then the economic life of the building is deemed to be the life of the unit in applying the 90 percent recovery criterion. On the other hand, if the land value is more than 25 percent of the total fair value of the leased property, land and building will have to separately accounted in applying the 75 percent of economic life or 90 percent of fair value of property criterion.[30]

Flaws and Consequences of FASB 13

It is interesting to note that FASB 13 has been criticized on the ground that the criteria are redundant, the cookbook approach raises more issues than it is designed to answer, and the encouragement of circumvention.

Redundancy of Criteria. Arthur Andersen & Co. have pointed out that the transfer of ownership and the bargain

[28] Idem.

[29] Ibid., paragraph 2.

[30] Ibid., paragraph 26.

purchase option criteria "have not been applicable to most lease written in recent years,"[31] which have the effect of making the two criteria more decorative than substantive in practice.

Perhaps a more damaging argument is presented by Coughlan for the elimination of the first three criteria on the ground of apparent redundancy. He states that the transfer of ownership criterion is not needed because any lease that meets criterion (a) must also meet criterion (d) - the 90 percent recovery criterion. This is inevitable due to the fact that the lack of unguaranteed residual value (URV) accruing to the lessor will cause the implicit rate in the lease to equal 100 percent of fair value of the property at inception of the lease.[32]

The bargain purchase option is also in the same category since it is "included in minimum lease payments and title is assumed to pass, there can be no URV (unguaranteed residual value) accruing to the lessor, and lease must have a present value of 100 percent of fair value and thereby meets (d)" which is the 90 percent recovery criterion.[33]

In addition, criterion (c) - 75 percent of economic life - can also be dispensed with, on the reasoning that a

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[31] Arthur Andersen & Co., Letter of Comment No. 103, October 30, 1975, File Ref. No. 1002-017P, p. 669.

[32] Coughlan, John W., "Regulation, Rents and Residuals," Journal of Accountancy, February 1980, p. 60.

[33] Idem.

great majority of cases whenever the lease meets 75 percent of economic life, it must also meet 90 percent. This seems to be an inexorable result, since the "URV (unguaranteed residual value) for a lease covering 75 percent or more of economic life will because of the partial obsolescence of the asset and its need for greater maintenance, be small and the present value of that URV will be but a small part of the value at inception."[34]

Consequences of Cookbook Approach. Baker has criticized the use of cookbook approach because it has given the impression of conciseness, yet the results are not borne out by subsequent turn of events; and has rather the effect of an inverted pyramid requiring further and endless refinements.[35]

For example, Dieter has cited the problem of leases of terminal space and other airport facilities, where the lessor is a governmental unit, as a case of proliferation of rules and conditions. Initially, FASB No. 13 has already appeared to have excluded such leases from capitalization by stating the rationale that the life of airport facilities is essentially indeterminate, and with no provisions regarding transfer of ownership or bargain purchase option, and therefore the operating lease classification is the only

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[34] Idem.

[35] See Baker, Richard C., "Leasing and the Setting of Accounting Standards: Mapping the Labyrinth," Journal of Accounting, Auditing and Finance, Spring 1980.

conclusion.[36] Additionally, FASB has explained also that:

> By virtue of its power to abandon a facility during the term of a lease, the governmental body can effectively control the lessee's continued use of the property for its intended purpose, thus making its economic life essentially indeterminate. Finally, since neither the lease property nor equivalent property is available for sale, a meaningful fair value cannot be determined, thereby invalidating the 90 percent recovery criterion.[37]

The above explanation is apparently not sufficient as the Board has to clarify that it is not the intention to use sovereign rights as the sole justification for classification of operating leases.[38] The problem is that:

> ... the six conditions are themselves subject to interpretations, and one can envision the process of interpretation of interpretations proceeding indefinitely. This seems to be the inevitable result of making finer and finer distinction in criteria.[39]

Incidentally, a footnote has to be added to explain the meaning of equivalent property in the same service area as an afterthought.[40]

Moreover, Palmon and Kwatinetz have documented the variability of interpretation, which is based on a survey of

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[36]Dieter, Richard, "Is Lessee Accounting Working," The CPA Journal, August 1979, p. 18.

[37]FASB, op. cit., paragraph 106.

[38]Ibid., paragraph 6.

[39]Baker, op. cit., p. 202.

[40]FASB, op. cit., paragraph 6.

experiences of 28 lessee companies.[41] For instance, one facet of the study shows that there is no unique solution to the determination of the lease term.[42] As a result, the authors conclude that FASB No. 13 has

> ... allowed substantial inconsistencies in the practices followed by companies and thus did not prevent the wide use of leases as a form of off-balance-sheet financing.[43]

But that is not all, the implication is that comparability of financial statements in the same type of business would be impaired, as Goldman Sachs Research states that:

> ... interpretations of the FAS #13 criteria have varied so much and fail to include many types of stores, the rating agencies, most creditors, and most investors are likely to disregard capital lease obligations in measuring leverage comparatively among companies.[44]

The variability has the additional consequence that capitalization of leases in its present form is not very useful because:

> The rating agencies and many major lenders have already indicated that they will continue to employ traditional benchmarks, such as pretax coverage of interest and rental expense and simple multiplication of gross or minimum rentals by eight or ten. ... it appears likely that a lenders and the rating agencies may request companies to submit financial data on a pre-FAS

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[41] Palmon, Dan and Kwatinetz, Michael, "The Significant Role Interpretation Plays in the Implementation of SFAS No. 13," Journal of Accounting, Auditing and Finance, Spring 1980, p. 208.

[42] Ibid., p. 211.

[43] Ibid., p. 207.

[44] Goldman Sachs Research, "Investment Research," October 27, 1978, p. 59.

> #13 basis, so that traditional calculations may be made more accurately.[45]

However, in a recent study, Houlihan and Sondhi have questioned the usefulness of traditional benchmarks, which is referred to as the factor method. The authors have tested the factor method on 31 retailers, and have indicated that:

> ... the factor methods overestimate the debt-equivalent amount of lease obligations far more than they underestimate them and that the degree of overestimation exceeds the degree of underestimation.[46]

They have pointed out that there are several reasons for the errors. First, the trend in rising interest rates will tend to cause the interest component to increase, when the factor used is not adjusted. Second, the existence of different implicit rates and lease terms will cause a gap between the top- and lesser-rated credits, and the differential will grow over time. Third, the shorter lease term that is caused by the desire to avoid capitalization under FASB No. 13 will further aggravate the error, which is the result of the uniform application of the factor method. Fourth, if the capitalization is based on annual lease rental expense, the inclusion of contingent rentals will overstate the debt-equivalent of operating leases, since contingent rentals are not unconditional obligations at the

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[45]Idem.

[46]Houlihan, William A. and Sondhi, Ashwinpaul C., "De Facto Capitalization of Operating Leases: The Effect on Debt Capacity," Corporate Accounting, Summer 1984, p. 10.

balance sheet date. Besides, the inclusion is inconsistent with FASB No. 13 which has explicitly excluded it. Finally, the lease rentals also include "true" short term leases and other cancelable leases which should not be capitalized.[47]

The implication is that the shortcomings of FASB No. 13, as it is presently structured, cannot be cured by the alternative procedure of capitalizing operating leases by the factor method for it may still work to the detriment of the lessee company.[48]

The reason is that credit rating agencies are being relied upon by overwhelming majority of investors, and in particular, the mutual funds relied on it exclusively. Additionally, the Comptroller of the Currency uses the rating agency symbols to indicate those securities eligible for bank investment, and the laws of various states also use it for purpose of investment by savings banks, trust companies, insurance companies and fiduciaries.[49]

Perhaps not until the adoption of the property rights concept, uniform comparison under FASB No. 13 or the factor method is very questionable. The conclusion is that:

> Investors would be better off making their own direct assumptions about lease interest rates and terms in capitalizing operating leases.[50]

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[47] Ibid., pp. 6-7.

[48] Ibid., p. 13.

[49] Ibid., p. 4.

[50] Ibid., p. 13.

In any event, the lesson that may be drawn from the study of the consequences of cookbook approach is that there is no substitute for professional judgment, for so "long as accounting rules do not completely ignore future events, it is virtually impossible to implement the rules without applying some judgment. Therefore, it is not surprising to find implementing SFAS No. 13 requires judgment which stems from uncertainty regarding the future of the lease."[51] Further, the variability of interpretation has opened up new methods of circumvention.

Ease of Circumvention

Palmon and Kwatinetz have indicated that there are two methods of circumvention:

First, the judicious interpretation of the rules has enabled the lessee to minimize the impact on debt to equity ratio.[52] For instance, leases involving part of a building is brought to the attention of the Board for clarification regarding the detérmination of fair value of leased property if there were no sale of similar propery in the vicinity. In response, the Board has suggested the use of appraisal value or replacement costs, but it has not imposed the suggestion as part of the requirement. Consequently, in practice lessees have asserted uniformly that it has never been practical to estimate the fair value of a part of a building which has the effect of ruling out the

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[51] Palmon, Dan and Kwatinetz, Michael, op. cit., p. 208.

[52] Idem.

application of the 90 percent recovery rule.[53]

Moreover, "retailers have concluded that major part would be equivalent to more than 50 percent of the available space which would be an extreme rarity in a shopping mall."[54] This has the apparent result of subverting the intent of the Board because it would be reasonable to think that "an anchor tenant[55] would be assumed to have information to estimate fair market value," and besides the "anchor tenants are an integral part of the developer's plans."[56] As a matter of fact, a major retailer by its own admission states that:

> Although we recognize that there are valid techniques developed to adequately estimate fair value, any attempt to do so by lessees of parts of facility could be extremely burdensome, very costly, and perhaps inconclusive, and accordingly, should not be required.[57]

When the Board has suggested the alternative that if fair value is not determinable, the lessee would apply the

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[53]Dieter, op. cit., p. 14

[54]Ibid., p. 18.

[55]An anchor tenant may be defined as a major retailer, such as J. C. Penney, that serves as a magnet to attract customers to the shopping mall, and thereby benefiting the business of small retailers within the mall.

[56]Dieter, op. cit., p. 18.

[57]J. C. Penney, Letter of Comment No. 3, May 24, 1978, File Reference No. 1002-054.

75 percent of economic life criterion; but the rub of the matter is that the suggestion is being subverted by using subjective judgment to estimate useful life.[58]

A second example of judicious interpretation is the selection of the discount rate. The requirement that implicit rate should be used if it is known by the lessee, and if it is lower than the lessee's incremental borrowing rate, is for all practical purpose inoperative.

As one study indicates that:

> Some lessee companies have decided that it is not practicable to determine the implicit rate while others have decided that it is practicable to estimate this rate.[59]

The quotation has the implication that the use of the implicit rate is dependent upon its impact on the balance sheet of the lessee.

A further comment by Arthur Andersen & Co. has pointed out that in most cases the implicit rate is not favored because in the majority of cases "the lessor's implicit interest rate in the lease is lower than the lessee's incremental borrowing rate."[60]

The conditions that helped to lower the implicit rate of the lessor are the lessor's estimate of residual value, and the additional tax benefits accruing to the lessor.[61] Particularly, in the case of leverage leases, it has been

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[58]Dieter, op. cit., p. 14.

[59]Palmon and Kwatinetz, op. cit. p. 214.

[60]Dieter, op. cit., p. 15.

calculated that the implicit rate is usually between 0 to 3%. The reason is that the tax benefit resulting from a leveraged lease is flow through to the lessee in the form of lower rental payments. Consequently, "the vast majority of such leases are not so classified because much higher incremental borrowing rates are used by the lessees for purposes of the 90% recovery test."[61] As a result, "most practioners realized today, a lessee request from the lessor for the implicit interest rate will "reluctantly" be declined. In most situations, the lessee will not press because the direction of the answer is known in advance."[62]

Second, the other major form of circumvention of lease capitalization is accomplished by judicious drafting or lease restructuring. For instance, Longs Drug Stores have stated that:

> ... our negotiators inform me that it would be relatively simple matter to calculate the highest minimum rent which would keep the lease in the operating category and negotiate from that point trading on non-economic issues and other things to hold the rent under the 90% barrier.[63]

And when it comes to changing the lease term, it states that it is a simple procedure for it has to do is to ask that it be different. "It is not generally a major item of negotiation and tends to be more a product of personality

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[61]Arthur Andersen & Co., Letter of Comment No. 23, December 28, 1978, File Ref. No. 1002-025, p. 85.

[62]Dieter, op. cit., pp. 15-16.

[63]Longs Drug Stores, Letter of Comment No. 46, September 17, 1978, File Ref. No. 1002-01P, p. 1159.

than economic reality."[64]

Moreover, a whole new industry has been created just for the sole purpose of guaranteeing the residual value of property leased for a fee, which may be viewed as an appendage in expediting lease restructuring.[65] Since the main objective of lessor is immediate revenue recognition, it is able to meet the 90 percent of fair value because of the inclusion of guaranteed residual value in the minimum lease payments. As for the lessee, it does not have to include the guaranteed residual value in the minimum lease payments, with the result that it would fail the capitalization test, and therefore, the lease is treated as an operating lease.[66]

The moral of the situation is the difficulty of enforcing rules with arbitrary breakpoints which inevitably leads to circumvention.[67]

Summary

The chapter has touched upon selected controversial issues surrounding lease capitalization by lessees including the deliberation and attitude of the FASB Board. The Board stopped short of embracing the property rights concept by enunciating the transfer of substantially all the risks and

[64] Ibid., p. 1158.

[65] Kieso, Donald E. and Weygandt, Jerry J., Intermediate Accounting," 4th Edition, John Wiley & Sons, New York, 1983, p. 1005.

[66] Idem.

[67] Idem.

rewards of ownership as the basis for capitalization.

In addition, the discussions have focused on the redundancy of the first three criteria for capitalization, the use of cookbook appraoch which has the effect of spawning multiple amendments and interpretations, and the choice of arbitrary breakpoints which have encouraged circumvention.

## CHAPTER IV

## PRACTICAL CONSEQUENCES OF LEASE CAPITALIZATION IN LITERATURE

This chapter will review the literature on some of the practical consequences of lease capitalization. It covers pre-FASB No. 13 and post-FASB No. 13 periods.

### Impact on Key Financial Ratios

One of the earliest studies in its attempt to gauge the impact of capitalization of leases on some key financial ratios is Nelson (1963). Selecting eleven companies where the data were adequate to enable him to calculate and capitalize the lease rentals, it was found that the selected ratios were "quite substantially affected."[1] The result of the calculation showed all but two situations, the financial conditions were in a less favorable position when compared to the then conventional reporting.[2] The conclusion drawn from his study was that financial analysts would be misled by the conventional financial statements without adjustment for lease capitalization; and therefore, it could lead to faulty decisions. The basic premise for capitalization was the "extension of the long-recognized concept of looking

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[1]Nelson, Tom A., "Capitalizing Leases - The Effect on Financial Ratios," Journal of Accountancy, July 1963, p. 52.

[2]Idem.

through legal details to the financial and economic facts."[3] In short, the justification was based on the idea of substance over form.

Prior to FASB No. 13, Gritta (1974) confined his study on eleven domestic airlines in order to demonstrate the impact of capitalizing leases by lessee companies. He found that in 1970, 317 aircrafts were leased which constituted 20 percent of the total fleet of 1,651.[4] By capitalizing long-term leases of aircraft at a rate of 10 percent, the result showed a significant and striking impact on the debt to equity ratios.[5] The impact would be even more telling if ground leases were also capitalized.[6] The conclusion was that the existence of many long-term lease commitments had added significant debt burden to many of the companies sampled, and had affected intra-industry analysis.[7] It is instructive to note that "detailed data on lease contracts" were very hard to obtain.[8]

Kintzele (1975) generated model financial statements in estimating the impact of capitalization versus lease

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[3]*Ibid*., p. 57.

[4]Gritta, Richard D., "The Impact of the Capitalization of Leases on Financial Analysis," *Financial Analysts Journal*, March/April 1974, p. 47.

[5]*Ibid*., p. 49.

[6]*Ibid*., p. 51.

[7]*Ibid*., p. 50.

[8]*Ibid*., p. 51.

non-capitalization on the electric utility industry. He used data from Statistics of Privately Owned Electric Utilities in the U. S., an annual publication of the Federal Power Commission. With off balance sheet leasing arrangement, a projected increase of 15 percent in their value at the beginning of a five-year period was assumed. Also, the same assumption was made except were capitalized. His conclusion was that non-capitalization of leases produced higher net income after tax for the five-year period. However, the difference was "less than one per cent higher over the five year period if the lease was not capitalized."[9] In addition, the gross operating revenues were compared in terms of charges against customers, they showed the same rates under either method; nevertheless, investors would be better off under non-capitalization of leases because the securities of public utility would be more attractive in the capital market.[10]

Kalata, Campbell and Shumaker (1977) illustrated the effect of footnote disclosure of leasing by Kresge (K Mart Corporation) as compared to May Department Store which did not have too many leases outstanding. They concluded that Kresge received preferential treatment, because the sophisticated investor did not seem to use the footnotes. Based

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[9]Kintzele, Philip L., "Accounting Treatment by Lessees in the Electric Utility Industry," Akron Business and Economic Review, Fall 1975, p. 39.

[10]Idem.

on this two-company study, it appeared that footnote disclosure had not affected the rating nor the price-earning ratio. As a result, the perceived advantage of May Department Store was not obvious, which showed a low debt to equity ratio. In short, the potential for growth was overlooked, which result in lower credit rating and lower price-earnings ratio. They cited an example of distortion which was caused by non-capitalization of leases: May Department Store's pre-tax retrun on assets declined from 7.77 to 7.09 percent, but Kresge's pre-tax return dropped substantially when leases were capitalized as it came down from 10.28 to 5.7 percent.[11]

In a different study, Phalen contrasted the impact on financial ratios for the year 1977 between the application of FASB No. 13 and ASR 147 on ten large retailers. Since it was the motivation of FASB No. 13 to capitalize substantially all the leases, the study indicated that the effect of FASB No. 13 was to water down the ASR 147 financing lease guideline.[12] In all companies, except one, the liability was drastically less under FASB No. 13 than under ASR 147. There was also a dramatic earnings decline under FASB No. 13 in term of reduction in 1977 earnings as

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[11]Kalata, John J., Campbell, Dennis G. and Shumaker, Ian K., "Lease Financing Reporting," Financial Executive, March 1977, p. 40.

[12]Phalen, Francis T., "The Impact of SFAS 13 on the Retail Industry," Financial Executive, November 1978, p. 53.

compared to ASR 147 computation.[13] The conclusion of the study was that the cause of discrepancy was due to the exclusion of most real estate leases. Further, it was also due to presumed inability to allocate costs in the case of anchor and small tenants in shopping center, and the ignoring of increment in construction costs when the lease was signed.[14]

A different possible fallout was indicated by Horwitz (1979). The study was on the effect on hospital reimbursement procedure as a result of lease capitalization. The author asserted that:

> 1. The higher allowable costs in the earlier years may place the hospital in excess of the Section 223 routine inpatient per diem limitation.
>
> 2. The higher allowable costs in the earlier years may place the hospital's costs in excess of its charges, thus affected by the Section 233 lower of cost or charges limitation.[15]

A further possible complication could mean the loss of imputed depreciation and interest expense affecting capital leases, if certificate of needs were obtained for leases whose present value exceeds $100,000.[16] It would also cause the deterioration on at least three financial ratios.

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[13] Idem.

[14] Ibid., p. 54.

[15] Horwitz, Ronald M., "Accounting - Management Impact of FAS 13," Hospital Financial Management, August 1979, p. 16.

[16] Idem.

The ratios were the rate of return, interest coverage and the debt ratio. The result could portend difficulty of obtaining financing or could be obtained only at substantially higher costs.[17]

Ingberman, Ronen and Sorter (1979) explored the impact of lease capitalization on 17 common financial ratios. Comparison was made between two identical leases except for the estimated lives, assuming a 20-year lease term, lease rental payment of $100,000, discount rate of 10%, and a life of 26 years 9 months for lease B (2 months more than Lease A) so as to qualify for operating lease criterion. The authors generated an expense comparison for operating and capital lease over the life of the lease term.[18]

Some of the results of the comparison were: the timing difference would give rise to deferred taxes under capitalization, funds from operation would be greater by the difference between lease rental payment and interest expense under capital lease, and capitalization would decrease working capital that would decrease progressively over time and subsequently increase the other way.[19]

Two additional observations were as follows:

Capitalization increases long-term debt

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[17]*Ibid*., p. 19.

[18]Ingberman, Monroe, Ronen, Joshua and Sorter, George H., "How Lease Capitalization Under FASB Statement No. 13 Will Affect Financial Ratios," *Financial Analysts Journal*, Jan./Feb. 1979, pp. 29-30.

[19]*Ibid*., pp. 30-31.

> Capitalization increases long-term debt without altering equity, so the capital lease firm initially has a larger debt-equity ratio than the operating lease firm. As annual repayments of the debt reduce the ratio over time, however, the difference ... progressively decreases without disappearing altogether.
>
> Capitalization decreases income without altering equity. In the first year of a lease, the income to equity ratio will decrease. Over time, however the ratio increases as income grows, eventually exceeding the income to equity ratio of the operating lease firm.[20]

The conclusion drawn was that FASB Statement No. 13 would alter financial ratios in a subtle way, with the ratios changing over time, and the cash flows remaining the same under both operating and capital lease.

Fraser (1979) tested the impact of FASB No. 13 on utility financial statements, if it were to adopt the new lease capitalization rule. Using 45 companies' 10-K reports for 1977, the results indicated that for firms with capital leases: First, the real impact on net income could not be determined because of the uncertainty regarding rate-making process, but the increase in expenses would be extremely small; second, the debt ratio would increase "by less than 1% for most (27) of the firms and by less than 3% for the remaining 5 firms;" third, the capitalized leases as a percentage of total assets would be "less than 1% for 20 of the 32 firms; between 1% and 3% for 9; and 3%-5% for 3 firms;" fourth, no single type of utility firms was uniquely affected by capitalization. The conclusion was that

[20] Ibid., p. 31.

any impact on assets, liabilities, and expenses would be very small. In addition, the increase in debt ratios for the firms under analysis would also be slight, which was specially significant for an industry that was highly leveraged.[21]

Impact on Stock Market Price

Prior to FASB No. 13, Ro (1973) studied whether the disclosure of leases, in compliance with ARS 147, would have an impact on market-determined risks. The study concluded that there was an adverse impact on security prices.[22]

In contrast, Martin, Anderson and Keown (1979) examined the impact on security prices when the lease information was moved from the footnote into the balance sheet proper. The writers used a sample of 17 firms which had 22 months of information on dividend and prices. "Specifically, each subject firm had thirty-six months of information both prior to and following the lease capitalization data."[23] The results indicated that capitalized leases ranged from a low of 0.35 percent for May Department Store to a high of

[21] Ibid.,

[22] Ro, Byung, T., "The Disclosure of Capitalized Lease Information and Stock Prices," Journal of Accounting Research, Autumn 1978, p. 340.

[23] Martin, John D., Anderson, Paul F. and Keown, Arthur J. "Lease Capitalization and Stock Price Stability: Implications for Accounting," Journal of Accounting, Auditing and Finance, Winter 1979, p. 156.

13.44 percent for Affiliated Hospital Products.[24] The conclusion was that there was not "any evidence of a market reaction to the announcement of lease capitalization.[25]

Bowman (1980), using multiple regression model, tested whether the market participants view leases as tantamount to debt financing. His conclusion was that "the lease variable was not statistically significant in an association test on market risk, and only when the leverage variable is omitted from the model does the lease variable become significant; however, there was a high level of association between the leverage and lease variable.[26]

Another study made by Finnerty, Fitzsimmons and Oliver (1980) replicated the conclusion that there was no significant impact on market-determined risk of three groups of companies studied during pre- and post-June 1973. Market-determined risk did not react significantly to the impact of ARS 147 and FASB No. 13 pronouncement.[27]

Abdel-khalik, Ajinkya, and McKeown (1981), by using questionnaires, asked controllers, financial analysts, bank

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[24]Ibid, p. 157.

[25]Ibid, p. 162.

[26]Bowman, R. G., "The Debt Equivalent of Leases: An Empirical Investigation," The Accounting Review, April 1980, p. 251.

[27]Finnerty, J. E., Fitzsimmons, R. N. And Oliver, T. W., "Lease Capitalization and Systematic Risk," The Accounting Review, October 1980.

loan officers, and auditors whether "implementation of FASB No. 13 had adverse effects on stock prices of lessee companies in general."[28] The indication was that there was no perceived adverse effect on market prices. The conclusion was validated by interviewing 60 individuals selected from the group. It was also supplemented by aggregate market analysis, which tested the hypothesis that there would be no significant impact on share prices resulting from implementation of FASB No. 13.

> ... (a) no significant changes in average risk-adjusted returns were associated with the change in accounting for leases, even after allowing for changes in the financial decisions of lessee companies, and (b) there was no conclusive evidence of association between changes in market based measures of risk and capitalization of leases.[29]

Murray (1982) studied 18 firms that had changed their lease accounting reporting in accordance with FASB No. 13, and the market responses to such changes. The author employed three measures of market reaction: risk-adjusted rates of return, changes in systematic risk (beta), and abnormal trading volume.[30] The conclusion was consistent with the Efficient Market Hypothesis, that it did not

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[28]Abdel-khalik, A. R. (Principal Researcher), "The Economic Effects of Lessees of FASB Statement No. 13, Accounting for Leases," Research Report, FASB, Stamford: Conn., 1981.

[29]Ibid, p. 127

[30]Murray, Dennis, "The Irrelevance of Lease Capitalization," Journal of Accounting, Auditing and Finance, Winter 1982 p. 156.

matter how leases were presented. "What does matter, however, is that the information necessary to permit financial statement users to restate financial statements ... is disclosed."[31]

Wilkins and Zimmer (1983) used a field experiment to gauge the behaviors of Singaporean financial analysts on the effect of earnings projection and shares valuation, when alternative methods of reporting leases were used. They used two hypothetical companies, one highly leveraged and the other moderately leveraged. Both assumed the use of extensive lease financing, and using lease capitalization and footnote disclosure methods.[32] With 60 financial analysts participating in the experiment, the result indicated that "the method of accounting did have a significant effect with regard to the 'medium levered' LMN Company, but did not have significant effect in respect of the 'highly levered' PQR Company.[33] They confirmed that shares valuation was not affected by different methods of reporting leases; but earnings projection was significantly affected by the methods of reporting leases. The authors speculated that the financial analysts, who received the

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[31]Ibid, p. 158.

[32]Wilkins, Trevor and Zimmer, Ian. "The Effects of Alternative Methods of Accounting for Leases - An Experimental Study," Abacus, Vo. 19, No. 1, 1983, p. 67

[33]Ibid, p. 73

footnote disclosure, had not taken into account leases in its debt to equity ratio. Further, the effect was significant to the medium levered LMN Company. In the final analysis, the authors concluded that the methods of capitalization versus non-capitalization was not trivial and that it could affect users behavior. One important limitation was suggested that participants were not as serious in answering the experiments since their careers were not affected, and since it was purely hypothetical.[34]

Bond Risk Premium

A survey was made by Abdel-khalik and others (1981) on the attitudes of bond financial analysts on the implication of FASB No. 13. In general, a favorable attitude was indicated by the survey. Among the findings were:

> Capitalization of leases enhanced comparability between financial statements of lessee companies and companies that buy rather than lease.
>
> Capitalization of leases did not alter bond analysts' assessment of the debt-paying ability of lessee companies.
>
> Implementation of Statement 13 had no significant adverse effect on the ability of lessee companies to raise capital or their cost of debt.[35]

But on the other hand, when the bond financial analysts was asked to evaluate two identical companies whose difference

[34] Ibid., p. 74.

[35] Abdel-khalik, A. R., Op. Cit., p. 164.

lies only in the treatment of leases, the result was somewhat ar variance with the conclusion drawn from the question-answer survey. A substantial percentage, 39 percent to be exact, favored the company that kept the leases off the balance sheet.[36]

Wilkins and Zimmer (1983) tend to confirm that the use of alternative methods of accounting for leases would not have any significant impact on term loan ratings. Procedurally, participants who received the capitalized leases would treat the lease item as part of long or short term in the same way as other short and long term debt. The calculation of cash flows was made by adding back non-fund items including amortization of leases. The two groups of participant, the one with "debt only" statement and the one with lease capitalized, reached the same result. They viewed leases as essentially a form of funded debt as reflected in banking literature. The conclusion of this field experiment was that:

> ... loan officers respond differently to different levels of financial leverage of profitable companies, but not to different methods of fixed asset financing or reporting of financing or reporting of financial leases.[37]

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[36] Ibid., p. 165. The variance in attitudes between bond and financial analysts may reflect occupational bias.

[37] Wilkins, Trevor and Zimmer, Ian. "The Effect of Leasing and Different Methods of Accounting for Leases on Credit Evaluation," The Accounting Review, October 1983, p. 761.

Lease Capitalization and User Preference

Munter and Ratcliffe (1983), using a surrogate group for potential investor, evaluated the impact of lease accounting on the investor's decision preferences. The surrogates were investment managers who were in the position to make investment decisions. Three sets of financial statements were prepared: without capitalization, capitalization of leases in accordance with FASB No. 13, and all leases were capitalized by lessee. The financial data were all the same except how the leases were reflected on the financial statement.

The result of respondents showed that "while the difference in investor preference between firms 2 (capitalization per SFAS No. 13 only) and 3 (all operating leases) was not statistically significant, an absolute difference does exist."[38] The average preference showed that firm 2 (capitalization per SFAS No. 13) was the most preferred.[39] Therefore, the conclusion was that 'sophisticated' investors had exhibited preferences for 'improved' method of lease presentation in accordance with the criteria of SFAS No. 13.[40]

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[38] Munter, Paul and Ratcliffe, Thomas A., "An Assessment of User Reactions to Lease Accounting Disclosures," Journal of Accounting, Auditing and Finance, Winter 1983, p. 112.

[39] Ibid., p. 113

[40] Idem

Bond Indenture Restrictions

There was no doubt that changes in the application of accounting could cause the bond indenture to be violated. However, with respect to institutional investors, the solution could be dealt with easily. Amendments and waivers of institutional debt agreements could be accomplished easily, since the borrower need only communicate with the lender, or the lead lender of a group of institutional lenders, and could negotiate the amendment or waiver.[41]

But the main concern is that it would be more difficult to amend a public debt, since such amendment would require a meeting of the bondholders, usually with the approval of 2/3 majority, to waive technical default. Possibilities were also raised about the issue of "whether the amendment affects the rights of the holders substantially enough so as to give rise to the sale of new security. For example, in SEC v. Associated Gas & Elec. Co., the Second Circuit held that the extension of the maturity date of an issue of debt constituted the issuance of a security within the meaning of the Public Utility Holding Company Act of 1935.[42]

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[41]Fogelson, James H., "Impact of Changes in Accounting Principles on Restrictive Covenants in Credit Agreements and Indentures," Business Lawyer, Jan. 1978, p. 777.

[42]Ibid., p. 778.

Though, there was no direct evidence to the effect that technical default would give rise to lawsuits and damages.

In any case, future retroactive restatement would not be an issue because recent indenture contained provision for such eventuality, for instance:

> The Indenture of Macmillian, Inc. in connection with its 1975 public issue of $50,000,000 of 8.85 percent Sinking Fund Debentures, due November 1, 2001, provides in effect that all the restrictions contained therein are to be determined on the basis of GAAP in effect at the time the indenture was executed.[43]

Lease Restructuring

A review of some of the empirical studies, using field experiments and aggregate market analysis, seem to point to the direction that the use of alternative methods of reporting leases should not have any significant impact upon credit evaluation risks, stock and bond market prices; and therefore, it should not lead to accounting induced lease restructuring, but the verdict is inconclusive.

In a Conference Board Study, Davey (1980) made a survey of 118 lessee companies on the impact of FASB No. 13, with sales that ranged from "just over $30 million to well in excess of $10 billion, only five fall below the $100 million mark,"[44] and it included utilities, transportation,

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[43]Fogelson, James H., Op. Cit., p. 780.

[44]Davey, Patrick J., "Leasing: Experiences and Expectations," The Conference Board Report No. 791, 1980, p. iv.

wholesale-retail, mining companies and manufacturing.[45]

Majority of the findings did not affect their leasing policies, for instance, fifty-five companies indicated that FASB No. 13 had no impact on their attitudes toward leasing decision nor the nature of their business. It was suspected that the reason for this nonchalant attitude was due to the "ease with which its strictures - particularly those on capitalization - can be circumvented."[46] Only eleven companies had changed their attitudes toward financing assets, which was due to being deprived of off balance sheet financing, hence, they resorted more to purchase. A few companies had ignored smaller leases, because of the burden of compliance. Two companies had decided to change their hurdle rates in the lease or buy decision. Lastly, several companies felt some indirect impact on financial statement analysis. The evaluation was uncertain as to whether it helped or hindered the comparison with that of competitors and the measurement of the underlying units. The opinions on comparability of lease presentation were equally divided.[47]

Abdel-khalik and others (1981) had also surveyed the implications of lease restructuring. The major findings

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[45] _Idem_.

[46] _Ibid_., p. 31

[47] _Ibid_., p. 34

were that:

> The majority of the survey respondents indicated that the terms of new lease contracts were structured to avoid capitalization.
>
> About 30 to 45 percent of the respondents from all groups indicated that there was an increase in buying or constructing assets instead of leasing them.
>
> About 45 percent of the users and auditors and about 10 percent of the chief financial officers indicated that existing lease contracts were renegotiated to avoid capitalization.[48]

The authors speculated that managers did not act in accordance with reality, rather, their behaviors were influenced by what they perceived as reality. In other words:

> ... human behavior is conditioned by perceived reality, and by reality itself, the perceived effect of the change becomes the relevant attribute in motivating manager's decisions.[49]

The attitudes of management may be influenced by what is referred to as the 'information inductive hypothesis.' This theory postulated that "management will view the financial reports as reflecting its (managerial) performance. Hence, management will be "concerned with the feedback affects due to <u>all</u> uses of the reported information."[50] The inductance-based consequences of accounting policy could

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[48]Abdel-khalik, A. R., Op. Cit., p. ii.

[49]Ibid., p. 40

[50]Prakash, Prem and Rappaport, Alfred, "Information Inductance and Its Significance for Accounting," Accounting, Organization and Society, Vol. 2, No. 1, Pergamon Press, 1977, p. 35.

have the potential of creating real shifts in the economy. It further states that:

> The shifts may be the outcome of the economy's reaction to the changed (accounting) description of the firm, or - as is more likely - may be caused by management in its desire to produce accounting descriptions which avoid adverse reactions from the economy and, preferably yield economic rewards to (the shareholders of) the firm. But take place they will.[51]

It also argues that "every accounting description is, nonetheless, a description of some facet of economic reality as well as of managerial behavior, with no description having an exclusive franchise on truth. And, in virtue of this, no accounting choice is "neutral"; each involves potential wealth redistribution and effectively, therefore, social choice.[52]

Summary

Some of the studies of the impact of key financial ratios are not uniquely determined. The actual balance sheet impact will depend upon industry, management policy and the degree of leasing involvement. Most aggregate market studies have suggested the irrelevance of lease capitalization, but field experiments have been less conclusive. Further, the verdict against lease capitalization is still not resolved inasmuch as opinion survey of management attitudes has suggested lease restructuring.

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[51] Ibid., p. 37

[52] Idem

CHAPTER V

# CASES, COMPLIANCE AND CONSEQUENCES OF FASB STATEMENT No. 13

Surveys have indicated that lease restructuring is an on-going process in order to circumvent the requirements of FASB Statement No. 13.[1] The purpose of this chapter, therefore, will test empirically the existence of lease restructuring, and its concomitant shift toward more purchases of operating assets; and at the same time, gauge the impact on selected financial ratios during retroactive restatement.

## Methodology

A sample of fifteen compaines in the retailing business are selected on a non-random basis. The selections are confined to the category of department stores and limited variety stores.

In order to test the impact of FASB No. 13 on selected financial ratios, financial statements for the fiscal year that contained capitalized leases for the first time; and also, the subsequent fiscal year when retroactive restatement is implemented will be utilized.

Thirteen financial ratios are selected for illustrating

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[2] Ingberman, Ronen, and Sorter, op. cit., p. 31.

the impact of FASB Statement No. 13.[2] The financial ratios are:

1. Net Income/Sales
2. Operating Income/Interest Expense
3. Operating Income/Total Assets
4. Operating Income/Total Debt
5. Networth/Fixed Assets
6. Sales/Fixed Assets
7. Net Income/Networth
8. Income before Interest/Interest
9. Sales/Working Capital
10. Current Ratio
11. Quick Ratio
12. Debt/Equity
13. Net Income/Total Assets

If it be assumed that lease restructuring is used to circumvent compliance of FASB No. 13, then the increment in new operating leases each year as compared with the increment in new capital leases will display perceptible shift away from capital leases and into operating leases. And whenever possible, trend comparison will also be tested between the growth of contingent rentals applicable to capitalized leases and the annual minimum capital lease obligation.

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[2]Ingberman, Ronen, and Sorter, op. cit., p. 31.

A corollary to be tested is the accounting induced behavior of management to increase the ownership of plant assets where the main reason is due presumably to the loss of advantage of off balance sheet financing. The procedure of detecting such a shift is the gross addition of leased assets relatively and absolutely, in comparison with the gross addition of owned assets. The evidence deduced from the gross addition of plant assets will reinforce and reaffirm the presence of lease restructuring, since both motives emanate from the requirement of lease capitalization under FASB No. 13.

Case Study of K Mart Corporation

K Mart Corporation is the second largest retailer in the United States. It derives its incomes primarily from K Mart stores. Its mode of operation is substantially conducted in leased facilities. The normal term of lease arrangement is described below:

> Store leases are generally for terms of 25 years with multiple five-year renewal options which allow the company the option to extend the life of the lease up to 50 years beyond the initial noncancellable term. Certain leases provide for additional rental payments based on sales volume in excess of a specified base.[3]

Impact on Selected Financial Ratios. Comparisons of selected financial ratios for the fiscal year ended January 25, 1978, when only 1977 capital leases were capitalized,

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[3] K Mart Corporation, Form 10-K, 1982, p. 35.

as compared to the financial ratios computed after full implementation of FASB No. 13, have resulted in significant differences in some ratios. While other financial ratios are not as significantly affected, but it does show perceptible impact. The following observations are indicated, per Table 7-K-1 (page 73), thus:

(1) The debt to equity ratio had worsened from 21.5 percent to 89.5 percent. In other words, K Mart had about 22 cents of debt to every dollar of equity, but when the leases were capitalized on a retroactive basis as required by FASB No. 13, it showed about 90 cents of debt for each dollar of equity.

(2) The ratio of operating income to interest expense had a coverage of 20.2 times prior to full implementation, but it was only 4.4 times after retroactive restatement. Significant change was also registered in the ratio of operating income to total debt, it declined from 26.9 percent to 19.6 percent; while the ratio of operating income to total assets had decreased from 13.6 percent to 12.4 percent, a noticeable decrease of 1.2 percent difference.

(3) The ratio of income before interest to interest had substantial impact, as the coverage on interest dropped from 26 to only 5.4 times.

(4) The net income to networth had deteriorated significantly from 23.3 to 16.3 percent, a change of about 30 percent. The same situation was indicated in the ratio

Table 7-K-1
K Mart Corporation
Selected Key Financial Ratios

(thousands)

| | For year ended 1/25/78 | | For Year ended 1/25/78* | |
|---|---|---|---|---|
| Net Income/Sales | 392,919/9,941,398 | 3.95% | 297,816/9,941,398 | 3.00% |
| Operatin Income/ Interest Expense | 467,319/23,163 | 20.2 X | 556,427/127,291 | 4.4 X |
| Operating Income/ Total Assets | 467,319/3,428,110 | 13.6% | 556,427/4,488,719 | 12.4% |
| Operating Income/ Total Debt | 467,319/1,740,293 | 26.9% | 556,427/2,839,274 | 19.6% |
| Networth/Fixed Assets | 1,687,817/755,422 | 2.2 X | 1,649,445/1,827,421 | 0.9 X |
| Sales/Fixed Assets | 9,941,398/755,422 | 13.2 X | 9,941,398/1,827,421 | 5.4 X |
| Net Income/Networth | 392,919/1,687,817 | 23.3% | 297,816/1,649,445 | 16.3% |
| Income before interest/ interest | 601,357/23,163 | 26 X | 691,000/127,291 | 5.4 X |
| Sales/Working Capital | 9,941,398/1,272,427 | 7.8 X | 9,941,398/1,231,017 | 8.1 X |
| Current Ratio | 2,552,111/1,279,684 | 1.99 | 2,551,946/1,320,929 | 1.93 |
| Quick Ratio | 369,775/1,279,684 | 0.29 | 369,610/1,320,929 | 0.28 |
| Debt/Equity | 362,911/1,687,817 | 21.5% | 1,476,713/1,649,445 | 89.5% |
| Net Income/Total Assets | 392,919/3,428,110 | 11.5% | 297,816/4,488,719 | 6.6% |

*Restated for full implementation of Fasb Statement No. 13

Sources: K Mart Corporation, Form 10-K, Consolidated Balance Sheets and Consolidated Statements of Income, 1978 and 1979

of net income to total assets, a substantial decline of from 11.5 to 6.6 percent. The other measure of profitability, net income to sales, had dropped from 3.95 to 3 percent, a change of about 24 percent.

(5) The current ratio, the quick ratio, and sales to working capital ratio did not have as significant in its impact, although the differences could produce perceptible and subtle changes which would have long-term ramifications if more stringent rules were to be instituted by the Board in the future.

Existence of Induced Lease Restructuring Table 7-K-2 (page 75) indicated that minimum lease payments in 1980, which was the year that K Mart clearly separated capital leases and operating leases, capital lease minimum payments were $3,832.3 million or 67.56 percent of total minimum lease payments. By 1984, it was $5,832.1 million or 62.72 percent. In the meantime, operating leases were $1,840.1 million or about 32.44 percent of the total in 1980, and the corresponding amount in 1984 and increased to $3,462.7 million or 37.28 percent of total operating and capital leases. Slowly but surely, the proportionate balance between capital lease payments to operating lease payments had tipped in favor of operating leases for four consecutive years since 1980. The decline of the percentage of capital lease payments was roughly about a little over one percentage point per year, or a cumulative difference of 4.84 percent since 1980.

Table 7 - K - 2
K Mart Corporation
Schedule of Minimum Lease Payments
(millions)

| | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|
| Capital Leases | $3,832.3 | $4,876.0 | $5,521.8 | $5,859.9 | $5,832.1 |
| Operating Leases | 1,840.1 | 2,475.4 | 2,941.3 | 3,134.6 | 3,462.7 |
| | $5,672.4 | $7,351.4 | $8,463.1 | $8,994.5 | $9,294.8 |

Percentage of Capital Lease Payments to Operating Lease Payments

| | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|
| Capital Leases | 67.56% | 66.33% | 65.25% | 65.15% | 62.72% |
| Operating Leases | 32.44 | 33.67 | 34.75 | 34.85 | 37.28 |
| | 100.00% | 100.00% | 100.00% | 100.00% | 100.00% |

Trend of Percentages of Minimum Lease Payments
(1980 Base Year)

| | 1980 | 1981 | 1982 | 1983 | 1984 | Cumulative 1981-84 |
|---|---|---|---|---|---|---|
| Capital Leases | 100.0% | 127.2% | 144.1% | 152.9% | 152.1% | 176.3% |
| Operating Leases | 100.0% | 134.5% | 159.8% | 170.3% | 188.2% | 252.8% |

Sources: K Mart Corporation, Form 10-K, Notes to Consolidated Financial Statements on Leases, 1980 to 1984

Using trend of percentages, with 1980 as the base year, capital lease payments had increased three straight years, and had declined in 1984, but the rate of increases were below that of operating lease payments. In fact, operating lease payments had an upward trend, at proportionately higher rates every single year. The cumulative percentage for capital lease payments was 176.3 percent as compared to 252.8 percent for operating lease payments.

An examination of new leases added on by K Mart showed substantial increases from 1981 to 1984, but the incremental proportion was below the proportion of the capital lease payments for each of the preceding year, and in 1984, it turned negative incrementally. The result was the tendency to pull down the proportionate share of capital lease payments to operating lease payments. The smoothness of the perceptible shift away from capital lease payments to operating lease payments were supported by the increment in the respective types of leases as showed on Table 7-K-3 (page 77). Moreover, on a cumulative basis, incremental capital leases amounted to $1,999.8 million but only 55.2 percent of the total; while incremental operating leases added $1,622.6 million, and furthermore, at a greater proportionate share of 44.8 percent. From the behavior of the data, there are apparent evidence of lease restructuring.

Purchase Versus Lease Financing. The common size analysis of the percentages of owned assets as compared to

Table 7-K-3
K Mart Corporation
Schedule of Incremental Minimum Lease Payments

(millions)

| | Capital Leases | Incremental Capital Leases Amount | Incremental Capital Leases Percent | Operating Leases | Incremental Operating Leases Amount | Incremental Operating Leases Percent |
|---|---|---|---|---|---|---|
| 1981 | $4,876.0 | | | $2,475.4 | | |
| 1980 | 3,832.3 | $1,043.7 | 62.2% | 1,840.1 | $ 635.3 | 37.8% |
| 1982 | $5,521.8 | | | $2,941.3 | | |
| 1981 | 4,876.0 | 645.8 | 58.1% | 2,475.4 | 465.9 | 41.9% |
| 1983 | $5,859.9 | | | $3,134.6 | | |
| 1982 | 5,521.8 | 338.1 | 63.6% | 2,941.3 | 193.3 | 36.4% |
| 1984 | $5,832.1 | | | $3,462.7 | | |
| 1983 | 5,859.9 | ( 27.8) | n/c* | 3,134.6 | 328.1 | n/c* |
| | | $1,999.8 | | | $ 1,622.6 | |
| Cumulative Percentages of Capital Lease to Operating Lease | | 55.2% | | | 44.8% | |

*Not Computed

Sources: K Mart Corporation, Form 10-K, Notes to Consolidated Financial Statements on Leases, 1980 to 1984

the percentages of leased assets portrayed an unmistable shift away from leased assets to owned assets. In 1977, owned assets were $873.7 million or 37.4 percent, while leased assets were $1,464.7 million or 62.6 percent of total operating assets; but by 1984, owned assets were $2,331.4 million or 49.2 percent of total plant assets. The effect was that owned assets increased about 11.8 percentage point for leased assets. The data are presented in Table 7-K-4 (page 79).

The trend analysis for owned assets when arrayed against leased assets, showed that owned assets had been increasing at a faster rate than leased assets. Using 1977 as the base year, owned assets were then $873.7 million or 100 percent, it practically doubled by 1981 which was 199.8 percent, and by 1984, it was over two and one-half times to 266.8 percent. While leased assets had also increased nevertheless, in 1981 it was a little less than one and one-half times, and it reached only 162.9 percent in 1984. In every single year and in between, owned assets growth had outpaced the growth of lease assets without exception as evidenced by Table 7-K-4 (page 79).

The shift to ownership of plant assets was confirmed by the percentage of gross addition of plant assets by purchase as compared to gross addition of leased assets as illustrated in Table 7-K-5 (page 81). In 1978, for every dollar of investment in plant assets, 53 cents represented purchase of assets and 47 cents represented

Table 7 - K - 4
K Mart Corporation
Comparative Amount of Owned Assets to Leased Assets
(millions)

| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|---|
| Owned Assets | $ 873.7 | $1,018.3 | $1,183.4 | $1,453.0 | $1,746.0 | $2,015.1 | $2,143.2 | $2,331.4 |
| Leased Assets | 1,464.7 | 1,612.7 | 1,666.2 | 1,833.7 | 2,074.2 | 2,250.0 | 2,352.8 | 2,385.3 |
| | $2,338.4 | $2,631.0 | $2,849.6 | $3,286.7 | $3,820.2 | $4,265.1 | $4,496.0 | $4,716.7 |

Percentages of Owned Assets to Leased Assets From 1977 - 1984

| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|---|
| Owned Assets | 37.4% | 38.7% | 41.5% | 44.2% | 45.7% | 47.2% | 47.7% | 49.2% |
| Leased Assets | 62.6 | 61.3 | 58.5 | 55.8 | 54.3 | 52.8 | 52.3 | 50.8 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend of Percentages of Owned Assets as Compared to Leased Assets
(1977 Base Year)

| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|---|
| Owned Assets | 100.0% | 116.6% | 135.5% | 166.3% | 199.8% | 230.7% | 245.3% | 266.8% |
| Leased Assets | 100.0% | 110.1% | 113.8% | 125.2% | 141.6% | 153.6% | 160.6% | 162.9% |

Sources: K Mart Corporation, Form 10-K, Schedule V, 1978 to 1984

capitalized leases. Owned assets took a larger and larger proportion of total gross addition for the six years under analysis, and the proportion was always higher than the percentage of comparative amount of owned assets to leased assets for the preceding year. Therefore, by 1984, gross addition by purchase added 91.1 cents for each dollar of investment.

It was collaborated further by trend percentages of gross addition of owned assets which had grown from $162 million or 100 percent in 1978 to $386.7 million or 238.7 percent in 1984; on the other hand, the gross addition of leased assets was $143.6 million or 100 percent in 1978, and reached a high of $232.8 million or 162.1%, then subsequently declined to $37.8 million or 26.3% in 1984.

Conclusion. The full implementation of capitalization has resulted in significant impacts on certain financial ratios of K Mart Corporation, in particular, the most telling is the debt to equity ratio. It has minimal, but obvious, impact on net income.

There is apparent evidence of lease restructuring. There is conclusive evidence of deliberate shift from leased assets to owned assets, which is due more to the decrease of capitalization of leases rather than resort to purchase.

Case Study of Gaylords National Corporation

Gaylords National Corporation adopted the retroactive

Table 7 - K - 5
K Mart Corporation
Schedule of Gross Addition of Plant Assets
(millions)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | $162.0 | $217.4 | $291.7 | $350.6 | $361.4 | $306.4 | $386.7 |
| Leased Assets | 143.6 | 187.8 | 178.8 | 232.8 | 178.2 | 85.0 | 37.8 |
| | $305.6 | $405.2 | $470.5 | $583.4 | $539.6 | $391.4 | $424.5 |

Percentage of Gross Addition in Owned Assets To Leased Assets

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | 53.0% | 53.6% | 62.0% | 60.1% | 67.0% | 78.3% | 91.1% |
| Leased Assets | 47.0 | 46.4 | 38.0 | 39.9 | 33.0 | 21.7 | 8.9 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend Percentages of Gross Addition of Owned Assets as Compared to Leased Assets

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | 100.0% | 134.2% | 180.1% | 216.4% | 223.1% | 189.1% | 238.7% |
| Leased Assets | 100.0% | 130.8% | 124.5% | 162.1% | 124.1% | 59.2% | 26.3% |

Sources: K Mart Corporation, Form 10-K, Schedule V, 1979 to 1984

restatement as of January 27, 1979. Accordingly, the fiscal period ended January 28, 1978 had been restated.

> The Company operates its store locations under non-cancellable leases which are generally for initial periods of 5 to 25 years and which generally contain renewal option clauses.[4]

Impact on Selected Financial Ratios. Following the computations found on Table 7-G-1 (page 83), the analysis of the ratios are indicated below:

(1) The indicator of net income to sales had declined ever so slightly as a result of restatement. The net income to networth had mild positive increase of from 5.6 to 6.2 percent. The return as measured by net income to total assets had significant deterioration of from 2.6 to 1.7 percent.

(2) The ratio of operating income to interest expense had declined from 3 to 1.5 times, a drop of 50 percent. While the ratio of operating income to total assets had moved up from 5.3 to 6.4 percent, which was 20 percent higher; and the ratio of operating income to toal debt had worsened somewhat from 9.7 to 8.8 percent, a declined of about 10 percent.

(3) The ratio of networth to fixed assets indicated a significant change of from 2.75 to 0.65 times. The ratio of sales to fixed assets had substantial impact, from 21 times to just about 5.6 times. The income before interest

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[4] Gaylords National Corporation, Form 10-K, 1981, p. 28.

Table 7-G-1
Gaylords National Corporation
Selected Key Financial Ratios

| (thousands) | For year ended 1/28/78 | | For year ended 1/28/78* | |
|---|---|---|---|---|
| Net Income/Sales | 742/101,309 | 0.73% | 724/101,309 | 0.73% |
| Operating Income/ Interest Expense | 1,519/514 | 3.0X | 2,784/1,869 | 1.5X |
| Operating Income/ Total Assets | 1,519/28,875 | 5.3% | 2,784/43,385 | 6.4% |
| Operating Income/ Total Debt | 1,519/15,620 | 9.7% | 2,784/31,759 | 8.8% |
| Networth/Fixed Assets | 13,255/4,824 | 2.75 X | 11,626/18,015 | 0.65 X |
| Sales/Fixed Assets | 101,309/4,824 | 21 X | 101,309/18,015 | 5.6 X |
| Net Income/Networth | 742/13,255 | 5.6% | 724/11,626 | 6.2% |
| Income before Interest/ Interest | 1,822/514 | 3.5 X | 3,170/1,869 | 1.7 X |
| Sales/Working Capital | 101,309/11,550 | 8.8 X | 101,309/10,355 | 9.8 X |
| Current Ratio | 23,742/12,192 | 1.95 | 23,742/13,387 | 1.77 |
| Quick Ratio | 2,694/12,192 | 0.22 | 2,694/13,387 | 0.20 |
| Debt/Equity | 2,713/13,255 | 20.5% | 17,924/11,626 | 154.2% |
| Net Income/Total Assets | 742/28,875 | 2.6% | 724/43,385 | 1.7% |

*Restated for Lease Capitalization

Sources: Gaylord National Corporation, Form 10-K, Balance Sheets and Statement of Earnings and Retained Earnings, 1978 and 1979

to interest had also deteriorated significantly of from 3.5 to 1.7 times.

(4) The current ratio and the quick ratio had minimal impacts. The ratio of sales to working capital had perceptible change of from 8.8 to 9.8 times.

(5) The debt to equity ratio was only 20.5 percent prior to full implementation, but the ratio after the change was indeed quite substantial as it went up to 154.2 percent.

Existence of Induced Lease Restructuring. Table 7-G-2 (page 85) indicated that the proportion of minimum lease payments in 1980 were $33,190 thousand or 84.5 percent for capital leases; conversely, operating leases were $6,077 thousand or 15.5 percent. The result was turned around by 1985 somewhat in favor of operating leases by 22.7 percentage points. The proportion of minimum capital lease obligations in 1985 were $21,081 thousand or 61.8 percent, while operating leases were $13,016 thousand or 38.2 percent.

The implication could also be seen from the trend of percentages of minimum lease payments, with 1980 base year, the trend for capital leases kept moving down for five consecutive years. On the other hand, operating leases were showing an upward trend, with a slight dip in 1983, and then resumed its climb to 214.2 percent.

Confirmation of the shift toward operating leases, and away from capital leases, were presented in Table 7-G-3

Table 7 - G - 2
Gaylords National Corporation and Subsidiaries
Schedule of Minimum Lease Payments
(in thousands)

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| Capital Leases | $33,190 | $30,227 | $29,929 | $26,753 | $24,488 | $21,081 |
| Operating Leases | 6,077 | 9,199 | 10,777 | 9,089 | 9,624 | 13,016 |
| | $39,267 | $39,426 | $40,706 | $35,842 | $34,112 | $34,097 |

Percentage of Capital Lease Payments to Operating Lease Payments

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| Capital Leases | 84.5% | 76.7% | 73.5% | 74.6% | 71.8% | 61.8% |
| Operating Leases | 15.5 | 23.3 | 26.5 | 25.4 | 28.2 | 38.2 |
| | 100.0% | 100.0% | 100.0 | 100.0 | 100.0 | 100.0% |

Trend of Percentages of Minimum Lease Payments

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| Capital Leases | 100.0% | 91.1% | 90.2% | 80.6% | 73.8% | 63.5% |
| Operating Leases | 100.0% | 151.4% | 177.3% | 149.6% | 158.4% | 214.2% |

Sources: Gaylords National Corporation and Subsidiaries, Form 10-K, Notes to Consolidated Financial Statements on Leases, 1979 to 1984

Table 7-G-3
Gaylords National Corporation
Schedule of Incrmental Minimum Lease Payments
(thousnads)

| | Capital Leases | Incremental Capital Leases | Operating Leases | Incremental Operating Leases |
|---|---|---|---|---|
| 1981 | $30,227 | | $ 9,199 | |
| 1980 | 33,190 | ($ 2,963) | 6,077 | $3,122 |
| 1982 | $29,929 | | $10,777 | |
| 1981 | 30,227 | ($ 298) | 9,199 | $1,578 |
| 1983 | $26,753 | | $ 9,089 | |
| 1982 | 29,929 | ($ 3,176) | 10,777 | ($1,688) |
| 1984 | $24,488 | | $ 9,624 | |
| 1983 | 26,753 | ($ 2,265) | 9,089 | $ 535 |
| 1985 | $21,081 | | $13,016 | |
| 1984 | 24,488 | ($ 3,407) | 9,624 | $3,392 |
| | | ($12,109) | | $6,939 |

Sources: Gaylords National Corporation, Form 10-K, Notes to Consolidated Financial Statements on Leases, 1979 to 1984

leases and incremental operating leases. Incremental capital leases had five years of negative increment, which varied from $298 thousand in 1982 to a high of $3,407 thousand in 1985, for a cumulative total of $12,109 thousand. At the same time, operating leases were registering increases in four of the five years under scrutiny, with an incremental increase over five-year period of $6,939 thousand. The pattern of the incremental changes of capital leases vis-a-vis operating leases pointed toward lease restructuring.

<u>Purchase Versus Lease Financing</u>. The presentation of the data on Table 7-G-4 (page 88) had shown the balance of owned assets was $9,562 thousand or 27.1 percent of operating assets. Between 1977 to 1981, the proportion of owned assets stayed within a narrow range without apparent direction, moving between 26.1 to 28.1 percent. In 1982, however, owned assets' proportion increased to 29.7 percent, increasing again in 1983, and took off in 1984 to 41.2 percent of plant assets.

The non-directional trend of the proportion of owned assets to leased assets was also indicated by the trend of percentages of owned assets. Using 1977 as the base year, from 1978 to 1982, both the leased assets and the owned assets exhibited similar patterns. Thereafter, however, owned assets began to move upward in opposite direction to the trend of leased assets, so that by 1984, owned assets were 198.3 percent, while the leased assets dipped to 61.2 percent.

Table 7-G-4
Gaylords National Corporation
Comparative Amount of Owned Assets to Leased Assets
(thousands)

| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|---|
| Owned Assets | $ 9,562 | $ 8,997 | $ 9,453 | $ 9,542 | $ 8,308 | $ 7,556 | $ 7,937 | $11,020 |
| Leased Assets | 25,718 | 25,461 | 24,439 | 24,439 | 22,932 | 17,913 | 16,665 | 15,733 |
| | $35,280 | $34,458 | $33,892 | $33,981 | $31,240 | $25,469 | $24,602 | $26,753 |

Percentages of Owned Assets to Leased Assets From 1977 to 1984

| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|---|
| Owned Assets | 27.1% | 26.1% | 27.9% | 28.1% | 26.6% | 29.7% | 32.3% | 41.2% |
| Leased Assets | 72.9 | 73.9 | 72.1 | 71.9 | 73.4 | 70.3 | 67.7 | 58.8 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend of Percentages of Owned Assets as Compared to Leased Assets
(1977 Base Year)

| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|---|
| Owned Assets | 100.0% | 94.1% | 98.9% | 99.8% | 86.9% | 79.0% | 83.0% | 198.3% |
| Leased Assets | 100.0% | 99.0% | 95.0% | 95.0% | 89.2% | 77.4% | 64.8% | 61.2% |

Sources: Gaylords National Corporation, Form 10-K, Schedule V, 1979 to 1984

The gross addition of plant assets as shown on Table 7-G-5 (page 90) had portrayed a policy of substantial ownership of plant assets. In only three out of the seven years did capitalization of new leases were present. In terms of proportion, gross assets addition varied from a low of 43 percent to a complete domination of addition of 100 percent. Besides the percentages of addition of owned assets were all higher than the proportion of the balance of owned assets, which had suggested movement into purchasing than leasing.

The direction towards more purchases apparently was also indicated by trend percentages of gross addition of owned assets. With 1978 base year, gross addition of owned assets was higher than the base year except for 1982. Conversely, the leased assets addition was absent for four years, and in particular, there was zero addition from 1982 to 1984. The evidence suggested that the relative growth of gross asset addition was due to lack of capitalization of new leases although the impact on the balance of owned assets did not become pronounced until 1984.

Conclusion. The full implementation of FASB No. 13 has brought about significant differences in many of Gaylords' financial ratios. Noteworthy of substantial change is the debt to equity ratio. It does not have significant impact on earnings.

The evidence is reasonably conclusive that Gaylord

Table 7-G-5
Gaylords National Corporation
Schedule of Gross Addition of Plant Assets
(thousands)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | $ 582.9 | $1,324.7 | $1,003.3 | $1,119.7 | $ 273.8 | $ 956.0 | $3,737.4 |
| Leased Assets | 772.8 | 840.3 | 0 | 1,071.8 | 0 | 0 | 0 |
| | $1,355.7 | $2,165.0 | $1,003.3 | $2,191.5 | $ 273.8 | $ 956.0 | $3,737.4 |

Percentage of Gross Addition in Owned Assets to Leased Assets

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | 43% | 61% | 100% | 51% | 100% | 100% | 100% |
| Leased Assets | 67 | 39 | -- | 49 | -- | -- | -- |
| | 100% | 100% | 100% | 100% | 100% | 100% | 100% |

Trend Percentages of Gross Addition of Owned Assets As Compared to Leased Assets

(1978 Base Year)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1979-84 Cumulative |
|---|---|---|---|---|---|---|---|---|
| Owned Assets | 100% | 227% | 172% | 192% | 47% | 164% | 641% | 833% |
| Leased Assets | 100% | 108% | -- | 247% | -- | -- | -- | (145%) |

Sources: Gaylords National Corporation, Form 10-K, Schedule V, 1979 to 1984

is restructuring leases. The paradox of the shift in emphasis on buying rather than leasing is caused primarily by lack of capitalization of new leases.

Case Study of Zayre Corporation

The nature of the leasing arrangement of Zayre Corporation is explained thus:

> The Company is committed under long-term leases for the rental of real estate (stores, warehouses and office facilities) and equipment (principally computer and automotive) ... The real estate leases range from 3 to 36 years and have varying renewal options .... The equipment leases range from 3 to 11 years.[5]

Impact on Selected Financial Ratios. Per Table 7-Z-1 (page 92), which showed the computation of selected financial ratios, the following observations are indicated.

(1) The full implementation of FASB No. 13 had impacted slightly on the ratio net income to sales; while the net income to networth had been almost identical. The net income to total assets had somewhat deteriorated, and had worsened from 3.1 to 2.4 percent.

(2) The coverage ratio of operating income to interest expense had declined from 3.4 times to 2.2 times, a negative difference of 1.2 times. The ratio of operating income to total assets remained the same; but operating income to total debt came down from 14.5 percent to 12 percent, a noticeable negative change of about 17 percent.

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[5] Zayre Corporation, Form 10-K, 1981, p. F-14.

Table 7 - Z -1
Zayre Corp. and Subsidiaries
Selected Key Financial Ratios

(thousands)

| | For Year ended 1/28/78 | | For Year ended 1/28/78* | |
|---|---|---|---|---|
| Net Income/Sales | 11,756/1,261,301 | 0.93% | 10,998/1,261,301 | 0.87% |
| Operating Income/ Interest Expense | 33,070/9,653 | 3.4 X | 39,555/17,713 | 2.2 X |
| Operating Income/ Total Assets | 33,070/380,981 | 8.7% | 39,555/456,754 | 8.7% |
| Operating Income/ Total Debt | 33,070/228,688 | 14.5% | 39,555/328,740 | 12.0% |
| Networth/Fixed Assets | 137,275/83,306 | 1.6 X | 128,014/159,079 | 0.8 X |
| Sales/Fixed Assets | 1,261,301/83,306 | 15.1 X | 1,261,301/159,079 | 7.9 X |
| Net Income/Networth | 11,756/137,275 | 8.56% | 10,998/128,014 | 8.59% |
| Income before Interest/ Interest | 33,070/9,653 | 3.4 X | 39,555/17,713 | 2.2 X |
| Sales/Working Capital | 1,261,301/153,889 | 8.2 X | 1,261,301/148,742 | 8.5 X |
| Current Ratio | 288,530/134,641 | 2.14 | 288,530/139,788 | 2.02 |
| Quick Ratio | 40,272/134,641 | 0.29 | 40,272/139,788 | 0.29 |
| Debt/Equity | 98,822/137,275 | 72% | 187,752/128,014 | 147% |
| Net Income/Total Assets | 11,756/380,981 | 3.1% | 10,998/456,754 | 2.4% |

*Restated for Leased Capitalization

Sources: Zayre Corp. and Subsidiaries, Form 10-K, Consolidated Balance Sheets and Statements of Income, 1978 and 1979

(3) The current ratio had been marginally affected. The quick ratio had been identical, and the sales to working capital had improved slightly from 8.2 to 8.5 times, a marginal increase of over 3 percent.

(4) The turnover ratio of sales to fixed assets decline substantially of from 15.1 times to 7.9 times, a negative change of 48 percent prior to full implementation of FASB No. 13.

(5) A substantial negative impact was registered by the debt to equity ratio, the upsurge was from 72 percent to 147 percent, an increase of 104 percent after retroactive restatement.

<u>Existence of Induced Lease Restructuring</u>. As indicated on Table 7-Z-2, the minimum lease payments for capital leases were $188,088 or about 38.7 percent. The Table (page 94) was also showing operating leases, at the same point in time in 1980, of $297,653 thousand or 61.3 percent. The balance of capital lease payments was continuously on the down slide since 1980, except for 1984, and by 1985, it was only $139,945 thousand and in terms of proportion, it was 19.6 percent. Conversely, operating leases were larger and larger dollarwise every single year until it amounted to $575,148 or 80.4 percent of the total minimum lease payments.

The decline in the relative share of capital lease payments was accompanied by decline in absolute amount as

Table 7-Z-2
Zayre Corporation
Schedule of Minimum Lease Payments
(thousands)

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| Capital Leases | $188,088 | $184,261 | $160,820 | $149,476 | $152,659 | $139,945 |
| Operating Leases | 297,653 | 303,500 | 316,241 | 382,158 | 454,614 | 575,148 |
| | $485,741 | $487,761 | $477,061 | $531,634 | $607,273 | $715,093 |

Percentages of Capital Lease Payments to Operating Lease Payments

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| Capital Leases | 38.7% | 37.8% | 33.7% | 28.1% | 25.1% | 19.6% |
| Operating Leases | 61.3 | 62.2 | 66.3 | 71.9 | 74.9 | 80.4 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend of Percentages of Minimum Lease Payments

| (1980 Base Year) | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| Capital Leases | 100.0% | 98.0% | 85.5% | 79.5% | 81.2% | 74.4% |
| Operating Leases | 100.0% | 102.0% | 106.2% | 128.4% | 152.7% | 193.2% |

Sources: Zayre Corporation, Form 10-K, Notes to Consolidated Financial Statements on Leases, 1979 to 1984

indicated by the trend of percentages of capital lease payments. Operating leases, on the other hand, the trend of percentages for the five years under observations had been climbing upward.

The pattern was confirmed on an incremental basis as shown on Table 7-Z-3 (page 96). Incremental capital leases were not present at all, in fact, it decreased every single year with a five-year cumulative decline of $54,512 thousand. The exact opposite for incremental operating leases were happening where it registered increases for the successive years under calculation, and the five-year cumulative increase totaled $277,489 thousand. The behavior of the data indicated lease restructuring, as operating leases had picked up 19.1 percentage point in 1985 when compared to 1980.

<u>Purchase Versus Lease Financing</u>. Comparison of owned assets to leased assets, as portrayed in Table 7-Z-4, showed that it was $158,732 thousand or 56.7 percent; while leased assets amounted to $121,407 thousand or 43.3 percent. In 1978, owned assets decreased slightly, but from there on, it took a larger and larger proportionate share for six consecutive years. By 1984, owned assets amounted to $367,680 thousand or 87.4 percent. All told, it added 20.7 cents to owned assets for every dollar of investment in plant assets. Correspondingly, leased assets were only 22.6 cents in 1984 for each dollar of investment in fixed assets as compared to investment of 43.3 cents in 1977. Hence, leased

Table 7-2-3
Zayre Corporation
Schedule of Incremental Minimum Lease Payments
(thousands)

| | Capital Leases | Incremental Capital Leases | Operating Leases | Incremental Operating Leases |
|---|---|---|---|---|
| 1981 | $184,261 | | $303,500 | |
| 1980 | 188,088 | ($ 3,827) | 297,653 | $ 5,847 |
| 1982 | $160,820 | | $316,241 | |
| 1981 | 184,261 | ($23,441) | 303,500 | $ 12,741 |
| 1983 | $149,476 | | $382,152 | |
| 1982 | 160,820 | ($11,344) | 316,241 | $ 65,911 |
| 1984 | $152,659 | | $454,614 | |
| 1983 | 149,476 | ($ 3,183) | 382,158 | $ 72,456 |
| 1985 | $139,945 | | $575,148 | |
| 1984 | 152,659 | ($12,714) | 454,614 | $120,534 |
| | | ($54,512) | | $277,489 |

Sources: Zayre Corporation, Form 10-K, Notes to Consolidated Financial Statements on Leases, 1979 to 1984

Table 7-Z-4
Zayre Corporation
Comparative Amount of Owned Assets to Leased Assets
(thousands)

| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|---|
| Owned Assets | $158,732 | $154,367 | $163,287 | $183,352 | $204,664 | $255,598 | $305,554 | $367,680 |
| Leased Assets | 121,407 | 121,325 | 124,268 | 123,802 | 112,471 | 107,426 | 111,307 | 107,214 |
| | $280,139 | $275,692 | $287,555 | $307,394 | $317,135 | $363,024 | $416,861 | $474,894 |

Percentages of Owned Assets to Leased Assets From 1977 to 1984

| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|---|
| Owned Assets | 56.7% | 56.0% | 56.8% | 59.7% | 64.5% | 70.4% | 73.3% | 87.4% |
| Leased Assets | 43.3 | 44.0 | 43.2 | 40.3 | 35.5 | 29.6 | 26.7 | 22.6 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend of Percentages of Owned Assets as Compared to Leased Assets

| (1977 Base ) | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|---|
| Owned Assets | 100.0% | 97.3% | 102.9% | 115.5% | 128.9% | 161.0% | 192.5% | 231.6% |
| Leased Assets | 100.0% | 99.9% | 102.4 | 102.0% | 92.6% | 88.5% | 91.7% | 88.3% |

Sources: Zayre Corporation, Form 10-K, Schedule V, 1979 to 1984

assets showed a reduction of 20.7 cents in 1984.

In the same Table 7-Z-4 (page 97), the trend of owned assets, with 1977 base year, had registered increases every year except for a slight decrease in 1978. It was 231.6 percent by 1984. On the contrary, leased assets had shown downward trend, except for 1979, and a slight uptrend in 1983 over 1982.

The trend of the shift toward owned assets was collaborated by the gross addition of plant assets as indicated in Table 7-Z-5 (page 99). The gross addition of owned assets from 1978 to 1984 had been very substantial. The proportion of owned assets' gross addition was always higher than the proportion of the balance of owned assets to leased assets in every year under analysis. The impact was the taking of an increasing proportion of operating assets by ownership than by leasing. In fact, the proportion of owned assets' gross addition fluctuated between 76.5 percent and 98.9 percent. Trend indicator showed that the gross addition of owned assets, with 1978 base year, was portraying substantial increases, and by 1984, it was 724% of base period. The paradox appeared to indicate that management policy is resorting more to purchases but the truth is a collaboration of lease restructuring.

This could be seen in the capitalization of new leases which was present every year, but the amount was relatively insignificant. The trend indicator was not meaningful because

Table 7-2-5
Zayre Corporation
Schedule of Gross Addition of Plant Assets
(thousands)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | $10,536 | $21,174 | $41,601 | $48,279 | $54,914 | $63,658 | $76,279 |
| Leased Assets | 614 | 6,521 | 6,732 | 1,021 | 637 | 9,534 | 308 |
| | $11,150 | $27,695 | $48,333 | $49,300 | $55,551 | $73,192 | $76,587 |

Percentages of Gross Addition in Owned Assets to Leased Assets

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | 94.5% | 76.5% | 86.1% | 97.9% | 98.9% | 87.0% | 99.6% |
| Leased Assets | 5.5 | 23.5 | 13.9 | 2.1 | 1.1 | 3.0 | 0.4 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend Percentages of Gross Addition of Owned Assets as Compared to Leased Assets

| (1978 Base Year) | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | 100% | 201% | 395% | 458% | 521% | 604% | 724% |
| Leased Assets* | 100% | 1026% | 1096% | 166% | 104% | 1553% | 50% |

*Leased Assets' trend is affected by abnormally low base amount. The trend is indicative of the sporadic nature the gross addition of leased assets.

Sources: Zayre Corporation, Form 10-K, Schedule V, 1979 to 1984

the base year was abnormally low. It showed the sporadic nature of the gross addition of leased assets, which created a false impression of substantial gross addition of fixed assets.

Conclusion. The capitalization of leases has created significant to perceptible variation in the selected financial ratios. Specifically, the debt to equity, sales to fixed assets, and net income to total assets were significantly altered.

The evidence analyzed is reasonably conclusive as to the presence of lease restructuring. Additionally, it is also reasonably consistent with lease restructuring that the apparent shift into purchase is due to lack of lease capitalization.

Case Study of R. H. Macy & Co., Inc.

Macy is a major retailer. Its operating policy include significant leases. "The Corporation and its subsidiaries lease land and/or buildings, warehouses and store equipment for certain of their retail stores."[6]

Impact on Selected Financial Ratios. R. H. Macy adopted the retroactive restatement during the fiscal year ending July 28, 1979. Consequently, comparisons were made between financial ratios without capitalized leases and with full implementation under FASB No. 13. Table 7-R-1 (page 101) indicated the following observations, thus:

(1) The measures of profitability showed very slight

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[6] R. H. Macy & Co., Inc., Form 10-K, 1983.

Table 7-R-1
R. H. Macy & Co., Inc.
Selected Key Financial Ratios

| (thousands) | For year ended 7/29/78 | | For year ended 7/29/78* | |
|---|---|---|---|---|
| Net Income/Sales | 62,164/1,834,100 | 3.39% | 61,677/1,834,100 | 3.36% |
| Operating Income/ Interest Expense | 150,858/43,563 | 3.5 X | 162,438/48,529 | 3.4 X |
| Operating Income/ Total Assets | 150,858/1,053,430 | 14.32% | 162,438/1,115,042 | 14.57% |
| Operating Income/ Total Debt | 150,858/595,631 | 25.3% | 162,438/667,549 | 24.3% |
| Networth/Fixed Assets | 457,799/469,866 | 0.97 X | 447,493/536,759 | 0.83 X |
| Sales/ Fixed Assets | 1,834,100/469,866 | 3.9 X | 1,834,100/536,759 | 3.4 X |
| Net Income/Networth | 62,164/457,799 | 13.6% | 61,677/447,493 | 13.8% |
| Income before Interest/ Interest | 159,975/43,563 | 3.7 X | 173,731/48,529 | 3.6 X |
| Sales/Working Capital | 1,834,100/134,152 | 13.7 X | 1,834,100/130,771 | 14.0 X |
| Current Ratio | 457,274/341,122 | 1.39 | 463,646/332,935 | 1.39 |
| Quick Ratio | 168,267/341,122 | 0.49 | 156,639/332,935 | 0.47 |
| Debt/Equity | 165,929/457,799 | 36.3% | 256,394/447,493 | 57.3% |
| Net Income/Total Assets | 62,164/1,053,430 | 5.9% | 61,677/1,115,042 | 5.5% |

*Restated for Leased Capitalization

Sources: R. H. Macy & Co., Inc., Form 10-K, Consolidated Balance Sheets and Statement of Earnings, 1978 and 1979

variation. The net income to sales showed slight variation. The net income to sales was in the direction of slight deterioration. The net income to networth indicated a mild upbeat from 13.6 to 13.8 percent. The net income to total assets had worsened slightly from 5.9 to 5.5 percent.

(2) The coverage ratios on interest expense did not exhibit any material change. The ratios are operating income to interest expense, income before interest to interest, and the related operating income to total debt had immaterial change in terms of slight negative impact.

(3) The turnover ratios showed mixed results. Sales to fixed assets declined from 3.9 to 3.4 times, but sales to working capital improved mildly from 13.7 to 14 times.

(4) The current ratio remained the same. The quick ratio had worsened slightly from 0.49 to 0.47.

(5) The debt to equity ratio did have significant impact by moving up from 36.3 percent to 57.3 percent.

Existence of Induced Lease Restructuring. As shown in Table 7-R-2 (page 103), the future minimum lease payments for capital leases for 1980 were $166,306 thousand or 75.6% while operating leases were $53,607 thousand or 24.4% of total future minimum lease payments, suggesting to the effect that only about 24 cents out of every dollar represented operating lease obligation. It also indicated that the comparative proportion between the capital leases and operating leases, from 1980 to 1984, had tilted more and more in favor of operating leases in every single year. As

Table 7 -R - 2
R. H. Macy & Co., Inc.
Schedule of Minimum Lease Payments
(thousands)

| | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|
| Capital Leases | $166,306 | $154,796 | $143,889 | $132,856 | $132,201 |
| Operating Leases | 53,607 | 92,018 | 101,309 | 103,643 | 129,107 |
| | $219,913 | $246,814 | $245,198 | $236,499 | $252,308 |

Percentage of Capital Lease Payments to Operating Lease Payments

| | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|
| Capital Leases | 75.6% | 62.7% | 58.6% | 56.0% | 48.8% |
| Operating Leases | 24.4 | 37.3 | 41.4 | 44.0 | 51.2 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend of Percentages of Minimum Lease Payments
(1980 Base Year)

| | 1980 | 1981 | 1982 | 1983 | 1984 | Cumulative 1981-84 |
|---|---|---|---|---|---|---|
| Capital Leases | 100% | 93% | 87% | 80% | 74% | ( 66%) |
| Operating Leases | 100% | 172% | 189% | 193% | 240% | 394% |

Sources: R. H. Macy & Co., Inc., Form 10-K, Notes to Financial Statements on Leases, 1979 to 1983

a result by 1984, capital lease obligation was $123,201 thousand or 48.8 percent, and operating lease obligation was $129,017 thousand or 51.2 percent of the total. The trend pointed toward a deliberate avoidance of capital lease obligation which tended to indicate lease restructuring.

In the same Table 7-R-2, computation of the trend of percentages of minimum lease payments indicated a continuous decline in capital leases; on the other hand, operating leases were moving upward in the opposite direction. On a cumulative basis, from 1981 to 1984 inclusive, capital leases declined by 66 percent; and concurrently, operating leases showed a hefty increase of 394 percent.

The confirmation of the evidence of lease restructuring to circumvent capitalization of leases could be seen from the calculation of incremental minimum lease payments in Table 7-R-3 (page 105). From 1982 to 1984 inclusive, incremental capital lease payments persistently declined on an absolute basis, and meanwhile, the incremental operating lease payments increased every single year. The total reduction of capital lease obligation was $34,105 thousand as contrasted to the addition of operating leases of $75,500 thousand.

A significant and further collaboration of lease restructuring is the comparison of the proportion of annual lease rentals on capital leases to contingent rentals applicable to capital leases. As indicated in Table 7-R-4 (page 106), in 1979 the annual lease rentals on

Table 7-R-3
R. H. Macy & Co., Inc.
Schedule of Incremental Minimum Lease Payments
(thousands)

| | Capital Leases | Incremental Capital Leases | Operating Leases | Incremental Operating Leases |
|---|---|---|---|---|
| 1981 | $154,796 | | $ 92,018 | |
| 1980 | 166,306 | ($11,510) | 53,607 | $38,411 |
| 1982 | $143,889 | | $101,309 | |
| 1981 | 154,796 | ($10,907) | 92,018 | $ 9,291 |
| 1983 | $132,856 | | $103,643 | |
| 1982 | 143,889 | ($11,033) | 101,309 | $ 2,334 |
| 1984 | $132,201 | | $129,107 | |
| 1983 | 132,856 | ($ 655) | 103,643 | $25,464 |
| | | ($34,105) | | $75,500 |

Sources: R. H. Macy & Co., Inc., Form 10-K, Notes to Consolidated Financial Statements on Leases, 1979 to 1983

Table 7 - R - 4
R. H. Macy & Co., Inc.

Amount of Annual Capital Lease Rentals to Contingent Rentals Applicable to Capital Leases

| (thousands) | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|
| Annual Capital Lease Rentals | $10,202 | $11,510 | $10,907 | $10,877 | $ 9,655 |
| Percentage Rentals on Capital Leases | 2,910 | 2,978 | 3,217 | 3,403 | 4,053 |
| | $13,112 | $14,488 | $14,124 | $14,280 | $13,708 |

Proportion of Annual Capital Lease Rentals to Contingent Rentals Applicable to Capital Leases

| | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|
| Annual Capital Lease Rentals | 78% | 79% | 77% | 76% | 70% |
| Percentage Rentals on Capital Leases | 22 | 21 | 23 | 24 | 30 |
| | 100% | 100% | 100% | 100% | 100% |

Trend of Percentages of Annual Capital Lease Rentals as Compared to Percentage Rentals on Capital Leases

| | 1979 | 1980 | 1981 | 1982 | 1983 | Cumulative 1980-83 |
|---|---|---|---|---|---|---|
| Annual Capital Lease Rentals | 100.0% | 112.8% | 106.9% | 106.6% | 94.6% | 20.9% |
| Percentage Rentals on Capital Leases | 100.0% | 95.5% | 104.6% | 109.1% | 136.4% | 45.6% |

Sources: R. H. Macy & Co., Inc., Form 10-K, Notes to Financial Statements on Leases, 1979 to 1983

capital leases were $10,202 thousand or 78 percent of total capital lease rentals, while contingent rentals applicable to capital leases were $2,910 thousand or 22 percent. But by the year 1983, the annual lease rentals applicable to capital leases increased to $9,655 thousand or 70 percent, and at the same time, contingent rentals as a percentage of sales on capital leases crept up to $4,053 to 30 percent of the total.

A comparison of trend, with 1979 as the base year, indicated that annual capital lease rentals were not growing rapidly and it turned negative growth by 1983; conversely, the growth of contingent lease rentals on capital leases were definitely on the upbeat with the slight exception of a small dip in 1980. Cumulatively, from 1980 to 1983 inclusive, the percentage growth of annual capital lease rentals were 20.9 percent as contrasted with the growth of contingent rentals applicable to capital leases of 45.6 percent.

<u>Purchase Versus Lease Financing</u>. As shown in Table 7-R-5 (page 108), owned assets in 1978 were $671,786 thousand or 81.4 percent of total operating asset structure. Leased assets in the same year were $153,609 thousand or about 18.6 percent. Five years later, in 1983, owned assets were $1,110,055 thousand or 90 percent of the total; meanwhile, leased assets declined to $123,092 thousand or 10 percent of plant assets.

Table 7 - R -5
R. H. Macy & Co. Inc.
Comparative Amount of Owned Assets to Leased Assets
(thousands)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|
| Owned Assets | $671,786 | $745,810 | $838,031 | $ 953,688 | $1,006,381 | $1,110,055 |
| Leased Assets | 153,609 | 154,060 | 151,891 | 136,847 | 129,266 | 123,092 |
| | $825,395 | $899,870 | $989,922 | $1,090,535 | $1,135,647 | $1,233,147 |

Percentages of Owned Assets to Leased Assets From 1978 to 1983

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|
| Owned Assets | 81.4% | 82.9% | 84.7% | 87.5% | 88.6% | 90.0% |
| Leased Assets | 18.6 | 17.1 | 15.3 | 12.5 | 11.4 | 10.0 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend of Percentages of Owned Assets as Compared to Leased Assets
(1978 Base Year)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|
| Owned Assets | 100.0% | 101.8% | 104.1% | 107.5% | 108.9% | 110.6% |
| Leased Assets | 100.0% | 92.0% | 82.3% | 67.2% | 61.3% | 53.8% |

Sources: R. H. Macy & Co. Inc., Form 10-K, Schedule V, 1978 to 1983

Further, the trend of percentages of owned assets had increased every year, while the trend of percentages of leased assets had shown an opposite negative growth.

The cause of the change was confirmed by an analysis of the gross additon of plant assets in Table 7-R-6 (page 110). With the single exception of 1979 when $451 thousand was added to capitalized assets, there was a complete drought in terms of gross addition arising from capital leases. The only meaningful trend was that the percentage of gross addition of owned assets indicated a healthy increase every year. By all indications, there is an apparent conscious effort on the part of management to prevent on stream addition of new leased assets.

Conclusion. The changes brought about by the retroactive restatement by Macy in order to conform to FASB No. 13 has caused subtle changes in the 1978 financial ratios. Even though Macy is not as lease-intensive as other retailers, nonetheless, the impact of the change on debt to equity ratio is still significant.

There is, however, conclusive evidence that Macy has pursued a policy of deliberate restructuring over the period under analysis. The paradox of the shift to greater ownership of assets as indicated by gross addition of owned assets is the direct outgrowth of lease restructuring rather than a policy shifting to purchase of assets. Moreover, substantial leases have not come under the criteria of FASB No. 13.

Table 7 - R-6
R. H. Macy & Co., Inc.
Schedule of Gross Addition of Plant Assets
(thousands)

| | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|
| Owned Assets | $ 92,948 | $115,949 | $143,914 | $ 86,593 | $141,592 |
| Leased Assets | 451 | 0 | 0 | 0 | 0 |
| | $ 93,399 | $115,949 | $143,914 | $ 86,593 | $141,592 |

Trend of Percentages of Gross Addition of Owned Assets
as Compared to Leased Assets

| | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|
| Owned Assets | 100.0% | 124.7% | 154.8% | 93.2% | 152.3% |
| Leased Assets | 100.0% | -- | -- | -- | -- |

Sources: R. H. Macy & Co., Inc., Form 10-K, Schedule V, 1979 to 1983

Case Study of Ames Department Stores

Ames "is committed under long-term leases for the various retail stores, warehouses and equipment expiring at various dates through 2007 with varying renewal options."[7]

Impact on Selected Financial Ratios. The following observations were obtained from Table 7-D-1 (page 112) regarding Ames' financial ratios for the fiscal year ended January 28, 1978 on before and after restatement.

(1) The ratio of net income to sales had negligible impact, while the ratio of net income to networth had a slight improvement. The other ratio of net income to total assets had declined from 9.1 to 7.3 percent, a significant deterioration of 20 percent.

(2) The coverage ratio of operating income to interest expense had dipped from 5.2 to 3.5 times, a decline of about one-third after restatement. The ratio of operating income to total assets had shown a slight improvement from 12.7 to 13.1 percent. The ratio of operating income to total debt had declined from 26.7 to 22.2 percent.

(3) There was almost no impact on the current ratio, while the quick ratio did not vary much, and the ratio of sales to working capital had remained about even.

(4) The ratio of networth to fixed assets declined from 2.6 to 1.2 times, a significant change of about 53 percent. The ratio of sales to fixed assets also suffered

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[7]Ames Department Stores, Inc., Form 10-K, 1982, p. 29.

Table 7 - D-1
Ames Department Stores, Inc.
Selected Key Financial Ratios

(thousands)

| | For year ended 1/28/78 | | For year ended 1/28/78* | |
|---|---|---|---|---|
| Net Income/Sales | 5,153/168,131 | 3.06% | 5,109/168,131 | 3.00% |
| Operating Income/ Interest Expense | 7,211/1,374 | 5.2 X | 9,168/2,631 | 3.5 X |
| Operating Income/ Total Assets | 7,211/56,879 | 12.7% | 9,168/69,971 | 13.1% |
| Operating Income/ Total Debt | 7,211/26,975 | 26.7% | 9,168/41,267 | 22.2% |
| Networth/Fixed Assets | 29,904/11,628 | 2.6 X | 28,704/24,084 | 1.2 X |
| Sales/Fixed Assets | 168,131/11,628 | 14.5 X | 168,131/24,084 | 7 X |
| Net Income/Networth | 5,153/29,904 | 17.2% | 5,109/28,704 | 17.8% |
| Income before Interest/ Interest | 10,710/1,374 | 7.8 X | 12,903/2,631 | 4.9 X |
| Sales/Working Capital | 168,131/32,316 | 5.20 X | 168,131/31,737 | 5.29 X |
| Current Ratio | 44,684/12,368 | 3.6 | 44,684/12,947 | 3.5 |
| Quick Ratio | 11,757/12,368 | 0.94 | 11,757/12,947 | 0.89 |
| Debt/Equity | 13,725/29,904 | 45% | 27,960/28,704 | 97% |
| Net Income/Total Assets | 5,153/56,879 | 9.1% | 5,109/69,971 | 7.3% |

*Restated for Leased Capitalization

Sources: Ames Department Stores, Inc., Form 10-K, Financial Statements, 1978 and 1979

significant decline which was from 14.5 to 7 times.

(5) The ratio of income before interest to interest had also declined significantly from 7.8 to 4.9 times. The debt to equity ratio showed substantial impact, as debt was 45 cents to every dollar of equity, but went up to 97 cents for each dollar of equity after restatement.

Existence of Induced Lease Restructuring. Capital leases amounted to $46,349 thousand or 36.1 percent of future minimum lease payments; and operating leases amounted to $82,067 thousand or 63.9 percent of the total. From 1981 to 1984, capital lease payments gradually took a smaller and smaller proportion of the total lease obligations, that it was only 26.2 percent in 1984, a decline of 10 percentage point. However, capital lease payments reversed the down trend in 1985 and took 30 percent of the total minimum lease payments. Conversely, operating lease payments took a larger and larger proportion until 1984, it settled at 70 percent of the total minimum lease payments. The pattern was reasonably suggestive if not conclusive in behind the scene lease restructuring. The data were presented in Table 7-D-2 (page 114).

An examination of the trend of percentage indicated that capital lease payments decline three consecutive years, but it reversed the downward trend in 1984 to 110.9 percent. Operating leases, on the other hand, showed a steady upward trend except for a minimal dip in 1981.

Table 7 -D-2
Ames Department Stores, Inc.
Schedule of Minimum Lease Payments
(000's Omitted)

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| Capital Leases | $ 46,349 | $ 44,863 | $ 42,104 | $ 44,242 | $ 51,404 | $ 61,003 |
| Operating Leases | 82,067 | 81,824 | 82,625 | 98,296 | 144,667 | 142,699 |
| | $128,416 | $126,687 | $124,729 | $142,538 | $196,071 | $203,702 |

Percentage of Capital Lease Payments to Operating Lease Payments

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| Capital Leases | 36.1% | 35.4% | 33.8% | 31.0% | 26.2% | 30.0% |
| Operating Leases | 63.9 | 64.6 | 66.2 | 69.0 | 73.8 | 70.0 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend of Percentages of Minimum Lease Payments
(1980 base year)

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| Capital Leases | 100.0% | 96.8% | 90.8% | 95.5% | 110.9% | 131.6% |
| Operating Leases | 100.0% | 99.7% | 100.7% | 119.8% | 176.3% | 173.9% |

Sources: Ames Department Stores, Inc., Form 10-K, Notes to Consolidated Financial Statements on Leases, 1979 to 1984

A strong confirmation of the evidence of lease restructuring was the behavior of incremental minimum lease payments. Capital leases declined two successive years, and the percentages were larger proportionately to incremental operating leases, as shown on Table 7-D-3 (page 116). The reverse was also true where the increment for capital lease payments were proportionately smaller though the pattern was truncated in 1985 where it registered a large increment while operating leases were declining but not as much. In any case, over the five years, increment in capital leases was only $14,654 thousand or 19.5 percent while increment in operating leases was by far larger absolutely and relatively, it amounted to $60,632 thousand or 80.5 percent of the total incremental minimum lease payments.

<u>Purchase Versus Lease Financing</u>. From Table 7-D-4 (page 117), owned assets were $15,646 thousand or 43.6 percent of operating assets, in comparison with leased assets which were $20,280 thousand or 56.4 percent. From 1979 to 1983 without interruption, owned assets increased between 2.4 to 5.4 percentage point, even in 1984 it managed to increase 1.2 percentage point. The result was that in 1984, owned assets were $63,582 thousand or 63.8 percent of the total, and the balance was about four times the amount in 1978. In the meantime, leased assets were a diminishing proportion year by year, that by 1984 it was only $36,077 thousand or 36.2 percent.

Table 7-D-3
Ames Department Stores, Inc.
Schedule of Incremental Minimum Lease Payments
(thousands)

| | Capital Leases | Incremental Capital Leases Amount | Incremental Capital Leases Percent | Operating Leases | Operating Leases Amount | Operating Leases Percent |
|---|---|---|---|---|---|---|
| 1981 | $44,863 | | | $81,824 | | |
| 1980 | 46,349 | ($ 1,486) | (86.0%) | 82,067 | ($ 243) | (14.0%) |
| 1982 | $42,104 | | | $82,625 | | |
| 1981 | 44,863 | ($ 2,759) | (87.5%) | 81,824 | ($ 801) | (12.5%) |
| 1983 | $44,242 | | | $98,296 | | |
| 1982 | 42,104 | $ 2,138 | 12.0% | 82,625 | $15,671 | 88.0% |
| 1984 | $51,404 | | | $144,667 | | |
| 1983 | 44,242 | $ 7,162 | 13.4% | 98,296 | $46,371 | 86.6% |
| 1985 | $61,003 | | | $142,699 | | |
| 1984 | 51,404 | $ 9,599 | n/c* | 144,667 | ($ 1,968) | n/c* |
| | | $14,654 | | | $60,632 | |
| Cumulative Percentages of Capital Lease to Operating Lease | | 19.5% | | | 80.5% | |

*Not computed

Sources: Ames Department Stores, Inc., Form 10-K, Notes to Consolidated Financial Statements on Leases, 1979 to 1984

Table 7-D-4
Ames Department Stores, Inc.
Comparative Amount of Owned Assets to Leased Assets
(thousands)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | $15,646 | $18,619 | $23,753 | $29,537 | $36,057 | $47,911 | $63,582 |
| Leased Assets | 20,280 | 21,836 | 22,556 | 22,556 | 24,473 | 28,679 | 36,077 |
| | $35,926 | $40,455 | $46,309 | $52,093 | $60,530 | $76,590 | $99,659 |

Percentages of Owned Assets to Leased Assets From 1978 to 1984

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | 43.6% | 46.0% | 51.3% | 56.7% | 59.6% | 62.6% | 63.8% |
| Leased Assets | 56.4 | 54.0 | 48.7 | 43.3 | 40.4 | 37.4 | 36.2 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend of Percentages of Owned Assets as Compared to Leased Assets
(1978 Base Year)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | 100.0% | 119.0% | 151.8% | 340.6% | 230.5% | 306.2% | 406.4% |
| Leased Assets | 100.0% | 107.7% | 111.2% | 111.2% | 120.7% | 141.4% | 177.9% |

Sources: Ames Department Stores, Inc., Form 10-K, Schedule V, 1979 to 1984

The trend of percentages of owned assets, with 1978 base year, were on an upward direction without a pause; while leased assets were also moving in the same direction, except for 1981, the percentages were significantly lower, and it began to widen from 1981 on as owned assets were showing a larger growth trend.

In Table 7-D-5 (page 119), the data of gross addition of owned assets seem to have collaborated the directional shift toward more ownership. The gross addition of owned assets took a substantially larger percentage of the increment between 1979 to 1984. It varied between a low of 67 percent to a high of 100 percent, and at all times, the percentage was higher than the percentage of the balance of the owned assets. Capitalization of new leases were a little bit sporadic and though it apparently started to add over 20 percent of the gross addition of plant assets since 1982. Since the percentage of gross addition of leased assets were still below the percentage of the balance of leased assets, it would exert a downward pull. From all indications, it is reasonably suggestive, if not conclusive, of some policy shift caused by lease restructuring rather than increased purchasing.

Conclusion. The retroactive restatement has significant impact on turnover ratios such as sales to fixed assets, and has resulted in subtle changes in measures on profitability, and has substantial negative impact on debt to equity ratio.

Table 7 -D-5
Ames Department Stores, Inc.
Schedule of Gross Addition of Plant Assets
(000's Omitted)

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|
| Owned Assets | $3,137 | $5,329 | $6,687 | $6,578 | $12,430 | $20,694 |
| Leased Assets | 1,556 | 720 | - - | 1,917 | 4,206 | 7,398 |
| | $4,729 | $6,049 | $6,687 | $8,495 | $16,636 | $28,092 |

Percentage of Gross Addition in Owned Assets to Leased Assets

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|
| Owned Assets | 67.0% | 88.1% | 100.0% | 87.4% | 74.7% | 73.7% |
| Leased Assets | 33.0 | 11.9 | -- | 22.6 | 25.3 | 26.3 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend Percentages of Gross Addition of Owned Assets as Compared to Leased Assets
(1979 Base Year)

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|
| Owned Assets | 100.0% | 169.9% | 213.2% | 209.7% | 396.2% | 659.7% |
| Leased Assets | 100.0% | 46.3% | -- | 123.2% | 270.3% | 457.4% |

Sources: Ames Department Store, Form 10-K, Schedule V, 1980 to 1983

There is sufficient ground to conclude that lease restructuring is present, and reasonably supportive, if not conclusive, that some directional shift is occurring that is caused by decrease in the capitalization of new leases.

Case Study of Grand Central, Inc.

> The Company operates principally in leased premises. Generally the leased period is 25 to 30 years with renewal options. In addition, the Company leases certain equipment.[8]

Impact on Selected Financial Ratios. Table 7-C-1 provided the basis for the following observations the impact of retroactive restatement under FASB Statement No. 13.

(1) The ratio of net income to sales had minor negative impact, which dropped from 2.63 to 2.46 percent. The ratio of net income to networth had registered a slight improvement from 18.49 percent to 18.84 percent. The ratio of net income to total assets had deteriorated significantly. It declined from 7.8 to 4.8 percent, a decline of about 38 percent.

(2) The ratio of operating income to interest expense had moved down from 8.9 to 2.8 times, which was a substantial deterioration. The ratio of operating income to total assets had declined from 16.4 to 13.9 percent, which was more than noticeable. The ratio of net income to total debt came down from 28.4 to 18.7 percent, which had to be considered significant.

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[8]Grand Central, Inc., Form 10-K, 1979, p. F-10.

Table 7-C-1
Grand Central, Inc.
Selected Key Financial Ratios

(thousands)

| | For year ended 7/30/78 | | For year ended 7/30/78* | |
|---|---|---|---|---|
| Net Income/Sales | 4,650/176/706 | 2.63% | 4,344/176,706 | 2.46% |
| Operating Income/ Interest Expense | 9,752/1,098 | 8.9 X | 12,597/4,552 | 2.8 X |
| Operating Income/ Total Assets | 9,752/59,619 | 16.4% | 12,597/90,494 | 13.9% |
| Operating Income/ Total Debt | 9,752/34,467 | 28.3% | 12,597/67,439 | 18.7% |
| Networth/Fixed Assets | 25,152/11,583 | 2.2 X | 23,055/40,372 | 0.6 X |
| Sales/Fixed Assets | 176,706/11,583 | 15.3 X | 176,706/40,372 | 4.4 X |
| Net Income/Networth | 4,650/25,152 | 18.49% | 4,344/23,055 | 18.84% |
| Income before Interest/ Interest | 9,752/1,098 | 8.9 X | 12,597/4,552 | 2.8 X |
| Sales/Working Capital | 176,706/25,319 | 7.0 X | 176,706/23,947 | 7.4 X |
| Current Ratio | 47,388/22,069 | 2.15 | 47,388/23,441 | 2.02 |
| Quick Ratio | 1,718/22,069 | 0.78 | 1,718/23,441 | 0.73 |
| Debt/Equity | 12,290/25,152 | 49% | 43,998/23,055 | 191% |
| Net Income/Total Assets | 4,650/59,619 | 7.8% | 4,344/90,494 | 4.8% |

*Restated for Lease Capitalization

Sources: Grand Central Co., Inc., Form 10-K, Consolidated Balance Sheets and Statement of Income and Retained Earnings, 1978 and 1979

(3) The ratio sales to fixed assets decreased from 15.3 to 4.4 times, a drop of about 70 percent. The ratio of networth to fixed assets also declined significantly from 2.2 to 0.6 times.

(4) The current ratio, and the quick ratio had deteriorated marginally. The sales to working capital was affected slightly.

(5) The ratio of debt to equity was substantially altered. It had increased from 49 to 191 percent.

Existence of Induced Lease Restructuring. In Table 7-C-2 (page 123), the minimum capital lease payments were $164,275 thousand or 74.1 percent of total lease obligations; while operating lease payments were $57,341 thousand or 25.9 percent in 1980. Since 1980, the proportion of capital lease payments had declined slowly at the rate of one percentage point per year. By 1984, the share of capital lease payments declined to $140,795 thousand or 70.2 percent of the total. The smoothness of the decrease year after year would imply a mild form of lease restructuring.

With 1980 as the base year, the trend of percentage of capital lease payments indicated that it had been moving downward, except for a very minor increase in 1981. Conversely, operating lease payments' percentage trend had moved up the first two years and then it declined the subsequent two years. Nonetheless, on a cumulative basis from 1981 to 1984 inclusive, capital lease payments

Table 7 -C-2
Grand Central, Inc.
Schedule of Minimum Lease Payments
(in thousands)

| | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|
| Capital Leases | $164,275 | $164,772 | $159,903 | $153,049 | $140,795 |
| Operating Leases | 57,341 | 61,201 | 63,364 | 61,636 | 59,620 |
| | $221,616 | $225,973 | $223,267 | $214,685 | $200,415 |

Percentage of Capital Lease Payments to Operating Lease Payments

| | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|
| Capital Leases | 74.1% | 72.9% | 71.6% | 71.3% | 70.2% |
| Operating Leases | 25.9 | 27.1 | 28.4 | 28.7 | 29.8 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend of Percentages of Minimum Lease Payments
(1980 Base Year)

| | 1980 | 1981 | 1982 | 1983 | 1984 | Cumulative 1981-84 |
|---|---|---|---|---|---|---|
| Capital Leases | 100.0% | 100.3% | 97.3% | 93.2% | 85.7% | (23.5%) |
| Operating Leases | 100.0% | 106.7% | 110.5% | 107.5% | 104.0% | 28.7% |

Sources: Grand Central, Inc., Form 10-K, Notes to Consolidated Financial Statements on Leases, 1979 to 1983

registered a negative 23.5 percent, while operating lease payments added 28.7 percent.

Evidence of mild lease restructuring was apparently supported by the data on incremental minimum lease payments as shown in Table 7-C-3 (page 125). In 1981, capital lease increment was $457 thousand or 11.4 percent, while operating lease increment was $3,860 thousand or 88.6 percent. Then in 1982, capital lease increment was decreasing, and at the same time, operating lease increment was increasing. The subsequent two years, 1983 and 1984, both were decreasing but the percentages for capital lease increment were substantially higher as a proportion of the annual decline in the respective years. Consequently, the cumulative impact for the four years under analysis showed that there was no increment in capital leases, rather it declined $23,480 thousand. For operating leases, it managed to increase $2,279 thousand. The behavior of the data apparently indicated a trend toward operating leases at the expense of capital leases.

Purchase Versus Lease Financing. In Table 7-G-4 (page 126), owned assets were $8,741.8 thousand or 16.2 percent in 1978, on the other side, leased assets were $45,198.4 thousand or 83.8 percent of operating assets. The proportion of leased assets had increased its share in the subsequent three years, reaching a percentage of 87 percent, while owned assets declined correspondingly.

Table 7-C-3
Grand Central, Inc.
Schedule of Incremental Minimum Lease Payments

(thousand)

| | Capital Leases | Incremental Capital Leases Amount | Incremental Capital Leases Percent | Operating Leases | Incremental Operating Leases Amount | Incremental Operating Leases Percent |
|---|---|---|---|---|---|---|
| 1981 | $164,772 | | | $ 61,201 | | |
| 1980 | 164,275 | $ 457 | 11.4% | 57,341 | $3,860 | 88.6% |
| 1982 | $159,903 | | | $ 63,364 | | |
| 1981 | 164,772 | ($ 4,869) | n/c | 61,201 | $2,163 | n/c |
| 1983 | $153,049 | | | $ 61,636 | | |
| 1982 | 159,903 | ($ 6,854) | (79.9%) | 63,364 | ($1,728) | (20.1%) |
| 1984 | $140,795 | | | $ 59,620 | | |
| 1983 | 153,049 | ($12,254) | (85.9%) | 61,636 | ($2,016) | (14.1%) |
| | | ($23,480) | | | $2,279 | |

Sources: Grand Central, Inc., Form 10-K, Notes to Consolidated Financial Statements on leases, 1979 to 1983

Table 7 -G-4
Grand Central, Inc.
Comparative Amount of Owned Assets to Leased Assets
(in thousands)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|
| Owned Assets | $ 8,741.8 | $ 8,908.5 | $ 8,846.0 | $ 8,313.4 | $ 9,704.7 | $11,145.0 |
| Leased Assets | 45,198.4 | 55,097.3 | 56,502.6 | 55,845.2 | 53,738.5 | 50,455.0 |
| | $53,940.2 | $64,005.8 | $65,348.6 | $64,158.6 | $63,443.2 | $61,600.0 |

Percentages of Owned Assets to Leased Assets From 1978 to 1983

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|
| Owned Assets | 16.2% | 13.9% | 13.5% | 13.0% | 15.3% | 18.1% |
| Leased Assets | 83.8% | 86.1% | 86.5% | 87.0% | 84.7% | 81.9% |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend of Percentages of Owned Assets as Compared to Leased Assets

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|
| Owned Assets | 100.0% | 101.9% | 101.2% | 95.1% | 111.0% | 127.5% |
| Leased Assets | 100.0% | 121.9% | 125.0% | 124.0% | 118.9% | 111.6% |

Sources: Grand Central, Inc., Form 10-K, Schedule V, 1978 to 1983

Leased assets in the ensuing two years had begun to decline, so that by 1983, it was $11,145 thousand or 81.9 percent of operating assets. The pattern was not clear-cut though it apparently had leaned toward leasing, but then it started to decline.

With 1980 as the base year, the trend of percentages of owned assets was languishing during 1979 to 1980, then it followed by two years of uptrend in 1982 and 1983. Conversely, leased assets were indicating two years of increasing trend, and from 1981, the trend was heading downward showing no net addition.

The type of trend or the lack of it was consistent with the data on gross addition of plant assets, as shown in Table 7-C-5 (page 128). During the three years, from 1979 to 1981, the proportion of gross addition of leased assets was close to if not above the proportion of the balance of leased assets in the respective years. Then in 1982 and 1983, there was an abrupt above face when it added only 16.6 percent and zero percent respectively.

The trend of gross addition of owned assets had indicated fluctuating trend; while the trend of gross addition of leased assets beginning 1979 had indicated decreasing trend. From the behavior of the data, the mildness of lease restructuring had not impacted on the division between leased and owned assets. Whether, starting 1982, a trend favoring owning or at lease avoiding capital leases would require additional years of observation.

Table 7 - C-5
Grand Central, Inc.
Schedule of Gross Addition of Plant Assets
(thousands)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|
| Owned Assets | $ 1,984.0 | $ 909.0 | $ 555.4 | $ 539.1 | $ 1,742.8 | $ 1,534.5 |
| Leased Assets | 5,873.4 | 11,027.0 | 2,405.3 | 3,354.6 | 346.2 | -- |
| | $ 7,857.4 | $11,936.0 | $2,960.7 | $3,893.7 | $ 2,089.0 | $ 1,534.5 |

Percentage of Gross Addition in Owned Assets to Leased Assets

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|
| Owned Assets | 25.3% | 7.6% | 18.8% | 13.8% | 83.4% | 100% |
| Leased Assets | 74.7 | 92.4 | 81.2 | 86.2 | 16.6 | - |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100% |

Trend Percentages of Gross Addition of Owned Assets As Compared to Leased Assets
(1978 Base Year)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1979-83 Cumulative |
|---|---|---|---|---|---|---|---|
| Owned Assets | 100.0% | 45.8% | 28.0% | 27.2% | 87.8% | 77.3% | (233.9%) |
| Leased Assets | 100.0% | 187.7% | 41.0% | 57.1% | 5.9% | 0.0% | (208.3%) |

Sources: Grand Central, Inc., Form 10-K, Schedule V, 1979-1983

Conclusion. The implementation of FASB No. 13 had impacted substantially the debt to equity ratio. It also affected some turnover ratios significantly. It has brought about subtle changes in the other ratios such as net income to networth.

Evidence of mild form of lease restructuring is indicated by the smoothness of the decline in the schedule of minimum lease payments. No pattern has emerged from the question of whether there is any shift, one way or the other, in the purchase versus leasing policy.

Case Study of Jamesway Corporation

Jamesway Corporation "over the years has entered into leases for retail stores, distribution centers and office facilities, as well as some equipment, expiring in 1 to 28 years."[9]

Impact on Selected Financial Ratios. Jamesway Corporation had adopted the requirement for retroactive restatement in fiscal 1978. It did not have any leases that would require capitalization under FASB No. 13 in fiscal 1977.[10] As shown in Table 7-J-1 (page 130), the following observations were indicated, thus:

(1) The net income to sales ratio was ever so slightly negative in its impact, the net income to networth ratio was very minimally improved, and the net income to total

[9] Jamesway Corporation, Form 10-K, 1978, p. 13.

[10] Ibid., p. 14.

Table 7 -J-1
Jamesway Corporation
Selected Key Financial Ratios

| (thousands) | For year ended 1/28/78 | | For year ended 1/28/78* | |
|---|---|---|---|---|
| Net Income/Sales | 4,941/167,302 | 2.95% | 4,905/167,303 | 2.93% |
| Operating Income/ Interest Expense | 7,927./598 | 13.3 X | 8,366 /1,106 | 7.6 X |
| Operating Income/ Total Assets | 7,927 /51,828 | 15.3% | 8,366/ 56,453 | 14.8% |
| Operating Income/ Total Debt | 7,927 /26,101 | 30.4% | 8,366 /31,199 | 26.8% |
| Networth/Fixed Assets | 25,726/11,083 | 2.3 X | 25,254/15,709 | 1.6 X |
| Sales/Fixed Assets | 167,303/11,083 | 15.1 X | 167,303/15,709 | 10.7 X |
| Net Income/Networth | 4,941/25,726 | 19.2% | 4,905/25,254 | 19.4% |
| Income before interest/ Interest | 10,256/598 | 17.2 X | 10,693/1,106 | 9.7 X |
| Sales/Working Capital | 167,303/27,048 | 6.2 X | 167,303/26,754 | 6.3 X |
| Current Ratio | 40,514/13,466 | 3.00 | 40,514/13,760 | 2.94 |
| Quick Ratio | 6708/13,466 | 0.50 | 7,075/13,760 | 0.51 |
| Debt/Equity | 11,034/25,726 | 42.9% | 16,352/25254 | 64.8% |
| Net Income/ | 4,941/51,828 | 9.5% | 4,905/56,453 | 8.7% |

*Restated for Lease Capitalization

Sources: Jamesway Corporation, Form 10-K, Consolidated Balance Sheets and Consolidated Statements of Income, 1978 and 1979

assets ratio was worsened somewhat from 9.5 to 8.7 percent, a change of over 8 percent.

(2) The ratio of operating income to interest expense had substantially worsened from 13.3 to 7.6 times. The ratio of operating income to total assets had been marginally affected. The ratio of operating income to total debt had declined from 30.4 to 26.8 percent which had noticeable change of about 12 percent.

(3) The ratio of networth to fixed assets had dropped from 2.3 to 1.6 times, somewhat significant drop of 23 percent. The ratio of sales to fixed assets had also declined from 15.2 to 10.7 times, a negative impact of almost 30 percent before the change. The coverage ratio of income before interest to interest had moved down from 17.2 to 9.7 times, a significant deterioration.

(4) The current ratio was marginally affected. The quick ratio was about the same, and the ratio of sales to working capital had a slight improvement.

(5) The debt to equity ratio experienced a substantial increase of from 42.9 to 64.8 percent.

Existence of Lease Restructuring. As per Table 7-J-2 (page 132), capital lease payments were $15,731 thousand or 18.7 percent of total lease obligations; while operating leases were $68,325 thousand or 81.3 percent. The amount and the proportion of capital lease payments increased the following two years to $25,118 thousand or 24.5 percent of the total, but the trend was reversed downward subsequently

Table 7 -J-2
Jamesway Corporation
Schedule of Minimum Lease Payments
(thousands)

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|
| Capital Leases | $15,731 | $ 23,726 | $ 25,118 | $ 23,917 | $ 22,617 | $ 21,412 |
| Operating Leases | 68,325 | 70,416 | 77,203 | 77,042 | 102,668 | 120,023 |
| | $84,056 | $104,142 | $102,321 | $100,959 | $125,285 | $141,435 |

Percentage of Capital Lease Payments to Operating Lease Payments

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|
| Capital Leases | 18.7% | 22.8% | 24.5% | 23.7% | 18.1% | 15.1% |
| Operating Leases | 81.3 | 77.2 | 75.5 | 76.3 | 81.9 | 84.9 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend of Percentages of Minimum Lease Payments
(1979 base year)

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|
| Capital Leases | 100% | 151% | 160% | 152% | 144% | 136% |
| Operating Leases | 100% | 103% | 113% | 113% | 150% | 176% |

Sources: Jamesway Corporation, Form 10-K, Notes to Consolidated Financial Statements on Leases, 1979 to 1983

for the last three years in succession, and by 1984, it amounted to $21,412 thousand or 15.2 percent of total lease obligations. In the meantime, operating lease payments moved up from 81.3 percent in 1979 to 84.9 percent or $12,023 thousand, despite the fact that it had experienced the decline in 1980 and 1981.

Another indication of operating lease payments' direction was to refer to the trend of percentages with 1979 base year. The operating lease payments were increasing every year except for 1982, so that by 1984, it climbed to 176 percent. Concurrently, the behavior of capital lease payments had increased to 160 percent in 1981, but from thereon the pattern had indicated a downward trend. The evidence was reasonably suggestive that lease restructuring was going on during the period under study.

A confirmation of lease restructuring was apparently evident from the five-year comparison of the incremental pattern between capital lease payments and operating lease payments, as indicated in Table 7-J-3 (page 134). In 1980, incremental capital lease payments had increased $7,995 thousand or 79.3 percent of the total. The effect was to increase the share of minimum capital lease payments in 1980. In 1981, however, the incremental share had dropped to 17 percent, and heading toward negative increment in 1982 to 1984. The turning point of the shift toward operating lease increment was in 1981, when operating leases had substantial increment of $6,787 thousand or 83

Table 7-J-3
Jamesway Corporation
Schedule of Incremental Minimum Lease Payments

(thousand)

| | Capital Leases | Incremental Capital Leases | | Operating Leases | Incremental Operating Leases | |
|---|---|---|---|---|---|---|
| | | Amount | Percent | | Amount | Percent |
| 1980 | $ 23,726 | | | $ 70,416 | | |
| 1979 | 15,731 | $ 7,995 | 79.3% | 68,325 | $ 2,091 | 20.7% |
| 1981 | $ 25,118 | | | $ 77,203 | | |
| 1980 | 23,726 | $ 1,392 | 17.0% | 70,416 | $ 6,787 | 83.0% |
| 1982 | $ 23,917 | | | $ 77,042 | | |
| 1981 | 25,118 | ($ 1,201) | 88.2% | 77,203 | ($ 161) | 11.8% |
| 1983 | $ 22,617 | | | $102,668 | | |
| 1982 | 23,917 | ($ 1,300) | n/c* | 77,042 | $25,626 | n/c* |
| 1984 | $ 21,412 | | | $120,023 | | |
| 1983 | 22,617 | ($ 1,205) | n/c* | 102,668 | $17,355 | n/c* |
| | | $ 5,681 | | | $51,698 | |
| Cumulative Percentages of Capital leases to Operating Leases | | 9.9% | | | 90.1% | |

Sources: Jamesway Corporation, Form 10-K, Notes to Consolidated Financial Statements on Leases, 1979 to 1984

*Not Computed

percent of the annual increase. Despite a slight reduction in 1982 of $161 thousand or 11.8 percent, the increment in operating lease payments had experienced two successive years of substantial increases. The overall impact was evident in the cumulative total of the increment of $51,698 thousand or 90.1 percent for operating lease payments vis-a-vis $5,681 thousand or 9.9 percent for capital lease payments. Due to the fact that the share of operating lease payments were substantially higher percentage-wise, it was only able to increase the proportion to 84.9 percent of the total lease obligation, a net increase of 3.6 percentage point when comparted to 1979, or 9.4 percentage point when compared to 1981.

Purchase Versus Lease Financing. As shown in Table 7-J-4 (page 136), owned assets were $18,590 thousand or 73.2 percent of plant assets in 1978; in contrast, leased assets were $6,805 thousand or 26.8 percent. Owned assets had hovered around a narrow range, though it declined to 71.5 percent in 1980. From 1981 onward, it began its upward climb in terms of proportion of plant assets, and by 1984, it had increased to $52,514 thousand or 83.9 percent, with the result that owned assets were 10.7 percentage point more than in 1978.

The trend of percentages of owned assets, with 1978 as the base year, was drifting upward without abatement and it reached 282.5 percent in 1984; in comparison, for leased assets, it had increased to 154.7 percent in 1981,

Table 7 - J-4
Jamesway Corporation
Comparative Amount of Owned Assets to Leased Assets
(thousands)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | $18,590 | $20,947 | $26,098 | $29,785 | $35,544 | $40,285 | $52,514 |
| Leased Assets | 6,805 | 7,566 | 10,421 | 10,524 | 10,098 | 10,098 | 10,098 |
| | $25,395 | $28,513 | $36,519 | $40,309 | $45,642 | $50,383 | $62,612 |

Percentage of Owned Assets to Leased Assets From 1978 to 1983

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | 73.2% | 73.5% | 71.5% | 73.9% | 77.9% | 80.0% | 83.9% |
| Leased Assets | 26.8 | 26.5 | 28.5 | 26.1 | 22.1 | 20.0 | 16.1 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend of Percentages of Owned Assets as Compared to Leased Assets

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | 100.0% | 112.6% | 140.4% | 160.2% | 191.2% | 216.7% | 282.5% |
| Leased Assets | 100.0% | 111.2% | 153.0% | 154.7% | 148.4% | 148.4% | 148.4% |

Sources: Jamesway Corporation, Form 10-K, Schedule V, 1978 to 1983

but since then, it had stagnated for the next three years.

The suggestion of preference for purchase of plant assets was apparently affirmed by the comparison of gross addition of assets between owning and leasing as presented in Table 7-J-5 (page 138). New capitalization of leases occurred only in three out of seven years under observation. Further, the proportionate share of gross addition of leased assets was above the proportionate share of the balance of leased assets to owned assets in just one year - 1980. Conversely, from 1978 on, the gross addition of owned assets had indicated a robust growth trend in five out of six years.

Conclusion. The retroactive restatement under FASB No. 13 had a somewhat significant impact on turnover ratios. It had caused substantial deterioration in the debt to equity ratio, and it had brought about subtle changes in some other ratios.

Lease restructuring is suggested by the behavior of the data since 1981 particularly. It is collaborated by some shift toward apparent ownership as compared to capitalized leases. The paradox of increased ownership is due to the decline in lease capitalization.

Case Study of Mercantile Stores Co., Inc.

> The Company leases most of its operating properties such as store and warehouse facilities. The majority of these leases will expire within the next twenty years. The leases usually

Table 7 - J-5
Jamesway Corporation
Schedule of Gross Addition of Plant Assets
(thousands)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | $3,550 | $3,033 | $5,764 | $5,873 | $8,369 | $8,970 | $14,054 |
| Leased Assets | 0 | 761 | 2,855 | 1,128 | 0 | 0 | 0 |
| | $3,550 | $3,794 | $8,619 | $7,001 | $8,369 | $8,970 | $14,054 |

Percentage of Gross Addition in Owned Assets to Leased Assets

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | 100% | 80% | 67% | 84% | 100% | 100% | 100% |
| Leased Assets | -- | 20 | 33 | 16 | -- | -- | -- |
| | 100% | 100% | 100% | 100% | 100% | 100% | 100% |

Trend Percentages of Gross Addition of Owned Assets as Compared to Leased Assets

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | 100.0% | 85.4% | 162.4% | 165.0% | 235.8% | 252.6% | 395.9% |
| Leased Assets* | -- | n/c | n/c | n/c | -- | -- | -- |

*not computed

Sources: Jamesway Corporation, Form 10-K, Schedule V, 1978 to 1984

> contain renewal options and provide for payment by the lessee of real estate taxes and other expenses, and, in certain instances increased rentals based on percentage of sales.[11]

<u>Impact on Selected Financial Ratios</u>. Prior to the full implementation of FASB No. 13, Mercantile has apparently made a point not to enter into leases requiring capitalization, thus:

> The Company is not a party to any capilized leases under accounting principles prior to Statement No. 13 nor had it consummated any new capital leases (as defined) under Statement No. 13 since January 1, 1977.[12]

As shown in Table 7-M-1 (page 140), the retroactive restatment has produced the following results, thus:

(1) It has very slight impact on measures of profitability. The net income to sales declined slightly, while the net income to networth improved inperceptibly. The net income to total assets declined minimally from 7.1 to 6.9 percent.

(2) The ratio of operating income to interest expense was 10 times prior to restatement, and it fell to 8.6 times after restatement. The operating income to total assets suffered slight decline of no consequence, and operating income to total debt declined marginally.

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[11] Mercantile Stores Company, Inc., <u>Form 10-K</u>, 1983, p. 25.

[12] <u>Ibid</u>., p. F-39.

Table 7 - M - 1
Mercantile Stores Company, Inc.
Selected Key Financial Ratios

| (thousands) | For Year ended 1/31/78 | | For Year ended 1/31/78* | |
|---|---|---|---|---|
| Net Income/Sales | 31,253/789,217 | 3.96% | 31,142/789,217 | 3.95% |
| Operating Income/ Interest Expense | 64,945/5,502 | 10 X | 65,838/7,612 | 8.6 X |
| Operating Income/ Total Assets | 64,945/438,897 | 14.8% | 65,838/452,685 | 14.5% |
| Operating Income/ Total Debts | 64,945/188,027 | 34.5% | 65,838/203,330 | 32.3% |
| Networth/Fixed Assets | 250,870/164,594 | 1.5 X | 249,355/207,637 | 1.2 X |
| Sales/Fixed Assets | 789,217/164,594 | 4.8 X | 789,217/207,637 | 3.8 X |
| Net Income/Networth | 31,253/250,870 | 12.46% | 31,142/249,355 | 12.49% |
| Income before Interest/ Interest | 66,610/6,457 | 10.3 X | 67,543/7,612 | 8.9 X |
| Sales/Working Capital | 789,217/177,309 | 4.5 X | 789,217/167,306 | 4.7 X |
| Current Ratio | 101,587/98,588 | 1.03 | 101,587/99,178 | 1.02 |
| Quick Ratio | 69,331/98,588 | 0.70 | 69,331/99178 | 0.70 |
| Debt/Equity | 76,520/250,870 | 31% | 92,745/249,355 | 37% |
| Net Income/Total Assets | 31,253/438,897 | 7.1% | 31,142/452,685 | 6.9% |

*Restated for Lease Capitalization

Sources: Mercantile Stores Co., Inc., Form 10-K, Consolidated Balance Sheets and Statements of Consolidated Income, 1978 and 1979

(3) The current ratio was slightly worse off, and the quick ratio was unchanged. The sales to working capital improved somewhat from 4.5 to 4.7 times. The ratio of income before interest to interest dropped from 10.3 to 8.9 times, a change of about 14 percent.

(4) The ratio of networth to fixed assets declined from 1.5 to 1.2 times, a noticeable change of 20 percent. The same situation was happening to the ratio of sales to fixed assets as it declined from 4.8 to 3.8 times.

(5) The change in the debt to equity ratio was not substantial as it increased from 31 to 37 percent.

Existence of Lease Restructuring. As calculated in Table 7-M-2 (page 142), the amount of capital lease payments were $33,716 thousand or 25.4 percent of operating assets; while operating lease payments amounted to $99,100 thousand or 74.6 percent. Over a six-year period, the capital lease payments diminished every single year, except for a slight increase in 1983, and consequently, the percentage share of capital lease payments to total plant assets was sliding downward. By 1985, the capital lease payments were only 16.6 percent of plant assets, a decline of 8.8 percentage point since 1979. Apparently, the percentage share of capital lease payments had reached a plateau since 1983. Inevitably, operating lease payments took a larger share of plant assets as it increased to $118,694 or 83.4 percent.

The downward trek was collaborated by the trend of

Table 7-M-2
Mercantile Stores Company, Inc.
Schedule of Minimum Lease Payments
(thousands)

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|---|
| Capital Leases | $ 33,716 | $ 31,438 | $ 29,723 | $ 27,071 | $ 27,614 | $ 26,037 | $ 23,677 |
| Operating Leases | 99,100 | 94,183 | 117,650 | 126,487 | 137,355 | 131,066 | 118,694 |
| | $132,817 | $125,621 | $147,373 | $153,558 | $164,969 | $157,103 | $142,371 |

Percentage of Capital Lease Payments to Operating Lease Payments

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|---|
| Capital Leases | 25.4% | 25.0% | 20.2% | 17.6% | 16.7% | 16.6% | 16.6% |
| Operating Leases | 74.6 | 75.0 | 79.8 | 82.4 | 83.3 | 83.4 | 83.4 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend of Percentages of Minimum Lease Payments
(1979 Base Year)

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|---|
| Capital Leases | 100.0% | 93.2% | 88.2% | 80.3% | 81.9% | 77.2% | 70.2% |
| Operating Leases | 100.0% | 95.0% | 118.7% | 127.6% | 138.6% | 132.3% | 119.8% |

Sources: Mercantile Stores Company, Inc., Form 10-K, Notes to Consolidated Financial Statements on Leases, 1978 to 1984

percentages of minimum lease payments. With 1979 as the base year, capital lease payments had been declining for six consecutive years, and by 1985, it was only 70.2 percent. At the same time, operating lease payments had experienced increasing trend from 1981 to 1984, though it had moved down somewhat to 119.8 percent in 1985.

The confirmation of the shift from capital lease payments to operating lease payments was indicated in Table 7-M-3 (page 144). There was no increment year after year for capital lease payments except for a small increment of $543 thousand in 1983. The total decline over the six-year period was $10,039 thousand. On the other hand, operating lease payments had three years of increment, and three years of negative increment, however, the cumulative result had a net increment of $19,954 thousand. The evidence was conclusive enough to state that lease re-structuring was indicated.

Purchase Versus Lease Financing. As indicated in Table 7-M-4 (page 145), the comparative amount of owned assets in 1977 was $209,101 thousand or 89.26 percent; and the amount of leased assets was $25,163 thousand or 10.74 percent. The amount of owned assets moved inexorably upward, and in terms of percentage, it was taking a larger proportion of operating properties without pausing. By 1984, owned assets were $393,824 or 95.53 percent; and leaving the leased assets a very small share as it amounted only to $18,405 thousand

Table 7-M-3
Mercantile Stores Company, Inc.
Schedule of Incremental Minimum Lease Payments
(thousands)

| | Capital Leases | Incremental Capital Leases | | Incremental Operating Leases | Operating Leases | |
|---|---|---|---|---|---|---|
| | | Amount | Percent | | Amount | Percent |
| 1980 | $31,438 | | | $ 94,183 | | |
| 1979 | 33,716 | ($ 2,278) | (31.7%) | 99,100 | ($ 4,917) | (68.3%) |
| 1981 | $29,723 | | | $117,650 | | |
| 1980 | 31,438 | ($ 1,715) | n/c* | 94,183 | $23,467 | n/c* |
| 1982 | $27,071 | | | $126,487 | | |
| 1981 | 29,723 | ($ 2,652) | n/c* | 117,650 | $ 8,837 | n/c* |
| 1983 | $27,614 | | | $137,355 | | |
| 1982 | 27,071 | $ 543 | 4.8% | 126,487 | $10,868 | 95.2% |
| 1984 | $26,037 | | | $131,066 | | |
| 1983 | 27,614 | ($ 1,577) | (20.0%) | 137,355 | ($ 6,289) | (80.0%) |
| 1985 | $23,677 | | | $118,694 | | |
| 1984 | 26,037 | ($ 2,360) | (16.0%) | 131,066 | ($12,372) | (84.0%) |
| | | ($10,039) | | | $19,594 | |

*Not Computed

Sources: Mercantile Stores Company, Inc., Form 10-K, Notes to Consolidated Financial Statements on Leases, 1978 to 1984

Table 7-M-4
Mercantile Stores Company, Inc.
Comparative Amount of Owned Assets to Leased Assets
(thousands)

| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|---|
| Owned Assets | $209,101 | $240,273 | $272,188 | $304,613 | $331,496 | $342,789 | $370,570 | $393,824 |
| Leased Assets | 25,163 | 24,163 | 23,382 | 20,887 | 19,205 | 19,720 | 19,375 | 18,405 |
| | $234,264 | $264,436 | $295,570 | $325,500 | $350,701 | $362,509 | $389,945 | $412,229 |

Percentages of Owned Assets to Leased Assets From 1977 to 1984

| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|---|
| Owned Assets | 89.26% | 90.86% | 92.09% | 93.58% | 94.52% | 94.56% | 95.03% | 95.53% |
| Leased Assets | 10.74 | 9.14 | 7.91 | 6.42 | 5.48 | 5.44 | 4.97 | 4.47 |
| | 100.00% | 100.00% | 100.00% | 100.00% | 100.00% | 100.00% | 100.00% | 100.00% |

Trend of Percentages of Owned Assets as Compared to Leased Assets
(1977 Base Year)

| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|---|
| Owned Assets | 100.0% | 114.9% | 130.2% | 145.7% | 158.5% | 163.9% | 177.2% | 188.3% |
| Leased Assets | 100.0% | 96.0% | 92.9% | 83.0% | 76.3% | 78.4% | 77.0% | 61.2% |

Sources: Mercantile Stores Co., Inc., Form 10-K, Schedule V, 1977 to 1984

or 4.47 percent of total plant assets.

From 1977 base year, the trend of percentages of owned assets were increasing year after year in a smooth fashion over seven years. On the other hand, leased assets were sliding downhill almost every single year, except for a slight halt in 1982 when compared to 1981.

The situation was even more crystal clear when gross addition owned assets was arrayed againstleased assets over a seven year period from 1978 to 1984, as shown in Table 7-M-5 (page 147). Gross addition of owned assets was present every single year, though it did not reach the high of 1978. But comparing to gross addition of leased assets, there was almost complete dearth of capitalization of new leases except for $515 thousand in 1982. The pattern of lease restructuring was the cause of the paradox of the shift to greater ownership of plant assets.

Conclusion. The retroactive restatement under FASB No. 13 had brought about subtle and perceptible changes in the financial ratios. Most of the ratios have minimal impact. There is conclusive evidence of lease restructuring, and an apparent shift toward ownership to operating assets which was in response to lease restructuring rather than a resort to purchase.

Case Study of Rose's Stores, Inc.

> The Company has entered into leases for store locations which expire principally during the next 25 years. Computer equipment, transportation equipment, and certain other equipment are also leased under agreements which

Table 7-M-5
Mercantile Stores Company, Inc.
Schedule of Gross Addition of Plant Assets
(thousands)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | $47,263 | $42,314 | $39,986 | $35,624 | $21,445 | $41,277 | $39,816 |
| Leased Assets | 0 | 0 | 0 | 0 | 515 | 0 | 0 |
| | $47,262 | $42,314 | $39,986 | $35,624 | $21,960 | $41,277 | $39,816 |

Trend of Percentages of Gross Addition of Owned Assets as Compared to Leased Assets
(1978 Base Year)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | 100.0% | 89.5% | 84.6% | 75.4% | 45.4% | 87.3% | 84.2% |
| Leased Assets | -- | -- | -- | -- | n/c* | -- | -- |

*not subject to calculation

Sources: Mercantile Stores Company, Inc., Form 10-K, Schedule V, 1979 to 1984

> will expire during the next five years. Management expects that leases which will expire in the normal course of business will be renewed or replaced by other leases.[13]

Impact on Selected Financial Ratios. The following analysis was discerned from calculated ratios prior to and subsequent to retroactive restatement by Rose's Stores, as indicated in Table 7-0-1 (page 149), thus:

(1) The impact on the measure of profitability was very negligible. Net income to sales was almost identical, and so was net income to networth. The ratio of net income to total assets was worst off by about 3 percent as it declined from 6.5 to 6.3 percent.

(2) The ratio of operating income to interest expense dropped from 8.8 to 7.4 times, a perceptible change of 16 percent after restatement. Operating income to total assets was slightly unfavorable, it went from 13.4 to 14 percent. Operating income to total debt was almost identical.

(3) The ratio of networth to fixed assets had decreased from 3.8 to 3 times, another noticeable change of about 23 percent after lease capitalization. The ratio of sales to fixed assets was also noticeably affected, as it decreased from 31.3 to 24.7 times. The ratio of income before interest dropped from 9.3 to 7.4 times, a perceptible

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[13]Rose's Stores, Inc., Form 10-K, 1982, p. 20.

Table 7-0-1
Rose's Stores, Inc.
Selected Key Financial Ratios

| (thousands) | For year ended 1/25/78 | | For year ended 1/25/78* | |
|---|---|---|---|---|
| Net Income/Sales | 7,044/465,624 | 1.51% | 7,009/465,624 | 1.50% |
| Operating Income/ Interest Expense | 14,457/1,636 | 8.8 X | 15,671/2,124 | 7.4 X |
| Operating Income/ Total Assets | 14,457/107,838 | 13.4% | 15,671/111,792 | 14.0% |
| Operating Income/ Total Debt | 14,457/49,379 | 29.3% | 15,671/54,020 | 29.0% |
| Networth/Fixed Assets | 57,569/14,875 | 3.9 X | 57,233/18,830 | 3.0 X |
| Sales/Fixed Assets | 465,624/14,875 | 31.3 X | 465,624/18,830 | 24.7 X |
| Net Income/Networth | 7,044/57,569 | 12.24% | 7,009/57,233 | 12.25% |
| Income before Interest/ Interest | 15,250/1,636 | 9.3 X | 15,671/2,124 | 7.4 X |
| Sales/Working Capital | 465,624/55,704 | 8.36 X | 465,624/55,465 | 8.40 X |
| Current Ratio | 92,834/37,130 | 2.50 | 92,834/37,369 | 2.48 |
| Quick Ratio | 16,613/37,130 | 0.45 | 16,613/37,369 | 0.44 |
| Debt/Equity | 12,249/57,569 | 21.3% | 16,651/57,233 | 29.1% |
| Net Income/Total Assets | 7,044/107,838 | 6.5% | 7,009/111,792 | 6.3% |

*Restated for Lease Capitalization

Sources: Rose's Stores, Inc., Form 10-K, Balance Sheets and Statement of Earnings and Retained Earnings, 1978 and 1979

decline of 1.9 times or a change of 20 percent.

(4) The current and the quick ratios were just about marginally affected, if any; and the ratio of sales to working capital was not much different.

(5) The ratio of debt to equity was significantly affected. It had deteriorated from 21.3 to 29.1 percent, or a 36 percent increase after restatement.

Existence of Induced Lease Restructuring. In Table 7-0-2 (page 151) showed that capital lease payments were $11,361 thousand or 6.4 percent of total minimum lease payments; while operating lease payments were $166,407 thousand or 93.6 percent. The percentage of capital lease payments to operating lease payments portrayed a smooth and persistent downward trend, although the decline was less than one percentage point each time. The consequence was that by 1983, capital lease payments were only $7,342 thousand or 3.5 percent of the total.

The same condition was displayed by the trend of percentages of capital lease rentals, as it indicated a downward trend for five consecutive years. The result was that the percentage trend declined to 64.6 percent in 1983 when compared to the base year of 1978. For operating lease rentals, it had generally exhibited upward trend, with slight dip in 1980 and a very minor slip in 1982.

The shift away from capital leases and towards operating leases was confirmed by the behavior of the

Table 7 - 0-2
Rose's Stores, Inc.
Schedule of Minimum Lease Payments

(thousands)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|
| Capital Leases | $ 11,361 | $ 10,552 | $ 9,136 | $ 8,483 | $ 7,883 | $ 7,342 |
| Operating Leases | 166,407 | 177,458 | 170,417 | 179,339 | 178,272 | 201,489 |
| | $177,768 | $188,010 | $179,553 | $187,822 | $186,155 | $208,831 |

Percentage of Capital Lease Payments to Operating Lease Payments

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|
| Capital Leases | 6.4% | 5.6% | 5.1% | 4.5% | 4.2% | 3.5% |
| Operating Leases | 93.6 | 94.4 | 94.9 | 95.5 | 95.8 | 96.5 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend of Percentages of Minimum Lease Payments
(1978 Base Year)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | Cumulatiive 1979-83 |
|---|---|---|---|---|---|---|---|
| Capital Leases | 100.0% | 92.9% | 80.4% | 74.7% | 69.4% | 64.6% | (118%) |
| Operating Leases | 100.0% | 106.6% | 102.4% | 107.8% | 107.1% | 121.1% | 45% |

Sources: Rose's Stores, Inc., Form 10-K, Notes to Consolidated Financial Statements on Leases, 1979 to 1983

schedule of incremental minimum lease payments, as shown in Table 7-0-3 (page 153). Over a period of five years, there had been no increment in capital lease payments, rather, it had declined absolutely year by year. On the other hand, operating lease payments had increment in three out of the five years under analysis. Cumulatively, incremental capital lease rentals decreased $4,019 thousand, as compared to an increment of $35,082 for operating lease rentals.

Evidence of restructuring using contingent rentals applicable to capital leases was not discernable of any trend, as shown in Table 7-0-4 (page 154). The percentages of contingent rentals on capital leases varied between 8.4 percent in 1981 and 15.5 percent in 1979. On a trend basis, with 1978 base year, it had two years of increases but the direction from 1981 pointed downward.

Purchase Versus Lease Financing. As shown in Table 7-0-5 (page 155), owned assets were $51,389 thousand or 88.85 percent of plant assets; while leased assets were $6,454 or 11.15 percent. Every year thereafter, it had increased its percentage in relation to leased assets. By 1983, owned assets had amounted to $67,329 or 91.6 percent of the total; conversely, leased assets had declined to $6,169 or 8.4 percent.

The trend of percentages of owned assets in comparison to leased assets had confirmed the pattern. With 1978 as

Table 7 -0-3
Rose's Stores, Inc.
Schedule of Incremental Minimum Lease Payments

(thousands)

| | Capital Leases | Incremental Capital Leases | Operating Leases | Incremental Operating Leases |
|---|---|---|---|---|
| 1979 | $10,552 | | $177,458 | |
| 1978 | 11,361 | ($ 809) | 166,407 | $11,051 |
| 1980 | $ 9,136 | | $170,417 | |
| 1979 | 10,552 | ($ 1,416) | 177,458 | ($ 7,041) |
| 1981 | $ 8,483 | | $179,339 | |
| 1980 | 9,136 | ($ 653) | 170,417 | $ 8,922 |
| 1982 | $ 7,883 | | $178,272 | |
| 1981 | 8,483 | ($ 600) | 179,339 | ($ 1,067) |
| 1983 | $ 7,342 | | $201,489 | |
| 1982 | 7,883 | ($ 541) | 178,272 | $23,217 |
| | | ($ 4,019) | | $35,082 |

Sources: Rose's Stores, Inc., Form 10-K, Notes to Consolidated Financial Statements on Leases, 1979 to 1983

Table 7 - 0-4
Rose's Stores, Inc.
Schedule of Annual Capital Lease Payments As Compared to Contingent Rentals on Capital Leases
(thousands)

| | 1978 | 1979 | 1980 | 1981 | 1982 |
|---|---|---|---|---|---|
| Annual Capital Lease Payments | $810* | $795 | $653 | $600 | $542 |
| Contingent Rentals on Capital Leases | 118 | 146 | 148 | 55 | 53 |
| | $928 | $941 | $801 | $655 | $595 |

Proportion of Annual Capital Lease Rentals to Contingent Rentals Applicable to Capital Leases

| | 1978 | 1979 | 1980 | 1981 | 1982 |
|---|---|---|---|---|---|
| Annual Capital Lease Payments | 87.3% | 84.5% | 81.5% | 91.6% | 91.1% |
| Contingent Rentals on Capital Leases | 12.7% | 15.5% | 18.5% | 8.4% | 8.9% |

Trend of Percentages of Annual Capital Lease Rentals as Compared to Percentage Rental on Capital Leases

| | 1978 | 1979 | 1980 | 1981 | 1982 |
|---|---|---|---|---|---|
| Annual Capital Lease Payments | 100.0% | 98.0% | 80.6% | 74.0% | 66.9% |
| Contingent Rentals On Capital Lease | 100.0% | 123.7% | 125.4% | 46.6% | 44.9% |

*Minimum rental expense applicable to capital leases for 1977

Sources: Rose's Stores, Inc., Form 10-K, Notes to Financial Statements on Leases from 1979 to 1983

Table 7-0-5
Rose's Stores, Inc.
Comparative Amount of Owned Assets to Leased Assets
(in thousands)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|
| Owned Assets | $51,389 | $51,758 | $53,291 | $57,431 | $58,862 | $67,329 |
| Leased Assets | 6,454 | 6,454 | 6,169 | 6,169 | 6,169 | 6,169 |
| | $57,843 | $58,212 | $59,460 | $63,600 | $65,031 | $73,498 |

Percentages of Owned Assets to Leased Assets From 1978 to 1983

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|
| Owned Assets | 88.85% | 88.91% | 89.62% | 90.30% | 90.51% | 91.60% |
| Leased Assets | 11.15 | 11.09 | 10.38 | 9.70 | 9.49 | 8.40 |
| | 100.00% | 100.00% | 100.00% | 100.00% | 100.00% | 100.00% |

Trend of Percentages of Owned Assets as Compared to Leased Assets
(1978 Base Year)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|
| Owned Assets | 100.0% | 100.7% | 103.7% | 111.8% | 114.5% | 131.0% |
| Leased Assets | 100.0% | 100.0% | 95.6% | 95.6% | 95.6% | 95.6% |

Sources: Rose's Stores, Inc., Form 10-K, Schedule V and Balance Sheets, 1979 to 1983

the base year, owned assets had been increasing every year, and by 1983, it reached 131 percent. In contrast, the trend on leased assets had changed once by moving downward, and had remained stagnant for the next four years.

The existence of the shift toward apparent ownership was collaborated by the gross addition of plant assets, as shown in Table 7-0-6 (page 157). For five consecutive years, there were not capitalization of new leases. Concurrently, gross addition of operating assets was made through purchase in every year under study. The trend showed, with 1979 as the base year, gross addition of owned assets was increasing without interruption, and by 1983, there was a hefty increase of $12,122 thousand or 376 percent.

Conclusion. The financial ratios of Rose's Stores were marginally affected, due to the fact that substantial amount of leases did not come under the purview of FASB's criteria for capitalization of leases. In general, the turnover ratios are perceptibly affected. It does have some significant impact on the ratio of debt to equity.

Restructuring of leases is conclusively indicated, despite the fact that the proportion of leases capitalized is not that significant when compared to the total plant assets. Moreover, the apparent increase in owned assets is consistent with the policy of lease restructuring, and is the direct outcome of the lack of capitalization of new leases.

Table 7-0-6
Rose's Stores, Inc.
Schedule of Gross Addition of Plant Assets
(thousands)

| | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|
| Owned Assets | $2,329 | $4,439 | $6,418 | $5,832 | $12,122 |
| Leased Assets | 0 | 0 | 0 | 0 | 0 |
| | $2,329 | $4,439 | $6,418 | $5,832 | $12,122 |

Trend of Percentages of Gross Addition of Owned Assets as Compared to Leased Assets

| | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|
| Owned Assets | 100% | 138% | 199% | 181% | 376% |
| Leased Assets | -- | -- | -- | -- | -- |

Sources: Rose's Stores, Inc., Form 10-K, Schedule V and Statement of Changes in Financial Positions, 1979 to 1983

Case Study of Associated Dry Goods Corporation

> Many of the Company's noncellable leases, which principally convey the right to use real estate, require minimum fixed rentals, payment of taxes and other costs. Some leases require rents based on percentages of sales. Many leases contain options to renew for terms ranging from 5 to 70 years.[14]

Impact on Selected Financial Ratios. The changes in financial ratios as a result of retroactive restatement were indicated in Table 7-A-1 (page 159), thus:

(1) The ratios of net income to sales, net income to networth and net income to total assets had very slight impact, if any.

(2) The ratio of operating income to interest expense had dropped from 6.8 to 6.3 times, which had not been significant. The ratios of net income to total assets and net income to total debt had minor impact.

(3) The ratio of networth to fixed assets changed from 1.3 to 1.2 times after implementation of FASB No. 13; while the ratio of sales to fixed assets declined from 4 to 3.8 times. Both ratios were marginally affected.

(4) The ratio of sales to working capital improved negligibly. The current ratio deteriorated slightly from 2.1 to 2.07, and the quick ratio was just about the same.

(5) The ratio of debt to equity had somewhat more significant impact as it had increased from 21.8 to 27.5

[14] Associated Dry Goods Corporation, Form 10-K, 1979, p. 19.

Table 7-A-1
Associated Dry Goods Corporation
Selected Key Financial Ratios

| | For year ended 1/28/78 | | For year ended 1/28/78* | |
|---|---|---|---|---|
| No income/Sales | 42,149/1,467,755 | 2,87% | 42,309/1,467,755 | 2.88% |
| Operating Income/ Interest Expense | 94,699/13,877 | 6.8 X | 96,468/15,417 | 6.3 X |
| Operating Income. Total Assets | 94,699/814,191 | 11.63% | 96,468/834,932 | 11.55% |
| Operating Income/ Total Debt | 94,699/332,982 | 28.4% | 96,468/357,836 | 27.0% |
| Networth/Fixed Assets | 481,209/365,895 | 1,3 X | 477,096,386,636 | 1.2 X |
| Sales/Fixed Assets | 1,467,755/365,695 | 4.0 X | 1,467,755/386,636 | 3.8 X |
| Net Income/Networth | 42,149/481,209 | 8,76% | 42,309/477,096 | 8.87% |
| Income before Interest/ Interest | 94,699/13,877 | 6.8 X | 96,468/15,417 | 6.3 X |
| Sales/Working Capital | 1,467,755/213,261 | 6.9 X | 1,467,755/210,591 | 7.0 X |
| Current Ratio | 407,257/193,996 | 2,10 | 407,257/196,666 | 2.07 |
| Quick Ratio | 177,622/193,996 | 0.91 | 177,622/196,666 | 0.90 |
| Debt/Equity | 105,072/481,209 | 21.8% | 131,270/477,096 | 27.5% |
| Net Income/Total Assets | 42,149/814,191 | 5/2% | 42.309/834,932 | 5.1% |

*Restated for *Lease Capitalization*

Sources: Associated Dry Goods Corporation, Form 10-K, Consolidated Balance Sheets and Statement of Earnings, 1978 and 1979.

percent.

<u>Existence of Lease Restructuring</u>. In Table 7-A-2 (page 161) indicated that capital lease payments amounted to $43,554 thousand or 8.9 percent of total minimum lease payments in 1978; while operating lease payments were $445,474 thousand or 91.1 percent. The capital lease payments declined gradually for the next three years, and it amounted to $31,898 thousand or 6.1 percent in 1981. However, the trend was interrupted by sudden substantial increase in 1982 to a total of $209,567 thousand or 24.4 percent. Afterward, capital lease payments resumed its downward movement and settled at $178,955 or 19.4 percent of total minimum lease payments in 1984.

The trend of percentages, with 1978 base year, indicated the same pattern for capital lease payments, as the decline came to a halt in 1981. In 1982, it surged to 481.2 percent, and thereafter, it resumed its downward movement. As for operating lease payments, it has a more continuous upward trend with a slight dip in 1981, and eventually reached 167.1 percent in 1984.

The schedule of incremental capital lease payments, as shown in Table 7-A-3 (page 16 ), collaborated the same condition. From 1979 to 1981, there were significant decline, however, in 1982, it registered substantial increment which had the effect of reversing the downward spiral, though it scaled down its increase to $13,075

Table 7-A-2
Associated Dry Goods Corporation
Schedule of Minimum Lease Payments
(thousands)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Capital Leases | $ 43,554 | $ 39,557 | $ 35,637 | $ 31,898 | $209,567 | $196,492 | $178,955 |
| Operating Leases | 445,474 | 485,404 | 496,395 | 489,752 | 648,520 | 692,820 | 744,473 |
| | $489,028 | $524,961 | $532,032 | $521,650 | $858,087 | $889,312 | $923,428 |

Percentage of Capital Lease Payments to Operating Lease Payments

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Capital Leases | 8.9% | 7.5% | 6.7% | 6.1% | 24.4% | 22.1% | 19.4% |
| Operating Leases | 91.1 | 92.5 | 93.3 | 93.9 | 75.6 | 77.9 | 80.6 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend of Percentages of Minimum Lease Payments
(1978 Base Year)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Capital Leases | 100.0% | 90.8% | 81.8% | 73.2% | 481.2% | 451.1% | 410.9% |
| Operating Leases | 100.0% | 109.0% | 111.4% | 109.9% | 145.6% | 155.5% | 167.1% |

Sources: Associated Dry Goods Corporation, Form 10-K, Notes to Consolidated Financial Statements on Leases, 1978 to 1984

Table 7-A-3
Associated Dry Goods Corporation
Schedule of Incremental Minimum Lease Payments
(thousands)

| | Capital Leases | Incremental Capital Leases Amount | Incremental Capital Leases Percent | Operating Leases | Operating Leases Amount | Operating Leases Percent |
|---|---|---|---|---|---|---|
| 1979 | $ 39,557 | | | $485,404 | | |
| 1978 | 43,554 | ($ 3,997) | n/c* | 445,474 | $ 39,930 | n/c* |
| 1980 | $ 35,637 | | | $496,395 | | |
| 1979 | 39,557 | ($ 3,920) | n/c* | 485,404 | $ 10,991 | n/c* |
| 1981 | $ 31,898 | | | $489,752 | | |
| 1980 | 35,637 | ($ 3,739) | 36.0% | 496,395 | ($ 6,643) | 64.0% |
| 1982 | $209,567 | | | $648,520 | | |
| 1981 | 31,898 | $177,669 | 52.8% | 489,752 | $158,768 | 47.2% |
| 1983 | $196,492 | | | $692,820 | | |
| 1982 | 209,567 | $ 13,075 | 22.8% | 648,520 | $ 44,300 | 77.2% |
| 1984 | $178,955 | | | $744,473 | | |
| 1983 | 196,492 | ($ 17,537) | n/c* | 692,820 | $ 51,653 | n/c* |
| | | $161,557 | | | $298,999 | |
| Cumulative Percentages of Capital Leases to Operating Leases | | 35.1% | | | 64.9% | |

*Not Computed

Sources: Associated Dry Goods Corporation, Form 10-K, Notes to Consolidated Financial Statements on Leases, 1979 to 1984

thousand in 1983, and finally started to decrease again in 1984 in the amount of $17,537 thousand. Meanwhile, operating lease payments, incrementally, had one year of negative increment in 1981, with the other five years indicating continuous increment, and a substantial bulge in 1982 of $158,768 thousand.

The configuration of the trend would have to be subdivided into two separate phases. The reason was due to the fact that Associated Dry Goods had consummated a major acquisition on May 27, 1982 of Caldor, Inc. and was accounted as a purchase for accounting purposes. The result of the acquisition was to add $295.9 million to the operating assets, which was the major reason for the lump of increase in both types of plant assets. If lease restructuring is to maximumize off balance sheet presentation, the evidence analyzed was apparently suggestive of leases being restructured, even though the presence of the purchase of of Caldor, Inc. had unquestionably created a veil on the data.

In Table 7-A-4 (page 164) revealed that contingent rentals on capital leases were $1,345 thousand or 23.4 percent of total annual capital lease rents in 1978. Subse uently, it took a larger and larger proportion of the total annual capital lease rentals, that by 1981, it had reach 34.6 percent. But in 1982, the percentage of capital lease rentals in the contingent category took a nose dive to 13.9 percent, which it was presumably on

Table 7 -A - 4
Associated Dry Goods Corporatin
Schedule of Annual Capital Lease Payments as Compared to Contingent Rentals on Capital Leases

| (thousands) | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|
| Annual Capital Lease Payments | $ 4,396 | $ 3,919 | $ 3,739 | $ 3,739 | $13,075 | $12,884 |
| Contingent Rentals on Capital Leases | 1,345 | 1,396 | 1,611 | 1,980 | 2,111 | 1,713 |
| | $ 5,741 | $ 5,315 | $ 5,350 | $ 5,719 | $15,186 | $14,597 |

Proportion of Annual Capital Lease Rentals to Contingent Rentals Applicable to Capital Leases

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|
| Annual Capital Lease Rentals | 76.6% | 73.7% | 69.9% | 65.4% | 86.1% | 88.3% |
| Contingent Rentals on Capital Leases | 23.4% | 26.3% | 30.1% | 34.6% | 13.9% | 11.7% |

Trend of Percentages of Annual Capital Lease Rentals as Compared to Percentage Rental on Capital Leases

| (1978 Base Year) | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|
| Annual Capital Lease Payments | 100.0% | 89.1% | 85.1% | 85.1% | 297.4% | 293.1% |
| Contingent Rentals on Capital Leases | 100.0% | 103.8% | 119.8% | 147.2% | 156.9% | 127.4% |

Sources: Associated Dry Goods Corporation, Form 10-K, Notes to Financial Statements on Leases, 1979 to 1984

account of the acquisition of Caldor, Inc. Moreover, it declined again in 1983 to 11.7 percent of total annual capital lease rentals.

The trend analysis indicated that contingent rentals on capital leases, with 1978 as the base year, had increased four successive years to 156.7 percent in 1982, but dropped to 127.4 percent in 1983. Even if the evidence was not conclusive as to lease restructuring, nonetheless, it had the effect of keeping off the balance sheet a significant portion of the total annual capital lease rentals between 1978 and 1981, although it had somewhat tapered off in 1982.

Purchase Versus Lease Financing. As indicated in Table 7-A-5 (page 166), in 1977, owned assets were $464,407 thousand or 88.7 percent of total operating assets; while leased assets were $59,119 thousand or 11.3 percent. The percentage of owned assets for the next successive four years had been taking an increasing proportionate share of the total; and, conversely, leased assets had been reducing its proportionate share, The result was, by 1981, owned assets reached 92.9 percent of total plant assets. However, in 1982, it took a sudden plunge in terms of its percentage share when it dropped to 74 percent, and by 1984, it was only 72.6 percent.

An examination of the trend of percentages, with 1977 as the base year, showed asset acquisition via purchase was moving up without interruption, and by 1984, it had reached

Table 7-A-5
Associated Dry Goods Corporation
Comparative Amount of Owned Assets to Leased Assets
(thousands)

| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|---|
| Owned Assets | $464,407 | $517,068 | $571,637 | $615,208 | $677,206 | $ 807,020 | $ 869,253 | $ 883,476 |
| Leased Assets | 59,119 | 59,119 | 58,828 | 52,001 | 52,001 | 283,965 | 278,320 | 332,724 |
| | $523,526 | $576,187 | $630,465 | $667,209 | $729,207 | $1,090,985 | $1,147,573 | $1,216,200 |

Percentages of Owned Assets to Leased Assets From 1977 to 1984

| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|---|
| Owned Assets | 88.7% | 89.7% | 90.7% | 92.2% | 92.9% | 74.0% | 75.7% | 72.6% |
| Leased Assets | 11.3 | 10.3 | 9.3 | 7.8 | 7.1 | 26.0 | 24.3 | 27.4 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend of Percentages of Owned Assets as Compared to Leased Assets
(1977 Base Year)

| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|---|
| Owned Assets | 100.0% | 111.3% | 123.1% | 132.5% | 145.8% | 173.8% | 187.2% | 190.2% |
| Leased Assets | 100.0% | 100.0% | 99.5% | 89.0% | 89.0% | 480.3% | 470.8% | 562.8% |

Sources: Associated Dry Goods Corporation, Form 10-K, Schedule V, 1978 to 1984

190.2 percent. Concurrently, leased assets had no increases from 1978 to 1981, then in 1982, it surged to 480.3 percent and after a slight decline in 1983, it moved up to 562.8 percent.

From the movement of the data, there was apparent evidence of concentrating more on purchase, but it was not actually caused by policy shift to more purchase, rather it was a reflection primarily due to a complete drought on capitalization of new leases for at least four years. But between 1982 to 1984, the pattern was inconclusive because three major events had veiled any apparent trend line. The acquistion of Caldor, Inc. in 1982 had, in fact, increased plant assets by about $280,430 thousand, while the sale of Stix, Baer & Fuller had reduced an unspecified amount of operating assets. Further, the purchase of the net assets of Loebmann's Inc. had added about $62,801 thousand.[16]

The configuration of the data and its analysis were further supported by the portrayal of the gross addition of owned assets vis-a-vis leased assets, as indicated in Table 7-A-6 (page 168). Owned assets accounted for all the gross addition from 1978 to 1981, and it continued to account for a substantial portion of the gross addition in subsequent years. The percentages were 40 percent, 98.3 percent, and 65.5 percent in the years 1982, 1983 and 1984

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[16] Associated Dry Goods Corporation, Form 10-K, 1984, p. 32.

Table 7-A-6
Associated Dry Goods Corporation
Schedule of Gross Addition of Plant Assets
(thousands)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | $72,850 | $71,986 | $59,630 | $69,211 | $153,957 | $84,407 | $119,513 |
| Leased Assets | 0 | 0 | 0 | 0 | 231,964 | 1,421 | 65,822 |
| | $72,850 | $71,986 | $59,630 | $69,211 | $385,921 | $85,828 | $185,335 |

Percentage of Gross Addition of Owned Assets to Leased Assets

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | 100.0% | 100.0% | 100.0% | 100.0% | 40.0% | 98.3% | 64.5% |
| Leased Assets | -- | -- | -- | -- | 60.0 | 1.7 | 35.5 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend Percentages of Gross Addition of Owned Assets as Compared to Leased Assets
(1978 Base Year)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | 100.0% | 98.8% | 81.9% | 95.0% | 427.4% | 115.9% | 164.1% |
| Leased Assets | -- | -- | -- | -- | n/c* | n/c* | n/c* |

*Not Computed

Sources: Associated Dry Goods Corporation, Form 10-K, Schedule V, 1979 to 1984

respectively.

Conclusion. The retroactive restatement under FASB Statement No. 13 has not impacted much on the financial ratios of Associated Dry Goods Corporation. The only change of significance is the debt to equity ratio. However, the impact would have been greater if it were not for the fact that substantial portion of leases has escaped capitalization.

Lease restructuring is apparently present but the acquisition of Caldor, Inc. has caused the trend to be out of kilter, and it seems that it is beginning to have another round of gradual decline for capital lease payments.

The greater preference for asset purchase is more apparent than real, because it is primarily the direct result of lease restructuring although the last three years have blurred any trend whatsoever by two major business acquisitions and the disposal of one major division.

Case Study of Almy Stores, Inc.

Almy Stores Inc. leases some of its retail outlets with various expiration dates including renewal options.[17]

Impact on Selected Financial Ratios. As shown in Table 7-Y-1 (page 170), the following observations on financial ratios of Almy Stores Inc. were indicated.

(1) The ratio of net income to sales had worsened slightly from 1.42 to 1.38 percent, so was the ratio of

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[17] Almy Stores Inc., Form 10-K, 1979, p. 30.

Table 7-Y-1
Almy Stores Inc.
Selected Key Financial Ratios

(thousands)

| | For year ended 12/31/77 | | For year ended 12/31/77* | |
|---|---|---|---|---|
| Net Income/Sales | 1,013/71,459 | 1.42% | 986/71,459 | 1.38% |
| Operating Income/ Interest Expense | 925/422 | 2.2 X | 1,176/728 | 1.6 X |
| Operating Income/ Total Assets | 925/37,866 | 2.44% | 1,176/40,721 | 2.89% |
| Operating Income/ Total Debt | 925/16,430 | 5.63% | 1,176/19,609 | 5.99% |
| Networth/Fixed Assets | 21,435/9,618 | 2.2 X | 21,111/12,473 | 1.7 X |
| Sales/Fixed Assets | 71,459/9,618 | 7.4 X | 71,459/12,473 | 5.7 X |
| Net Income/Networth | 1,013/21,435 | 4.73% | 986/21,111 | 4.67% |
| Income before interest/ Interest | 2,475/422 | 5.9 X | 1,726/728 | 2.4 X |
| Sales/Working Capital | 71,459/15,563 | 4.59 X | 71,459/15,410 | 4.64 X |
| Current Ratio | 26,736/11,172 | 2.39 | 26,736/11,325 | 2.36 |
| Quick Ratio | 14,797/11,172 | 1.32 | 14,797/11,325 | 1.31 |
| Debt/Equity | 4,165/21,435 | 19.4% | 7,541/21,111 | 35.7% |
| Net Income/Total Assets | 1,013/37,866 | 2.68% | 986/40,721 | 2.42% |

*Restated for Lease Capitalization

Sources: Almy Stores Inc., Form 10-K, Consolidated Balance Sheets and Consolidated Statements of Earnings and Retained Earnings, 1977 and 1978

net income to networth which had dropped from 4.73 to 4.67 percent. In corresponding fashion, net income to total assets declined from 2.68 to 2.42 percent.

(2) The ratio of operating income to interest expense had perceptible deterioration of from 2.2 to 1.6 times; while the ratio of operating income to total assets had marginal improvement from 5.63 to 5.99 percent. The ratio of operating income to total debt changed slightly from 5.63 to 5.9 percent.

(3) The current ratio had imperceptible change from 2.39 to 2.36, so was the quick ratio which had changed from 1.32 to 1.31. The ratio of sales to working capital improved ever so slightly from 4.59 to 4.64 times.

(4) The ratio of sales to fixed assets declined from 7.4 to 5.7 times, which had an unfavorable change of about 23 percent after restatement. The ratio of income before interest to interest was significantly affect as it dropped from 5.9 to only 2.4 times.

(5) The debt to equity ratio was substantially affected as it increased from 19.4 to 35.7 percent, a worsening impact of 84 percent after restatement.

Existence of Lease Restructuring. As indicated in Table 7-Y-2 (page 172), capital lease payments were $12,125 thousand or 53.2 percent of total minimum lease payments in 1979; while operating lease payments were $10,661 thousand or 46.9 percent. The common size percentage for capital lease payments increased to 59 percent in 1980,

Table 7-Y-2
Almy Stores Inc.
Schedule of Minimum Lease Payments

(thousands)

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|
| Capital Leases | $12,125 | $17,959 | $22,618 | $21,433 | $17,964 | $16,737 |
| Operating Leases | 10,661 | 12,478 | 15,798 | 14,506 | 12,601 | 14,475 |
| | $22,786 | $30,437 | $38,416 | $35,939 | $30,565 | $31,212 |

Percentage of Capital Lease Payments to Operating Lease Payments

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|
| Capital Leases | 53.2% | 59.0% | 58.9% | 59.6% | 58.8% | 53.6% |
| Operating Leases | 46.8 | 41.0 | 41.1 | 40.4 | 41.2 | 46.4 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend of Percentages of Minimum Lease Payments
(1979 Base Year)

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | Cumulative 1980-84 |
|---|---|---|---|---|---|---|---|
| Capital Leases | 100.0% | 148.1% | 186.5% | 176.7% | 148.2% | 138.0% | 297.5% |
| Operating Leases | 100.0% | 117.0% | 148.2% | 136.1% | 118.2% | 135.8% | 155.3% |

Sources: Almy Stores Inc., Form 10-K, Notes to Consolidated Financial Statements on Leases, 1979 to 1984

a gain of 8.2 percentage point. It had stabilized its proportionate share in that neighborhood for the next successive three years, ranging between 59.6 and 58.5 percent. It eventually receded almost to the percentage share at the start of the analysis by 1984.

The trend of percentages of capital lease payments, with 1979 as the base year, had increased to 186.5 percent in 1981, then it started to recede during the next three years, and was 138 percent by 1984. At the same time, operating lease payments peaked in 1981 to 148.2 percent, but the percentage trend declined the following two years, and then it climbed again to 135.8 percent.

An analysis of the trend of incremental capital lease payments, as shown in Table 7-Y-3 (page 174), collaborated the pattern. For 1980 and 1981, incremental capital lease payments had increment that were relatively greater than the increment of incremental operating lease payments; conversely, the decline for the two subsequent years were also relatively smaller than the decline of incremental operating lease payments with the exception of 1984. The cumulative impact was in favor of incremental capital lease payments, as it took 70.7 percent of the total increment for the five years under observation; while incremental operating lease payments had only 29.3 percent. The analysis did not indicate the existence of lease restructuring.

Table 7-Y-3
Almy Stores Inc.
Schedule of Incremental Minimum Lease Payments

(thousands)

| | Capital Leases | Incremental Capital Leases Amount | Incremental Capital Leases Percent | Operating Leases | Incremental Operating Leases Amount | Incremental Operating Leases Percent |
|---|---|---|---|---|---|---|
| 1980 | $17,959 | | | $12,478 | | |
| 1979 | 12,125 | $5,834 | 76.3% | 10,661 | $1,817 | 23.7% |
| 1981 | $22,618 | | | $15,798 | | |
| 1980 | 17,959 | 4,659 | 58.4% | 12,478 | 3,320 | 41.6% |
| 1982 | $21,433 | | | $14,506 | | |
| 1981 | 22,618 | (1,185) | (47.8%) | 15,798 | (1,292) | 52.2% |
| 1983 | $17,964 | | | $12,601 | | |
| 1982 | 21,433 | (3,469) | (64.5%) | 14,506 | (1,905) | (35.5%) |
| 1984 | $16,737 | | | $14,475 | | |
| 1983 | 17,964 | (1,227) | (97.5%) | 14,506 | ( 31) | ( 2.5%) |
| | | $4,612 | | | $1,909 | |
| Cumulative Percentages of Capital Leases to Operating Leases | | 70.7% | | | 29.3% | |

Sources: Almy Stores Inc., Form 10-K, Notes to Consolidated Financial Statements on Leases, 1978 to 1983

Purchase Versus Lease Financing. In Table 7-Y-4 (page 176), owned assets were $21,357 thousand or 89.8 percent of total operating assets in 1977; while leased assets were $2,855 thousand or 10.2 percent. In the succeeding two years, owned assets declined to 78.3 percent in 1979, however, in 1980, it climbed back to 89 percent or $23,358 thousand. Thereafter, the common size percentages for owned assets fluctuated within a very narrow range for the next three years, as the range of fluctuation was between 88.1 to 89 percent including the year of 1980. In effect, it had achieved certain stability during that period.

In terms of the trend of percentages, owned assets moved up gradually to 109.3 percent in 1980, and had dipped slightly in 1981 and 1982, but it settled at 11.9 percent in 1983. On the other hand, leased assets were registering healthy increases and peaked at 199.7 percent in 1980, and thereafter, it declined during the next three years, and was at 146.7 percent by 1983. Based on the behavior of the data, it could be concluded that there was no indication of any shift in the proportion between owned and leased assets.

As shown in Table 7-Y-5 (page 177), on a common percentage basis, gross addition of owned assets accounted between 78.1 to 80.4 percent of the total gross addition from 1978 to 1980; and subsequently, it accounted for all

Table 7-Y-4
Almy Stores Inc.
Comparative Amount of Owned Assets to Leased Assets
(thousands)

| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|---|
| Owned Assets | $21,357 | $22,035 | $22,427 | $23,358 | $22,834 | $23,305 | $23,909 |
| Leased Assets | 2,855 | 4,133 | 4,857 | 5,702 | 5,374 | 4,537 | 4,188 |
| | $24,212 | $26,168 | $27,284 | $29,060 | $28,208 | $27,842 | $28,097 |

Percentage of Owned Assets to Leased Assets From 1977 to 1983

| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|---|
| Owned Assets | 89.8% | 84.2% | 78.3% | 89.0% | 88.1% | 88.4% | 88.5% |
| Leased Assets | 10.2 | 15.8 | 21.7 | 11.0 | 11.9 | 11.6 | 11.5 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend of Percentages of Owned Assets as Compared to Leased Assets
(1977 Base year)

| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|---|
| Owned Assets | 100.0% | 103.2% | 105.0% | 109.3% | 106.9% | 109.1% | 111.9% |
| Leased Assets | 100.0% | 144.8% | 170.1% | 199.7% | 188.2% | 158.9% | 146.7% |

Sources: Almy Stores Inc., Form 10-K, Schedule V, 1978 to 1983

Table 7-Y-5
Almy Stores Inc.
Schedule of Gross Addition of Plant Assets
(thousands)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|
| Owned Assets | $ 934 | $ 995 | $1,053 | $ 655 | $ 685 | $2,198 |
| Leased Assets | 227 | 272 | 295 | 0 | 0 | 0 |
| | $1,161 | $1,267 | $1,348 | $ 655 | $ 685 | $2,198 |

Percentage of Gross Addition in Owned Assets to Leased Assets

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|
| Owned Assets | 80.4% | 78.5% | 78.1% | 100.0% | 100.0% | 100.0% |
| Leased Assets | 19.6 | 21.5 | 21.9 | -- | -- | -- |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend Percentages of Gross Addition of Owned Assets as Compared to Leased Assets
(1978 Base Year)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | Cumulative 1979-80 |
|---|---|---|---|---|---|---|---|
| Owned Assets | 100.0% | 106.5% | 112.8% | 70.2% | 73.3% | 235.4% | 98.2% |
| Leased Assets | 100.0% | 119.8% | 130.0% | -- | -- | -- | (349.8%) |

Sources: Almy Stores Inc., Form 10-K, Schedule V, 1978 to 1983

the gross increase of operating assets for the next three years. Conversely, the gross addition of new leases was between 19.6 to 21.9 percent from 1978 to 1980, and thereafter, it did not have any capitalization of new leases.

The trend of percentage of gross addition on owned assets, with 1978 as the base year, was increasing for two years, followed by decline for another two years, and then it took off to 235.4 percent in 1983. Meanwhile, for leased assets, it was showing two years of significant increases and after that, it went to zero.

The pattern in the first three years showed increasing share for leased assets, but the next three years, the situation was turned around as owned assets showed a larger proportion. However, the impact of the last three years was not as yet visible on the distribution of the common size proportion between owned and leased assets. It was plausible that an apparent pattern was emerging, whereby there would be a shift toward owned assets, but for the moment, it remained somewhat inconclusive.

Conclusion. The retroactive restatement does not have any significant impact on the financial ratios of Almy Stores, Inc., however, it does have some perceptible changes on the ratio of sales to fixed assets, and networth to fixed assets, and substantial impact on debt to equity ratio.

Evidence of lease restructuring is not discernible during the period under analysis, capital lease payments

of plant assets, but the outcome is inconclusive and as yet it is not able to exert any impact.

Case Study of SCOA Industries Inc.

SCOA Industries Inc. is a significant lease-intensive retailer. It had changed its method of accounting for leases during the quarter ending on January 27, 1979 to give effect to retroactive restatement.

Impact on Selected Financial Ratios. As shown in Table 7-S-1 (page 180), the following observation on the changes in financial ratios were indicated, thus:

(1) The ratio of net income to sales had very slight impact, which declined from 2.01 to 1.97 percent; while net income to networth made a marginal improvement from 21.08 to 21.57 percent. The ratio of net income to total assets had perceptible decline from 9 to 5.74 times.

(2) The operating income to interest expense had substantial change of from 11.55 times to 5.88 times, a negative impact of about 50 percent after restatement. The ratio of operating income to total assets had declined slightly, and the ratio of operating income to total debt had noticeable deterioration, as it came down from 24.2% to 21.8%.

(3) The turnover ratio of sales to fixed assets had substantial negative impact, as it declined from 29 times to only 12.1 times.

Table 7-S-1
SCOA Industries Inc.
Selected Key Financial Ratios
(thousands)

| | For year ended 1/28/78 | | For year ended 1/28/78* | |
|---|---|---|---|---|
| Net Income/Sales | 13,783/685,209 | 2.01% | 13,525/685,209 | 1.97% |
| Operating Income/ Interest Expense | 32,529/3,528 | 11.6% | 34,295/5,832 | 5.9% |
| Operating Income/ Total Assets | 32,529/202,103 | 16.09% | 34,295/219,986 | 15.59% |
| Operating Income/ Total Debt | 32,529/134,202 | 24.2% | 34,295/157,309 | 21.8% |
| Networth/Fixed Assets | 67,901/38,720 | 1.8 X | 62,677/56,499 | 1.1 X |
| Sales/Fixed Assets | 685,209/38,720 | 29 X | 685,209/56,499 | 12 X |
| Net Income/Networth | 13,783/67,901 | 21.08% | 13,525/62,677 | 21.57% |
| Income before Interest/ Interest | 31,725/3,528 | 9 X | 33,501/5,832 | 5.7 X |
| Sales/Working Capital | 685,209/73,503 | 9.3 X | 685,209/72,445 | 9.5 X |
| Current Ratio | 158,165/84,662 | 1.87 | 158,165/85,720 | 1.85 |
| Quick Ratio | 64,151/84,662 | 0.76 | 64,151/85,720 | 0.75 |
| Debt/Equity | 30,571/65,389 | 46.8% | 67,859/62,677 | 108.3% |
| Net Income/Total Assets | 13,783/184,364 | 7.48% | 13,525/219,986 | 6.15% |

*Restated for Lease Capitalization

Sources: SCOA Industries Inc., Form 10-K, Consolidated Balance Sheets and Statement of Income and Retained Earnings, 1978 and 1979

The ratio of networth to fixed assets had significant change of from 1.8 to 1.1 times, and the ratio of income before interest to interest had declined perceptibly from 9 to 5.74 times.

(4) The current ratio, the quick ratio and the ratio of sales to working capital had very slight impact.

(5) The ratio of debt to equity had substantial negative impact as it increased from 46.8 to 108.3 percent.

Existence of Induced Lease Restructuring. As presented in Table 7-S-2 (page 182), capital lease payments were $97,026 thousand or 32 percent of total minimum lease payments in 1980; while operating lease payment were $205,966 thousand or 69 percent. The common size percentage for capital lease payments increased noticeably its share beginning 1980. It was 38 percent in 1981 and it moved up to take a larger proportion year after year, that by 1984, it was 45.4 percent of the total, though it had declined somewhat to 42.7 percent in 1985. Nevertheless, capital lease payments were 10.7 percentage point higher in 1985; correspondingly, operating lease payments declined 10.7 percentage point.

An examination of the trend of percentages of capital lease payments as compared to operating lease payments, with 1980 base year, indicated that both were increasing for the five years under analysis. But the percentage trend for capital lease payments were showing a higher

Table 7-S-2
SCOA Industries Inc.
Schedule of Minimum Lease Payments
(thousands)

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| Capital Leases | $ 97,026 | $141,039 | $153,099 | $168,332 | $228,427 | $239,475 |
| Operating Leases | 205,966 | 230,506 | 232,252 | 270,309 | 274,831 | 321,424 |
| | $302,992 | $371,544 | $385,351 | $438,641 | $503,258 | $560,899 |

Percentage of Capital Lease Payments to Operating Lease Payments

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| Capital Leases | 32.0% | 38.0% | 39.7% | 38.4% | 45.4% | 42.7% |
| Operating Leases | 68.0 | 62.0 | 60.3 | 61.6 | 54.6 | 57.3 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend of Percentages of Minimum Lease Payments

| (1980 Base Year) | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| Capital Leases | 100.0% | 145.4% | 157.8% | 173.5% | 235.4% | 246.8% |
| Operating Leases | 100.0% | 111.9% | 112.8% | 131.2% | 133.4% | 156.1% |

Sources: SCOA Industries Inc., Form 10-K, Note to Consolidated Financial Statements on Leases, 1979 to 1984

rate of growth than the rate of growth for operating lease payments. Consequently, capital lease payments were able to account for a larger percentage of the total minimum lease payments.

As shown in Table 7-S-3 (page 184), calculation of incremental changes of capital lease payments vis-a-vis operating lease payments confirmed the directional trend of the behavior of capital lease payments. From 1981 to 1985, the annual percentage increment for capital lease payments in three of the five years. The result of the cumulative impact was that capital lease payments added $142,449 thousand or 55.5 percent of the total compared to operating lease payments of $114,458 thousand or 44.5 percent. There was no indication of the existence of lease restructuring. Actually, capital leases were taking a greater share of the new leases.

The unusual use of contingent rentals on capital leases as a form of off balance sheet financing was not indicated as shown in Table 7-S-4 (page 185). The share of contingent rentals on capital leases was $454 thousand or 9.6 percent of total annual capital lease payments in 1980. It declined to 6.6 percent in 1981 and then it increased to 10.6 percent in 1983, but receded to 8.1 percent the year after. It did not exhibit unusual growth trend when compared to annual capital lease payments.

Purchase Versus Lease Financing. In Table 7-S-5 (page 186), owned assets were $45,660 thousand or 52

Table 7-S-3
SCOA Industries Inc.
Schedule of Incremental Minimum Lease Payments

(thousands)

| | Capital Leases | Incremental Capital Leases Amount | Incremental Capital Leases Percent | Operating Leases | Incremental Operating Leases Amount | Incremental Operating Leases Percent |
|---|---|---|---|---|---|---|
| 1981 | $141,039 | | | $230,506 | | |
| 1980 | 97,026 | $ 44,013 | 64.2% | 205,966 | $ 24,540 | 35.8% |
| 1982 | $153,099 | | | $232,252 | | |
| 1981 | 141,039 | 12,060 | 87.4% | 230,506 | 1,746 | 12.6% |
| 1983 | $168,332 | | | $270,309 | | |
| 1982 | 153,099 | 15,233 | 28.6% | 232,252 | 38,057 | 71.4% |
| 1984 | $228,427 | | | $274,831 | | |
| 1983 | 168,332 | 60,095 | 94.5% | 270,309 | 3,522 | 5.5% |
| 1985 | $239,475 | | | $321,424 | | |
| 1984 | 228,427 | 11,948 | 19.2% | 274,831 | 46,593 | 80.8% |
| | | $142,449 | | | $114,458 | |
| Cumulative Percentages of Capital Leases to Operating Leases | | 55.5% | | | 44.5% | |

Sources: SCOA Industries Inc., Form 10-K, Notes to Consolidated Financial Statements on Leases, 1979 to 1984

Table 7-S-4
SCOA Industries Inc.
Schedule of Annual Capital Lease Payments As
Compared to Contingent Rentals on Capital Leases

(thousands)

| | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|
| Annual Capital Lease Payments | $4,727 | $6,538 | $7,089 | $7,889 | $10,467 |
| Contingent Rentals on Capital Leases | 453 | 465 | 638 | 938 | 925 |
| | $5,180 | $7,003 | $7,727 | $8,827 | $11,392 |

Proportion of Annual Capital Lease Rentals to Contingent
Rentals Applicable to Capital Leases

| | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|
| Annual Capital Lease Payments | 90.4% | 93.4% | 91.7% | 89.4% | 91.9% |
| Contingent Rentals on Capital Leases | 9.6 | 6.6 | 8.3 | 10.6 | 8.1 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend of Percentages of Annual Capital Lease Rentals as
Compared to Percentage Rental on Capital Leases
(1980 Base Year)

| | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|
| Annual Capital Lease Payments | 100.0% | 138.3% | 150.0% | 166.9% | 221.4% |
| Contingent Rentals on Capital Leases | 100.0% | 102.6% | 140.8% | 207.1% | 204.2% |

Sources: SCOA Industries Inc., Form 10-K, Notes to Consolidated Financial Statements on Leases, 1979 to 1984

Table 7-S-5
SCOA Industries Inc.
Comparative Amount of Owned Assets to Leased Assets
(thousands)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | $ 45,660 | $ 47,516 | $ 54,019 | $ 62,630 | $ 80,576 | $ 91,110 | $125,771 |
| Leased Assets | 42,219 | 44,028 | 63,041 | 67,229 | 72,065 | 85,148 | 91,250 |
| | $ 87,879 | $ 91,544 | $117,060 | $129,859 | $152,641 | $176,258 | $217,021 |

Percentages of Owned Assets to Leased Assets From 1978 to 1984

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | 52.0% | 51.9% | 46.1% | 48.3% | 52.8% | 51.7% | 58.0% |
| Leased Assets | 48.0 | 48.1 | 53.9 | 51.8 | 47.2 | 48.3 | 42.0 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend of Percentages of Owned Assets as Compared to Leased Assets
(1978 Base Year)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | 100.0% | 104.1% | 118.3% | 137.2% | 176.5% | 199.5% | 275.5% |
| Leased Assets | 100.0% | 104.3% | 149.3% | 159.2% | 170.7% | 201.7% | 216.1% |

Sources: SCOA Industries Inc., Form 10-K, Schedule V, Consolidated Statements' Notes on Leases, 1979 to 1984

percent of the total operating assets in 1978; while leased assets were $42,219 thousand or 48 percent. The common size percentages on owned assets had declined two years in a row to 46.1 percent in 1980, which was its lowest plateau. However, its percentage began to move up gradually in the next four years until it reached 58 percent in 1984, which was 6 percentage point higher than 1978, but 11.9 percentage point since 1980. The trend of percentages indicated both types of operating assets had exhibited continuous growth without abatement.

The pattern of percentage increase of owned assets had been collaborated by the gross increase of plant assets as shown in Table 7-S-6 (page 188). In fact, except for 1980 when it added only 44.5 percent of the annual gross addition, owned assets' percentage share of gross addition for the successive four years was between 57.1 percent in 1983 and 83.4 percent in 1984. The percentage of the respective years was above the percentage of the balance of the owned assets. The effect was the tendency to increase the share of owned assets vis-a-vis leased assets.

Both types of operating assets had experienced addition every year except that leased assets had the tendency to fluctuate from year to year. Thus the trend of increase of gross assets or the lack of it by capital leases was not reliable. From the analysis presented, it would seem to be reasonable to conclude that there was apparent inclination to shift into owned assets from 1980 to 1984.

Table 7-S-6
SCOA Industries Inc.
Schedule of Gross Addition of Plant Assets
(thousands)

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|
| Owned Assets | $ 9,072 | $15,268 | $16,511 | $23,858 | $20,897 | $36,147 |
| Leased Assets | 3,269 | 19,013 | 5,008 | 4,836 | 15,706 | 7,209 |
| | $12,341 | $34,281 | $21,519 | $28,694 | $36,603 | $43,356 |

Percentage of Gross Addition in Owned Assets to Leased Assets

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|
| Owned Assets | 73.5% | 44.5% | 76.7% | 83.1% | 57.1% | 83.4% |
| Leased Assets | 26.5 | 55.5 | 23.3 | 16.9 | 42.9 | 16.6 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend of Percentages of Gross Addition of Owned Assets as Compared to Leased Assets
(1979 Base Year)

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | Cumulative 1980-84 |
|---|---|---|---|---|---|---|---|
| Own Assets | 100% | 168% | 182% | 263% | 230% | 398% | 741% |
| Leased Assets | 100% | 581% | 153% | 148% | 480% | 220% | 1,082% |

Sources: SCOA Industries Inc., Form 10-K, Schedule V, and Statement of Changes in Financial Position, 1979 to 1984

Conclusion. The retroactive restatement has brought about significant changes in some of the ratios, such as the operating income to interest expense. The debt to equity ratio has been substantially affected. It has less impact on profitability ratios.

There is no evidence of lease restructuring, on the contrary, capital leases have taken a larger share of the new leases. There is apparent inclination to increase ownership of plant assets from 1980 on, which may portend a policy of lease restructuring, or a shift in policy to increase ownership through purchase.

Case Study of Federated Department Stores

The Company leases a significant, but not substantial, portion of the real estate and personal property used in the operation of the business.

Impact on Selected Financial Ratios. The computation of financial ratios, as shown in Table 7-F-1 (page 190), compared before and after retroactive restatement, which would indicate the following results, thus:

(1) The net income to sales ratio was about unchanged, and the net income to nethworth ratio was very slightly favorable. On the contrary, the ratio of net income to total assets was slightly unfavorable.

(2) The result on current ratio was practically unchanged. The quick ratio was just about where it was before restatement, and the ratio of sales to working capital was about the same.

Table 7 - F- 1
Federated Department Stores, Inc.
Selected Key Financial Ratios

(thousands)

| | For year ended 1/28/78 | | For year ended 1/28/78* | |
|---|---|---|---|---|
| Net Income/Sales | 196,565/4,923,399 | 3.99% | 196,088/4,923,399 | 3.98% |
| Operating Income/ Interest Expense | 407,423/27,068 | 15.1 X | 414,780/35,433 | 11.7 X |
| Operating Income/ Total Assets | 407,423/2,520,168 | 16.1% | 414,780/2,632,036 | 15.8% |
| Operating Income/ Total Debt | 407,423/1,118,188 | 36.4% | 414,780/1,341,555 | 31.0% |
| Networth/Fixed Assets | 1,401,980/1,135,342 | 1.23 X | 1,390,481/1,247,210 | 1.11 X |
| Sales/Fixed Assets | 4,923,399/1,135,342 | 4.3 X | 4,923,399/1,247,210 | 4.0 X |
| Net Income/Networth | 196,565/1,401,980 | 14.0% | 196,088/1,390,481 | 14.2% |
| Income before Interest/ Interest | 411,133/27,068 | 15.2 X | 418,490/35,433 | 11.8 X |
| Sales/Working Capital | 4,923,399/595,967 | 8.26 X | 4,923,399/589,562 | 8.35 X |
| Current Ratio | 1,338,904/742,937 | 1.8 | 1,338/904,749,342 | 1.78 |
| Quick Ratio | 759,487/742,937 | 1.02 | 759,487/749,342 | 1.01 |
| Debt/Equity | 242,357/1,401,980 | 9.6% | 371,791/1,390,481 | 19.5% |
| Net Income/Total Assets | 196,565/2,520,168 | 7.8% | 196,088/2,632,036 | 7.5% |

*Restated for Lease Capitalization

Sources: Federated Department Stores, Inc., Form 10-K, Consolidated Financial Statements, 1978 and 1979

(3) The ratio of operating income to interest expense was significantly affected, which declined from 15.1 to 11.7 times. The ratio of operating income to total assets was negligibly affected, and the ratio of operating income to total debt was perceptibly changed from 36.4 to 31 percent.

(4) The ratio of networth to fixed assets had declined from 1.23 to 1.11 times, which had marginal impact. The ratio of sales to fixed assets had also deteriorated marginally from 4.3 to 4 times. The ratio of income before interest to interest was somewhat significantly affected, which dropped from 15.2 to 11.8 times.

(5) The debt to equity ratio had increased from 9.6 to 19.5 percent, which had an increase of about 103 percent after restatement.

Existence of Induced Lease Restructuring. As presented in Table 7-F-2 (page 192), capital lease payments were $255.4 million or 55.9 percent of total minimum lease payments in 1979; while operating lease payments were $201.3 million or 44.1 percent. The capital lease payments increased its amount to $263.2 million or 57.5 percent in 1980, but from thereon, the percentage share began to decline noticeably, as it dropped to 52.5 percent in 1981, and by 1984, the percentage of capital lease payments declined to 35.8 percent. The result was that it decreased 20.1 percentage point when compared to 1979. Correspondingly, operating lease payments had picked up 20.1 percentage

Table 7 - F - 2
Federated Department Stores, Inc.
Schedule of Minimum Lease Payments
(in millions)

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|
| Capital Leases | $255.4 | $263.2 | $255.1 | $238.2 | $251.7 | $243.1 |
| Operating Leases | 201.3 | 194.4 | 233.8 | 250.6 | 376.2 | 435.9 |
| | $456.7 | $457.6 | $488.9 | $488.8 | $627.9 | $679.0 |

Percentage of Capital Lease Payments to Operating Lease Payments

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|
| Capital Leases | 55.9% | 57.5% | 52.2% | 48.7% | 40.1% | 35.8% |
| Operating Leases | 44.1 | 42.5 | 47.8 | 51.3 | 59.9 | 64.2 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend of Percentages of Minimum Lease Payments
(1979 Base Year)

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|
| Capital Leases | 100% | 103.1% | 99.9% | 93.3% | 98.6% | 95.2% |
| Operating Leases | 100% | 96.6% | 116.2% | 124.5% | 186.9% | 216.5% |

Sources: Federated Department Stores, Inc., Form 10-K, Notes to Consolidated Financial Statements on Leases, 1979 to 1984

point, so that by 1984, it had amounted to $435.9 million or 64.2 percent of the total minimum lease payments.

The trend of percentages of capital lease payments, with 1979 as the base year, indicated that it moved up to 103.1 percent in 1980, but since then, it had fluctuated between 99.9 percent to 93.3 percent in the following four years. As for operating lease payment, except for the decline to 96.6 percent in 1980, it had experienced increases every year and it reached 216.5 percent in 1984. The pattern of the data indicated that lease restructuring was present for the duration under analysis.

The collaboration of lease restructuring was confirmed by the incremental pattern for the successive years starting with 1980 and ending in 1984, as shown in Table 7-F-3 (page 194). Although capital lease had increases of $7.8 and $13.5 million in 1980 and 1983 respectively, yet the overall impact had caused a net decline of $12.3 million. On the other hand, incremental operating leases, except for the decline of $6.9 million in 1980, had successive increases for the next four years, which resulted in the adding of $234.6 million to operating leases.

As shown in Table 7-F-4 (page 195), contingent rentals on capital leases were 1.6 million or 8.7 percent of total annual capital lease payments; while the annual capital lease payments were 16.8 million or 91.3 percent in 1979. The common size percentage for contingent rentals on capital

Table 7-P-3
Federated Department Stores, Inc.
Schedule of Incremental Minimum Lease Payments
(thousands)

| | Capital Leases | Incremental Capital Leases | Operating Leases | Incremental Operating Leases |
|---|---|---|---|---|
| 1980 | $263.2 | | $194.4 | |
| 1979 | 255.4 | $ 7.8 | 201.3 | ($ 6.9) |
| 1981 | $255.1 | | $233.8 | |
| 1980 | 263.2 | ($ 8.1) | 194.4 | $ 39.4 |
| 1982 | $238.2 | | $250.6 | |
| 1981 | 255.1 | ($16.9) | 233.8 | $ 16.8 |
| 1983 | $251.7 | | $376.2 | |
| 1982 | 238.2 | $13.5 | 250.6 | $125.6 |
| 1984 | $243.1 | | $435.9 | |
| 1983 | 251.7 | ($ 8.6) | 376.2 | $ 59.7 |
| | | ($12.3) | | $234.6 |

Sources: Federated Department Stores, Inc., Form 10-K, Notes to Consolidated Financial Statements on Leases, 1979 to 1984

Table 7-F-4
Federated Department Stores
Schedule of Annual Capital Lease Payments As Compared to Contingent Rentals on Capital Leases
(millions)

| | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|
| Annual Capital Lease Payments | 16.8 | 17.3 | 18.5 | 17.5 | 19.4 |
| Contingent Rentals on Capital Leases | 1.6 | 2.1 | 2.4 | 2.0 | 2.6 |
| | 18.4 | 19.4 | 20.9 | 19.5 | 22.0 |

Proportion of Annual Capital Lease Rentals to Contingent Rentals Applicable to Capital Leases

| | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|
| Annual Capital Lease Payments | 91.3% | 89.2% | 88.5% | 89.7% | 88.2% |
| Contingent Rentals on Capital Leases | 8.7% | 10.8% | 11.5% | 10.3% | 11.8% |

Trend of Percentages of Annual Capital Lease Rentals as Compared to Percentage Rental on Capital Leases

| | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|
| Annual Capital Lease Payments | 100.0% | 102.9% | 110.1% | 104.2% | 162.5% |
| Contingent Rentals On Capital Leases | 100.0% | 131.3% | 150.0% | 125.0% | 162.5% |

Sources: Federated Department Stores, Form 10-K, Notes to Consolidated Financial Statements on Leases, 1979 to 1983

leases had shown an inclination to increase its share continually, though it had dipped in 1982 to 10.3 percent. Nevertheless, it reached 2.6 million or 11.8 percent in 1983; in contrast, annual capital lease payments were 19.4 millions or 88.2 percent.

A comparison of trend of percentages indicated that contingent rentals on capital leases fluctuated in unison with the annual capital lease payments. However, it had shown a greater rate of increase on the upside, and it had a lower rate of decrease on the downside. Thus, its tendency was to increase its proportionate share of the total annual capital lease payments. The evidence indicated that, in the last four years, it had kept off the balance sheet between 10.3 to 11.8 percent of total annual capital lease payments.

Purchase Versus Lease Financing. As presented in Table 7-F-5 (page 197), owned assets were $1,416 million or 87.2 percent of total plant assets in 1977; while leased assets were $208.2 million or 12.8 percent. The common size percentage of owned assets as compared to leased assets had gradually increased its proportionate share during the successive seven years under analysis. The result was that owned assets had reached $2,916 million or 93.4 percent in 1984, which had gained 6.2 percentage point.

The trend of percentages of owned assets, with 1977 as the base year, had registered a smooth upward trend without

Table 7-F-5
Federated Department Stores, Inc.
Comparative Amount of Owned Assets to Leased Assets
(millions)

| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|---|
| Owned Assets | $1,416.0 | $1,577.9 | $1,760.7 | $1,994.9 | $2,161.3 | $2,457.0 | $2,775.1 | $2,916.0 |
| Leased Assets | 208.2 | 207.7 | 205.8 | 211.2 | 208.7 | 207.1 | 201.2 | 206.9 |
| | $1,624.2 | $1,785.6 | $1,966.5 | $2,206.1 | $2,370.0 | $2,664.1 | $2,976.3 | $3,122.9 |

Percentages of Owned Assets to Leased Assets From 1977 to 1984

| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|---|
| Owned Assets | 87.2% | 88.4% | 89.5% | 90.4% | 91.2% | 92.2% | 93.2% | 93.4% |
| Leased Assets | 12.8 | 11.6 | 10.5 | 9.6 | 8.8 | 7.8 | 6.8 | 6.6 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend of Percentages of Owned Assets as Compared to Leased Assets
(1977 Based Year)

| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|---|
| Owned Assets | 100.0% | 111.4% | 124.3% | 140.9% | 152.6% | 173.5% | 190.0% | 205.9% |
| Leased Assets | 100.0% | 99.8% | 98.8% | 101.4% | 100.2% | 99.5% | 96.6% | 99.4% |

Sources: Federated Department Stores, Inc., Form 10-K, Schedule V, 1979 to 1984

abatement, consequently, it had reached 205.9 percent in 1984. Concurrently, leased assets had registered one increase in 1980 to 101.4 percent, since then, it had a slight decline of no consequence, and had settled at 99.4 percent in 1984. There seemed to be apparent shift toward owned assets, though it was not considered significant.

An examination of the gross addition of owned assets vis-a-vis leased assets had collaborated the same tendency, as shown in Table 7-F-6 (page 199). The common size percentage of the gross addition of owned assets had fluctuated within a narrow range as it ranged from a low of 96.62 percent to a hight of 99.65 percent. The capitalization of new leases had not been a significant proportion of the total gross addition of operating assets.

The analysis of trend of percentages of gross addition of owned assets had exhibited consistent growth trend, and it reached 199.6 percent in 1983, and then, it tapered off to 134.5 percent in 1984. On the other hand, the trend of gross addition of leased assets had indicated more fluctuation, though it had kept pace with owned assets in 1980, 1983 and 1984.

Conclusion. The retroactive restatement have not impacted much on most of the financial ratios, but have caused perceptible changes in coverage ratio such as operating income to total debt, and have significant impact on debt to equity ratio.

Table 7 - F - 6
Federated Department Stores, Inc.
Schedule of Gross Addition of Plant Assets
(thousands)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | $216,171 | $238,498 | $309,869 | $304,474 | $386,843 | $431,551 | $290,740 |
| Leased Assets | 7,556 | 1,513 | 11,829 | 8,816 | 1,375 | 13,962 | 10,165 |
| | $223,727 | $240,011 | $321,698 | $313,290 | $388,218 | $445,513 | $300,905 |

Percentage of Gross Addition in Owned Assets to Leased Assets

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | 96.62% | 99.37% | 96.32% | 97.19% | 99.65% | 96.87% | 96.62% |
| Leased Assets | 4.38 | 0.63 | 3.68 | 2.81 | 0.35 | 3.13 | 4.38 |
| | 100.00% | 100.00% | 100.00% | 100.00% | 100.00% | 100.00% | 100.00% |

Trend Percentages of Gross Addition of Owned Assets As Compared to Leased Assets
(1978 Base Year)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | 100.0% | 110.3% | 143.3% | 140.8% | 179.0% | 199.6% | 134.5% |
| Leased Assets | 100.0% | 20.0% | 156.6% | 116.7% | 18.2% | 184.8% | 134.5% |

Sources: Federated Department Stores, Form 10-K, Schedule V, 1979-1984

There is conclusive evidence that lease restructuring is practiced for the duration under observation, and there is also apparent shift to greater ownership, though relatively insignificant, which is supportive of lease restructuring.

Case Study of Wal-Mart Stores, Inc.

The Company uses several devices in its leasing arrangement. It leases substantially all its stores from commercial property developer, leases with sale and leaseback arrangement, and the use of industrial revenue bond with option to purchase at the end of the lease period at nominal cost.[19]

Impact on Selected Financial Ratios. As shown in Table 7-W-1 (page 201), the impact on selected financial ratios were as followed.

(1) The ratio of net income to sales was marginally affected, while the ratio of net income to networth showed slight change. The ratio of net income to total assets had declined perceptibly from 10.6 to 8.4 percent.

(2) The ratio of operating income to interest expense was adversely affected, as it declined from 15.1 to 5.7 times, a change of about 62 percent. The ratio of operating income to total assets decreased noticeably from 17.8 to 15.8 percent; while the ratio of operating income to total debt declined significantly from 34.1 to 25.7 percent.

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[19]Wal-Mart Stores, Inc., Form 10-K, 1983, p. 5.

Table 7-W-1
Wal-Mart Stores, Inc.
Selected Key Financial Ratios

(thousands)

| | For year ended 1/31/78 | | For year ended 1/31/78* | |
|---|---|---|---|---|
| Net Income/Sales | 21,886/678,456 | 3.23% | 21,191/678,456 | 3.12% |
| Operating Income/ Interest Expense | 36,692/2,425 | 15.1 X | 39,913/6,985 | 5.7 X |
| Operating Income/ Total Assets | 36,692/206,691 | 17.8% | 39,913/251,865 | 15.8% |
| Operating Income/ Total Debt | 36,692/107,748 | 34.1% | 39,913/155,383 | 25.7% |
| Networth/Fixed Assets | 98,943/55,402 | 1.8 X | 96,482/100,550 | 0.96 X |
| Sales/Fixed Assets | 678,456/55,402 | 12.3 X | 678,456/100,550 | 6.7 X |
| Net Income/Networth | 21,886/98,943 | 22.1% | 21,191/96,482 | 22.0% |
| Income before Interest/ Interest | 44,611/2,425 | 18.4 X | 47,832/6,985 | 6.9 X |
| Sales/Working Capital | 678,456/77,903 | 8.7 X | 678,456/76,095 | 8.9 X |
| Current Ratio | 150,986/73,083 | 2.07 | 150,986/74,891 | 2.02 |
| Quick Ratio | 13,605/73,083 | 0.19 | 13,605/74,891 | 0.18 |
| Debt/Equity | 32,392/98,101 | 32.7% | 80,492/96,482 | 83.4% |
| Net Income/Total Assets | 21,886/206,691 | 10.6% | 21,191/251,865 | 8.4% |

*Restated for Lease Capitalization

Sources: Wal-Mart Stores, Inc., Form 10-K, Consolidated Balance Sheet, 1978 and 1979, Summary of Operations, 1978 and 1980

(3) The impact on the ratio of sales to working capital, the current ratio and the quick ratio were all inconsequential.

(4) The ratio of sales to fixed assets had significant deterioration from 12.3 to 6.7 times, a change of 45 percent. The ratio of networth to fixed assets also declined significantly from 1.8 to 0.96 times, a change of about 47 percent.

(5) The ratio of debt to equity experienced substantial increase from 32.7 to 83.4 percent, a change of 155 percent after full implementation of FASB 13.

Existence of Induced Lease Restructuring. As presented in Table 7-W-2 (page 203), capital lease payments were $170,633,000 or 70.4 percent of total future minimum lease payments in 1980; in contrast, operating lease payments were $71,977,000 or 29.6 percent. The capital lease payments, after increasing its percentage share to 72.8 percent in 1981, had plummeted to 44.6 percent in the subsequent two years. Thereafter, it began to move up, and the capital lease payments settled at 56.6 percent as compared to operating lease payments of 43.4 percent in 1985. Inspite of its lack of smooth trend, the changes in percentage share of capital lease payments were still substantial as it lost 13.8 percentage point in a period of five years.

A comparison of trend of percentages between capital lease payments and operating lease payments had apparently pointed toward greater increases in operating lease payments.

Table 7-W-2
Wal-Mart Stores, Inc.
Schedule of Minimum Lease Payments
(thousand)

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| Capital Leases | $170,633 | $228,319 | $328,129 | $383,993 | $ 588,276 | $ 932,363 |
| Operating Leases | 71,877 | 85,420 | 188,842 | 477,532 | 559,622 | 717,189 |
| | $242,510 | $313,739 | $516,971 | $861,525 | $1,147,898 | $1,649,552 |

Percentage of Capital Lease Payments to Operating Lease Payments

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| Capital Leases | 70.4% | 72.8% | 63.5% | 44.6% | 51.2% | 56.6% |
| Operating Leases | 29.6 | 27.2 | 36.5 | 55.4 | 48.8 | 43.4 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend of Percentages of Minimum Lease Payments (1980 Base Year)

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| Capital Leases | 100.0% | 133.8% | 192.3% | 225.0% | 344.8% | 546.4% |
| Operating Leases | 100.0% | 118.4% | 262.7% | 664.4% | 778.6% | 997.8% |

Sources: Wal-Mart Stores, Inc., Form 10-K, Notes to Consolidated Financial Statements on Leases, 1979 to 1984

It was indicated that both types were, with 1980 as the base year, showing upward trend; but the rate of increment for capital lease payments was lower in almost every year except for 1981. For operating lease payments, the rate of increase from 1982 on was substantially higher than the rate of increase for capital lease payments. It had not exerted as great an impact because it had started from a smaller absolute base. The existence of lease restructuring was suggestive, particularly, capital lease payments still lost 13.8 percentage point since 1980.

An examination of the incremental capital lease payments as compared to operating lease payments had indicated fluctuating increases, as shown in Table 7-W-3 (page 205). The ebb and flow of the annual increment still favored operating lease payments on a cumulative basis. Over the five-year period, incremental capital leases added $761,730 thousand or 54 percent of the total; while incremental operating leases added $645,312 thousand or 46 percent.

Purchase Versus Lease Financing. As shown in Table 7-W-4 (page 206), owned assets were $37,784 thousand or 45 percent of total operating assets; in contrast, leased assets were $46,125 thousand or 55 percent. The common size percentage of owned assets, as compared to leased assets, had increased its relative share for the next three years since 1977. It was 52.8 percent in 1980, and it dipped in 1980, and peaked at 59.2 percent the next year. However, the relative share of owned assets was scaled down to 53.6

Table 7-W-3
Wal-Mart Stores, Inc.
Schedule of Incremental Minimum Lease Payments
(thousands)

| | Capital Leases | Incremental Capital Leases Amount | Incremental Capital Leases Percent | Operating Leases | Incremental Operating Leases Amount | Incremental Operating Leases Percent |
|---|---|---|---|---|---|---|
| 1981 | $228,319 | | | $ 85,420 | | |
| 1980 | 170,633 | $ 57,686 | 81% | 71,877 | $ 13,543 | 19% |
| 1982 | $328,129 | | | $188,842 | | |
| 1981 | 228,319 | 99,810 | 49% | 85,420 | 103,422 | 51% |
| 1983 | $383,993 | | | $477,532 | | |
| 1982 | 328,129 | 55,864 | 16% | 188,842 | 288,690 | 84% |
| 1984 | $588,276 | | | $559,622 | | |
| 1983 | 383,993 | 204,283 | 71% | 477,532 | 82,090 | 29% |
| 1985 | $932,[illegible]03 | | | $717,189 | | |
| 1984 | 588,276 | 344,087 | 69% | 559,622 | 157,567 | 31% |
| | | $761,730 | | | $645,312 | |
| Cumulative Percentages of Capital Leases to Operating leases | | 54% | | | 46% | |

Sources: Wal-Mart Stores, Inc., Form 10-K, Notes to Consolidated Financial Statement on Leases, 1979 to 1984

Table 7-W-4
Wal-Mart Stores, Inc.
Comparative Amount of Owned Assets to Leased Assets
(thousands)

| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|---|
| Owned Assets | $ 37,784 | $ 56,860 | $ 80,198 | $122,373 | $150,483 | $245,203 | $321,483 | $419,904 |
| Leased Assets | 46,125 | 66,577 | 83,225 | 109,608 | 152,882 | 168,712 | 246,045 | 363,015 |
| | $ 83,909 | $123,437 | $163,423 | $231,981 | $303,365 | $413,915 | $567,528 | $782,919 |

Percentages of Owned Assets to Leased Assets From 1977 to 1984

| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|---|
| Owned Assets | 45.0% | 46.0% | 49.1% | 52.8% | 49.6% | 59.2% | 56.7% | 53.6% |
| Leased Assets | 55.0 | 54.0 | 50.9 | 47.2 | 50.4 | 40.8 | 43.3 | 46.4 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend of Percentages of Owned Assets as Compared to Leased Assets
(1977 Base Year)

| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|---|
| Owned Assets | 100.0% | 150.5% | 212.3% | 323.9% | 398.3% | 649.0% | 850.8% | 1111.3% |
| Leased Assets | 100.0% | 144.3% | 180.4% | 237.6% | 331.5% | 365.8% | 533.4% | 787.0% |

Sources: Wal-Mart Stores, Inc., Form 10-K, Schedule V, 1978 to 1984

percent or $419,904 in 1984. The overall impression was that there was a slight tilt in favor of owned assets, even though the trend line exhibited some fluctuations, but the gain of 8.3 percentage point over the eight years was not insignificant.

The trend of percentages for owned assets portrayed a persistent growth every year since 1977. Moreover, from 1982 to 1984, the percentages had accelerated and reached 1,111.3 percent in 1984, in comparison, leased assets were also indicating an upward trend, but the rate of increase was always lower than that of owned assets.

As presented in Table 7-W-5 (page 208), the pattern of the gross increase in owned assets as compared to leased assets had collaborated the tendency. The gross addition of owned assets had a higher annual percentage share of five of the seven years under analysis. The range was from a low of 48.3 percent in 1984 to a high of 84.8 percent in 1982.

The trend of percentage of gross addition of owned assets indicated a continual growth since 1978, and the growth had accelerated in 1981 to 1984. Moreover, the rate of increase for owned assets was always above that of leased assets except for 1984. On the other hand, the gross addition of leased assets had fluctuated greatly, though it had also picked up its pace in 1983 and reaching 575.9 percent in 1984.

<u>Conclusion</u>. The retroactive restatement has brought

Table 7-W-5
Wal-Mart Stores, Inc.
Schedule of Gross Addition of Plant Assets

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | $19,843 | $28,675 | $58,949 | $48,891 | $ 99,124 | $ 85,589 | $110,454 |
| Leased Assets | 20,526 | 13,965 | 30,317 | 42,947 | 17,824 | 80,781 | 118,212 |
| | $40,369 | $42,640 | $89,266 | $91,838 | $116,948 | $166,370 | $228,666 |

Percentage of Gross Addition in Owned Assets to Leased Assets

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | 49.0% | 67.2% | 66.0% | 53.2% | 84.8% | 51.4% | 48.3% |
| Leased Assets | 51.0 | 32.8 | 34.0 | 46.8 | 15.2 | 48.6 | 51.7 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend Percentages of Gross Addition of Owned Assets as Compared to Leased Assets
(1978 Base Year)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| Owned Assets | 100.0% | 144.5% | 297% | 246.4% | 499.8% | 431.3% | 556.6% |
| Leased Assets | 100.0% | 68.0% | 147.7% | 209.2% | 86.8% | 393.5% | 575.9% |

Sources: Wal-Mart Stores, Inc., Form 10-K, Schedule V, 1979 to 1984

about significant changes in some of the financial ratios, in particular, it has brought about substantial changes in the debt to equity ratio.

The existence of lease restructuring is suggestive though not conclusive. The tilt toward owned assets is indicated, even though it has some fluctuations in the pattern.

Case Study of S. E. Nichols Inc.

> The Company conducts its operations primarily from leased premises under leases which expire at various dates to 2010. In general, the retail stores leases include renewal options, usually for additional rentals based sales plus certain tax and maintenance costs.[20]

Impact on Selected Financial Ratios. As shown in Table 7-N-1 (page 210), the following result of retroactive restatement under FASB No. 13 was indicated, thus:

(1) The ratio of net income to sales improved slightly from 1.07 to 1.15 percent, a favorable increase of about 7 percent; while the ratio of net income to networth had also improved marginally from 12.4 to 13.7 percent, a change of about 10 percent. The ratio of net income to total assets had worsened slightly from 3.97 to 3.77 percent, a change of about 5 percent.

(2) The ratio of operating income to interest expense had a perceptible decline of 10 percent as it dropped from 2.1 to 1.9 times; while the ratio of operating income to total assets had improved noticeably from 5.4 percent to

[20] S. E. Nichols Inc., Form 10-K, 1983, p. 14.

Table 7-N-1
S. E. Nichols Inc. and Subsidiaries
Selected Key Financial Ratios

(thousands)

| | For year ended 1/31/78 | | For year ended 1/31/78* | |
|---|---|---|---|---|
| Net Income/Sales | 2,115/197,603 | 1.07% | 2265/197,603 | 1.15% |
| Operating Income/ Interest Expense | 2,885/1,376 | 2.1 X | 3,953/2,136 | 1.9 X |
| Operating Income/ Total Assets | 2,885/53,178 | 5.4% | 3,953/60,130 | 6.6% |
| Operating Income/ Total Debt | 2,885/36,156 | 7.9% | 3,953/43,607 | 9.1% |
| Networth/Fixed Assets | 17,022/4,024 | 4.2 X | 16,523/10,621 | 1.6 X |
| Sales/Fixed Assets | 197,603/4,024 | 49 X | 197,603/10,621 | 18.6 X |
| Net Income/Networth | 2,115/17,022 | 12.4% | 2,265/16,523 | 13.7% |
| Income before Interest/ Interest | 5,584/1,376 | 4.1 X | 6,651/2,136 | 3.1 X |
| Sales/Working Capital | 197,603/23,058 | 8.6 X | 197,603/21,792 | 9.1 X |
| Current Ratio | 48,928/25,870 | 1.89 | 48,928/27,136 | 1.80 |
| Quick Ratio | 7,323/25,870 | 0.28 | 7,322/27,136 | 0.27 |
| Debt/Equity | 10,122/17,022 | 59.5% | 16,471/16523 | 99.7% |
| Net Income/Total Assets | 2,115/53,178 | 3.97% | 2,265/60,130 | 3.77% |

*Restated for Lease Capitalization

Sources: S. E. Nichols Inc. and Subsidiaries, Form 10-K, Consolidated Balance Sheets and Statements of Income, 1978 and 1979

6.6 percent, a change of about 22 percent. The ratio of operating income to total debt had worsened from 7.9 to 9.1 percent, a change of about 15 percent.

(3) The ratio of income before interest to interest had worsened from 4.1 to 3.1 percent, a change of about 24 percent. The turnover ratio of sales to fixed assets showed a substantial decline of from 49 to 18.6 times, a change of 62 percent; while the ratio of networth to fixed assets had deteriorated from 4.2 to 1.6 times, a significant change of 62 percent.

(4) The ratio of sales to working capital improved marginally from 8.6 to 9.1 percent, a change of about 6 percent; while the current ratio and the quick ratio had slight negative impact.

(5) The debt to equity ratio had been adversely affected as it increased from 59.5 to 99.7 percent, a change of 67 percent.

Existence of Induced Lease Restructuring. As shown in Table 7-N-2 (page 212), capital lease payments were $9,123.6 thousand or 6.6 percent of total minimum lease payments in 1980; while operating lease payments were $129,055.1 thousand or 93.4 percent. The common size percentage indicated that capital lease payments had been gradually reduced as it took a smaller share each succeeding year; so that, by 1984, capital lease payments were only 2.8 percent or $3,681.7 thousand. Conversely, operating lease payments were 97.2 percent or $128,518.3 thousand.

Table 7-N-2
S. E. Nichols and Subsidiaries
Schedule of Minimum Lease Payments
(in thousands)

| | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|
| Capital Leases | $ 9,123.6 | $ 8,382.1 | $ 7,084.7 | $ 5,383.6 | $ 3,681.7 |
| Operating Leases | 129,055.1 | 124,927.3 | 136,623.0 | 132,122.1 | 128,518.3 |
| | $138,178.7 | $133,309.4 | $143,707.7 | $137,505.7 | $132,200.0 |

Percentage of Capital Lease Payments to Operating Lease Payments

| | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|
| Capital Leases | 6.6% | 6.3% | 4.9% | 3.9% | 2.8% |
| Operating Leases | 93.4% | 93.7 | 95.1 | 96.1 | 97.2 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend of Percentages of Minimum Lease Payments
(1980 base year)

| | 1980 | 1981 | 1982 | 1983 | 1984 | Cumulative 1981-84 |
|---|---|---|---|---|---|---|
| Capital Leases | 100.0% | 91.9% | 77.7% | 59.0% | 40.4% | (131%) |
| Operating Leases | 100.0% | 96.8% | 105.9% | 102.4% | 99.6% | 4.7% |

Sources: S. E. Nichols and Subsidiaries, Form 10-K, Notes to Consolidated Financial Statements on Leases, 1979 to 1983

The trend of percentage on capital lease payments portrayed a diminishing trend, consequently, it was only 40.4 percent by 1984. Although operating lease payments had also moved downward, the decline was insignificant. Besides, it had experienced an increase to 105.9 percent in 1982, and was almost the same level as the base year of 1980. The pattern indicated the existence of lease restructuring.

An examination of the incremental capital lease payments confirmed the pattern of lease restructuring, as indicated in Table 7-N-3 (page 214). There was no increment for capital leases from 1981 to 1984, rather, it experienced a proportionately larger decline when compared to its relative amount. Concurrently, operating leases had also negative increment in three out of the four years, but it was partially offset by a substantial increment in 1982 of $11,695.7 thousand. Therefore, over the four-year span, capital lease payments had a cumulative decrease of $5,441.9 thousand or 81 percent; while operating leases, the decline was only $536.8 thousand or 9 percent.

<u>Purchase Versus Lease Financing</u>. As shown in Table 7-N-4 (page 216), owned assets were $3,589 thousand or 17.7 percent of total operating assets in 1977; while leased assets were $16,688 thousand or 82.3 percent. The common size percentage for owned assets took an increasing proportion without interruption in the succeeding six years. By 1983, owned assets were $16,454 thousand or 48 percent;

Table 7 - N - 3
S. E. Nichols Inc. and Subsidiaries
Schedule of Incremental Minimum Lease Payments

(thousands)

| | Capital Leases | Incremental Capital Leases | Operating Leases | Incremental Operating Leases |
|---|---|---|---|---|
| 1981 | $8,382.1 | | $124,927.3 | |
| 1980 | 9,123.6 | ($ 741.5) | 129,055.1 | ($ 4,127.8) |
| 1982 | $7,084.7 | | $136,623.0 | |
| 1981 | 8,382.1 | ($1,297.4) | 124,927.3 | $11,695.7 |
| 1983 | $5,383.6 | | $132,122.1 | |
| 1982 | 7,084.7 | ($1,701.1) | 136,623.0 | ($ 4,500.9) |
| 1984 | $3,681.7 | | $128,518.3 | |
| 1983 | 5,383.6 | ($1,701.9) | 132,122.1 | ($ 3,603.8) |
| | | ($5,441.9) | | ($ 536.8) |
| Cumulative Percentages of Capital Lease to Operating Lease | | (81%) | | ( 9%) |

Sources: S. E, Nichols Inc. and Subsidiaries, Form 10-K, Notes to Consolidated Financial Statements on Leases, 1979 to 1983

while leased assets were $17,872 thousand or 52 percent. The effect was that owned assets had gained 30.3 percentage point when compared to 1977.

With 1977 as the base year, the trend of percentages of owned assets had experienced continual increase every year, so that by 1983, it was about four and one-half times since 1977 or 458.5 percent. Concurrently, leased assets had a slight increase in 1980 and 1981, and it reached 107.1 percent without any further increase since 1981. The shift toward more ownership of operating assets was patently unmistakable, which was due to the lack of capitalization of new leases.

The evidence was collaborated by gross addition of plant assets between owning and leasing, as shown in Table 7-N-5 (page 217). Gross addition by owned assets was proportionately larger year by year from 1978 to 1981, and was responsible for all the addition in 1982 and 1983.

With 1978 as the base year, gross addition by owned assets had shown accelerated increase and had peaked at 894 percent in 1981. However, it had declined to 274 percent in 1983. Conversely, gross addition by leased assets indicated substantial reduction for the three years following 1978, and there were no capitalization of new leases thereafter.

<u>Conclusion</u>. The full implementation under FASB No. 13 has brought about perceptible changes in the financial ratios, even though a substantial portion of the leases did not come

Table 7-N-4
S. E. Nichols and Subsidiaries
Comparative Amount of Owned Assets to Leased Assets
(thousands)

| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|---|
| Owned Assets | $ 3,589 | $ 5,410 | $ 6,360 | $ 9,486 | $13,455 | $15,926 | $16,454 |
| Leased Assets | 16,688 | 16,050 | 16,630 | 17,446 | 17,872 | 17,872 | 17,872 |
| | $20,277 | $21,466 | $22,990 | $26,932 | $31,371 | $33,798 | $34,326 |

Percentages of Owned Assets to Leased Assets From 1978 to 1983

| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|---|
| Owned Assets | 17.7% | 25.2% | 27.7% | 35.2% | 42.9% | 47.1% | 48.0% |
| Leased Assets | 82.3 | 74.8 | 72.3 | 64.8 | 57.1 | 52.9 | 52.0 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Trend of Percentages of Owned Assets as Compared to Leased Assets
(1977 Base Year)

| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|---|
| Owned Assets | 100.0% | 150.7% | 177.2% | 264.3% | 374.9% | 443.7% | 458.5% |
| Leased Assets | 100.0% | 96.2% | 99.7% | 104.5% | 107.1% | 107.1% | 107.1% |

Sources: S. E. Nichols, Form 10-K, Schedule V and Notes to Consolidated Financial Statements 1978 to 1983

Table 7 - N- 5
S. E. Nichols and Subsidiaries
Schedule of Gross Addition of Plant Assets
(thousands)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|
| Owned Assets | $ 949 | $1,565 | $3,127 | $4,013 | $2,428 | $1,230 |
| Leased Assets | 1,158 | 575 | 816 | 426 | 0 | 0 |
| | $2,107 | $2,140 | $3,943 | $4,439 | $2,428 | $1,230 |

Percentage of Gross Addition in Owned Assets to Leased Assets

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|
| Owned Assets | 45% | 73% | 79% | 90% | 100% | 100% |
| Leased Assets | 55 | 27 | 21 | 10 | -- | -- |
| | 100% | 100% | 100% | 100% | 100% | 100% |

Trend Percentages of Gross Addition of Owned Assets as Compared to Leased Assets

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | Cumulativ 1979-83 |
|---|---|---|---|---|---|---|---|
| Owned Assets | 100% | 349% | 696% | 894% | 541% | 274% | 2,254% |
| Leased Assets | 100% | 49% | 70% | 37% | -- | -- | ( 344%) |

Sources: S. E. Nichols and Subsidiaries, Form 10-K, Schedule V, Consolidated Statements of Changes in Financial Position, and Notes on Leases, 1978 to 1983

under the criteria of capitalization. It has minimal impact on measures of profitability, but it has significant impact on turnover ratios, and substantial impact on debt to equity ratio.

There is conclusive evidence that accounting induced lease restructuring is an on-going process, and there is also an apparent shift toward more owned assets which is caused by the lack of capitalization of new leases.

CHAPTER VI

# CONCLUSION

## Results of the Study

The retroactive restatement under FASB Statement No. 13 created, on the aggregate, perceptible if not significant changes in many of the financial ratios. The impact is even more muddled because of the existence of lease restructuring in substantial number of retailers under study. Moreover, it has also changed other ratios significantly, in particular, the most noticeable ones are the ratio of sales to fixed assets and, operating income to interest expense. It has minimal impact on measures of profitability, the current ratio, the quick ratio, and the sales to working capital ratio. Its substantial impact is, of course, on the ratio of debt to equity.

The trend analysis confirmed the existence of lease restructuring in the overwhelming majority of the retailers under scrutiny. Of the 15 retailers, only two companies, Almy Stores, Inc. and SCOA Industries Inc. have not exhibited lease restructuring. Associated Dry Goods Corporation is still suggestive of some evidence of lease restructuring, even though it has been masked by the policy of major acquisition. The other 12 retailers, in

the writer's observation, have exhibited conclusively lease restructuring characteristics, with the exception of two which are suggestive. In any case, the trend analysis of each of the 12 retailers has indicated the shift away from capital leases and into operating leases.

The corollary impact of lease restructuring is the shift to greater ownership of operating assets. In addition, comparison between the proportion of owned assets vis-a-vis leased assets have provided, in a sense, behind the scene lease restructuring since the requirements for lease capitalization and the indentification of capital lease from operating lease were given a transition period prior to implementation. With the probable loss of some off balance sheet benefit, the analysis seems to point toward apparent increase in owned assets as compared to leased assets in the great majority of cases, but the paradox is due primarily to the lack of capitalization of new leases.

Recommendations

Replication of the existence of lease restructuring may be extended to other forms of lease-oriented retailers such as grocery chains and airlines.

Further, the behavior of lease restructuring may be correlated with the financial structure of the company.

Another possible topic of research is to relate the behavior of lease restructuring as part of the historical phase of attempting to narrow alternative methods of

presenting essentially similar data, or an attempt to circumscribe the notion of management prerogatives in the area of external reporting.

In so far as policy recommendation, the writer believes the Board has reached an impasse and should require capitalization of all leases or none at all. Conceptually, leasing classification should not limit and hamper lease capitalization objective, and should not be cluttered by the timing of revenue recognition. The implication is that FASB Statement No. 13 should be scraped because the conceptual distinction between capital and operating lease is artificial and convoluted, creating its own maze with self-defeating rules.

## APPENDIX A

The following 15 Retailers are the object of this study of compliance with FASB Statement No. 13, thus:

1. Almy Stores, Inc.
2. Ames Department Stores
3. Associated Dry Goods Corporation
4. Federated Department Stores
5. Gaylord National Corporation
6. Grand Central, Inc.
7. Jamesway Corporation
8. K Mart Corporation
9. Mercantile Stores, Inc.
10. R. H. Macy & Co., Inc.
11. Rose's Stores, Inc.
12. S. E. Nichols, Inc.
13. SCOA Industries, Inc.
14. Wal-Mart Stores, Inc.
15. Zayre Corporation

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