Appeal 1 – Appeal of Accounting Decision

A bank appealed two Office of the Comptroller of the Currency (OCC) decisions regarding the accounting treatment for income earned and expenses incurred from two separate affinity card relationships. The issues involved the bank's contractual agreements with an affinity group (contract no. 1) and an affiliate (contract no. 2), respectively, and are individually discussed below.

Contract No. 1

Background

The bank purchased an existing affinity portfolio from another institution at a premium. The contract with the affinity association required an advance at signing and minimum annual payments (royalty expense). The bank computed the expenses associated with the contract based on a formula that allocated most of the expense to the latter years of the contract because of the belief that the economics of the program would improve over time. The bank recorded the difference between the minimum payments and the formula expense as a prepaid asset.

Discussion

The OCC and the bank agreed that the guiding standards fell under generally accepted accounting principles (GAAP), and the Financial Accounting Standards Board Statement of Financial Accounting Concepts (No. 5), which requires that expenses be allocated in a *systematic and rational* manner during the period in which the related assets are expected to provide benefits.

In determining the criteria of systematic and rational, the bank considered the totality of the agreement with the recognition of royalty expenses, which include the amortization of the purchase premium. The premium for the portfolio reflected the benefit in prior years of the affinity group's endorsements compared to the benefits enjoyed from royalty payments in later years. The bank believed that the combination of royalty expense and premium amortization resulted in a reasonably consistent charge against receivables. Escalation of royalty fees paid to the affinity group mirrored the improving economics of the program over time. The bank's external auditors agreed that the bank's approach was systematic and rational.

The OCC concluded that a systematic and rational approach was one that recognized periodic expense in relationship to the average revolving receivable balances in the corresponding period. Based on the bank's projections, the OCC determined that an amortization rate of between 1.1 and 1.3 percent of average revolving balances would provide this level relationship. The OCC estimated that such a method would reduce the prepaid balance by almost 75 percent and directed the bank to charge off this amount.

Conclusion

The accounting standards and principles relevant to this transaction are not specific. Therefore, when considering the bank's and the OCC's methods, it was believed that there existed a legitimate difference of opinion regarding a *systematic and rational* approach to accounting for this complex transaction. The ombudsman clearly acknowledged that there could be different judgments made, and different conclusions reached, on the asset valuations. Therefore, the ombudsman opined that the most appropriate resolution of this difference of opinion rested with the Securities and Exchange Commission (SEC) accounting division. The bank was directed to contact the SEC to discuss the accounting treatment for this transaction.

Contract No. 2

Background

In a separate agreement the affinity group's affiliate agreed to pay the bank a percentage of the shortfall if a specified rate of return was not met. This gross profit adjustment was recorded as a prepaid asset. This receivable was recorded during the early years of the contract but was not payable by the affiliate until the expiration of the 16-year contract.

Discussion

The bank believed that the prepaid asset was fully bankable, based on the unconditional contractual obligation of the affiliate, and therefore carried it at full value. The OCC concluded that the bank's accounting treatment for this asset was inappropriate. The OCC considered this prepaid asset to be a gain contingency, and as such, under GAAP it should not be recognized until payment is realized. The bank was of the opinion that the asset had economic value, and therefore, the OCC should not impose an accounting treatment that assigns no value.

Conclusion

In considering all of the dimensions of the prepaid asset, the ombudsman opined that it was appropriate to recognize the revenue. However, in light of the extended time period required to receive payment, it would have been more appropriate to record the prepaid asset at a discounted value. Therefore, the bank was directed to adjust its books to reflect the discounted value of the asset for each of the periods in question and amend the call reports as appropriate.