lessors in sales-type and direct financing leases is required. A "permanent" decline in such value necessitates revised accounting for the lease; no adjustments are to be made for increases in estimated residual value.

- When land and building are leased together, the land may be included with the buildings in the lease classification computation unless its fair value exceeds 25 percent of the combined fair value of the leased land and buildings.

The standard's requirements for the accounting and reporting for leveraged leases are essentially the same as those of the revised exposure draft, except that the classification criteria for leveraged leases no longer excludes the "90 percent recovery" test and the standard includes a provision that the investment tax credit must be treated as a part of the lessor's investment in the leveraged lease.

The standard retains the compromise transitional stance that characterized the revised exposure draft. The initial (1975) exposure draft had, in effect, placed all existing leases under a "grandfather clause"; capitalization would not have been required. It appears that adverse reaction to this provision by many respondents influenced the FASB to revise its transition plan to incorporate retroactive as well as prospective application. The procedure adopted by the Board makes the standard effective for all leases entered into on or after January 1, 1977, and requires retroactive application for financial statements after December 31, 1980. The Board cited problems relating to data accumulation and loan indenture provisions as reasons for allowing the four-year transition period. Various disclosures are required for existing lease agreements during this transition period that should serve to communicate much of the same information as would have resulted from immediate retroactive application.

Prospective Impact of FASB Statement No. 13

FASB No. 13 represents the culmination of a long, controversial debate among accountants and members of the financial community. In large measure, it also represents a victory for the advocates of balance sheet capitalization and a setback for its opponents. As reported previously, it appears that a large majority of financial analysts are in the former group and a large majority of corporate controllers are in the latter.[2]

It remains to be seen if the standard is a victory for sound financial reporting. The reaction in the capital markets to the new disclosures will be watched with interest to see if the dire predictions of opponents of lease capitalization come to pass. *Careful evaluation of the impact of FASB Statement No. 13 should tell us a great deal about the impact of accounting techniques on economic realities.* At this juncture, the financial media is generally shrugging off the possibilities of any significant dislocations resulting from the new accounting and reporting requirements relating to leasing. Nonetheless, lessees should move quickly to determine the impact of the standard on existing debt agreements, covenants or bond indentures.

It is the authors' view that FASB Statement No. 13 constitutes a significant advance in accounting and reporting for leases, even though it is likely that a number of implementation problems will arise in application. The problems of implementation were summarized in Arthur Andersen & Co.'s *Executive News Briefs* (December 1976) as follows: "The objective of achieving symmetry in accounting between lessees and lessors will probably be frustrated in many cases, partly because lessees and lessors will use different (sometimes significantly different) rates of interest in determining the present value of the minimum lease rentals, and partly because lessors are likely to enter into contractual arrangements with third parties for all or a portion of the residual values associated with leased property. On the other hand, if lease arrangements continue to have the attributes of those leases presently in existence, many lessees will find it necessary to account for leasing arrangements as assets and liabilities." As stated in APB Statement No. 4, financial accounting should emphasize the economic substance of events and not their legal form. In Raymond Chambers' term, an accounting system should be "isomorphic with the system of actual events which impinge directly on an entity," just as a map should correspond to the terrain it depicts.[3] This basic principle should take precedence over expressed concerns that reported realities may be detrimental to the interests of affected firms. In the case of leasing, such concerns are probably unfounded; it is unlikely that the highly sophisticated capital markets of today are deceived by "off-the-balance-sheet financing." What the new leasing standard accomplishes is to make relevant information concerning financing realities available to all financial statement users on an equitable basis.

Related Move on Internal Control by AudSEC

Excerpt from *News Summary* (Main Lafrentz & Co.), March 1977.

The AICPA's Auditing Standards Executive Committee, too, has addressed the issue of internal accounting control. In a recently proposed statement on auditing standards ("Required Communication of Material Weaknesses in Internal Accounting Control," which was issued for comment), AudSEC proposes the following:

> When any material weaknesses come to the independent auditor's attention in the course of his examination, and such material weaknesses have not been corrected during the period of the examination, the auditor would be required to report these to senior management, and to the Board of Directors or the Audit Committee. Preferably, the auditor should communicate in writing.

Note that the proposed standard does not call for the auditor to report on the *adequacy* of the sys-

[2] *Ibid.*, p. 36.

[3] Raymond J. Chambers, *Accounting, Evaluation and Economic Behavior*, Prentice-Hall, 1966, pp. 126–127.

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tem of internal control (although this matter is presently under the Committee's consideration).

By and large, we believe that both the SEC and the AudSEC internal control proposals represent a positive step toward greater credibility in financial reporting. Increased requirements always have a somewhat onerous connotation. But, in our view, it is better that these requirements come by the way of AudSEC or the SEC than through Congressional action.

Flowchart of Accounting for Leases—Lessee

By Dr. Bill D. Jarnagin and Dr. Jon A. Booker, University of Tulsa.

Prior to January 1, 1977, APB Opinion Nos. 5 and 31 were used in accounting for leases by lessees. The lessee could account for the transaction as a capitalized or noncapitalized lease depending on the lease agreement. If a lease agreement met certain conditions, an asset or liability was established, valued at the present value of the future rental payments. The asset was amortized over the life of the lease using the interest method.

If the lease was treated as a noncapitalized lease, the periodic lease payments were charged against income. Even with these specific rules, inconsistencies in accounting for leases remained.

To eliminate the inconsistencies, and to provide definitive guidance, FASB No. 13 established new and more elaborate rules to handle accounting for leases by lessees.

This article presents a flowchart demonstrating the applications of FASB No. 13.

Following is a hypothetical lease situation with Table 1 presenting its solution. The flowchart, presented in Figure 1, is used to depict the major decisions incorporated in FASB No. 13 relating to lessees, along with the accounting implications that follow from each decision.

Lease Assumptions

1. A five-year noncancellable lease.
2. Annual advance lease payments of $32,000 ($2,000 represents property taxes) are required.
3. The appropriate discount rate is 8 percent.
4. Leased property has a fair value of $140,000 and a seven-year estimated economic life.
5. Ownership of the property does not transfer to the lessee at the end of the lease.
6. The lease does not contain a bargain purchase option.

Capital vs *Operating Lease Decision*

The first major decision reflected in the flowchart is determining if the lease is to be classified as a capital or operating lease. If the

TABLE 1

Solution to Capital Lease Assumptions

A. Calculation of minimum lease payment:

$32,000 − $2,000[1] = $30,000 × 4.312[2] = $129,360

B. Computation of interest for capital lease:

	Year	*Annual Rental Payment*	*Annual Interest Expense*	*Reduction in Lease Obligation*	*Present Value of Lease at End of Year*
Initial Value					$129,360
	1	$30,000	7,950[3]	$22,050[4]	107,310[5]
	2	30,000	6,180	23,820	83,490
	3	30,000	4,290	25,710	57,780
	4	30,000	2,220	27,780	30,000
	5	30,000	-0-	30,000	-0-
		$150,000	$20,640	$129,360	

C. Recorded expenses for capital lease

	Recorded Expenses					
Year	*Amortization*[6]	*Interest*	*Taxes*	*Total*	*Lease Payments*	*Difference*
1	$25,872	$7,950	$2,000	$35,822	$32,000	$3,822
2	25,872	6,180	2,000	34,052	32,000	2,052
3	25,872	4,290	2,000	32,162	32,000	162
4	25,872	2,220	2,000	30,092	32,000	(1,908)
5	25,872	-0-	2,000	27,872	32,000	(4,128)
	$129,360	$20,640	$10,000	$160,000	$160,000	-0-

[1] Property taxes.
[2] Present value factor for an annuity due for five periods at 8%.
[3] (129,360 − 30,000) × 8% = $7,950.
[4] $30,000 − $7,950 = $22,050.
[5] $129,360 − $22,050 = $107,310.
[6] Assuming that straight-line depreciation is used for owned assets ($129,360/5 years).

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