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Mr. Hans Hoogervorst  
Chairman  
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30 Cannon Street  
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October 14, 2014

Re: Leases Project Redeliberations -- Sale Leaseback Transactions

Dear Chairman Golden and Chairman Hoogervorst:

We at the Equipment Leasing and Finance Association (ELFA) have been following the Boards' redeliberation of matters related to the *Leases* project. The ELFA is the trade association representing over 600 financial services companies and manufacturers in the \$827 billion U.S. equipment finance sector. ELFA members are the driving force behind the growth in the commercial equipment leasing and finance market and contribute to capital formation in the U.S. and abroad. Overall, business investment in equipment and software accounts for 8.0 percent of the GDP; the commercial equipment finance sector contributes about 4.5 percent to the GDP. For more information, please visit <http://www.elfaonline.org>.

We are writing the Boards to express our support for the FASB's tentative decision to interpret the requirements for sale accounting in lease transactions within the context of the recently issued standard *Revenue from Contracts with Customers* ("Revenue Recognition"). We also support the FASB's clarification that a repurchase option exercisable at the then-prevailing fair market value would not preclude sale treatment in a sale leaseback transaction provided the underlying asset is both non-specialized and readily available in the marketplace. We are also writing to:

- Provide the Boards with additional information on sale leaseback transactions involving equipment,

- Raise several implementation questions that we believe should be addressed in a final *Leases* standard, and
- Request guidance on the interaction of the Revenue Recognition standard and the proposed *Leases* standards.

With regards to this last question, we are seeking additional guidance regarding which transactions are within the scope of sale leaseback accounting. Specifically, we are asking the Boards for clarification about whether the lessee is acting as an agent or as a principal when it is involved in asset construction or asset acquisition and for clarification of the meaning of “momentarily” when applied to leasing transactions. These questions arise due to the significant difference in the accounting for equipment leases that will result depending upon whether a lease is only a lessor to lessee transaction or whether it involves a seller/lessee and a lessor. In the sections below we offer background information on sale leasebacks to help in deliberating these issues.

Given the frequent use of sale-leaseback transactions executed on or about the time of new equipment acquisitions, a use facilitated by U.S. commercial law and tax law (the so-called “90 day window” as explained below) and by current GAAP, we also request that a final *Leases* standard provide for prospective application to sale leaseback transactions, as we believe there are compelling cost-benefit reasons in support of this request.

With regards to the accounting for “failed” sale leasebacks, the FASB discussed at the August 23, 2014 meeting “failed” sale leaseback accounting when the lease contains a fixed price non-bargain purchase option and asked the staff to provide detailed examples of suggested accounting alternatives. In order to aid this analysis, we have included in attachments to this letter our interpretation of the journal entries required when a sale leaseback transaction does not qualify as a sale under the Revenue Recognition standard. These attachments present alternative interpretations of the journal entries required by lessors and lessees under these circumstances.

### **Background on Equipment Sale Leasebacks**

Our members occasionally will participate as lessees or as lessors in transactions where:

- There is a sale leaseback involving assets that have been owned by the seller/lessee for some extended period of time; and
- Sale leasebacks that occur at or near the placed in service date of the asset, where the seller/lessee has taken delivery of the asset and shortly thereafter enters into a sale leaseback of the asset; the sale leaseback generally involves other assets that were also recently delivered.

While we do not have statistics regarding sale leasebacks of equipment, we believe a meaningful percentage of leases are sale leasebacks, especially sale leasebacks that fall into the second category.

Transactions that fall into the second category are often executed in this fashion for administrative ease as the purchase order does not have to be assigned to the lessor. These transactions are further aided by relief in tax and commercial law that provides for a 90-day window after the in-service date for companies to execute sale and leaseback transactions and still have the asset considered to be a new asset for tax purposes.

## Which Transactions Should be Within the Scope of Sale Leaseback Accounting?

We believe the first group of transactions, those involving assets that have been held by the seller/lessee for a meaningful period of time, should be included in the scope of the proposed sale leaseback accounting. We also believe that a transaction in which the lessee purchases an asset and simultaneously enters into a sale leaseback should not be within the scope of sale leaseback accounting. While the seller/lessee has taken possession of the asset, it has done so primarily for administrative convenience and is acting in a manner similar to that of an agent facilitating the sale leaseback. We also believe the lessee's execution of a delivery and acceptance certificate to commence the lease, which is necessary for the lease to have "hell or high water" standing, should not be viewed as a sale leaseback transaction when the execution occurs within the same reporting period that control passes from the manufacturer.

We believe the above conclusions would be consistent with guidance included in the Revenue Recognition standard. For example, it is stated in Revenue Recognition that if:

*. . . 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 [606-10-55-37].*

We ask that the Boards consider clarifying the scope of sale leaseback accounting by providing that mere delivery and temporary possession of the underlying by the lessee should not in and of itself result in finance accounting if the underlying is to be transferred in an administratively efficient time period within, say, the same reporting period. As indicated above, this goal may be best achieved by clarifying when the lessee is merely acting as an agent of the buyer/lessor in situations where the lessee was involved in the acquisition of the asset to be leased. This clarification would limit the impact on contract administration by applying a commercially reasonable substance over form approach.

Lease documentation could mirror this approach to transactions. For example, in master leases involving many small ticket assets, we can envision the lessee signing an agency agreement with the lessor that would also provide clear documentation for determining the nature of the lessee's involvement in asset acquisition. The agreement would state that the lessee is acting as an agent in readying the asset for lease by funding and temporarily taking possession of the underlying on behalf of the lessor for legal and administrative purposes. The lessor would then buy the assets from the lessee/agent in a "clean up" transaction and commence the lease. An alternative form of an agency arrangement might involve the lessee assigning purchase orders to the lessor before control passes from the manufacturer and receiving reimbursement from the lessor for any down payments made.

In summary, in order to avoid having lessors and lessees adjust the sequencing of transactions, it would be helpful to include more robust agent vs. principal guidance in the context of lease transactions. This guidance should provide clarity around the treatment of transactions where the lessee is in the "chain of ownership" for a short period of time at or near lease commencement. 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 we believe there is a strong basis to assert the lessee has only served as an agent in that phase of the transaction.

## **What is the Impact of Eliminating EITF Issue No. 97-10?**

We expect that EITF Issue No. 97-10, *The Effect of Lessee Involvement in Asset Construction*, [EITF 97-10] will be removed from the codification once a new *Leases* standard is adopted. While this guidance was primarily written for transactions involving real estate, it was also applied to equipment transactions. EITF 97-10, through a series of conditions and tests, sets out the instances when asset ownership should be imputed to a future lessee even when the lessee is not the owner of the asset.

Since EITF 97-10's criteria for asset ownership are very different from the customer perspective included in the Revenue Recognition standard, we believe guidance is necessary for preparers to determine which transaction features create a deemed sale leaseback transaction. For example, if a company orders an asset and places a deposit on the asset to be delivered in the future, has the company acquired an interest in the underlying asset as a principal or has it acquired an assignable contract right that should be excluded from sale leaseback accounting? When viewed from a Revenue Recognition perspective, it appears that the payment of a deposit does not represent ownership of the underlying asset, assuming a revenue related performance obligation has not yet been satisfied. As with the scenario described in the preceding section, we believe that clarifying guidance is required to assist preparers and their auditors.

## **Should a More Robust Analysis of Fixed Price Purchase Options be Considered?**

Fixed price purchase options (FPPO) became common features of lease agreements in response to record levels of inflation occurring in the 1970s – when asset values were appreciating significantly – and were compounded by the effects of deregulation in the transportation industry which altered the demand-supply conditions that had existed in a regulated environment. Simultaneously with these developments, the U.S. Supreme Court confirmed the appropriateness of non-bargain, non-compulsive FPPO in true lease transactions in *its Frank Lyon Company* decision (1978). As the equipment leasing and used equipment market matured, the granting of FPPO's (or early buy out options) in accordance with U.S. GAAP and U.S income tax case law became essentially “boiler plate,” that is, “expected” and not generally negotiated.

Given that a meaningful number of leases involve the seller/lessee taking delivery of a new asset prior to entering into the sale leaseback transactions, the preliminary conclusion that an FPPO will preclude sale (revenue) accounting and require a form of whole asset accounting, as a result of the sequencing of a transaction, is consequential. We are concerned it will create a significant disruption in an otherwise “settled” way of doing business. Accordingly, we believe the Boards should continue redeliberations on whether to sustain the tentative conclusion or to modify it by providing that the presence of an FPPO in a sale-leaseback transaction involving a “non-specialized” asset which is readily available in the market creates a rebuttable presumption that such an option is not substantive and fails to maintain a seller/lessee's control over the asset. It could then provide such a presumption can be overcome by assessing the facts and circumstances on a case-by-case basis. For example, it should be generally easier to overcome the presumption if an established secondary market for this class of assets makes it possible to reliably predict future market prices. We acknowledge the FASB briefly discussed situations where an FPPO might be acceptable; however, we believe a more complete discussion is warranted given the impact of the Board's decision will have on existing practice

## **How Would a Seller Apply Failed Sale Leaseback Accounting?**

The accounting by a lessee for a failed sale in a sale leaseback transaction raises a series of questions. Included in Attachment II to this letter are examples of the proposed accounting, together with the questions that we believe should be considered before a final standard is issued.

## **How Should a Lessor Account for a Failed Sale Leaseback Transaction?**

We are not certain the requirement that lessors account for failed sale leaseback transactions as financings results in a fair presentation of the lessor's position in a lease. If a lessor has purchased an asset, it has paid one hundred percent of an asset's fair value, but the leaseback will be for less than that fair value, significantly less in many instances. Recording the total investment as a loan financing rather than as a Type A or B lease will obscure the residual risks the lessor has in the lease. We also note that by removing failed sale leaseback transactions from the scope of the standard it could result in different accounting treatment for initial direct costs, variable payments and possibly raise questions regarding the grandfathering of leveraged lease transactions. Included in Attachment II to this letter are some of the practice questions that we believe should be resolved with regards to applying this tentative decision.

We understand the Boards' desire for symmetry in sale leaseback transactions. We also appreciate the concern some may have about introducing asymmetry into sale leaseback transactions when that asymmetry is a direct result of the evaluation of the accounting for the buyer/customer. Still, we believe the accounting should be representationally faithful and should not transform a lessor's residual risk into lessee credit risk simply to benefit the coherence of the accounting model.

## **Transition**

If the final *Leases* standard contains the existing scope proposals for sale leaseback transactions, we ask the Boards to considering grandfathering sale leasebacks that are in place as of the effective date of the new standard. It will be a time consuming and costly exercise for lessors and lessees to determine which transactions are sale leasebacks. It may be very difficult to determine which transactions are within the scope of sale leasebacks without a thorough review of all of the transaction documentation, as once these transactions were executed there was no need to tag transactions in an accounting system as sale leasebacks. Accordingly, we believe the cost will exceed the possible benefits associated with retroactive treatment of this class of transactions.

The basic transition rules will require both lessees and lessors to account for existing sale leasebacks as if they were any other lease transaction. This will result in the recognition of a lease asset and liability by the lessee and will not result in any meaningful reduction of the key information regarding the substance of those transactions. As part of transition, we would also suggest that any gains related to existing sale leaseback transactions be deferred until the purchase option and/or residual guarantees have been resolved.

## **Conclusion**

We generally support the FASB's recent deliberations on sale leaseback transactions; however, we believe further deliberations and clarifying guidance is needed to address constituent concerns regarding the scope of its provisions and the implementation questions outlined in this letter. We remain willing and available to assist the Boards and staff and provide any additional information as may be necessary to further support our above stated positions.

Sincerely,

A handwritten signature in black ink, appearing to read 'WGS', with a stylized flourish extending to the right.

William G. Sutton, CAE  
President and CEO

*Attachments*

## Attachment I

### Accounting for Failed Sale Leasebacks: Lessee Examples and Questions

The ELFA's general position is that the underlying asset in a sale leaseback transaction should be considered sold and derecognized by the seller/lessee even if the lease contains a FPPO as long as the FPPO is not substantive and the assets are not specialized and readily available in the marketplace. We also believe that transactions close to the in-service date where the seller/lessee has effectively been an agent of the buyer/lessor in connection with the lease transaction should be outside the scope of sale leaseback accounting.

If it is necessary, however, to apply failed sale accounting to a sale leaseback, there are implementation issues that should be resolved prior to the issuance of a final *Leases* standard. These issues are illustrated in the following examples.

#### Assumptions

The lease contains a FPPO that would not be included in the measurement of the lease liability under the tentative decisions in the *Leases* project. The FPPO is set at projected FMV and no significant incentive to exercise it exists. Other assumptions are as follows:

Asset book/carrying value	\$90.00
Sales price/fair value	\$100.00
Lease term	5 yrs
Rent payment annual in arrears	\$20.89
Lessee incremental borrowing rate	6%
Lessor implicit rate	1.47%
PV of rents @ 6% Incr. borrowing. rate	\$88.00
Fixed PO (at end of year 4)	\$19.71
Lease type	Type B

- A. Record the sale leaseback as a financing (debt) with a loan amount equal to the proceeds received and the whole asset is retained on the balance sheet. Interest on the obligation is imputed using an interest rate equal to the implicit rate (1.47%) without the residual. The example assumes the FPPO is not exercised.**

Journal Entry 1: To record the receipt of cash from the "sale" as a loan payable

Dr. Cash	100.00	
	Cr. Loan payable	100.00

Journal Entry 2: To record the first year's interest accrual

Dr. Interest expense	1.47	
	Cr. Loan payable	1.47

Journal Entry 3: To record the first year's lease payment

Dr. Loan payable	20.89	
Cr. Cash		20.89

**Commentary**

Pros: This approach may be desirable as

- The transaction is not accounted for as a sale
- Journal entries reflect a financing concept

Cons: Issues with this approach are as follows

- Seller's position in the asset (including risks of ownership) is overstated.
- Amount of obligation is overstated and is presented as "debt" vs. a Type B lease liability.
- Interest rate on obligation is understated

***B. Record the sale leaseback as a financing (debt) with a loan amount equal to the proceeds received and the whole asset is retained on the balance sheet. Interest on the obligation is imputed using an interest rate equal to the lessee's incremental borrowing rate (6.0%) and applying only the contractual lease payments to pay down the loan. There is negative amortization of the financing which leaves a remaining unpaid principal at the end of the lease of \$16.04.***

Journal Entry 1: To record the receipt of cash from the "sale" as a loan payable

Dr. Cash	100.00	
Cr. Loan payable		100.00

Journal Entry 2: To record the first year's interest accrual

Dr. Interest expense	6.00	
Cr. Loan payable		6.00

Journal Entry 3: To record the first year's lease payment

Dr. Loan payable	20.89	
Cr. Cash		20.89

**Commentary**

Pros:

- The transaction is not accounted for as a sale
- Journal entries reflect a financing concept

Cons: Issues with this approach are as follows

- Seller's position in the asset (including risks of ownership) is overstated.
- The amount of the financing obligation is overstated and is presented as "debt" vs. a Type B lease liability.
- Negative amortization results in an unpaid balance at the FPPO date that is higher than the FPPO. If the FPPO is not exercised, there is an unpaid balance at lease expiration, which is not an obligation of the lessee; details are provided below:

Negative amortization run out					
RATE	6%				
Year	Int Exp	Pmt	Bal	FPPO	Diff
0			100.00		
1	6.00	20.89	85.11		
2	5.11	20.89	69.33		
3	4.16	20.89	52.60		
4	3.16	20.89	34.86	19.71	(15.15)
5	2.09	20.89	16.06		

**C. Financing method – gross presentation: Record the exchange of the physical asset for a leasehold interest and the retention of residual interest (the asset controlled by the seller-lessee). Defer any gain until the purchase option has been resolved. Allocate the seller-lessee's book value by imputing the recorded value of the leasehold interest, using the lessee's incremental borrowing rate (6%), and report the remainder as the retained residual interest controlled by the lessee.**

Journal Entry 1: To record exchange of the physical asset for a leasehold interest, the retention of a residual interest in the asset, and defer all of the gain until the FPPO is resolved.

Dr. Cash	100.00	
Dr. ROU asset	88.00	
Cr. Asset's book value	79.20	(\$90 x 88/100, leaving 10.80 as a residual)
Cr. Deferred credit	20.80	(\$10.80 [recovery] + \$10.00 [\$100-\$90])
Cr. Loan payable	88.00	

Journal Entry 2: To record the first year's interest accrual

Dr. Interest expense	5.28	
Cr: Loan payable		5.28

Journal Entry 3: To record the first year's payment

Dr. Loan payable	20.89	
Cr: Cash		20.89

A.) If the purchase option is *not* exercised, the sale is completed

Dr. Deferred credit	20.80	
Cr. Residual interest		10.80
Cr. Gain on sale		10.00

B.) If the purchase option *is* exercised, the deferred gain is netted against the PO price

Dr. Physical asset	9.71	
Dr. Deferred credit	20.80	
Cr. Residual		10.80
Cr. Cash		19.71

### Commentary

Pros: This approach accounts for the transaction as a failed sale, but also considers the change in the nature of the asset held by the lessee, with an ROU asset and liability recognized. It also gives explicit recognition to the retained interest controlled by the lessee. The gain is deferred until the FPPO is resolved, to be either recognized at the time the FPPO expires or to be netted against the repurchase price.

Cons: Issues with this approach are as follows

- Reacquired asset is recorded below FMV
- The residual asset is not an asset of the lessee in liquidation and the seller/lessee may not benefit from it by either pledging or selling it

***D. ELFA's approach - Derecognize the "sold" asset, defer any gain until the FPPO is resolved, and account for the lease as a Type B lease, consistent with its classification.***

Journal Entry 1: To record the receipt of cash from the "sale"

Dr. Cash	100.00	
Cr. Asset's book value		90.00
Cr. Deferred credit		10.00

Journal Entry 2: To record the leaseback

Dr. Type B ROU asset	88.00	
Cr. Type B lease liability		88.00

Note: Day 2 accounting will follow the Type B lease decisions on measurement, subsequent accounting and financial presentation to be representationally faithful.

Journal Entry 3: To record the first year's lease cost

Dr. Rent expense	20.89	
Cr. Accrued rent payable		20.89

Journal Entry 4: To record the first year's rent payment:

Dr. Accrued rent payable	20.89	
Cr. Cash		20.89

Journal Entry 5: To resolve the deferred credit:

If the purchase option is not exercised, the sale is completed:

Dr. Deferred credit	10.00	
Cr. Gain on sale		10.00

If the purchase option is exercised, the sale never took place and the asset carrying value is reduced by the deferred gain:

Dr. Physical asset	9.71	
Dr. Deferred credit	10.00	
Cr. Cash		19.71

## Commentary

Pros: The asset and liability from the lease leg of the transaction are accounted for and presented according to their substance as a Type B lease, in this example.

- Initial accounting recognizes the transfer without recognizing the profit on the sale of the underlying asset.
- A "sale" occurs if the PO is not exercised.

Cons: Issues with this approach are as follows

- Requires consideration of FPPO as potentially non substantive or additional interpretations of agency and principal relationships
- Reacquired asset is recorded below FMV

## Attachment II

### Accounting for Failed Sale Leasebacks: Lessor Examples and Questions

The ELFA's general position is that, for lessor accounting, the underlying asset in a sale leaseback transaction should be considered to have been purchased by the lessor and leased to the seller lessee – with the lease accounting following lessor Type A or B accounting depending on the classification decision. This should be true even if the lease contains a feature, such as an FPPO, that would preclude the seller lessee from recognizing revenue (formerly, a sale in the accounting literature). We also believe that applying loan accounting for a failed sale when a leaseback exists produces results that are not representationally faithful and should be avoided. These concerns are illustrated in the following examples.

#### Assumptions

Example assumes the buyer lessor purchases the asset and leases it back to the lessee under a lease that contains a FPPO. The FPPO is set at projected FMV and no significant incentive to exercise it exists

Purchase price/fair value	\$100
Rent payment annual in arrears	\$20.89
Lessor assumed residual	\$12.50
Lease term	5 yrs
Fixed PO (at end of year 4)	\$31.78
Lessor implicit rate without the residual	1.47%
Lessor implicit rate with the FPPO as the residual	5.08%

- A. Record the sale leaseback as a financing with a loan amount equal to the asset "purchase" price. Interest on the loan is imputed using an interest rate equal to the implicit rate (1.47%) in the lease without the residual being considered (assumes the purchase option is not exercised and the loan must fully amortize to zero by the end of the lease term).**

Journal Entry 1: To record the cash purchase price paid to the lessee as a loan receivable

Dr. Loan receivable	100.00	
Cr. Cash		100.00

Journal Entry 2: To record the first year's interest accrual

Dr. Loan receivable	1.47	
Cr. Interest revenue		1.47

Journal Entry 3: To record receipt of the first year's lease payment

Dr. Cash	20.89	
Cr. Loan receivable		20.89

## Commentary

Pros: This approach may be desirable as

- It is consistent with the Revenue Recognition standard. The transaction is not accounted for as an asset purchase and a lease by the lessor.
- Journal entries reflect a financing concept.

Cons: Issues with this approach are as follows

- Buyer's risk position in the asset (including credit risks) is misrepresented.
- Residual asset risk is not reported.
- Interest rate on the loan is understated as the residual is not considered.

***B. Alternative financing method – Record the sale leaseback as a financing with a loan amount equal to the purchase price. Interest on the loan is imputed using an interest rate equal to the implicit rate (5.08%) in the lease, assuming the FPPO is the last payment in the financing (loan).***

Journal Entry 1: To record the cash purchase price paid to the lessee as a loan receivable

Dr. Loan receivable	100.00	
Cr. Cash		100.00

Journal Entry 2: To record the first year's interest accrual

Dr. Loan receivable	5.08	
Cr. Interest revenue		5.08

Journal Entry 3: To record receipt of the first year's lease payment

Dr. Cash	20.89	
Cr. Loan receivable		20.89

## Commentary

Pros:

- Consistent with the Revenue Recognition standard, the transaction is not accounted for as an asset purchase and a lease by the lessor
- Journal entries reflect a financing concept.

Cons: Issues with this approach are as follows

- Buyer's risk position in the asset (including credit risks) is misrepresented.
- Presenting the residual value/FPPO as the final payment of the loan financing makes the lessor's residual asset risk appear as if it were lessee credit risk.

**C. ELFA's approach - Recognize the purchased asset and account for the lease as a Type A or B lease**

Journal Entry 1: To record the cash paid and purchase of the asset

Dr. Asset	100.00	
Cr. Cash		100.00

If the leaseback is a Type B lease to the lessor:

Journal Entry 2: To record the annual revenue

Dr. Depreciation	20.00	
Cr. Accumulated depreciation		20.00

Journal Entry 3: To record the annual rent revenue

Dr. Cash	20.89	
Cr. Rent revenue		20.89

If the leaseback is a Type A to the lessor:

Journal Entry 1: To derecognize the asset and record the Type A lease

Dr. Lease receivable	104.45	
Dr. Residual asset	12.50	
Cr Unearned lease income		16.95
Cr. Cash		100.00

Journal Entry 2: To record the first year's revenue

Dr. Unearned lease revenue	5.08	
Cr. Lease revenue		5.08

Journal Entry 3: To record rent received

Dr. Cash	20.89	
Cr. Lease receivable		20.89

Note: Day 2 accounting will follow the Type A or B lease decisions, as appropriate.

**Commentary**

Pros:

- Initial accounting recognizes the purchase of the asset and a lease.
- The lessor's assets clearly reflect the nature of the assets and their associated risk profiles.

- For leases classified as Type A the revenue recognized reflects a financing pattern.

Cons: Issues with this approach are as follows,

- Does not follow the Revenue Recognition concept that the lessor has not purchased the asset and does not control it.
- Does not follow the Revenue Recognition concept the transaction is a financing and not a lease.
- May raise questions regarding the symmetry in other areas of Revenue Recognition.