



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

October 16, 2015

**Re: File Reference No. 2015-290, *Proposed Accounting Standards Update Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)***

Dear Mr. Golden:

As you know, we at the Equipment Leasing and Finance Association (ELFA) have been following the redeliberations on matters related to the *Leases* project. During the redeliberations we have noted the leasing proposals are often viewed as a discrete body of literature and leasing proposals often incorporate implicitly or explicitly accounting standards in related areas.

In particular, we have noted the influence the Revenue Recognition project and its decisions have had on the *Leases* project, especially with regards to lessor accounting and sale leaseback accounting. We thank you for the opportunity to comment on the *Principal versus Agent Considerations* exposure draft as it – or may – impact the accounting for sale-leasebacks.

A meaningful number of equipment leases are transacted as sale-leasebacks due to “90 day window” afforded by commercial, income tax and sales tax laws (under which a sale leaseback consummated within 90 days of the placed-in-service date is treated as a new transaction) and the application of the risks and rewards approach to such transactions generally. Under current GAAP the decision as to whether the transaction is to be accounted for as a sale or financing depends on whether the lease transfers the risks and rewards of ownership to the lessor. To get sale- leaseback accounting treatment, the transfer of ownership must qualify as a sale and the leaseback must be classified as an operating lease.

Purchase options in the leaseback that are not reasonably assured of being exercised do not negate sale-leaseback treatment. In the analysis of whether the leaseback is an operating lease

the lessor must assume the risks of ownership in the asset and the purchase option must be set at no lower than the expected fair market value. This means the lessor has all the expected rewards in the asset. The purchase option set at expected fair market value means the lessee has an option only on the unexpected rewards in the leased asset.

Real estate and integral equipment sale leaseback rules differ as they were aligned with 606 in May of 1988 through SFAS No. 98, which only allows repurchase pursuant to a right of first refusal at a price no lower than a bona-fide third party offer. Any purchase option negates sale treatment. However, this guidance only applied to lessees. Lessor accounting did not vary based on whether the transaction involved a newly originated lease or a sale-leaseback.

When developing the sale-leaseback proposals in the *Leases* project, the Board developed a model that accounted for a sale leaseback considering each leg of the transaction in isolation. As a result, the sale leg of the transaction would be accounted for as a sale based upon the sale criteria developed in the Revenue project. As a result of this consideration and the concept that a fixed priced, but market based, purchase option would not result in a transfer of control, it is expected that a significant subset of sale leaseback transactions will no longer be accounted for as sale leasebacks but as financings. Since this is a “sea change” in the accounting for common equipment leasing transactions, it therefore places greater emphasis on determining which transactions would be affected by the sale leaseback proposals.

The question of whether or not a transaction is a sale leaseback will hinge on whether or not the customer-lessee has gained control of the asset prior to the commencement of the lease. There are a few possible interpretations of the new Revenue standard that may allow for equipment operating leasebacks with non-bargain purchase options to continue getting sale treatment, but the guidance is not sufficiently clear to make its implementation less disruptive and more cost effective. One possible position is that, if the lessee is effectively acting as an agent evident by its taking only temporary control over the underlying (e.g., taking delivery for administrative purposes or to achieve economies of scale) and by the absence of a profit element for the lessee, then the transaction should be accounted for as a sale and an operating leaseback. Another position could be that, if the lessee makes reimbursable progress payments to a vendor during the asset construction period and does not gain or exercise control over the physical asset, it should also be accounted for as a sale and then a leaseback. Finally, as noted in paragraph 606-10-55-37, if the lessee only momentarily takes title of the asset subject to the sale leaseback, it is not a sale transaction subject to the sale leaseback proposals. Each of these possible conclusions comes down to interpretations of what control means and what separates a principal in a transaction from an agent.

Our views are also shaped by the likelihood the proposed sale leaseback model, when applied to these transactions, will complicate the administration and analysis of these transactions.

Control is a concept that is contrary to the risks and rewards that is at the heart of the *Leases* project framework and the US legal and tax regimes.<sup>1</sup> Lease accounting generally has been in sync with commercial and tax law. Control based on factors other than the allocation of risks and rewards between the parties can result in an accounting outcome inconsistent with the legal (commercial law, bankruptcy law, and income tax law) and economic realities in the determination of whether a sale has taken place in a sale leaseback. This creates an “apples and oranges” financial reporting issue. Fixed assets reported on the lessee’s balance sheet would include “leased” asset that are not “owned” assets under commercial law related to bankruptcy or tax law. If fixed assets include those “controlled” but not “owned,” it creates the need for a means to separately identify such assets for user analysis purposes, notably for regulatory capital and credit analysis by lenders who need to know which assets are legally owned and what claims can be made against such assets in bankruptcy proceedings. While user needs can be met by footnote disclosure, the Boards generally prefer on balance sheet presentation.

Given the impact the sale leaseback model has on accounting, we believe the population of transactions to which this model applies should not be applied expansively. We have previously expressed the view that the failed “purchase” accounting by the buyer-lessor produces a financial reporting result that does not reflect the nature of the lessor’s assets and does not properly portray the separation between asset and credit risk that exists in these transactions. The seller-lessee’s accounting for these transactions also does not necessarily depict the lessee’s asset risks and obligations. In an example used in the *Leases* project of a “failed” sale leaseback (the sale leaseback of an existing asset of the lessee) the asset is “sold” for \$2 million and the book basis of \$1.8 million is not derecognized but continues to be reported as PP&E. The alternative accounting would have been to derecognize the asset and record the leaseback’s right of use asset for only \$1.3 million -- the ROU asset is the value that the lessee has in the sale leaseback and it is calculated using the lessee’s incremental borrowing rate of 4%. The cash proceeds of \$2 million are recorded as debt yet the only obligation is the operating lease’s “other” non-debt liability of \$1.3 million. The interest rate in the debt amortization in the failed sale example is a rate chosen (4.71%) so as to avoid negative amortization (to our knowledge, the need to derive a “forced” rate has not been employed elsewhere in GAAP and is only employed to make up for deficiencies in the “failed” sale leaseback accounting). Given the deficiencies in this model, it would be best if the circumstances to which it will be applied were limited.

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<sup>1</sup> This may not be the case if the primary indicator of control is considered to be the transfer of risks and rewards, which may be allowed under 606-10-25-30.

In addition to these summary comments are responses to the specific questions in the exposure draft, provided below;

**Question 1:** *The proposed amendments to paragraph 606-10-55-36 clarify the unit of account (the “specified good or service”) at which an entity would determine whether it is a principal or an agent and clarify that an entity can be both a principal and an agent in a single contract. Would the proposed amendments improve the operability and understandability of the principal versus agent guidance in Topic 606? If not, please explain why and suggest alternatives.*

**Response:** If paragraph 606-10-55-36 were to be used within or analogized to in leasing transactions, we are not certain if the guidance is clear enough to be applied. The section was written with transactions other than those that are encountered in the provision and delivery of assets that would be subject to a lease in mind. In leasing it is common for lessors to acquire the right to an order position in an asset that is still to be constructed by the supplier. The order position may also include a deposit the future lessee has made.

When an asset is constructed - like an aircraft, vessel, locomotive, and rail car - there is often a sourcing process that includes the future lessee deciding on the equipment it wishes to acquire the use of, the ordering of the asset, and making down payments and/or progress payments as required by the manufacturer. The lessee then issues requests for proposals to several potential lessors outlining a description of the asset and desired lease terms. The lessors develop structures and prices (lease rent and purchase option amounts and terms) and terms and submit bids to the lessee. The lessee accepts a bid. The lessee assigns its rights and down payments/progress payments to the chosen lessor. The lessor funds the cost (no profit element for the lessee acting as agent) by paying the lessee for its funds invested and paying the balance to the manufacturer when the asset is delivered.

In these transactions, we do not view the transfer of order positions as Revenue transactions, but if they were viewed as Revenue transactions, we are not certain if the buyer-lessor is an agent or a principal. Given the risks the lessor is assuming and since risks and rewards are an indicator of control under the Revenue standard, we believe the lessor has gained control of the underlying asset and is a principal. By corollary we believe the lessee is the agent of the lessor. The guidance proposed in 606-10-55-36 that an entity could be both an agent and a principal in a transaction is difficult to operationalize in this context.

**Question 2:** *Paragraph 606-10-55-37A clarifies application of the control principle to certain types of arrangements by explaining what a principal controls before the specified good or service is transferred to the customer. Would the proposed amendments improve the operability and understandability of the principal versus agent guidance in Topic 606? If not, please explain why and suggest alternatives.*

**Response:** When evaluating the roles of the three parties to many sale leaseback transactions – the customer-lessee, the manufacturer and the buyer-lessor – we are not clear how to apply 606-10-55-37A to a right to an asset yet to be constructed. It is not leasable as the physical asset has not been completed or delivered so that no one can control its use or benefit from its use as is required in the definition of a lease.

Further, paragraph 606-10-55-38 provides: ... “An entity that is an agent does not control the specified good or service provided by another party before that good or service is transferred to the customer”. It appears that the lessee does not control the physical asset since it is to be constructed. As per above we recommend specific guidance regarding common sale leaseback transactions.

**Question 3:** *The proposed amendments to paragraph 606-10-55-39 provide indicators of when an entity controls the specified good or service before it is transferred to the customer and, therefore, would be a principal. The amendments also clarify the relationship of each indicator to the control principle in paragraph 606-10-55-37. Paragraph 606-10-55-39A was added to explain that the indicators may be more or less relevant to the principal versus agent assessment depending on the nature of the arrangement and that different indicators may provide more or less persuasive evidence about whether the entity controls the specified good or service before it is transferred to the customer in different contracts. Would the proposed amendments improve the operability and understandability of the principal versus agent guidance in Topic 606? If not, please explain why and suggest alternatives.*

**Response:** In the case of 606-10-55-39 it appears that the manufacturer/supplier of a to-be-constructed equipment asset, which will be leased, has the responsibility for acceptability, inventory and other risks of ownership and is therefore a principal. As per above we recommend specific guidance regarding application of this guidance to transactions that may include a sale leaseback.

**Question 4:** *Would the revisions to the principal versus agent illustrative examples (Examples 45 through 48) and the added illustrative examples (Examples 46A and 48A) improve the operability and understandability of the principal versus agent guidance in Topic 606? If not, please explain why and suggest alternatives.*

**Response:** *Example 46—Promise to Provide Goods or Services (Entity Is a Principal)* should be expanded upon to cover the accounting when an order position is transferred or when a sale leaseback is executed at the time of delivery. We do not view the lessee’s involvement as evidence they control the asset and we do not consider the future transaction within the scope of the sale leaseback proposals. Our conclusion would be that it is really merely a lease, not a sale leaseback, but we believe further guidance would be helpful and needed.

We appreciate the opportunity to comment on the exposure draft, and we also thank the Board for its policy of open communications during the standards setting process. We remain available to help in any way needed and urge you and the staff to contact us if you have any questions with regards to the comments made in this letter.

Respectfully yours,

*Ralph Petta*

Ralph Petta  
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Equipment Leasing and Finance Association