

July 15, 2014

Mr. Russ Golden, Chairman
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Delivered Electronically

SUBJECT: COMMENTS RE: Final Tentative Decisions in the Lease Project – Sale leaseback transactions

Dear Chairman Golden and Chairman Hoogervorst:

We, the Railcar Leasing Coalition (“the Coalition”), represent many of the largest railcar lessors doing business in North America, with some companies operating globally as well. According to the Association of American Railroads, more than fifty-seven percent of the 1.6 million railcars utilized in the US are lessor-owned¹. We have closely followed the progress of the FASB and IASB (collectively, “the Boards”) redeliberations on the Proposed Accounting Standards Update (Revised), *Leases (Topic 842)* (“the Leases ED”). We have also reviewed the recently issued Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (“Topic 606”)*. This letter sets out the consensus views of the Coalition relating to the potential interaction of Topic 606 with the proposed lease accounting model for sale leaseback transactions (“SLBs”) for both the lessee and the lessor.

Our recommendations herein are intended to provide a basis to address SLB transactions without compromising or changing the revenue model under Topic 606.

SLB Transactions

¹ Numbers derived from data in Umler Database. 1 January 2013. Available for purchase from Railinc (www.railinc.com).

The SLB arrangement contains two components: an asset sale to a lessor and a corresponding lease issued by the lessor. The lease will typically include standard lease features, including a form of purchase option that: (a) is part of an end-of-lease choice to lessee to either return, renew or purchase the asset at the then-current fair value or a fixed price established at lease origination intended to approximate the fair value at end of lease; or (b) is an early buyout option (EBO), which is a fixed price purchase option established at lease origination intended to approximate the fair value at the contractually stipulated EBO exercise date(s). In both cases, the option is a non-bargain purchase option under both existing lease accounting guidance and the proposed lease accounting model. Consequently, the options will not be factored into lease measurement, unless the embedded option provides a significant economic incentive that makes it reasonably certain of exercise at time of lease origination.

There may be added complexity in SLBs if the transaction (a) is combined with a lease of additional assets such that the number of assets covered by the lease agreement exceeds the number of assets originally “sold” by the lessee; or (b) grants the buyer-lessor the ability to replace or substitute assets that have become damaged during the lease term such that the group of assets subject to an end-of-lease purchase option includes assets that were not previously owned by the lessee.

Lessee

General comments:

We recognize that the Boards have worked to simplify the accounting for SLB transactions. Under existing U.S. Generally Accepted Accounting Principles (“US GAAP”), the accounting depends on whether the underlying asset(s) are equipment or real estate and may result in the following:

- Operating leases involving equipment would have either an immediate or deferred/amortized gain recognition under certain conditions, and
- Purchase options do not impact lessee’s sale accounting for SLBs involving equipment; however, purchase options at any strike price would preclude sales accounting in an SLB involving real estate as they represent a prohibited form of continuing involvement.

Accounting concerns for SLB arrangement:

Topic 606 applies to sales contracts. The model has a binary outcome. That is, an asset is derecognized and revenue is recognized when the entity (supplier) satisfies a performance obligation by transferring a promised good or service to a customer, which is when (or as) the customer obtains control of that good or service. Unless the performance obligation meets the conditions to be considered as being satisfied over time, it is considered to be satisfied at a point in time that is based on when control of the asset has transferred. If control transfers, then the supplier derecognizes the asset resulting in revenue recognition; otherwise, there is no asset derecognition and no revenue.

Separately, a standalone lease contract will be governed by the proposed lease accounting model whereby the lessee will be required to recognize a right of use asset along with a corresponding lease liability.

We believe that the contract combination language provided in Topic 606 and in the proposed lease model (tentative decisions reached in April 2014) would result in treating the SLB as one unit of account as (a) the contracts are negotiated as a package with a single commercial objective; (b) the amount of consideration to be paid in one contract depends on the price or performance of the other contract; and (c) it would be considered a single performance obligation. However, Topic 606 does not contemplate sale contracts which, in conjunction with another contract, require the contemporaneous recognition of a different asset. In the case of SLBs, this is the right of use asset arising from the lease component, which we believe is something different from the original underlying asset. Because the SLB's lease component results in a non-binary outcome, it raises the question whether it is appropriate to evaluate the accounting for the SLB by applying Topic 606 alone. The answer to this question is important given that the accounting guidance concerning inclusion of purchase option differs. Under Topic 606, a transaction does not qualify for sales treatment if the seller "has an obligation or a right to repurchase the asset (a forward or call option)" because the "customer does not obtain control of the asset" due to the limitation imposed by forward or call option. This does not similarly apply to put options for which such features only preclude sales accounting if there is a significant economic incentive to exercise (Topic 606-10-55-66 to 78), which is a similar conceptual basis used in the proposed lease accounting model for evaluating if purchase options are included in lease measurement.

Recommendation:

We do not believe that applying Topic 606 in isolation is appropriate for SLBs. Instead, we recommend one of two alternatives below.

Alternative 1: On the basis that the SLB meets the contract combination criteria to be treated as one unit of account, we recommend that the proposed lease accounting model is applied when determining whether any embedded lease features would preclude sales accounting so long as the lease and the embedded lease features serve a valid business purpose and were not established to achieve an accounting result. This would appear appropriate in the context of contract combination guidance in Topic 606 which is consistent with other US GAAP guidance

such as DIG K-1². If the lease and the embedded lease features are not substantive, then the accounting evaluation of the SLB, including any purchase option embedded in the lease, should be evaluated entirely under Topic 606. We understand that this approach may result in some form of deferred gain recognition.

Alternative 2: We recommend that the Topic 606 Transition Resource Group consider the extent to which other authoritative guidance concerning the evaluation of purchase options should be considered when such features are included in combined contracts treated as one unit of account. In other words, why should there be two forms of accounting guidance for purchase options in lease arrangements depending on whether the feature is contained within a separate standalone lease contract, or in the lease component of a SLB. A call option embedded in the lease component of a SLB does not have characteristics similar to a call option embedded in a sale contract that would indicate an ability of the supplier to call back the asset (at a future date) implying a form of continuing involvement. Therefore, call options that take the form of a standard purchase option embedded in the lease component of a SLB arrangement should not preclude the sale if (a) the lease and the embedded lease features serve a valid business purpose and are not established to achieve an accounting result, and (b) the purchase option embedded in the lease does not require recognition and measurement under the proposed lease accounting model based on whether there is a significant economic incentive such that it is reasonably certain that the option will be exercised (determined at lease origination date when the contract is negotiated). We would recommend that this issue be considered by the Transition Resource Group for added clarity via implementation. An alternative would be to align the evaluation of call options in a manner consistent to that for put options based on whether there is a significant economic incentive that the option will be exercised. This clarity would go a long way given the Topic 606 guidance indicates that non-substantive call options can be ignored but is (a) lost in the Topic 606 Basis of Conclusions (BC427) that will not be codified, and (b) nonsubstantive is not defined.

Lessor

There is a separate matter concerning the accounting treatment of a SLB from the lessor perspective. If we look to current US GAAP, the accounting by the lessor does not require an evaluation of whether the lessee has an asset sale. Consideration is given only to the accounting for the lease according to the criteria set out in ASC Topic 840. The revised lease proposals issued in May 2013 state that lessor accounting is based on an evaluation of whether the seller-lessee meets the Topic 606 conditions for sales accounting. More specifically, the transferee shall not recognize the transferred asset and shall account for the amounts paid as a receivable in accordance with applicable Standards (Lease Project, ED 2013 para 115(b)). The Boards need to reconsider this guidance given the tentative decision reached in March 2014 to retain the dual model concept underlying existing US GAAP and IFRS lessor accounting.

We recommend that the buyer-lessor retain existing accounting guidance, which assumes asset purchase and focuses on accounting for the lease according to the proposed lease model, given

² DIG K-1 “Determining Whether Separate Transactions Should Be Viewed as a Unit” looks to whether the transactions were entered into with the same counterparty, were executed simultaneously, relate to the same risk, and whether the facts reflect a valid substantive business purpose for the transaction (i.e., not a transaction structured to overcome certain accounting)

complications that would arise in applying ED2013 para 115(b) especially for SLB arrangements involving real estate or longer-lived assets subject to shorter-term leases (e.g., railcars subject to SLB for a pool of cars) that would fall under Type B. In this case, the lessor financial statements would report a receivable for an amount significantly greater than the present value of the cash flows on the lease.

Recommendations

Our recommendations are intended to provide a basis to address SLB transactions without compromising or changing the Topic 606 revenue model.

For a seller-lessee involved in an SLB, we do not believe that the SLB should be accounted for under Topic 606 in isolation but rather in the broader context of the proposed lease accounting model assuming: (a) the SLB would fall under the criteria for contract combination as one unit of account; (b) the unit of account yields a non-binary outcome given the recognition of another form of asset due to the lease component not contemplated by Topic 606; and (c) the lease and the embedded lease features serve a valid business purpose. Otherwise, we recommend that the Transition Resource Group consider (a) clarifying implementation of Topic 606 in context of contract combinations whereby the basis to evaluate call options is provided in other authoritative literature and should not give rise to two different approaches to recognizing and measuring purchase options depending on whether they exist in a standalone lease contract or in a combined contract treated as one unit of account, and/or (b) clarifying what is meant by nonsubstantive in the context of when call options can be ignored.

For a buyer-lessor involved in an SLB, we recommend that existing accounting guidance is retained, which assumes an asset purchase and focuses on accounting for the lease based on the proposed lease model.

We are available to assist the Boards and staff and provide any additional information as may be necessary to further support our stated positions.

Sincerely,

The Railcar Leasing Coalition consisting of the following organizations:

American Railcar Leasing, LLC
Chicago Freight Car Leasing Co.
Equipment Leasing and Finance Association (ELFA)
First Union Rail Corporation, A Wells Fargo Company
GATX Corporation
GE Capital, Rail Services
The Andersons, Inc.
The Greenbrier Companies, Inc.

Railway Supply Institute (RSI)
SMBC Rail Services
Trinity Industries, Inc.
VTG Rail, Inc.