

BLACKWELL

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OF ACCOUNTING

(影 印 版)

布莱克韦尔
会计学百科辞典

EDITED BY
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Edited by A. Rashad Abdel-khalik

University of Florida



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Foreword

It is a privilege to introduce this book and its contributors to a great new readership – the people of China.

In a transforming economy the challenge is to find new ways of managing and organising that harmonise with national culture. In meeting this challenge the most important tools are ideas and knowledge. This book is a toolbox containing a wealth of powerful and influential ideas. This is knowledge that has been influential in shaping how we think about what goes on in organisations, and which has stood the test of time. You will also find here ideas that are emerging as signposts for the future development of organisations and management. One major barrier to adopting this knowledge has been its restriction to the readers of specialist journals and books. This has led, over the years, to a great proliferation of specialist concepts and terminology – impenetrable jargon to the nonspecialist, making it unnecessarily difficult for lay readers to understand and get full value from the insights of scholars. The present volume solves this problem by providing a systematic inventory of key concepts, with clear explanations of them by a collection of the world's experts.

In a transforming economy like China, it is my hope that a book like this will be immensely valuable to

- a) scholars and students who want a source book for key concepts, references to further reading, and linkages with other topics [cross references are indicated by words in SMALL CAPITALS]
- b) business leaders and professionals who want clear explanations of management and organisational terms, and ideas about how to apply them in business settings
- c) broad-minded and intelligent general readers who want quick digests of the essential academic knowledge on a given topic.

There are many ways of using a book like this. The cross-indexing system allows you to explore at will. If you pick a theme, you can follow a path of interconnected ideas through the main areas of business and management. For readers in China, as a region in the

midst of radical economic and social change, so of these might be as follows:

1. **Management style.** What kinds of leadership seem to work best and why? What are the preconditions for effective authority?

[see, for example, entries on: CEOS; DELEGATION; ENTREPRENEURSHIP; LEADERSHIP, MANAGERIAL BEHAVIOR; MANAGEMENT STYLE; POWER; RISK-TAKING; STRATEGIC MANAGEMENT; SUCCESSION PLANNING; SUPERVISION; TEAMBUILDING; TOP MANAGEMENT TEAMS; TURNAROUND MANAGEMENT; WOMAN MANAGERS]

2. **Organisational design.** How do you get the best out of people through how you organise tasks, communication networks and decision-making systems?

[see, for example, entries on: BUREAUCRACY; COMMUNICATION; DECENTRALIZATION; FAMILY FIRMS; INFORMATION TECHNOLOGY; JOB DESIGN; MATRIX ORGANIZATION; MULTINATIONAL CORPORATIONS; ORGANIZATION DEVELOPMENT; ORGANIZATIONAL DESIGN; ORGANIZATIONAL EFFECTIVENESS; RESTRUCTURING; SOCIOTECHNICAL THEORY; TECHNOLOGY]

3. **Human Resource systems.** What is current accepted wisdom about the effectiveness of key practices and processes? How do you make them work best?

[see, for example, entries on: ASSESSMENT CENTRES; DISABILITY; HOURS OF WORK; HUMAN RESOURCE STRATEGY; JOB ANALYSIS; MANAGEMENT DEVELOPMENT; NEGOTIATION; PARTICIPATION; PAYMENT SYSTEMS; PERFORMANCE APPRAISAL; PSYCHOLOGICAL CONTRACT; RACE; RECRUITMENT; SAFETY; SELECTION METHODS; TRAINING]

4. **Individual performance and adaptation.** Under conditions of change, which methods work best and how do people's motives translate into productive action?

[see, for example, entries on: ABSENTEEISM; CHANGE METHODS; COMPETENCIES; CREATIVITY; ERRORS; GOAL SETTING; INTERPERSONAL SKILLS; MENTAL HEALTH; MOTIVATION; PERFORMANCE, INDIVIDUAL; PERSONALITY; PRODUCTIVITY; QUALITY CIRCLES; STRESS]

5. **The cultural context for management.** How can we best understand and analyse how values and practices adapt to different national and industrial contexts?

[see, for example, entries on: CRISES; CULTURE; DOWNSIZING; EXPATRIATES; GOVERNMENT AND BUSINESS; INTERNATIONAL MANAGEMENT; MANAGEMENT OF DIVERSI-

TY; ORGANIZATIONAL CULTURE; POPULATION ECOLOGY; PRIVATIZATION; TECHNOLOGY TRANSFER]

6. **Strategic decision making.** What are the hazards and opportunities for how business plans are formulated? How can groups and teams be used to best effect? what biases distort judgement?

[see, for example , entries on: BEHAVIORAL DECISION THEORY; CONSULTANCY INTERVENTION METHODS; DECISION MAKING; DIVERSIFICATION; GROUP DECISION MAKING; INNOVATION; MERGERS & ACQUISITIONS; NETWORKING TOTAL QUALITY MANAGEMENT]

7. **Ethics.** What do we know about how principled business can be achieved in demanding market environments? How can employees be encouraged to act as good corporate “citizens” and businesses as socially responsible forces?

[see, for example, entries on: BUSINESS ETHICS; CONFLICT, CORPORATE SOCIAL PERFORMANCE; DISCRIMINATION; JUSTICE; LEARNING ORGANISATION; MORAL DEVELOPMENT; ORGANIZATIONAL CITIZENSHIP; POLITICS; VALUES]

This list is not exhaustive. There are almost as many ways of using this book as there are entries. For this reason it is my hope and belief that Chinese readers will find their own special interests served by its rich contents.

Nigel Nicholson

London Business School

September 1999

— Preface —

In any group or organizational setting, having access to information facilitates the process of management and control. Although it is not the only source of information, accounting has been the basic conventional business activity that drives the formal information structure within organizations. Measurement and evaluation of performance transcend all business activities from the level of individual responsibility, to divisions, to the entire firm. Many of these methods appeal to some theoretical reasoning, while others are governed by pragmatic criteria. Whereas the criteria for revenue recognition have withstood the test of time, novel and new transactions create new challenges for which no theoretical support exists. In those situations, professional accounting rule-making bodies promulgate stop-gap rules that would help serve short-term needs. Accounting for new financial instruments, swaps, and derivatives has come to the forefront and is the most formidable task facing accountants in the late 1990s.

In past years, accounting for transactions such as debt defeasance was considered too complex for the traditional accounting model to handle. But in more recent times, the ingenuity of capital market participants in creating new financial instruments for which no known accounting treatment exists continue to pose challenges to accountants. Even some familiar types of executory contracts such as leases continue to frustrate rule makers as they vacillate between well specified criteria that can be evaded in writing lease contracts and professional judgments that allow more freedom for accountants. Accounting for leases join other executory contracts such as pensions and post retirement benefits in their being measured by accounting standards that could end up providing more garbled than precise information. Many users of financial information do not have a reasonable appreciation for the degree of latitude allowed accountants in the measurement and reporting of financial information. Indeed managers are often assumed to use the accounting flexibility allowed them to manage earnings. The complexity of the business has created diversity within and among different nations. Accounting for goodwill and foreign currency translations are good examples of this diversity. Because of the high degree of judgment involved in the measurement and reporting of information, international harmonization of accounting is not likely to materialize in our lifetime.

In addition, many of those pragmatically driven rules become accepted as a common body of knowledge merely because accountants and users of financial statements have grown accustomed to them. Accounting for inventory valuation is one example. Although lacking theoretical support, it enjoys unusual longevity in the field. In many countries, it is the lower-of-cost or market rule that perpetuates the conservative mind set of accounting policy makers. The conservative policy-making posture has led to other accounting problems for activities such as research and development that essentially ignore the investment nature of the activity. Conservatism and adherence to historical cost has reduced the interest in alternative valuation models such as current cost or other market valuation basis. In some countries, the accounting profession allows asset revaluation to reflect market prices, while in most countries the revaluation is allowed only for conditions of asset impairment. Because investors and other external users make use of the publicly reported accounting information, understanding these concerns is important in making ratio analysis and other uses of financial reports.

Because accounting is a process of measurement and reporting that is subject to a great deal of judgment, independent accountants (i.e., auditors) must assess the extent to which the reported

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information *faithfully represent the economic conditions of the firm*. The process of auditing financial statements has thus become an important function. First, because of the complexity of business and the cost, auditors must sample transactions for verification and audit sampling has become more specialized. Second, the audit sampling as well as other evidence-generating processes is subject to certain levels of risk. Auditors are required to follow a particular audit risk model. Third, undertaking the audit process requires analysis of trends and analysis of deviations of information from their expectations, an area known as analytical review. Fourth, in searching for evidence, auditors exercise judgment on what processes to use and what information cues are relevant. Fifth, in making those judgments, auditors apply various technical as well as rules-of-thumb methods and use different approaches to testing audit evidence. The final outcome of an audit is a report that must state whether or not the disclosed financial statements are prepared in accordance with accepted methods and whether or not they reflect the underlying economic conditions within the accepted bounds of audit risk. The format of the report, but not the substance, differ slightly among different countries.

Accounting information is used not only by capital market participants who continue to monitor the information content of different signals, but also by insiders who manage the firm. Planning and budgeting for normal operating activities as well as for capital projects are major functions that require use of and generate accounting information. Analysis of deviations from cost standards and budgets constitute important input for managerial decisions. Evaluating divisional performance requires identification of the managerial unit, perhaps setting a set of transfer prices, as well as devising allocation schemes for the cost of shared resources. Much of these activities are dependent on the level of technology employed by the firm. Integrated manufacturing technology and strategic cost analysis are elements of a new perspective on accounting for internal purposes.

The level of technology employed by the firm has a pervasive effect on all of these elements of the accounting domain. Management information systems, database management, technological auditing are all manifestations of the effect of technology.

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accounting for defeasance Defeasance is a procedure that allows a firm to remove debt from its financial statement without having to formally retire the debt issue. There are two types of debt defeasance transactions: legal and in-substance. In a legal defeasance the firm ceases to be the party primarily liable for the payment of the interest and principal of the debt.

Under the provisions of Statement of Financial Accounting Standards No. 76 (SFAS 76, 1983) a firm can also remove debt from its financial statements by executing an in-substance defeasance transaction: the firm transfers risk-free securities, or cash, sufficient to meet the interest and principal payments of a specified debt issue to an irrevocable trust. This effectively eliminates the firm's obligation to make future payments to the debt holders.

At the date of transfer, the firm removes both the debt issue and the companion investment securities from its books, with the difference between them generating an extraordinary gain or loss from early debt retirement.

However, the firm is not legally released from the terms of the covenants nor from its legal standing as the primary obligor of the debt. In addition, an in-substance defeasance transaction does not affect the status of publicly traded debt.

SFAS 76 imposes two criteria that must be met for an in-substance defeasance transaction to qualify as an early extinguishment of debt. First, the sole purpose of the trust must be to administer the cash flow obligation of the debt issue. Second, the trust must own only securities that are "essentially risk free" with regard to the amounts and timing of their future cash payments. This is typically satisfied by US government securities that are matched in the

timing and amount of cash as the debt being extinguished.

When the debt is denominated in a currency other than US dollars, the same requirements hold except that the risk-free securities must be denominated in the same currency.

In-substance defeasance can also be used to eliminate callable bonds and long-term lease obligations from the firm's balance sheet. However, in-substance defeasance accounting is permitted only if the firm irrevocably commits itself to exercising the call option at a specific date. Once this is done, the firm can retire the debt using in-substance defeasance accounting.

Under current tax laws, the gain or loss that results from an in-substance defeasance of debt is not taxable. Following the provisions of Statement of Financial Accounting Standards No. 96, issued December 1987, the firm must, however, report the gain or loss on early extinguishment of debt net of the related tax effect.

Effects of Defeasance

Permitting firms to eliminate debt from their balance sheet through an in-substance defeasance is controversial. Accordingly, before undertaking an in-substance defeasance a firm's management must evaluate the effect of an in-substance defeasance on the firm's financial position and assess the reaction of the firm's existing and potential creditors and shareholders to the transaction.

Much of the controversy surrounding in-substance defeasance is traceable to the fact that defeasance also affects the amount of net income reported by the firm. If market interest rates have risen since the issuance of the debt, then the *book value* of the liability will exceed the cost

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of acquiring the risk-free securities. Therefore, under current accounting rules, a firm can generate an accounting gain in its net income statement by retiring the debt. The financial community became concerned that the firms would engage in defeasance transactions for the sole purpose of generating increases in reported net income.

Incentives For Defeasance

The accounting and finance literature contains several possible explanations for why a firm's management would decide to execute an in-substance defeasance transaction. One explanation that is frequently advanced in accounting texts is that the firm's management has concluded that the best use of the firm's resources is to retire outstanding debt, but that a direct repurchase of debt is prohibitively costly. The management then chooses to achieve this goal through an in-substance defeasance. This explanation implies that the market value of the defeased debt issue should increase and the value of the firm's equity should decrease. Research shows that, on average, following defeasance transactions the increase in bond values is less than would be predicted solely on the basis of defeased debt being made less risky by the defeasance.

In practice, it appears that the underlying reason for a firm's management electing to retire debt is simply that the firm lacks alternate profitable investment opportunities. In other cases, it appears that the firm's management is concerned that the firm is operating too close to the accounting based covenants in its lending agreements. To reduce the likelihood of violating these constraints, the firm's management seeks to improve its debt to equity position by retiring some portion of the firm's debt. Either of these motivations raises questions about the firm's long-term performance. Consequently, analysts and investors may interpret the defeasance as a negative indicator of firm value.

A defeasance transaction may also be a part of financing strategy in which new debt is to be issued. Thus, analysts and investors may interpret the defeasance as a favorable indicator of firm value.

STEVEN A. ALLEN

accounting for fixed assets Long-lived assets are those income-producing resources that expect to benefit more than one accounting period. They are often called "fixed" assets. Tangible fixed assets, such as machinery and buildings, often make up a large part of an enterprise's total assets, especially for nonfinancial enterprises. Accounting for fixed assets includes recognizing the assets in the accounts at date of acquisition, charging their cost to expense over the periods expected to benefit from their use through the process known as depreciation, accounting for related costs subsequent to acquisition, and removing the amounts and related contra asset account amounts for accumulated depreciation upon disposal.

U.S. accounting principles currently require fixed assets to be recorded at historical cost, which is the amount expended for the asset on the acquisition date including freight, installation, setup costs, and other charges to get the asset ready for its intended use. Arguments for the use of historical cost usually center on its objective and reliable nature and its representation of fair market value of the asset on the date it is acquired. It is a conservative measure; the amount reflected in the balance sheet subsequent to acquisition does not reflect replacement costs, and income for the period does not include gains or losses from holding the asset.

Accounting Measures

Land acquired for productive use is recorded at cost, which includes the contract price and amounts expended for title search, title insurance, past due taxes, legal fees, recording and notary fees, surveys and any amounts necessary to prepare the land for its intended use. Demolition costs to raze an existing structure, net of salvage value, are included in the cost of the land if needed to ready the land for its intended use. Generally land is not depreciated, and accounting practices do not record its appreciation, except in special circumstances. The land is carried in the account at cost until the time of disposal.

The cost of a building acquired includes the amount paid for the building plus any expenditures to ready the building for use. If the building is substantially renovated prior to use or if a new building is constructed, related costs

of designing, net demolition costs, costs of securing bids and permits, and actual costs of construction are included in the cost of the building. Unlike land, buildings gradually deteriorate and they ultimately will require expenditures to renew or replace them. Their cost is charged to current and future operations as depreciation expense.

Other fixed assets such as equipment, machinery, and furniture and fixtures are recorded on the date of acquisition at cost, including all amounts paid to install and prepare the assets for their intended productive use. Additional expenditures include freight and insurance charges for the asset in-transit, setup charges, and leveling and testing costs incurred.

Self-constructed assets require consideration of interest costs and fixed overhead costs incurred. Financial Accounting Standards Board (FASB), Statement of Financial Accounting Standards (SFAS) No. 34 (1979) requires interest costs to be capitalized based on actual amounts borrowed when an entity constructs a qualifying asset for its own use. This practice enables more accurate measurement of an asset's cost, and it more accurately matches expenses with revenues for the periods benefited by expenditures. Imputed interest is not allowed; the amount of interest that should be charged to the asset account is the amount that theoretically could have been avoided. It is calculated by applying the interest rate to the average cumulative invested costs for the asset during the capitalization period. Total interest incurred during the period must be disclosed, and the amount that has been capitalized should be disclosed separately as well.

Fixed overhead costs incurred when an entity constructs an asset, such as building occupancy costs and depreciation, are most commonly allocated proportionately to that asset. Arguments are made that no overhead should be included in the cost of the asset if overhead is not affected by the construction, and that only the incremental fixed overhead incurred should be included in the asset's cost when excess capacity exists. Allocating a portion of the fixed overhead is most justifiable when the entity is operating at full capacity and usable production is therefore foregone, but it is used in most circumstances.

Transactions other than "cash for asset" arise as well. When dissimilar fixed assets are acquired as a group for one sum, the amount must be prorated to the individual assets acquired. The basis for the allocation is the relative fair market values of the individual assets. When fixed assets are acquired by issuing securities, the general rule is that the assets should be recorded at the more reliable of the fair market value of the assets acquired or the stock issued. When a series of deferred payments is established to pay for the acquisition of an asset, the cost of the asset is the more reliable of its fair value or the fair value of the liability on the date of the transaction. According to US Accounting Principles Board (APB) Opinion No. 21 (1971), the present value of the deferred payments computed at the stated rate may be used if neither fair value is readily determinable and if the stated rate is not materially different from the market rate of interest. If an asset is donated to the entity, the "cost" to be reflected in the accounting records is the fair value on date of acquisition. SFAS No. 116 (1994) requires that this amount be reflected in income for the period.

Exchanging Nonmonetary Assets

Accounting for exchanges of nonmonetary assets, including fixed assets, is somewhat complex. US Accounting Principles Board (APB) Opinion No. 29 (1973) indicates that the general rule is to record an asset acquired in this manner at the fair value of the asset surrendered, recognizing a gain or loss on the exchange if the fair value of the asset given up is different from its carrying value. If money is paid or received as part of the transaction, the cost of the asset acquired includes any amount paid or is net of any amount received. If the fair value of the asset surrendered is less reliable than the fair value of the asset acquired, then the latter amount should be used. This rule applies in the exchange of dissimilar productive assets that are not employed in the same line of business.

When similar productive assets are exchanged between two dealers or two non-dealers, the rules are modified to the extent that the earning process is not considered to be complete as the transaction closes. Revenue is not recognized, based on the conservatism

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principle. In the case where gain is not recognized, the acquired asset is recorded at the carrying value of the asset surrendered. When an amount of money is received as part of the exchange, a gain is recognized in proportion to the amount of money received to the total consideration received. If the amount of money involved in the transaction exceeds 25 percent of the total consideration, the exchange is considered to be monetary in nature and fair value is used by both parties to the transaction. In any case, a loss incurred on the exchange should be recorded.

Costs incurred after the productive asset has been placed in service should be added to the amount in the account if the expenditures increase the future economic benefits of the asset over those initially expected. The cost of an addition should be capitalized. Improvements and replacements typically extend the useful life or increase an asset's productivity, so their costs should be capitalized. The particular circumstances determine whether the costs should be added to the asset account, used to reduce the related accumulated depreciation account, or substituted for the carrying value of the original asset.

Depreciation

The matching concept requires that cost be allocated to expense in the periods when related revenues are recognized. According to US Accounting Terminology Bulletin No. 1 (1953), the primary consideration is that the allocation be systematic and rational. For fixed assets, depreciation is the means by which the cost of the assets is charged to expense. In some cases, the amount is shown in the income statement as "depreciation expense." Depreciation on factory facilities, however, is included as an inventoriable item and, therefore, is shown in the income statement as part of "cost of goods sold" when the related inventory items are sold. Regardless of format, several depreciation methods are acceptable and widely used. Two types of methods predominate. Time-based methods include the straight line and decreasing charge methods; activity methods typically base depreciation charges on units produced or hours operated.

Since an asset's cost is spread over its service life, an estimate must be made of the service life.

It is usually based on experience with similar assets, and engineering or economic studies can assist in making the determination. Physical deterioration is an important factor, as is technological obsolescence. Frequency and quality of maintenance can affect the former, while market studies can help predict the latter.

The easiest method used is the straight line method. The amount of depreciation each period is the cost less salvage value divided by the estimated useful life. Since an equal amount is charged to expense each year, an implicit assumption is that the process of asset consumption or deterioration occurs uniformly over time. While this might be true for some fixed structures, other assets such as machinery deteriorate more as a function of use than time. Another criticism of this method is that the loss of productivity and increased maintenance costs in the later years of an asset's life are implicitly ignored. It is a popular method, however, due to its simplicity.

Accelerated depreciation methods charge decreasing amounts to expense as time passes. One argument in their favor is that lower depreciation charges in later years would offset the higher maintenance costs likely during those periods. In addition, the higher depreciation charges in the earlier years would reflect the uncertainty about obsolescence in future periods. Many companies have used some variant of accelerated depreciation for financial reporting since it was first sanctioned by the US Internal Revenue Service for tax purposes in 1954.

The sum-of-the-years' digits method computes depreciation expense each period by multiplying the cost less salvage value by a reducing fraction each period. The denominator of the fraction is constant at the sum of the digits from one to the number of years of life of the asset. (It can be computed as $n(n+1)/2$, with n being the expected life of the asset.) The numerator changes each year; it is the number of years remaining of the useful life as of the beginning of the period.

Decreasing charge methods apply a constant percentage to the declining carrying value of the asset each period to determine the amount of depreciation expense for the period. A formula can be used to compute a rate that will reduce the asset balance to the salvage value at the end

of the estimated useful life. That rate is calculated as follows:

$$[1 - (\text{salvage value}/\text{cost})^{1/n}]$$

Although this formula is not used often, a variant known as the declining balance method is in common use. Double-declining-balance is a common application of this procedure wherein 200 percent of the straight line rate is used as the percentage applied to the carrying value each period. No higher rate is used, but lower rates are often applied. Salvage value is ignored in the computation; however, the asset should not be depreciated below this amount. Many entities will switch to straight line from the declining balance rate at either the midpoint in the asset's life or when the amount of depreciation computed using the straight line rate exceeds that amount computed with the declining balance rate. If used systematically, such a procedure is acceptable.

Intensity of use or activity is the basis for computing depreciation for some entities. The amount of depreciation per unit of activity is computed as cost less salvage value divided by the estimated total number of units of activity (hours or units produced for example) over the asset's expected useful life. This fraction is then multiplied by the actual number of units of activity during a period to determine the depreciation expense for that period. This method yields a constant per-unit charge, but depreciation expense varies from period to period depending on the rate of activity each period.

The method selected by an entity should be systematic and rational, and ideally it would consider the rate of usage of the asset as well as the expected repair and maintenance expenditures over the asset's service life. The objective in this case is to achieve a matching of the total cost of the asset (including any costs required to keep it operating as planned) with the revenues generated by the asset. In the USA, most companies use the straight line method of depreciation. This is also true of companies in the UK. In some countries, such as Germany, Switzerland, France, and Italy, depreciation methods used for financial reporting are driven largely by tax requirements.

Regardless of the method of depreciation used, the actual recording of depreciation expense each period is straightforward. It requires a debit entry (an increase) to "depreciation expense" and a credit entry (an increase) to "accumulated depreciation," which is a contra asset account, for the amount of depreciation expense for that period. Assets are often acquired during a period. In this event, one of several conventions is usually used to compute depreciation expense for the partial period. Most common methods are to record depreciation to the nearest month or nearest year, or to record one-half year's depreciation on all assets acquired during the year (with dispositions being treated in a similar manner).

Disclosures related to depreciation required by US Accounting Principles Board (APB) Opinion No. 12 (1967) include the following:

- A general description of the method(s) used in computing depreciation with respect to the major classes of depreciable assets.
- Depreciation expense for the period.
- The balance in the accounts of the major classes of depreciable assets at the balance sheet date.
- The balance in the accumulated depreciation accounts as of the balance sheet date, either by major classes of depreciable assets or in total.

Disposal of Long-lived Assets

When an asset is retired, the capitalized cost amount must be removed from the asset account, and the related accumulated depreciation amount should be removed from the contra asset account. If retired during a period, depreciation should be recorded on the asset using one of the conventions discussed above. A gain or loss computed as the amount of net proceeds minus the net carrying value of the asset is usually included in ordinary income. If the transaction meets the criteria in US Accounting Principles Board (APB) Opinion No. 30 (1973) for recording as an extraordinary item or as the disposal of a segment, then the gain or loss would be shown below income from continuing operations on the income statement.

Accounting for fixed assets varies across countries. Some countries, such as Germany

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and Japan, have adhered even more strictly to the historical cost principle than has the USA. Other countries, including the UK, the Netherlands, and Switzerland, have allowed more flexibility with respect to revaluations of fixed assets to market values. The US accounting standards still indicate historical cost should be used, with the possible exception of impairment in the value of a long-lived asset. In Australia and New Zealand, accounting practice allows revaluing assets up or down as market values deviate from recorded values.

NANCY D. WEATHERHOLT

accounting for leases standards This entry provides a comparison of the various standards on the accounting for leases that have been issued by the standard setting bodies in the USA, UK, Australia, and New Zealand, and by the International Accounting Standards Committee (IASC). These are the US Statement of Financial Accounting Standard No. 13, "Accounting for Leases" (SFAS 13); the Australian Statement of Accounting Standard No. 17, "Accounting for Leases" (now titled Approved Accounting Standard ASRB 1008 "Accounting for Leases") (AAS 17); the UK Statement of Standard Accounting Practice No. 21, "Accounting for Leases and Hire Purchase Contracts" (SSAP 21); the New Zealand Statement of Standard Accounting Practice No. 18, "Accounting for Leases and Hire Purchase Contracts," (SSAP 18); and the International Accounting Standard No. 17, Accounting for Leases (IAS 17).

Accounting policy-makers in these countries have usually been concerned with accounting for leases following a rapid growth in lease financing. In Australia, the value of all lease agreements increased rapidly in the decade up to 1976 and then subsequently almost doubled in real terms in the next three years to A\$5.8 billion (US\$4.1 billion) (Bazley et al. 1985, p. 45). Similarly, the UK Accounting Standards Committee issued its standard, SSAP 21, in 1984 following a decade where annual expenditure on leased assets by the leasing industry increased tenfold (from 288 million (US\$450 million) in 1973 to 2,894 million (US\$4,560

million) in 1983) (Deloitte et al., 1985, p.1). A similar sequence of events was noted in India.

Analysis of Standards

Conceptually, the various regulations governing the accounting for and reporting of lease transactions in published financial statements of lessees and lessors are based on the same general principles as those of SFAS 13 in the USA. All of the standards require lessees to capitalize leases that are considered finance, financial or capital leases, but only to recognize and disclose separately the total amount of annual lease rental expenses charged to income for other leases. Since a finance lease is considered, in substance, equivalent to a purchase with debt financing, the various pronouncements require that a finance lease be recorded by lessees as a lease asset and as a lease obligation in the lessee's balance sheet. The various pronouncements also set standards for the determination of the initial values of capitalized lease assets and liabilities, the amortization of the lease asset, the reduction of the lease liability, and the required disclosures for both finance and operating leases. (Capitalizing a finance lease requires the present value of the minimum lease payments to be recorded as an asset and a liability. The capitalized asset should then be depreciated in accordance with normal depreciation requirements and policies over the shorter of the asset's useful life or the lease term, while the lease rental payments should be apportioned between the finance or interest charge to income and the capital portion that reduces the outstanding lease liability.)

Lessors are also required to classify leases as finance or operating on the basis of whether the lessor "transfers substantially all the risks and rewards incident to the ownership of the leased property" to the lessee. Thus, lessors would treat rentals receivable under a finance lease as repayments of principal and finance income to reimburse and reward the lessor for the investment and services. However, under an operating lease, "the risks and rewards incident to ownership" remain with the lessor. Thus, lessors would treat assets held for operating leases as depreciable assets, and would include rentals receivable in periodic income over the lease term. (The particular accounting and

disclosure requirements for lessors depend upon whether the leases are classified as being either direct financing, sales type, or leveraged leases. There are also additional requirements for sale and leaseback transactions and leases involving land and buildings.)

There is little agreement as to what constitutes a finance lease and an operating lease. Because of this difficulty and the significant impact of such a classification on financial statements and key financial indicators, in particular lessee leverage ratios, the issue of economic consequences of lease capitalization has added to policy-makers' difficulties. Consequently, the chosen criteria are considered "too arbitrary," or "too ambiguous in interpretation," or "too easily circumvented by judicious structuring of lease contracts to avoid capitalization rules or tests" and mark most differences among countries.

In the USA (SFAS 13, para. 7), a finance lease is one that satisfies any one or more of the following four criteria:

- (1) The present value of the minimum lease payments at the beginning for the lease term is equal to or greater than 90 percent of the fair market value of the leased asset ("90 percent test").
- (2) The lease term is equal to 75 percent or more of the estimated remaining economic life of the leased asset ("75 percent test").
- (3) The lease transfers ownership of the leased asset to the lessee at the end of the lease term.
- (4) The lease contains a bargain purchase option.

A lease that does not meet any of the above criteria is classified as an operating lease.

However, the criteria in the UK and Australian regulations and in the IASC pronouncement are less prescriptive and leave more room for judgment. The Australian AAS 17 (paras 8 to 9) provides only guidelines and relies upon management interpretation of "economic substance" as the basis for classification, rather than prescribing specific criteria. In circumstances where "substantially all the risks and benefits incident to ownership effectively pass to the lessee," the lease should be classified as a finance lease. *Prima facie* evidence of such a transfer are:

- (1) the lease is non-cancellable; and
- (2) either of the first two SFAS 13 tests is met (para. 10).

The UK SSAP 21 (para. 15) defines a financial lease similarly and offers one criterion: at the inception of the lease the present value of all minimum lease payments must amount to substantially all (normally 90 percent or more) of the fair value of the leased asset. Otherwise, a lease is classified as operating.

In contrast to the SFAS 13 criteria, the SSAP 21 "90 percent test" and the three Australian conditions (non-cancellability, "90 percent test," and "75 percent test") only give rise to a rebuttable presumption that a lease is a finance lease. Consequently, it is possible to classify similar leases in different ways under the different standards.

By providing criteria as guidelines for classification, rather than strict rules, the Australian profession was attempting to discourage the practices of structuring lease contracts in order to avoid the strict capitalization rules (McGregor, 1985). Australian regulators amended the standard in November 1987. This new Australian regulation begins with a definition of an operating lease and then defines a financial lease as any lease other than an operating lease. However, as noted by Shanahan (1981) and discussed in Whittred & Zimmer (1988, p. 237), the new drafting was not effective. Thus, by constructing a lease which intentionally avoids "transferring substantially all the risks and benefits incident to ownership," a lease could still be classified as an operating lease.

Similar experiences in applying SSAP 21 in practice in the UK also indicate that leases were often constructed to avoid or "fail" the "90 percent test." In response, the Institute of Chartered Accountants in England and Wales even made a submission to the UK Accounting Standards Board in 1992 which recommended that the "90 percent test" be relegated in importance or even abandoned, and be replaced by the use of a number of suggested qualitative tests (Paterson, 1993, p. 42).

International Accounting Standard No. 17, issued in 1982, defines a finance lease as "a lease that transfers substantially all the risks and rewards incident to ownership of an asset"

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(para. 2), which is identical to that given in SSAP 21. IAS 17 also relies upon management interpretation of "economic substance over form" as the basis for classification of leases (para. 5). However, unlike other standards, IAS 17 does not prescribe any definitive rules or tests or attach any rebuttable presumptions to the definition. Instead, it gives four examples of *situations* where a lease "would normally be classified as a finance lease," and these situations are virtually identical to the four criteria prescribed in SFAS 13 in the USA.

The disclosure requirements under IAS 17 are also less onerous than those required under the USA, UK, and Australian equivalents. (IAS 17 does not prescribe disclosure of the depreciation and finance charges for finance leases, nor the total amount of rental expenses for operating leases. However, it does state that these may be "appropriate" or are sometimes disclosed, and that other disclosures, such as the nature of any renewal options, purchase options, or escalation clauses, may also be "appropriate.") There are also some minor differences in the accounting requirements, such as the discount factor to be used in calculating the present value of the minimum lease payments (defined as "the interest rate implicit in the lease, if it is practicable to determine; if not, the lessee's incremental borrowing rate" (para. 9)). However, in general, compliance with the much less-detailed and less onerous requirements of IAS 17 enables compliance with the USA, UK, Australian, and New Zealand equivalents.

The New Zealand SSAP 18, issued only in 1986 and amended in 1990, is the most recent of the standards. Much of the terminology and some of the definitions of terms used in this standard are similar or identical to those used in other countries (especially SSAP 21 and IAS 17). However, this New Zealand standard differs in applying the classification criteria. For example, paragraph 4.4 provides that a lease would normally be classified as a finance lease in circumstances where the lease is non cancellable and the four criteria of SFAS 13 (or "situations" given as examples in IAS 17) are satisfied. However, this standard also imposes the additional requirements of "collectibility of the minimum lease payments is reasonably predictable" (para. 4.4b), and "in the case of the lessor the amount of unreimbursable costs yet to be

incurred by the lessor under the lease can be ascertained with reasonable certainty" (para. 4.4d). Disclosure requirements for both finance and operating leases are also more stringent than those prescribed by IAS 17.

Expected Developments

Empirical research in at least the USA and Australia indicates there are incentives for firms, especially those that are "high lease" or highly levered, to avoid lease capitalization requirements (e.g., El-Gazzar et al., 1986; Imhoff & Thomas, 1988; Imhoff et al., 1991; Wilkins & Mok, 1991). Some of the many methods that innovative lessees and their contracting parties can use to mitigate or avoid perceived adverse effects of capitalization are discussed in some undergraduate texts (e.g., Whittred & Zimmer, 1988 ch. 9) and in professional journals. Indeed, the use of some of these methods by US firms was noted soon after Statement of Financial Accounting Standard (SFAS) 13 was first implemented (Abdel-Khalik, 1981). The Financial Accounting Standards Board Action Alert No. 79-10 (March 8, 1979) also reports that a majority of the Board members then expressed the tentative view that if SFAS 13 were to be reconsidered, they would support a property-right approach in which all leases would be included as rights to the use of property and as lease obligations in the lessee's balance sheet.

Since that time there have been a number of similar statements and suggestions by policy-makers and professions in other countries. These various policy-makers are concerned that the past attempts to develop lease accounting standards within the conventional accounting framework have "failed in their objective" and have been "largely ineffective in putting assets and liabilities relating to leasing transactions onto the balance sheet" (McGregor, 1993) Paterson (1993, Ch. 5) also reports that the property-right approach is hinted at in the UK Accounting Standards Board's draft *Statement of Principles* (Ch. 4); although the existing SSAP 21 rules presently take precedence in that country.

Bibliography

- Abdel-khalik, A. R. (1981). *The economic effect on leases of FASB Statement No. 13, Accounting for Leases*. Research report, Stamford, CT: FASB.