



Letter of Comment No: 91
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Ms. Suzanne Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Subject: Comments Regarding the Exposure Draft of the Proposed Interpretation for *Fair Value Measurements* , File Reference No. 1201-100

Dear Ms. Bielstein:

I am writing on behalf of the Equipment Leasing Association (ELA) to provide comments to the Board regarding the Proposed Statement of Financial Accounting Standards, *Fair Value Measurements* ("Proposed Statement"). We welcome the opportunity to provide both information and commentary in response to the Board's request on its Exposure Draft.

Organized in 1961, the ELA is a non-profit association that represents companies involved in the dynamic equipment leasing and finance industry to the business community, government, and media. ELA's diverse membership consists of independent leasing companies, banks, captives, financial services corporations, broker/packagegers and investment banks; as well as service providers like accountants, consultants, equipment managers, executive recruiters, insurance companies, lawyers, publishers, and software providers. ELA promotes the leasing industry as a major source of funds for capital investment in the U.S. and other countries. Headquartered in Arlington, Virginia, ELA is a national organization with 800 member companies and a staff of 25 professionals. In 2004, equipment leasing is estimated to be a \$220 billion industry.

A central part of the mission of the ELA and its Financial Accounting Committee is to provide educational information to the public as well as standards setters like the Financial Accounting Standards Board (Board) relative to data and analyses on leasing industry products, practices, and trends.

We understand that the Board is planning to reconsider whether to remove the broad scope exception for leases as presented in the Exposure Draft. The ELA generally supports eliminating scope exceptions in situations where the Board can provide sufficient guidance to address unique issues that prompted the proposed scope exception

in the first place. However, as discussed below, we believe that the Board should consider significantly narrowing the exception instead of eliminating the exception for leases all together.

We believe that, for most newly originated leases, the application of the proposed fair value measurement generally would yield the same fair value amounts as those determined under Statement of Financial Accounting Standards No. 13, *Accounting for Leases*, as interpreted and amended (“Statement 13”). For example, we believe that the Proposed Statement provides similar guidance to Statement 13 in determining the fair value of the leased property, the presence of any bargain or penalty elements, allocations of multiple elements or multiple property types, or the estimated residual value of the leased property. These items represent important values used in classifying leases.

On the other hand, we believe that the application of the Proposed Statement may yield significantly different fair value amounts for certain tax-advantaged leases, notably mature leveraged leases. More importantly, we believe that the valuation methodology under Statement 13, as interpreted and amended, provides a faithful representation of fair value for such leases.

Based on the comments below, we request that the Board consider narrowing, instead of eliminating, the proposed scope exception for leases. We propose that the revised scope exception carve out leveraged leases subject to FASB Interpretation No. 21, *Accounting for Leases in a Business Combination* (“FIN 21”). Alternatively, the Board could address our concerns by expanding the fair value measurement guidance to explicitly address the unique valuation issues associated with measuring the fair value of tax-advantaged leases.

We intend that the Board receive our request as more than a narrow technical point. The underlying issue involves the appropriate valuation of leases that transfer tax benefits where the lessor’s profit element principally arises from the timing of the tax benefits. We believe that this issue will likely resurface in future Board projects, including the revenue recognition project and the pending project on the accounting for leases. Further, we believe that the Board should not fundamentally change existing practice for leveraged leases acquired in a business combination or, by extension, the acquisition of a portfolio of such leases in a secondary market transaction, collectively FIN 21 leases, under the rubric of fair value measurement.

Fair Value Measurement under Statement 13

We anticipate that any decision to include leases within the scope of the Proposed Statement would involve a review of the technical terms in Statement 13 and prevailing practice under Statement 13. We believe that the existing technical terms defined in Statement 13 are consistent with those used in the proposed Statement. Accordingly, we anticipate that any narrowing or elimination of the scope exception would not lead to any amendments to these terms nor change well established practice hereunder.

We also anticipate that any decision to include leases within the scope of the Proposed Statement would not change how a lessor should determine the residual value of the leased property. In practice, lessors generally use an expected value methodology in estimating the residual value consistent with the nature of their operations. Under this methodology, the lessor considers all relevant outcomes, including estimated proceeds from re-leasing, lessee purchase, and third party purchases, and then weights such outcomes in determining the estimated residual value of the leased property. Accordingly, assuming that the Board does not intend to change existing practice under Statement 13, we would broadly interpret the phrase “exchanged in a current transaction between knowledgeable, unrelated willing parties” as used in the proposed fair value definition to include the fair value from redeploying leased property (e.g., re-leasing) and from selling the property to the lessee who generally would be willing to pay more than a third party purchaser to avoid return costs.

Given that future readers may not have the benefit of today’s prevailing thought, we request that, in connection with any change to the scope exception, that the Board clarify the intended effect, e.g., no change to the methodology currently employed under Statement 13. Further, if the Board believes that a change in the proposed scope exception should lead to a revision of the technical terms in Statement 13 or practice hereunder, we request that the Board provide constituents with the opportunity to comment on any contemplated amendments or changes. We also request that the Board address the appropriateness of using multiple scenario analysis, including lessee purchase and re-lease scenarios, in measuring residual values under the Proposed Statement.

Fair Value Measurement of FIN 21 Leases

We request that the Board preserve the scope exception for FIN 21, or, alternatively, preserve the methodology set forth in FIN 21 in determining the fair value of such leases. We believe that preservation will best facilitate closure on this unique valuation issue.

FIN 21 provides for a measurement methodology that is consistent with unique accounting applicable to leveraged leases. FIN 21 provides that the “acquiring enterprise shall assign an amount to the acquired net investment in the leveraged lease . . . based on the remaining future cash flows and giving appropriate recognition to the estimated future tax effects of those cash flows.” Under this measurement methodology, the acquiring enterprise applies an appropriate discount rate to the remaining after tax-cash flows arising from the lease. This methodology necessarily involves estimating the applicable composite income tax rate *from the standpoint of the acquiring enterprise*. The composite rate equals the applicable income federal tax rate and the applicable (multi-) state income tax rate (net of the federal deductibility benefit).

Key Dynamics of Tax-Advantaged Leveraged Leases

Tax-advantaged leveraged leases have the following characteristics that distinguish them from other types of investments, characteristics that we believe support continued use of the FIN 21 approach in measuring the fair value of mature tax-advantaged leveraged leases:

1. The pre-tax cash flows (equity rentals and residual value) generally provide the leveraged lessor with a rate of return substantially below the interest rate on the leveraged non-recourse debt. Further, in the case of a long term lease, the pre-tax rate of return is often at or below the risk free rate.
2. The after-tax cash flows (depreciation and available tax credits) generally provide the leveraged lessor with a pre-tax equivalent rate of return substantially in excess of the interest rate on the nonrecourse debt, a premium ranging from several hundred basis points upward to one thousand basis points. The pre-tax equivalent rate is determined by comparing the lessor's initial equity investment to the after-tax cash flows (using the multiple investment sinking fund) and dividing the resulting yield by one minus the applicable income tax rate.
3. The suitability and profitability of a leveraged lease investment depends on the federal and state tax attributes of the lessor. The size of the lessor's premium varies in direct proportion to the applicable tax rate. Lessors with a relatively high composite tax rate (e.g., lessors with significant nexus in California or New York) receive significantly higher premiums than those with a low composite tax rate.
4. Tax law does not provide symmetrical treatment in an exchange transaction. Tax law generally requires full depreciation recapture (an immediate reversal of deferred taxes) by the selling lessor. It provides for a half-year convention of first year depreciation, or an amount that is usually significantly less than the recapture amount. Accordingly, the tax value to a continuing lessor generally exceeds the tax value to a hypothetical replacement lessor.

The impact of tax law on the tax value of a leveraged lease can be illustrated by reviewing the example in FIN 21. Under FIN 21, the lessor determines the fair value of the acquired leveraged lease at \$(16,245). This example leveraged lease has a negative fair value because the present value of the future taxes to be paid significantly exceeds the present value of the remaining pre-tax cash flows (equity rentals and residual value). Assume that the lessor seeks to determine the hypothetical "exchange price" and uses the same key assumptions as the starting point (i.e., same rate of return, same applicable income tax rate, and same residual value). The lessor would determine a hypothetical pre-tax clearing price of approximately \$230,000. Since this price would also generate income taxes payable of \$273,161, the lessor would hypothetically receive \$(43,161) in after-tax cash, or \$26,916 less than the present value of the after-tax cash flow as determined under the FIN 21 methodology.

We believe that the tax dynamics discussed and illustrated above support the use of the FIN 21 valuation methodology instead of the hypothetical exchange price. The fundamental economics of tax-advantaged investments generally support a valuation methodology based on the value from the standpoint of the current investor-lessor. Unlike the valuation for most other investments, a marked difference in value exists when comparing the value from the standpoint of the current investor-lessor with the value from the standpoint of a hypothetical replacement lessor even when common assumptions are used. This difference arises from the unique relationship between the pre-tax and after-tax elements (notably, profit arising from the timing of tax benefits as opposed to use of the asset or a financing only margin) and the amplifying effect of the asymmetrical treatment of the sale/purchase sides under applicable tax laws.

Possible Valuation Approach under the Proposed Statement

In the interest of providing the Board with information to examine the merits of the alternative approach (i.e., adding fair value measurement guidance for mature tax-advantaged leveraged leases), the paragraph below provides certain information about the secondary market of such leases.

Leveraged lease transactions or portfolios occasionally trade in the secondary market, generally due to changes in tax economics or residual expectations. This market is a principal-to-principal market, characterized by independent negotiations with no intermediary and the release of little information to the public. Throughout the negotiating process, the selling lessor generally seeks a better after-tax cash outcome than the present value of the after-tax cash flow (a methodology similar to the one described in FIN 21). Additionally, the selling lessor seeks to maximize the cash purchase price by “shadow pricing” and using the resulting value as a fair value benchmark. The selling lessor attempts to estimate the buying lessor’s applicable tax benefits, applicable composite tax rate, and residual assumption. The selling lessor generally can only make rough estimates of these values given the nature of the market, the proprietary nature of tax and residual value assumptions, and the infrequent trading activity.

Based on the secondary market for leveraged leases as described above, we believe that the guidance contained in paragraph 24 (Level 3 Estimates with Significant Entity Inputs) could be expanded to cover this type of investment. Perhaps, the FIN 21 measurement guidance could be incorporated herein by reference.

Leveraged Leases vs. Other Tax-Advantaged Leases

While we believe that the scope exception should apply to all tax-advantaged leases (e.g., single investor tax leases), we recognize that the present accounting classification system makes the drafting of this type of scope exception not readily operational. Further, we note the Statement 13 specifically limits leveraged leasing to a specific subset of tax-

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advantaged leases. Accordingly, we intend to propose a scope exception that is consistent with the existing literature.

We appreciate your allowing us to provide our input on this important matter. We remain available as a resource to the Board and its staff to provide additional or clarifying information. Please feel free to contact me at any time to arrange for follow-on information.

Sincerely,

Michael Fleming, CAE
President