Frustrations of an Old Accountant

we are living in a new world

By Bill Bosco, Leasing 101

I went to college in the 1960's graduating with a Bachelor's of Business Administration ("BBA") in Public Accounting. I got a job as an internal auditor with CIT, and then moved on to Arthur Andersen where I passed the CPA exam. Then I went to work for Citibank in 1974 as a financial controller in their leveraged leasing group.

When I took the CPA exam the FASB had not been created. I think I am fortunate in that timing as I had a lot less to learn and worry about. Back in those days and up until the Revenue Recognition standard and the Lease project there were accounting concepts that we lived by like matching income with expense, respecting the "legal" treatment of financial items (linking to the accounting treatment) and striving to account for the substance of transactions. Since then things have changed. These concepts seem to be going away as the new accounting standards Boards re think our accounting rules using new theories that don't seem to give me the answers that are most useful in understanding financial results and financial positions.

Matching concept

The matching concept seems not to be the driver it once was. Look at the decision to eliminate leveraged lease accounting. The MISF yield method is considered one of the most "elegant" accounting solutions to accounting for a tax driven transaction. Under that method earnings are recognized to match the cost incurred by the lessor to fund the net cash invested in the lease transaction. Also The IASB decision that <u>all</u> leases – even those that are legally rental/executory contracts, have the same cost pattern as a financed purchase of the asset.

I also see the issue in the controversy with tax credit accounting regarding energy asset leases in the US (the IASB has IAS 20 that allows tax credits to be recognized as revenue when part of a financial transaction - that is what we need in the US). If you apply the US tax accounting GAAP the ITC or tax grant are either taken immediately or amortized straight line on the tax line, yet they represent a cash flow from the lease investment. The true yield and financial earnings are not evident if the ITC/tax grant is not recognized as revenue at a constant rate versus the declining investment. One needs to "interpret" the tax credit accounting treatment to avoid coming under the tax accounting GAAP. You have to convince your auditors that practice developed after the issuance of FAS 13 to treat ITC as revenue in non leveraged leases analogizing to the treatment of ITC in a leveraged lease. The 1976 Board that issued FAS 13 never gave an example of ITC accounting in a non-leveraged lease. Although they did leave us hints, as they tell you how to apply ITC in the classification tests and how to include ITC in the implicit rate calculation. That leads you to believe that ITC has an impact on the net investment

in the lease and in the mathematical calculation of recognizing revenue using the implicit rate in the lease. When ITC was available for all equipment it was common and practice developed to treat it as revenue in a direct finance lease. Since ITC was repealed in 1986 the deals that had ITC have expired and the new batch of auditors, many born after 1986, have not dealt with it in leases, that is until the energy assets tax credits were enacted. Now it is a big and controversial issue in the US.

The problem that I see in not matching revenue to expenses is that earnings are not as predictable or stable only due to how revenue and expenses are reported. Investors use earnings per share as a measure in evaluating investment alternatives and they need to know that future earnings will be consistent with the business results and not impacted by accounting created issues the create variances.

Legal and accounting congruence

I think that accounting must match with the legal system when determining what items are assets and liabilities. Also the type or kind of asset or liability should determine its financial presentation. The IASB in the proposed Leases standard disregards the legal nature of types of leases mixing capital leases with capitalized operating leases. Fortunately for us in the US the FASB made the decision to maintain a two lease model that separately reports the assets and liabilities from capital leases and operating leases. They recognize that lenders and credit analysts need to know which assets are available in bankruptcy liquidation and which liabilities are debts in bankruptcy liquidation.

The new Revenue Recognition standard follows a “control” concept rather than a risks and rewards concept to determine when an entity records a sale and an asset. The US legal and tax systems continue to use a risks and rewards concept to determine when a sale has taken place and when an entity owns an asset. Any differences present problems to a reader of the financial statements in understanding the financial results. I have to admit that I was not following this Revenue Recognition project as it did not seem important to the leasing industry as leases are “scoped” out of the Revenue Recognition standard. The proposed Leases project prescribes the rules for lessor revenue recognition. The real problem popped up when the Boards dealt with sale leasebacks with non-bargain purchase options in the leaseback that are so common in equipment leasing deals. Since a sale leaseback is a two part transaction – that Is, a sale and a leaseback, the question arose as to whether to use the Revenue Recognition rules, including consideration of the terms of the leaseback, to evaluate whether the sale was really a sale. The Boards have a concept of linked contracts that occur simultaneously – they collapse the two and treat them as one transaction. In that case the boards tentatively decided

that the Revenue Recognition standard trumps the Lease project so that any fixed price purchase option (bargain or non-bargain) negates sale treatment because the mere presence of a fixed price purchase option means the seller lessee still "controls' the asset. As I said, it is control, not risks and rewards, that is the basis of Revenue Recognition standard. There is still an opportunity to change this decision but to do that you would have to write a comment letter to the FASB – not the IASB – as we want the FASB to rule on this.

Substance

Substance also incorporates legal and accounting congruence, but also includes the issue of regulatory capital treatment that requires financial institutions to keep capital against assets. Financial industry regulators are concerned with safety and soundness of financial institutions. That includes the quality of the assets and the nature of the liabilities. Assets that are "true" assets of the institution have to be considered in bankruptcy liquidation – said another way what is the value of the asset in liquidating it to pay the depositors and lenders to the institution. Assets that one "controls" may not in fact be assets of the institution when it comes to liquidation. In my opinion that brings into question the IASB (thankfully not the FASB) idea that a capitalized operating lease creates an asset and "debt" because the right of use is not an asset and the executory lease obligation is not debt that survive in a bankruptcy.

It also brings into question the idea that an asset sold in a sale leaseback with an EBO (non bargain early buyout option) is still an asset on the books of the seller/lessee. That transaction transferred all of the risks in the sold asset and all the expected rewards and is considered a sale under US commercial and tax law. The only thing the seller has left besides the right of use for the term of the lease is the right to buy the asset at a price that is above what is expected. They only control unexpected value. Yet that whole asset will stay on the accounting books of the seller/lessee because of a "theory" that is not grounded in the law. Assets that remain in the books from a failed sale leaseback are not available to lenders or depositors in a bankruptcy liquidation.

As I see it, financial institutions will have to recast the accounting to appeal to their regulators for capital relief for those "theoretical' but not legal assets. That is not so simple, is it?

Where are we on some of these issues?

Fortunately the FASB and IASB are still meeting on the Lease project and can "fix" issues with ITC/tax grant and sale leaseback accounting. I view these as FASB issues as I believe they are more likely to listen (the FASB have done a great job in improving the proposed rules compared to where the project started from)than the IASB and the FASB will be issuing its own leasing

standard given that there are several large issues that are not converged. The FASB have a few received comment letters on these issues and more may come. The issue of how to change their minds is partly to write a comment letter but too few stakeholders write such letters. The other thing that is needed is follow up with a letter writing campaign and with follow up comment letters and meetings. Sadly many great letters have been written but they are not followed up on. The Boards have been deluged with letters so they need pressure when it appears they are not acting on the letters that offer constructive criticisms and better alternatives. The Boards and staff are highly intelligent, competent and hard working people but they are not experts in the details of every industry and their products/structures. It is up to us to make sure they have enough information to make decisions that are furthering the goal of providing the most useful financial information to lenders and investors.

About the Author:

Bill Bosco is the Principal of Leasing 101, a lease consulting company. Bill has over 40 years experience in the leasing industry. His areas of expertise are accounting, tax, financial analysis, structuring, pricing and training. He has been on the EFLA accounting committee since 1988 and was chairman for 10 years. He is a frequent author and speaker on leasing topics. He has been selected to the FASB/IASB Lease Project working group as a representative of the ELFA. He can be reached at wbleasing101@aol.com, www.leasing-101.com or 914-522-3233.