

LEASING 101

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Mr. Russell Golden
Chairman
Financial Accounting Standards Board
401 Merritt 7, PO Box 5116
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Submitted via email

October 31, 2014

Re: Leases Project Redeliberations – Sale Leasebacks

Dear Chairman Golden,

I have been following the Boards' redeliberations in the Leases Project and I wish to comment on the issues regarding non bargain fixed price purchase options (FPPO) negating sales treatment in sale leaseback (SLB) transactions and the resulting accounting alternatives.

At the FASB only meeting of August 23, 2014, the FASB discussed failed sale accounting regarding SLB transactions, but decided that sale treatment would not be precluded where the lease contains a fair market value purchase option and the underlying asset is non-specialized and readily available in the marketplace. I support that decision and thank the Board for coming to that conclusion.

The Board has asked the staff to provide detailed examples of suggested "failed" SLB accounting alternatives for SLBs with non bargain fixed price purchase options. I am perplexed with the fact that under the Leases project a non bargain FPPO ***is not*** considered substantive in a risks and rewards analysis to determine if a lease is a financed purchase or an executory/operating lease. In contrast, under the Revenue Recognition standard's control based analysis to determine if a transaction is a sale that same non bargain FPPO ***is*** considered substantive. Since the FPPO is set at a non bargain price it would appear that the buyer controls ***all*** the ***expected*** benefits in the asset and has ***all*** the asset value risks. The Revenue Recognition standard should be consistent with the Leases standard, but if there is reason not to conform then the standards should include an exception to the sale analysis in a SLB or provide explicit clarifications and guidance as I request in the balance of this letter. Another option is to exclude SLBs from the scope of the Revenue Recognition standard as leases are excluded from its scope and a SLB is a form of a lease.

I offer some more information on SLBs to help in the deliberations. I also ask the Board to provide specific guidance regarding some questions I have regarding the interaction between the Revenue Recognition and proposed Leases standards.

My specific recommendations are:

- Exempt SLBs from the Revenue Recognition standard as they are “special sales” and there is a conflict in models between Revenue Recognition and Leases.
- Clarify that if a lessee is acting as an agent in a SLB there is no SLB. The criteria the lessee must meet to be considered an agent in a SLB should be clearly stated in the Leases standard or Revenue Recognition standard.
- Clarify as to which events in the process of acquiring the use of an asset in a SLB put the lessee in an ownership position in the physical leased asset.
- If the Board chooses not to adopt the above recommendations, “failed” SLB accounting for lessees resulting from a FPPO should reflect a “non sale” and a Type B lease rather than a “debt” financing. For lessors a failed SLB should still be accounted for as any other lease.

I believe that there are provisions in the Revenue Recognition standard that would allow a seller/lessee to act as an agent of the buyer/lessor, thereby the lessee would not be a principal in the sale transaction. Also there may be significant open performance obligations in the lengthy, complex process of acquiring the use of large ticket assets that might mean that control of the physical has not transferred to the lessee prior to executing a SLB.

I also believe the Board should understand the implications in deciding on transition rules regarding the need for both lessees and lessors to review existing SLBs for possible re booking as failed SLBs.

Background

Although the amount of equipment SLBs done annually is not available, I can provide information that may help one understand that SLBs are pervasive and information that if extrapolated gives a good indication of the dollar amount of equipment SLBs executed annually. The ELFA estimates that \$827 billion in equipment cost is executed annually as leases. The ELFA estimates are understated as they represent responses received to the latest annual survey of their members who choose to respond which means it does not include the total population of US equipment lessors.

In general, many leased equipment acquisitions are originated as SLBs and a fixed price purchase option (FPPO) is a customary term in the large majority of Type B leases.

The SLBs of newly placed-in-service assets generally fall into 2 categories:

- large ticket items that have a long, complex acquisition process and
- high volume small ticket assets that are leased via master leases where for efficiency purposes, lessees fund individual assets and the lessor does a periodic mass sale leaseback.

Leases of large ticket items like corporate aircraft (an estimated 6% of total \$827 billion annual volume of equipment leases), vessels (3%), railcars (2%), energy (2%), and commercial aircraft (10%), represent about 23% or an estimated \$190 billion annually and most are executed as

SLBs. ILFC, the largest lessor of aircraft, recently reported that 40% of the 19,000+ aircraft in the world are leased. I estimate that about 25% of the leased aircraft were originated as SLBs and most would have FPPOs.

Leases of computers (20%), office machines & furniture (8%), autos (1%, also under reported as US fleet lessors have their own trade association), trucks/trailers (14%) representing about \$370 billion annually and most are executed as master leases where the lessee often funds the individual assets as they deliver and the lessor executes a monthly or quarterly "sweep" SLB to include the assets as schedules in the master lease.

Two Types of Equipment Sale leasebacks

Generally there are two types of equipment SLBs:

- those sale leasebacks that involve already owned assets of the seller/lessee and
- those that occur at or near the placed in service date of the asset

There is little concern under current US GAAP regarding the accounting for an equipment lease sale leaseback with a non bargain purchase option except for "integral" equipment that is subject to the real estate sale leaseback rules. The reason for little concern is because under current GAAP a risks and rewards analysis determines when a sale has taken place. As a result many equipment leases are executed as sale leasebacks with FPPOs. To deal with tax and commercial law issues that require differentiation between new and used equipment, relief is given typically in the form of a 90 day window after the placed in service (delivery) date to execute a sale leaseback yet still consider the leased asset to be new rather than used. The following phrase in Revenue Recognition guidance implies that the Boards considered this issue "an entity obtains legal title of a product only momentarily before the title is transferred to the customer, this does not necessarily indicate that the entity is acting as the principal in the arrangement". I ask that the Board consider expanding on this or clarifying it in terms of specifically dealing with the issue of SLBs executed at or near the placed-in-service date of the asset. The difference between a moment and 90 days where the ultimate lease has a term of 3, 5 or 15 years does not seem to be significant and I would like the Board to consider that and provide specific guidance or relief. If "momentarily" is not defined it will be left to interpretation would likely result in inconsistency in practice.

The "Nature" of a SLB with a FPPO

I believe a SLB with a non bargain FPPO is a unique "sale" in 7 respects: (1) the sale transfers ***all*** of the risks in the asset sold and ***all*** of the ***expected*** rewards to the buyer/lessor, (2) the seller/lessee continues to use the "sold" asset for the lease term as the buyer/lessor charges rent (an economic benefit to the lessor) for the transfer of the right to use the asset to the lessee, (3) the buyer legally owns the lease and residual interest in the leased asset and can sell or pledge either or both, (4) whether the transaction is in fact a sale between the seller/lessee and buyer/lessor is resolved in the future when the purchase option is either not exercised or exercised, (5) the lessee does not have a significant economic incentive to exercise the purchase option so the option could be viewed as non substantive, if the Board so

decides, (6) the only lessee liability assured at inception is a Type B “non-debt” executory lease liability, and (4) the only lessee asset that is assured at inception is the Type B ROU asset (an intangible executory contract asset) . To deal with these issues I recommend that SLB’s be excluded from the scope of Revenue Recognition or failed SLB accounting be executed using the view for failed SLB accounting presented below.

I believe that imposing the concept of control to define a sale in a sale leaseback transaction with a FPPO is an interesting accounting theory but lacks a practical, legal based view that is the basis that users like lenders and credit analysts employ when using financial statements to make their decisions. Those users want to know the amounts of assets that can be liquidated as collateral to repay the preparer’s debts. They also want to know the amounts of the preparer’s debt that would compete with new debt in a liquidation. If in a “failed” SLB the "sold" asset remains on the balance sheet and the sales proceeds appear as a loan/debt, the resulting balance sheet presentation will not reflect the nature of the assets and liability nor their actual amounts. I am not asking the Board to account for a SLB assuming a bankruptcy, but I am saying that users (particularly lenders and credit analysts) need to know which assets and liabilities of the preparer survive in a bankruptcy that reaches the liquidation stage.

Failed Sale Leaseback Accounting

SLBs occurring at or near the delivery date of the asset rarely involve a “gain on sale” as the asset cost typically is the sales price funded by the lessor. SLBs of already owned assets often involve gains on sale as the assets are depreciating assets. Those already owned assets are clearly controlled by the lessee. In the case where a SLB of an already owned asset contains a non-bargain purchase option Revenue Recognition would consider that a failed SLB. I recommend that failed SLB accounting for ***any*** type of SLB be executed by the lessee as follows:

1. To record the receipt of cash: Debit cash, credit the asset’s book value and credit deferred credit (if there is a loss it should be recognized immediately). This approach recognizes that a sale has not taken place at inception. The purchase option is an option embedded in the leaseback. The sale, if it occurs, happens in the future if the FPPO is ***not*** exercised. If the FPPO ***is*** exercised then the sale never took place.
2. To record the lease: Recognize a Type B ROU asset and lease liability. Follow the Type B lease decisions on measurement, subsequent accounting and financial presentation to be consistent with the Leases project decisions, but more importantly lease accounting reflects the true nature of the assets and liabilities in the transaction to users of the lessee’s financial statements. In particular, lenders and credit analysts need to know which lease assets and liabilities are Type A or Type B lease assets and liabilities. In substance the SLB is a lease not a loan/debt. It is a question of reporting the liability as a loan or an executory contract liability.
3. To resolve the deferred credit: Recognize any deferred credit as a gain from the “sale” when the lease ends and the asset is returned to the lessor. If the purchase option is exercised the deferred credit should be credited against the asset value reflecting that a sale never took place.

The result of this accounting is that there is no sale, no “sale” profit is recognized at inception and the transaction is accounted for according to its substance as a Type B lease.

From a lessor's perspective I also recommend that lease accounting be employed, whether it is Type A or Type B lease accounting. If the SLB is recorded as a loan by the lessor the asset will be misrepresented as a loan receivable rather than either a physical asset for Type B leases or a receivable and residual asset for Type A leases. Users of lessor financial statements will not understand the nature of and risk profile of the SLB assets.

Sale Leasebacks Occurring at or Near the Placed-in-Service Date of the Asset

I ask the Board to provide specific guidance in the standard for SLBs as to when a lessee is considered an agent of the ultimate buyer/lessor and when control of the physical asset transfers in a large ticket transaction where there is a construction period or long time between ordering the asset and taking delivery and placing it in service. I ask the Board if it is their intent that all third party lessor leases be considered SLBs, as in all those transactions the lessee is always involved in the process of the selection and acquisition of the asset and the selection of the lessor. If left to practice auditors may view agent arrangements as putting the lessee in control of the asset as the lessee chooses the asset and the lessor. They may also view a purchase order/commitment and/or a progress payment as effective control of the to-be-delivered physical asset.

I believe if the lessee is merely acting as an agent in the SLB then the sale of equipment is taking place between the asset provider/seller and lessor/buyer - the lessee is the agent of the lessor.

- I can foresee lessees in master leases involving many small ticket assets signing agency agreements with their master lease lessor. The agreement would state that the lessee is acting as agent in arranging the ultimate lease transaction, but funding the assets as a convenience for the ultimate lessor. The lessor will buy the assets from the lessee/agent in a monthly sweep transaction and then lease the assets to the lessee. The lessor charges a lower rate to the lessee in consideration for reducing the lessor's cost to administer the master lease. I ask that guidance be included in the standards for this common business arrangement.
- For big ticket transactions I can foresee a lessee (like an airline, railroad company or a rail car leasing company) entering agency agreements with entities that they pre-select as possible lessors in future lease transactions. The agreement would state that the lessee will act as agent in arranging a lease of an asset to be identified. The lessee would order the asset to be leased or contract to have the asset built. The lessee would make down payments, deposit payments and or make progress payments and then enter into a lease with the lessor selected with the best lease terms. Would those lessee actions be considered indicators of control of the to-be-delivered physical asset? Revenue Recognition exempts transactions as sales where the party who funds the asset temporarily is an agent of the ultimate buyer. Revenue Recognition also says an entity may obtain legal title of a product only momentarily before the title is transferred to the customer (buyer/lessor), and that action does not necessarily indicate that the entity (lessee) is acting as the principal in the sale arrangement.

Revenue Recognition includes guidance to help in assessing whether an entity is an agent in a transaction rather than a principal. In practice, the “lessee” may intend to execute a lease to obtain the right of use of large ticket asset, but due to logistical, administrative or commercial factors, may not identify the ultimate lessor or agree to final lease terms prior to the physical asset being delivered and placed into service. In this case, I believe the lessee may in effect be acting as an agent rather than a principal in the initial sale transaction. The “second sale” merely creates the means for the ultimate buyer-lessor to execute a lease with the lessee as evidenced by the fact that the lessee generally:

- Lacks exposure to the significant risks and rewards associated with the sale of the asset to be leased, that is, inventory or asset value risk before or after the asset has been put under the ultimate lease as the sale is at cost.
- Lacks a gross selling profit as the amount the lessee entity earns is predetermined at zero, because the amount paid by the lessor entity to the lessee entity is the **original cost** billed by the original seller/producer of the leased asset.
- Lacks discretion in establishing prices for the lessor’s purchase price or rent to be charged in the lease therefore, the benefit that the lessee can receive from the leased asset is limited.
- Lacks exposure to credit risk for the amount receivable from the lessor in exchange for the leased asset.
- Obtains legal title of a product only momentarily before the title is transferred to the lessor, this does not necessarily indicate that the entity is acting as the principal in the arrangement.

To avoid lessees having to execute costly extra steps to insure that their lease is not a failed SLB under the new rules it would be helpful to include more robust guidance focusing on providing clarity for the treatment of SLB transactions. The intent in these transactions, when occurring at or near the asset delivery date, is that the lessee is acting as an agent in the sale. The issue then is in what capacity does the lessee have control over the asset? If the lessee transfers ownership to the lessor at or about the time the asset is placed in service (e.g., gap between in-service and sale leaseback is momentary, possibly defined as no longer than 90 days), then I believe the lessee is merely acting as an agent.

Examining the issue from a “control” perspective, if a lessee orders equipment, pays down payments, pays progress payments or makes deposit payments, does that mean the lessee entity is in “control” of the asset prior to execution the SLB? It appears that the lessee has entered an executory contract prior to delivery of the physical asset and does not control the asset. I ask the Board to provide clarity and specific guidance.

Transition

I ask the Board to grandfather existing SLBs by not requiring lessees or lessors to review existing transactions to determine if the sale qualifies as a sale under the Revenue Recognition standard. It will be a costly exercise and possibly infeasible. It will be costly due to the pervasiveness of SLBs. It may not be feasible as the documentation may not be available to

determine if the lessee was in control of the asset at inception of the lease. For lessors, individual leases are often bought and sold and portfolios of leases may have been subject to mergers and acquisitions such that the current lessor is often not the original lessor. The documentation may be difficult to retrieve and analyze. The personnel managing the leases may not have been involved with their origination.

The basic Leases standard transition rules will require both lessees and lessors to record those grandfathered SLBs as any other leases. That will not result in any compromise of key financial information for users regarding the substance of those transactions as in fact they are Type B leases. Current US GAAP required that any gains be deferred and I would recommend that not be changed regarding the grandfathered SLBs that have FPPOs.

Conclusion

I continue to support the Leases project goal of capitalizing leases on the lessee's balance sheet, but also believe that this goal can be met in ways that continue to provide useful and relevant information for credit analysts, lenders and other users of financial statements. I am available to help the Board and staff with any additional information to clarify or further support my positions and recommendations.

Sincerely,

A handwritten signature in black ink, appearing to read "W. Bosco". The signature is fluid and cursive, with a large initial "W" and a long, sweeping tail.

William Bosco

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