LEASING 101

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Mr. Russell Golden
Chairman
Financial Accounting Standards Board
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Submitted via email

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Re: Leases Project Changes to Conform to Rev Rec

Dear Chairman Golden,

I thought the Revenue Recognition standard scoped leases out under the assumption that the Leases standard would deal with revenue recognition specifically as it applies to leases and lessors. As a result I did not track the Revenue Recognition project so I did not comment when the ED was issued. I have commented all along on the Leases project and the two Leases EDs.

The two standards have different models to determine when an asset has been "sold" and they are different in some key areas. The leases standard uses a risks and rewards model which aligns with commercial law and tax law, while revenue recognition uses a control model that sometimes results in denial of sale treatment in certain sale leasebacks when all the risks and all the expected rewards in an asset are transferred. Revenue Recognition does not deal with the unique issues in leases. Under the control model there are cases involving leases done as a sale leaseback where assets reported are not "owned' assets available as collateral in a liquidation and liabilities presented as debt that are not debt under commercial law which The Leases project concluded that reporting leases according to their legal substance is important to lenders' analysis of the lease assets and liabilities to enable them to make informed decisions as to extending more credit to a preparer.

What has happened is the Board and staff decided to conform parts of the Lease standard to the Revenue Recognition framework which reverses important decisions made in the Lease project that are unique to leases. The most troubling changes made are denying sale treatment in sale leasebacks with non-bargain purchase options and the classification tests exemptions for leases beginning in the last 25% of the leased asset's useful life. I believe in the case of the 25% of life exemption, the issue was not even discussed at a public meeting. I believe the sale leaseback decision was made after ED2. As a result the public may not be aware of the changes as there was no formal request for comment on either. One had to be closely following the Leases project to know that the changes were being made.

The decision that equipment sale leasebacks with a non-bargain purchase option is important because a high volume of leases could be deemed to be sale leasebacks. Most of these possible sale leasebacks occur at or near delivery of the asset and the lessee has no profit element. There are unanswered questions regarding whether the lessee controls the asset before the sale and whether the lessee is an agent. The balance of the equipment sale leasebacks occur after the lessee has used the asset. In those cases the lessee is a principal and may have a profit or loss but most importantly the asset has in fact been sold when the terms are reviewed vs. commercial law. In a failed sale leaseback the lessee does not derecognize the "sold" asset but reports is at its full value (cost for new assets and the sales proceeds in the case of an existing asset) as PP&E and reports the contra entry as debt. Under the Leases standard that leaseback is an Operating Lease and the only asset remaining for the lessee is the value of the ROU asset and the liability is a non-debt liability at the same value as the asset. This decision was made in the Leases standard to reflect the economic substance of an Operating Lease. In addition, the asset and liability value amounts are lower (than under "failed" sale leaseback accounting proposals) reflecting the substance of the transaction. Those differences are significant. I fail to see the financial reporting benefit of misclassifying the assets and liabilities and reporting inflated amounts. The lessee is deemed to "control" the asset due to the presence of an option to buy the ***unexpected*** residual benefits in the leased asset. The lessee must make an ***additional*** payment (the payment is for a purchase option that the Leases standard considers an option not reasonably assured of exercise) for the asset to be an "owned" asset and thus collateral for a lender to liquidate in a bankruptcy. The Board decided that bankruptcy matters in the Leases standard but apparently not in the Revenue Recognition standard. Improving presentation and disclosures regarding the bankruptcy and going concern nature of lease assets and liabilities should be in line with objective of improving the usefulness of financial information. *My recommendation is that sale leasebacks with non-bargain purchase options are "special sales". Those that occur at or near delivery and where there is no lessee profit element should be accounted for as Operating Leases – not "failed" sale leasebacks. The sale lease backs that have a profit element and/or where the lessee is a principal should still be accounted for as Operating Leases but any profit should be deferred and amortized over the lease term. The result will be the balance sheet presentation will best reflect the actual "owned" assets and the liabilities will be non-debt liabilities – all this in keeping with the Leases project decisions re Operating Leases.*

The decision to drop the last 25% of lease term classification test exclusion is important to both lessees and lessors of operating leases of railcars. More than fifty five percent of the 1.5 million railcars in the US are leased. The vast majority of these railcar leases are done under full service Operating Leases (most common term is five years) and the railcars have fifty year useful lives (there is a legally mandated limit of fifty years useful life with few exceptions). Even though there is a mandated fifty year life there is significant value in the fifty year old car in the form of spare parts and scrap value. As a result the lessor controls the value of the car, not the lessee. I understand that the decision to drop the last 25% of useful life carve out was done to conform to the control model in Rev Rec as the lessee "controls" the asset for most of its remaining life if the lease commences in the last few years of the asset's useful life. The FAS 13 basis for conclusions in essence said the reason for the carve out is that it is illogical for a fifty year life rail car to be leased ten times under five year leases with the first nine being Operating Leases but the last one is a Finance Lease, while the lease terms for all ten of the leases are identical. There is no purchase option in the leases. The lessor has all the risk of loss and rewards of ownership and will surely get the car returned at expiry and the lessor controls its significant remaining value. If we really want the classification tests to be based on judgement it would seem that the PV of rents test should "trump" the useful life test In the case of rail cars. It seems a five year lease of a fifty year life asset should always be considered an Operating Lease without having to ask how old the asset is. This decision also means Operating Leases are reported as Finance Leases for lessees so that the assets and liabilities are misrepresented. It also means added complexity in compliance for both lessors and lessees – each railcar must be analyzed for classification and two accounting systems are needed if some are finance leases. Lessors are likely to find some leases are sales type leases creating results inconstant with their business model which have to be explained. Those "sold" cars come back to the lessor and then will be "sold" again as spare parts or for the significant scrap value. Lessors and lessees will structure around the rule by reducing the term (but adding non-bargain renewal options) for those few assets (out of possibly hundreds of assets) in a master lease of railcars approaching the end of their useful life. This will add complexity but they will do it to get the economically "right" answer and avoid the complexity of different classification of cars in the master lease. *I recommend retaining the current classification carve out for leases beginning in the last 25% of the asset's life as a practical expedient to reduce complexity and get the "right" financial reporting results.*

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,

William Bosco

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