Stakeholders for Competitive Financing in America

Mr. Russell Golden
Chairman
Financial Accounting Standards Board
401 Merritt 7, PO Box 5116
Norwalk, CT 06856

July 21, 2014

Re: Leases Project Deliberations

Dear Chairman Golden,

The numerous signatories to this letter have formed the **Stakeholders for Competitive Financing in America,** which includes representatives from large ticket lessors, active equipment lessees, utilities and renewable energy developers, as well as related trade organizations, advisory and law firms, and others active in the business. We all have been following the Boards' deliberations of matters related to the Leases project (the "Leases Project") and we wish to comment on several important issues that impact vital areas of infrastructure and equipment financing in the United States.

Background

As the Project has progressed, FASB has indicated there will be substantial changes to two areas of the lease accounting rules. First, we believe the proposed changes to the sale/leaseback rules will have a significant adverse impact on a key alternative currently available to major US industries to acquire the use of assets. In the process of diversifying financing sources, reducing asset risk and raising the lowest possible cost of capital, entities often utilize sale/leasebacks to acquire the use of long-lived assets (both new and already in-service). As such we are concerned that proposed changes to sale/leaseback accounting rules could negate sale treatment and incorrectly gross-up a lessee's balance sheet with an asset and liability that does not accurately reflect the substance of the sale/leaseback transaction.

Second, FASB has indicated in prior discussions that a final leasing standard will eliminate leveraged lease accounting. The change will also impact the accounting for tax credits, grants, and other incentives as a component of revenue since the existing leveraged lease accounting rules defined how tax credits associated with leases are treated for accounting purposes. A major beneficiary of retaining the leveraged lease accounting rules, and the tax credit revenue recognition, would be the renewable energy industry, which has become an important cornerstone of US energy policy initiatives as well as growth in domestic employment.

Sale/Leasebacks

Sale/leaseback transactions typically involve long-lived assets (30+ years) and are used as important residual risk management tool for lessees in capital-intensive industries. Assets that have been sold and leased back include aircraft, rolling stock, power plants, renewable energy assets and the like. In addition, they offer an important alternative source of providing the right of use of assets for lessees for both new and in-service assets. Importantly, the leaseback will often contain a non-bargain purchase option, while still transferring to the lessor substantially all

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of the risks and all of the expected rewards regarding the leased asset. Under the lease classification criteria such non-bargain purchase option would not negate "Type B" lease treatment. We believe requiring a lessee to include the whole asset and the lease obligation as debt on its balance sheet will not properly reflect the substance and economic reality of such a transaction. Indeed, lenders, credit analysts and bank regulators view the asset sold and leased back as owned by the Lessor and recognize that it will not be available to service debt or other obligations of the lessee. The lease obligation associated with it is a Type B obligation that the Board has decided is not debt. Further, including the whole asset would not properly reflect the residual risk of the transaction as it is truly borne by the Lessor in a sale/leaseback. As an example, this validity of the residual risk transfer element has been proven in the aircraft market over the last several years as many airlines have passed on their early buyout options and instead have opted to return the equipment at the lease end to the original Lessors. These Lessors have needed to manage the resale or re-lease of such aircraft requiring very active involvement by the Lessors in order to recover their investment in the assets they bought and leased back.

It would misstate the economic result if sale/leaseback accounting was overly dependent upon the sale accounting model developed for the revenue recognition model. Sale accounting in the revenue recognition model is an "either/or" outcome: a transaction is either an accounting sale that generates revenue or it is an in substance a financing until control is passed to the buyer. The lessee accounting model, which calls for the lessee to recognize an asset and a liability for the remaining payments in a lease, is based upon a model that separates transactions where the lessee has acquired the underlying asset from the transactions where the lessee only has a temporary right of use. We do not think it is reasonable for a seller-lessee to retain on its books an asset that it has not acquired the right to own. Also, under lease accounting, the seller-lessee will record an asset and liability that is equivalent to its obligations under the lease and not more than such amount. Therefore the financing element of the failed sale in the revenue recognition model is reflected, but it is reflected using the criteria in a different area of accounting.

If a sale/leaseback with a non-bargain purchase option is not treated as a sale, the lessee will reflect an asset that they do not own for bankruptcy liquidation purposes. In addition, if the transaction fails the sale criteria then the seller/lessee will reflect a liability that is not debt in bankruptcy liquidation. The "failed sale/leaseback" asset and liability financial presentation will mislead credit analysts and lenders in their assessment of financial risk of the Lessee. Since the standards within the Leases Project generally will require the capitalization of the right of use asset and related payment obligation, "failed sale/leaseback" accounting would not be necessary to portray the financing element of the transaction on the balance sheet.

For new assets, the ultimate lessee is often involved in ordering the asset, committing to its purchase, overseeing construction, and making deposits/progress payments, which is likely to result in an ultimate sale/leaseback transaction that would fail under the Revenue Recognition sale accounting rules. Under the contemplated rules, if there is a non-bargain purchase option in the leaseback, the transaction would not be considered a sale/leaseback. Often the sequencing of events leading up to the sale takes place prior to the lessee identifying a lessor and negotiating and committing to a lease. In this circumstance, the lessee is acting as an agent rather than a principal. The lessee is not at risk in terms of the asset value before, during or at the end of the lease. In substance the principals to the sale are the equipment manufacturer and the ultimate lessor. The principals to the lease are the lessee and ultimate lessor. The lease, which often contains a non-bargain purchase option, transfers to the lessor

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substantially all the risks and all the expected rewards regarding the leased asset and under the lease classification criteria would not negate "Type B" lease treatment.

Accounting rules changes impact behavior. If the current sale/leaseback rules are changed for equipment and facilities, lessees will change their behavior to avoid actions that put them in the chain of ownership. This will result in increased cost and complexity just to achieve the necessary form of the transaction. Such rule changes will need to closely detail the guidance necessary to determine when a lessee is an owner and when they are not. Equipment and facility leasing transactions were originated under long-standing accounting rules where the extension of non-bargain purchase options did not affect the accounting treatment. The existing population of sale/leasebacks transactions is significant, particularly in the case of large ticket leases. Accordingly, in transition to the new rules, it may impose a considerable compliance task on lessees to obtain the particulars of the asset ownership occurring prior to the consummation of their existing sale/leaseback transactions.

We ask that sale/leasebacks, including those with non-bargain purchase options, continue to receive sale treatment and reflect the economic substance of the transaction (i.e., a "Type B" lease treatment).

Leveraged Leases

Since the Boards have decided to keep the lessor accounting methods in place, with minor changes, we ask that you include leveraged lease accounting rules in that decision as well.

One criticism of leveraged lease accounting is the perceived complexity in the MISF method of recognizing revenue. The rules have been in place for nearly forty years and are well understood. Moreover, there are now numerous commercially available analytical software applications that easily handle the accounting. In our view, leveraged lease accounting is merely a form of direct finance lease accounting, reflecting a rent receivable and a residual asset and recognizing revenue using an "interest rate", albeit the MISF yield. It fits well in the direction the Boards are taking with respect to keeping the current GAAP provisions in place for lessor accounting. To our knowledge no one has cited leveraged lease accounting as a financial reporting deficiency. In fact, those who understand it and practice it would say it is an elegant solution to reflecting the economic effects of a complex transaction. Complex transactions often result in complex accounting out of necessity. The complexity criticism likely comes from those who are not involved in execution of leveraged leases (as is the case with any complex accounting standard in any industry) and who are not aware of what the model is attempting to achieve.

In the development of the current leveraged lease accounting rules, the Board at that time cited that the combination of nonrecourse financing and a cash flow pattern that enables the lessor to recover his investment in the early years of the lease, and thereafter affords him the temporary use of funds from which additional "indirect/secondary" income can be derived, produces a unique economic effect. Despite the fact that each of the attributes of a leveraged lease may be found in other types of transactions, the Board believed that in a leveraged lease those attributes are combined in a manner that produces an overall economic effect that is distinct from that of other transactions. Accordingly, the Board concluded that a leveraged lease, as defined, should be accounted for in a manner that recognizes this overall economic effect and that the accounting should reflect the separate phases of the investment.

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This method also reflects the three-party nature of the transaction in that the lessor's investment is recorded net of the nonrecourse debt, and rental receipts are reduced by the debt service payments. The parties agree in the legal documents that the lessor has no claim on the rent until the debt is satisfied, the rent will first be paid directly to the lender and the lender has no recourse to other assets of the lessor. The legal documentation and intentions of the parties support a conclusion that netting is appropriate.

The lessor's true "at risk" investment is not a function of the amount of the future rental payments, which amount represents neither the funds he has at risk nor the asset from which he derives earnings. Bank regulatory capital regulations specifically require capital to be allocated only to the net investment in a leveraged lease. In fact, bank regulatory capital rules regarding other forms of non-recourse debt and the assets associated with them follow the same logic. The credit analysts, lenders and bank regulators are prime users of financial statements and need to see amounts in the balance sheet reflected as to their nature in bankruptcy liquidation in order to assess financial risk. Grossing up a leveraged lease displays an asset that is not available to satisfy the claims of other lenders and reflects a liability that has no claim on assets of the lessor except the portion of the rent that will retire the debt and a security interest in the leased asset, but nothing more. Grossing up the leveraged lease would mean that the rent receivable would be on the books of the both the lessor and lender and the debt would be recorded on both the lessee's and lender's books which does not seem logical as an asset or liability should be an asset or liability of one entity - not two. Information about the gross cash flows is more appropriately provided in the footnotes.

Tax Credits as a Source of Lease Revenue

The 1976 Board concluded that the investment tax credit ("ITC") is a component of the calculation of the implicit rate in the lease. It also concluded that the ITC is accounted for as revenue under the leveraged lease MISF yield method. In practice when ITC is present in a direct finance lease, the ITC is amortized as revenue using the leveraged lease rules by analogy. Accounting for the credit other than as prescribed by the investment with separate phases method or the direct finance method would abstract an important element of the overall profit in the transaction and a cash flow that reduces the net investment in the lease, thereby changing the lessor's net investment and the pattern of income recognition contemplated by the methods. Lessors consider tax credits as an integral lease cash flow just like the rent and residual value. In some cases US Federal income tax credits for renewable energy assets can be as high as 30%, and many states also provide tax credits. As such it results in an increase in the lessor's yield (lease revenue), which is explicitly taken into account in the pricing of the rental payments. In many renewable energy transactions, the implicit interest rate in the lease without the tax credits is negative, or a distortive reporting of the lessor's realizable yield. If the tax credit is separately accounted for under income tax accounting rules, its removal from the revenue stream would result in a reporting inconsistent with the lessor's true rate of return on its on net investment in the lease. This outcome would obscure the substance of the earning asset to readers of a lessor's financial statements. Furthermore, accounting for the tax credits on a standalone basis, separate from the investment to which it relates, would create a disincentive to invest in such transactions because it would have a dilutive effect on reported lease and loan income and related financial statement based metrics.

IFRS rules (IAS 20) treat certain tax credits related to assets as an item of deferred revenue or as reduction from the asset's carrying value, that is, a contra asset just like unearned income in a direct finance lease. By accounting for the tax credit on an integral basis, revenue recognition

faithfully portrays the economics of the lease investment by reporting the true periodic return on the investment.

We ask that the Board specifically include tax credits related to leased assets in revenue recognition by taking such credits into account in determining the implicit rate in the lease and thus preserve the amortization methods for both leveraged and direct finance leases in keeping with the Board's decision to keep current lessor accounting generally intact.

Conclusion

The revised lease accounting rules must fully consider the relevancy and usefulness of the financial statements for users. We believe that the current treatment of leveraged leases, asset related tax credits (e.g., ITC) and sale/leasebacks with non-bargain purchase options give users the most accurate and relevant information regarding the economic effects of leases. Under the current rules, the accounting of these transactions aligns with the substance of the transactions.

We draw your attention to Exhibit A, which provides a history of leasing activity across a diverse mix of assets. From a business perspective, the volume of transactions is eye opening. The undersigned, who come from a broad cross section of industry participants, feel strongly that in this time when significant capital formation needs for infrastructure assets and equipment is severely lacking in the US, leasing should continue to provide an important source of capital. Under the contemplated lease accounting changes, such capital would be greatly impaired for both lessors and lessees with the practical result having negative implications for our nation's economy.

Thank you for allowing us the opportunity to express our views on the Leases Project. We fully appreciate the Board's listening to industry feedback and making the many positive changes to the previous Exposure Drafts.

Sincerely,

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EXHIBIT A

Estimated Lease Volumes

Equipment/Facility Leasing (5-year Cumulative Activity)

Asset Type	2009-2013 Lease Volume ($ Billion)
Aircraft	23.0
Rail Cars	8.0
General Manufacturing / Industrial Facilities	20.1

Source: Annual ELFA surveys of equipment finance activity

Renewable Energy Asset Leasing (3-year Annual Activity)

Renewable Energy Source	Total Installation Volume ($ Billion)		
	2011	2012	2013
Solar [1]	8.6	11.5	13.7
Wind [2]	11.6	21.0	1.6

Source:

1. Solar Energy Industries Association (SEIA)
2. Calculated based upon annual megawatts (MWs) placed into service, as obtained from the American Wind Energy Association (AWEA) and converted into estimated dollar cost for each year's installation volume

Estimated Lease Volume in Renewable Sector*:* The Stakeholders estimate that approximately 70% and 20% of solar and wind installations, respectively, involve leasing structures. Other sources of renewable energy (such as biomass, fuel cells, CHP and hydro) have often involved lease structures as well.

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Signatories

American Capital Energy, Inc.,	Art Hennessey	CFO & Chairman
Bridgeway Capital Advisors, Inc.	Rodney W. Hurd	Chief Financial Officer
BTMU Capital Leasing & Finance	Thomas Thornton	Director
CoBank, ACB	Mike Vestal	Controller
Global Structured Finance Advisors	Ted Jenkins	Group Managing Director
Global Structured Finance Advisors	Joe Amaro	Managing Director
Healthy Planet Partners	Richard Dovere	Manager
Ivory Consulting Corporation	Scott Thacker	CEO
KBC Bank NV	Thomas R Lalli	Managing Director
Kingsbury Wax Bova, LLC	Robert M Wax	Co-President
Northfield Capital	Robert Kiley	Managing Partner
Peoples Electric Cooperative	Carlton Tilley	Senior VP - Adm. Services
PNC Equipment Finance	Richard Doherty	President
SMBC Leasing and Finance, Inc.	David A Ward	President
SunTrust Bank	Thomas Panther	Dir. Corp. Finance & Controller
Wells Fargo & Company	Richard D. Levy	EVP & Controller