July 8, 2013

Comment in response to Question 2: the accounting for Type B leases (lessee accounting)

I begin with the premise that the IASB and the FASB are faithful to the concepts that they say they are applying in the development of their leases ED.

In the basis for conclusions of the leases ED, paragraph BC36(a), the boards describe the annuity method of depreciation and then say that they have rejected its use. One reason for this rejection, they say, is that it “is currently prohibited in US GAAP.” In fact, prior to the FASB’s Accounting Standards Codification, the annuity method of depreciation was mentioned only once in all of the US authoritative literature: paragraph 37 in FAS 92, “Regulated Enterprises – Accounting for Phase-in Plans,” issued in 1987. Reference to the annuity method did not appear in the standard itself or in the basis for conclusions but was tucked away in a nondescript paragraph in an illustrative appendix, very much as an aside: “(annuity methods of depreciation are not acceptable under generally accepted accounting principles applicable to enterprises in general).” Nothing more was said about it than this, and a statement about the non-acceptability of the annuity method under GAAP was hardly germane to the subject of the standard. This is, in my view, a dubious basis for concluding that the annuity method is prohibited by US GAAP. On the basis of FAS 92, I wouldn’t relish the task of arguing its authoritative status before a court of law. Yet ASC 360-10-35-10 currently states, “Annuity methods of depreciation are not acceptable for entities in general.”

Let us accept that the annuity method is contrary to US GAAP. And the boards inform us that they have rejected the method. But they have not rejected the use of the method. They have actually used the annuity method, whether they admit to it or not, when accounting for Type B leases. The total expense to be shown by the lessee is the “single lease cost,” which, under paragraph 42(b), combines “the unwinding of the discount on the lease liability with the amortization of the right-of-use asset, calculated so that the remaining cost of the lease (as described in paragraphs B15-B16) is allocated over the remaining lease term on a straight line basis.” In the Snapshot: Lease, page 7, the total lease expense for the Type B lease is 231 in each period. But there is only one conceptual underpinning for this constant annual lease expense: the addition of the periodic unwinding of the discount on the lease liability to the periodic amortisation of the right-of-use asset by use of the annuity method. This total periodic expense for a lease where the payments are the same every year couldn’t be obtained any other way. As the periodic unwinding of the lease liability declines, the periodic amortisation of the leased asset increases correspondingly, dollar per dollar, just as the boards explain in paragraph B36(a), when discussing the effect of the annuity method: “Consequently, the amortisation charge would typically increase over the lease term.”
So why do the boards announce that they will not use the annuity method of depreciation (amortisation) when, in effect, they use precisely that method when accounting for amortisation of the right-of-use asset for Type B leases? The boards’ explanation of their derivation of the total lease expense is disingenuous and not explained in terms of its conceptual underpinning.

Prior to the issue of FAS 92 in 1987, there was substantial support in the US authoritative literature for the use of the annuity method when amortising the leased asset. In October 1958, Gordon Shillinglaw, a long-time accounting professor at Columbia University and an acknowledged authority on accounting for leases, wrote a widely cited article, “Leasing and Financial Statements,” in The Accounting Review. There he advocated the use of the “constant yield” method (the “annuity method” by another name) to amortise both the leased asset and the lease liability, the effect of which was to produce an equal periodic lease expense for the lessee over the course of the lease term. Shillinglaw argued explicitly in favour of amortising the leased asset by the “constant yield” method, yet the FASB and the IASB, which go to pains to disavow the annuity method in the leases ED, come to the same result, albeit without mentioning that they have actually made use of the annuity method.

Shillinglaw wrote, “If the constant yield method of amortization is used on both the asset and the liability, the same total will be charged annually to expense."

Why are the boards engaging in this deception? Discerning readers of the ED will realize that the boards implicitly use the annuity method to amortise the right-of-use asset even though they say they have rejected the method because it is contrary to US GAAP.

Sincerely,

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