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In these opening remarks I will review the work of the Accounting Principles Board on accounting for leases and attempt a forecast of the Board's timetable on the project.

Some of those who took part in earlier discussions on accounting for leases got the impression that the APB was reopening the entire subject. The record clearly indicates the opposite. The present project has a much more limited objective. This scope limitation was especially emphasized in the notice sent those interested in attending the recent public hearing on leases.

During its 12 years of existence, the Accounting Principles Board has gradually improved methods of accounting for leases. On several occasions it has considered the manner of reporting leases, both by lessees and lessors.

Accounting Research Study 4, Reporting of Leases in Financial Statements by Professor John Myers, was one of the first formal studies authorized by the Board. Soon after completion of the study, the Board began deliberation of the subject. It reached agreement on accounting for leases by lessees in mid-1964 with APB Opinion 5 and on accounting by lessors in mid-1966 with Opinion 7.

In the publication of the Opinion for lessors, however, the Board noted a possible inconsistency between the guidelines in the two Opinions; and efforts were undertaken to reconcile this. During the past two years, committees of the Board assigned to the lease project have carried out informal research and sought the ideas and suggestions of organizations and individuals from industry and elsewhere.

In Opinion 5 the Board concluded that leases, which are in substance acquisitions of property, should be recognized in financial statements as assets and obligations similar to debt. However, the criteria in Opinion 5 that identify a lease in substance as an acquisition were not clearly defined. Many leases that appeared to be installment purchases were not recorded as purchased property under Opinion 5.

The Board at this time does not intend to extend the concept of a leased asset as an installment purchase. Rather, it seeks only to improve the application of the concepts outlined in Opinion 5 through clearer definitions and guidelines.

As for Opinion 7, the Board concluded that the financing method should be restricted to financing leases. However, it was found that the guidelines for identifying a financing lease were too broadly defined. Many leases that seemed to be operating leases were nevertheless accounted for by the financing method. So the Board now hopes to define more clearly those provisions of a lease transaction that distinguish a financing lease from an operating lease.

The Board's attempt to clarify the provisions of Opinions 5 and 7 is related to the question of how interdependent the accounting by lessees and lessors should be. Stated more directly, should a financing lease of a lessor be reported as an acquisition of assets by a lessee?

The Board will not conclude that the lessee's accounting method should depend on how the lessor accounts for the transaction or, conversely, that the method of recording the transaction by the lessee should control the manner of accounting by the lessor.

But the precedence for consistency in accounting between the parties involved in a transaction is clearly established. The degree of consistency in other areas of accounting is controlled by the consistency of criteria established for the various parties. That concept may turn out to be appropriate in accounting for leases. Conceptually, then, the question is: Should the same standards, criteria, or rules be used for determining that a lessor should account for a lease by the financing method and a lessee should account for the same lease in substance as an installment purchase?

Other problems that the Board hopes to cover in a new lease Opinion are --

- What factors should be considered in evaluating a lease transaction that involves related parties?

- Should a gain or loss on a sale-and-leaseback transaction always be deferred?
- What information relating to leases should be disclosed in the notes accompanying the financial statements?

Also under study is the appropriate income statement treatment of capitalized leases. A typical lease with equal annual payments ordinarily would result in rent expense of the same equal annual amounts. Questions are being raised as to whether the combination of depreciation and interest expense that would arise through capitalization should also be made to result in equal annual amounts. Purchase of the same asset would ordinarily result in depreciation in equal annual amounts and interest expense in declining amounts, thus resulting in a combined expense that is high in earlier years of use of the asset and declining throughout its life.

In October the Board sought further the views of industry and government on the subject by holding a public hearing at which participants filed written position papers, made oral presentations, and answered questions from Board members. About 165 people attended and 15 of them presented oral statements. The hearing succeeded in providing additional insight, particularly for the participants, on the peculiar problems of lease accounting.

As for timing, a new Opinion on accounting for leases could be exposed by April 1972 for comment by interested persons in industry, education, government, and public accounting. If so, the Board might be able to publish a final Opinion late next summer. An APB committee is now preparing an initial draft for further Board consideration.

In the November issue of The Journal of Accountancy, the AICPA staff, with the approval of the Chairman of the APB and myself, published an accounting interpretation dealing with reporting of leases by manufacturer or dealer lessors. Opinion 7 described the operating and financing methods of accounting for lease revenues by lessors and described conditions under which each method is appropriate. That Opinion also specified that a manufacturer could record a manufacturing profit upon entering into a financing lease, provided certain conditions were met. Practice under this Opinion raised questions as to the adequacy of criteria for this purpose. Some lessors had recorded manufacturing profit upon entering into a lease for as short a period as one year. Therefore, the interpretation was issued to clarify the circumstances under which the financing method of accounting would be appropriate. It emphasizes again that the essential character of a financing lease is that future risks, rewards and costs associated with the lease and its property are substantially transferred to the lessee.

The staff interpretation will provide guidance to the accounting profession during the closing months of 1971.

Newspaper articles we have seen during the past year made it clear that a timely effort had to be made to guide accountants in applying the lease financing criteria of Opinion 7, as has now been done.

Accounting for leases continues to be controversial, with opposition to change coming from both lessors and lessees. Some say that lease financing has provided use of equipment not available through equity or debt, and capitalizing leases would eliminate this source of capital. Others say lease capitalization would make it impossible for airlines and railroads to obtain equipment. A manufacturer-lessor says that a change in its accounting for leases, which would prohibit reporting a sale upon entering into a lease, would result in a negative stockholders' equity. Still others express concern that accounting changes for financial reporting may jeopardize the considerable tax advantages enjoyed by lessor-investors.

On the other hand, strong support for tightened accounting guidelines for lease transactions has come from the SEC and security analysts.

During the coming year the APB will further clarify its thinking on accounting for leases. In doing so it will continue to seek and welcome constructive, well-reasoned recommendations from interested parties.

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