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Mr. Hans Hoogervorst, Chairman
International Accounting Standards Board
30 Cannon Street
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August 15, 2013

Re: Leases – Topic 842 Proposed Accounting Standards Update (Revised), Issued: May 16, 2013

Dear Chairman Golden, Chairman Hoogervorst, board members, and staffs:

We appreciate the opportunity to provide comments on the boards' second lease exposure draft.

It is our position that operating leases are forward contracts on rent. The bundle of forward contracts that make up an operating lease contract are used as hedges against potential future changes in the spot price of rent over a contractual period. Renewal options are call options on a bundle of forward contracts.

Rent is a payment made by one party in return for the *intangible right* to use another party's asset for a *specific interval of time*. Put another way, when a lessee enters an operating lease contract, they are purchasing right-of-use time units associated with future time intervals. The prices of these right-of-use time units can fluctuate over time due to changes in technology, supply, demand, and other forces. We view these rental time units as depleting commodities.

We refer to our collection of ideas discussed in this letter as the "forward contract approach" to lease accounting. I have expressed my view that operating leases are forward contracts and options on forward contracts to the boards for a number of years through my involvement in investor committees for both boards, but this perspective is a fundamental departure from the direction that the boards and the staffs have chosen to take the leases project. We believe the forward contract view that we explain in this letter is a comprehensive and internally-consistent view; and therefore, this letter is intended to be an efficient vehicle for expressing how the forward contract approach is superior to the boards' approach.

Our hope is that this letter will help the boards and staffs understand how the forward contract approach is backed by comprehensive consideration of various issues that the boards have confronted over the years. In our opinion, once the boards acknowledge that leases are indeed financial instruments, issues that the boards have struggled to address for decades actually have elegant answers that are supported by solid, proven financial theory.

After reviewing the IASB and FASB lease exposure draft, we believe the boards' proposal lacks a principles-based architecture and is flawed in some very material and fundamental ways. The accounting framework should be designed to reflect the true mechanics of the financial instruments embedded in lease contracts. We believe the proposed model fails to do so. If the boards' proposal is successful, we fear future constituencies of the boards will be forced to reopen the lease project in the not-too-distant future to address its numerous deficiencies.

Further, the goal of any accounting standard should be to produce decision-useful information for financial statement users. We have concerns that the boards' joint proposal will produce accounting information that is arbitrary in nature and of little relevance to users.

Some of the key flaws we have identified in the boards' model include:

- The proposed model does not recognize that leases are financial instruments;
- The proposed model will not accurately capture the economics of the lease relationship on day one of the contract or throughout its contractual life;
- The discount rate in the proposed model is inappropriate and remains fixed throughout the contract;
- The proposed model has inconsistent answers for real estate and equipment/vehicles;
- The proposed model's amortization of the lease asset over its remaining life is not a fundamentally-sound approach; and
- While the current accounting for leases inserts a bright line to set a boundary between operating and capital leases, the proposed accounting will replace that bright line with a blurry line that we expect different reporting companies to set at different places since they will interpret qualitative words such as "significant" in different ways.

In the end, we have concerns that investors will be misled regarding the inherent risks and rewards of ownership of companies with operating lease exposures if they rely on the information produced by the boards' proposed joint model.

Most of our comments in this letter discuss operating leases. It is our view that there is a clear boundary that can be defined between capital and operating leases, and we use this letter to help the boards understand where that definable boundary exists.

As we believe operating leases are hedging instruments on rent, we use the terms “renter” in place of “lessee” and “owner” in place of “lessor” in this comment letter to avoid unnecessary complexity.

We have structured our letter into a question and answer format to make our views more accessible. Before we begin our questions and answers, we begin the letter with an **Illustrative Example** to help the boards understand how we think about operating leases and to provide samples of some of the types of disclosures we think would be helpful.

The questions we ask and answer in this letter are:

1. What is the importance of linked presentation of operating leases on the balance sheet?

2. Do you believe that rental accounting should converge with ownership accounting?

3. Is there a natural dividing line between rental and ownership?

4. What is the lease asset in an operating lease?

5. Does it make sense for the FASB and IASB to introduce different accounting for real estate and equipment leases?

6. Does the boards’ proposal reduce structuring opportunities?

7. Do you believe the boards are correct in their decision to treat leases as non-financial assets?

8. Why are operating leases a form of forward contract?

9. Are rental units continuously delivered or are they delivered all at once at the beginning of the contract?

10. What is the appropriate discount rate to use in operating lease contracts?

11. What is the harm in replacing rent expense with interest expense and amortization expense on the income statement?

12. How could the joint proposal produce misleading results?

13. How do you view contractual terms that allow the owner or renter the opportunity to exit the contract at an earlier date than the end of the contract?

14. Would the forward approach produce consistent accounting for owners and renters?

15. Some see operating leases simply as a means for structuring to avoid formal ownership in an effort to keep balance sheets lean. Is this an accurate depiction of why companies enter operating leases?

16. How do you think about variable rents?

17. Why is it important that cash rent outflows be disclosed?

18. Is an operating lease liability on the balance sheet calculated based off of the contractual commitments of the company relevant to investors?

19. If the boards accept that operating leases are forward contracts, what should the accounting look like for such leases?

20. Can you provide an example of the type of lease payment disclosure you would want to see in the footnotes and why the information you are requesting is necessary?

21. What are some disclosures that you would like to be provided as part of a minimum required lease disclosure package.

22. Why is it important to have companies disclose contractual payments that arise from renewal options of operating leases?

23. In Question 20, you propose a large table disclosing contractual payments for minimum contracts and renewal options. Why do you need this information? Can it be collected in a cost-effective manner?

24. How should the boards think about leases offered by equipment manufacturers?

25. How would the forward contract approach deal with embedded servicing contracts that are part of some operating leases?

26. Should operating leases be included in the weighted-average cost of capital (WACC)?

27. Are right-of-use rental time units the only intangible rights that can be extracted from operating leases?

28. How can tax policy and other external influences affect leasing terms?

29. Does the presence of economic friction in the operating lease contract relationship result in a lease's derivative elements breaking down and converting to conventional debt?

We recognize that our views on leases may be regarded by some as unconventional. We have created an online questionnaire where readers are invited to provide feedback on each of our comments so we can isolate areas of agreement and disagreement. The questionnaire can be found at http://www.danemott.com/leasecommentletterquestionnair/. We can email questionnaire respondents a copy of their questionnaire feedback if they would like to share it with the boards, staffs, or others.

Thank you for your time and consideration.

Regards,

Dane Mott, CFA, CPA

Illustrative Example

Assume Renter has rented a building from Owner, and as of December 31, 2012 there were only 5 years remaining on the operating lease. Renter paid $100,000 rent in 2013 and the payment grows 3% each year to compensate the owner of the building for inflation. Rental prices in the area have steadily increased since the contract was entered 15 years ago. If Owner had not entered the operating lease with Renter and instead had rented the property to another party at today's market rate, Owner could have rented the building in 2013 for $120,000. As a result, Renter will realize a $20,000 gain ($120,000 market rent - $100,000 contractual rent) in 2013 from of its operating lease position. Rental prices continued to increase throughout 2013, and at December 31, 2013 it was estimated that market rent on the building would be $123,000 for 2014 and beyond. The risk-free rate is 4% at December 31, 2012 and 4.5% at December 31, 2013.

The lease asset and lease liability are inseparably linked and together they form the value of the operating lease forwards. The schedule below in **Exhibit 1** calculates the value of the lease asset and lease liability to arrive at the value of the forward as of yearend 2012 and 2013 on a discounted and undiscounted basis.

Exhibit 1. Calculated Values of Lease Asset and Lease Liability at YE2012 and YE2013 ($ in thousands)

Operating Lease Exposure as of December 31, 2012:

	Undiscounted for Time Value of Money			Discounted for Time Value of Money		
Year	Estimated Market Value of Lease Assets	Contractual Lease Payments	Estimated Value of Forward	Estimated Market Value of Lease Assets	Contractual Lease Payments	Estimated Market Value of Forward
2013	120	100	20	115	96	19
2014	120	103	17	111	95	16
2015	120	106	14	107	94	12
2016	120	109	11	103	93	9
2017	120	113	7	99	93	6
Total	**600**	**531**	**69**	**534**	**472**	**63**

Operating Lease Exposure as of December 31, 2013:

	Undiscounted for Time Value of Money			Discounted for Time Value of Money		
	Estimated Market Value of Lease Assets	Contractual Lease Payments	Estimated Value of Forward	Estimated Market Value of Lease Assets	Contractual Lease Payments	Estimated Market Value of Forward
2014	123	103	20	118	99	19
2015	123	106	17	113	97	15
2016	123	109	14	108	96	12
2017	123	113	10	103	94	9
Total	**492**	**431**	**61**	**441**	**386**	**55**

Source: Dane Mott Research LLC

With the information above, we can calculate the value of the operating lease by using accounting that recognizes that the operating lease is made up of forward contracts. Based on the information above, we estimate that the net present value of Renter's unrealized gain on the operating lease forward contract was $63,000 at December 31, 2012 and $55,000 at December 31, 2013, respectively. The roll-forward table of the lease asset and liability over 2013 is below in **Exhibit 2**.

Exhibit 2. Lease Asset and Lease Liability Roll-Forward Table ($ in thousands)

	Minimum Contracts	Renewal Options	Total
BOY NPV of Operating Lease Asset	534	-	534
Time-value-of-money effect (interest income)	21	-	21
Gain/loss on change in market value of rent time units	11	-	11
Market-value of rental time units utilized	(120)	-	(120)
Change in discount rate	(5)	-	(5)
NPV of new lease contracts	-	-	-
NPV of terminated lease contracts	-	-	-
Change in probability of renewal	N/A	-	-
EOY NPV of Operating Lease Asset	441		441

	Minimum Contracts	Renewal Options	Total
BOY NPV of Operating Lease Liability	472	-	472
Time-value-of-money effect (interest cost)	19	-	19
Minimum rental payments (rental time units utilized)	(100)	-	(100)
Contingent/variable rental payments (rental time units utilized)	-	-	-
Change in FV of contingent rent	-	-	-
Change in discount rate	(5)	-	(5)
NPV of new lease contracts	-	-	-
NPV of terminated lease contracts	-	-	-
Change in probability of renewal	N/A	-	-
EOY NPV of Operating Lease Liability	386	-	386
Gain/(Loss) on Operating Lease Forward Contracts	**55**	**-**	**55**

Source: Dane Mott Research LLC

As we illustrate above in our roll-forward example in Exhibit 2, both the lease asset and lease liability begin as net-present-value calculations. There is a time-value-of-money effect (interest income) on the net present value of the lease asset that offsets the time-value-of-money effect (interest expense) on the lease liability. If the lease asset and lease liability are equal in value, these "interest" effects which are really time-value-of-money effects, that would be described as fair value changes if they described other financial instruments, would net to zero.

In an ideal world, we would like the following line items presented in **Exhibit 3** reflected in the comprehensive income statement, balance sheet, and cash flow statement of Renter:

Exhibit 3. Financial Statement Treatment of Operating Leases under Forward Accounting ($ in thousands)

Comprehensive Income Statement	
Rent expense (at market price)	-120
Realized gain/(loss) on lease forwards	20
Unrealized gain/(loss) on lease forwards	11
Balance Sheet	
Asset:	
Lease Forwards:	
Fair value of rental units (lease asset)	441
Fair value of lease payments (lease liability)	-386
Gain/(loss) on operating lease forward contracts	**55**
Cash Flow Statement	
Operating Cash Flows:	
Base rent payments	-100
Contingent rent payments	0
Total rent payments	**-100**

Source: Dane Mott Research LLC

We anticipate that the largest impediment to this approach is that it is inherently difficult and potentially costly and time consuming for reporting companies to accumulate market rent estimates each reporting period to calculate the value of the forward contracts. In our opinion, operating leases cannot be accounted for correctly unless the boards are prepared to require companies to incorporate market rent assumptions in the lease asset valuation. We do not believe the boards are prepared at this time to incorporate market information into the valuation of operating lease forward contracts; therefore, the best outcome we can see from this current project is for the boards to agree that operating lease accounting should begin an evolution towards treatment as forward contracts. As markets and companies in those markets continue to move increasingly to forward contracts to manage risks, we expect that such contracting will become increasingly common and the financial reporting must of necessity follow if the reporting is to remain relevant to investors.

To that end, the accounting could be simplified so the following line items appear in financial statements:

Exhibit 4. Financial Statement Treatment under Simplified Forward Accounting ($ in thousands)

Comprehensive Income Statement	
Rent expense (net of realized gain/loss on lease forwards)	-100
Balance Sheet	
Liability:	
Lease Forwards:	
Estimated fair value/NPV of rental units (lease asset)	386
Estimated fair value/NPV of lease payments (lease liability)	-386
Estimated gain/(loss) on operating lease forward contracts	**0**
Cash Flow Statement	
Operating Cash Flows:	
Rent payments (including $0 contingent rent)	**-100**

Source: Dane Mott Research LLC

This simplified accounting in **Exhibit 4**, while not completely accurate, may not be materially different from today's accounting. The major difference is that the balance sheet would show equal offsetting lease assets and lease payments in a linked presentation format. That is, absent evidence of permanent impairment of the lease asset, we would have the standard accounting result in companies assigning a value to the lease asset that is identical to the value derived for the lease payments. This approach makes the simplifying assumption that the forward contracts have a value of zero because the gain/loss on the forward contract is not calculated under this simplified accounting. This simplification allows the boards to eliminate the complexity of calculating the realized and unrealized gain or loss on the forward contracts.

1. **What is the importance of linked presentation of operating leases on the balance sheet?**

Recognizing operating leases as forward contracts has some very interesting consequences. There are many parties that have very passionate views about whether operating leases should be on or off balance sheet. The boards' ultimate decision on a model will do little to change people's philosophical positions. That said, recognizing operating leases as what they are, forward contracts, can eliminate much of the controversy. In a sense, the parties that believe operating leases should be on balance sheet and the parties that believe they should be off balance sheet are both right.

A forward contract considers both the market price of the commodity and the contractual exercise price. Some could look at the market price and the contractual exercise price as separate assets and liabilities. Others could see them as inseparably linked to one another. The point here is that the appropriate conversation is not about on-balance-sheet or off-balance-sheet. The appropriate way to frame the issue is **gross versus net**.

From an economic perspective, a party's stake in a forward contract is only the fair value of its gain or loss which is calculated by comparing the spot rate to the contractual rate. This is essentially the market value of the intangible rental units minus the net present value of the contractual lease payments. If the accounting for the asset and liability components strays from these mechanics, what is released into the balance sheet is nonsense with no substantive meaning.

Ultimately, realizing that these are forward contracts provides the boards the opportunity to satisfy both the on-balance-sheet and off-balance-sheet camps. If the asset and liability are presented together using linked presentation so that a gross lease asset, a gross lease liability, and a net lease asset or liability are presented as three consecutive line items, financial statement users from either camp have the information they need to conduct the analysis they believe is appropriate.

A forward contract is essentially a bet, and it creates a winner and a loser. Our belief is that operating leases are typically entered to produce pricing protection for the counterparties. Given that we do not believe the boards are prepared to incorporate market pricing into the operating lease forward contract valuation process at this time, we believe the next best available outcome is for the boards to adopt the assumption in the standard that the value of the forward contract is zero for accounting purposes.

The total lease payments stipulated in the contract represent the notional values of the forward contracts. While the gain or loss on the forward contract is the value of the financial instrument to the holder, it is the relationship between market rental prices and the contractual lease payments that establishes that value. If the boards are not prepared to account for the forward correctly, it is their responsibility to account for them in the least misleading manner that they believe can be successfully implemented in a standard.

Given it is common practice for users to think about operating lease exposure as additional debt exposure, it is common for lease exposure to be seen as off-balance-sheet leverage. We do not consider derivatives such as forward contracts as a form of traditional leverage. If we return to the comment that every forward contract has a winner and loser, the implication is that every contract will create a gain on one company's balance sheet and a loss on another company's balance sheet. The issue is that the boards are not prepared to calculate those gains and losses, so financial statement users are not in a position to identify winners and losers and thus be able to evaluate the quality of managers' decisions. It is our opinion that it is in the best interest of the boards to acknowledge their limits. If the boards are not prepared to have companies make the necessary fair value calculations to calculate forward values in an appropriate manner, linked presentation makes it clear that the boards are attempting to stay neutral and not introduce bias into the financial analysis process by implying any differential between the value of the lease asset and lease payments.

It is our view that placing a separate lease asset and lease liability in different sections of the balance sheet and then amortizing the lease asset at a faster rate than the lease liability creates misleading results for users and has the potential to destroy investors' capital.

2. Do you believe that rental accounting should converge with ownership accounting?

No, we believe rentals and sales are substantively different transactions and they represent the execution of substantively different business strategies.

It is our belief that there is a rental-sale spectrum and there is a clear, definable boundary along that spectrum where a rental relationship ends and an asset purchase with financing begins. A simple, spot-price rental of an item exists at one end of the spectrum, and an asset purchase without any financing exists at the other end of the spectrum. A range of contracts exist in between those ends of the spectrum to alter and transform the bundle of rights and obligations exchanged to meet the needs of the contracting parties. While many believe there are points along the spectrum where it can be difficult to classify whether the parties are contracting to rent or sell an item, we do not see any ambiguity and we believe it remains crucial that the distinction between rental and sale be made.

Operating leases are for rental agreements. If the contracting parties enter the relationship with the primary mission to lock-in rental prices in the future over a *specifically quantified period of time*, we believe the contract remains a rental contract. These arrangements are forward contracts on the commodity of depleting rental time units.

Capital leases are for sale agreements. If the parties are contracting so that one party is transferring or optioning to sell *all* owned risks and rewards of ownership to another party, this is an asset sale. Puts and calls can be used to option the sale of all of the owner's rights and obligations associated with the item. Debt financing can be used to finance the consideration exchanged as part of the sale of the item.

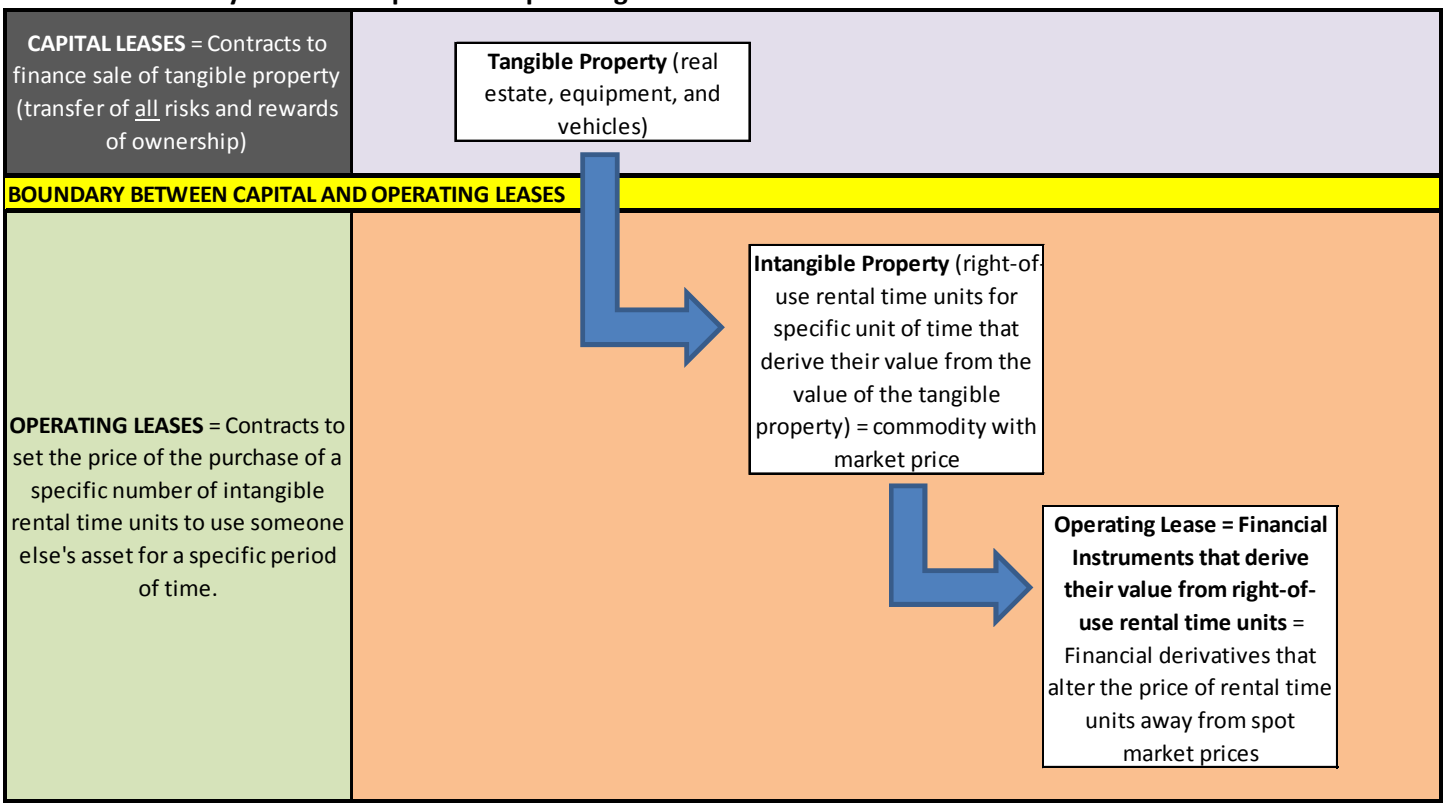
Our emphasis here is that forward contracts, options, and debt financing are used to bridge the spectrum between rental and sale. Forward contracts, options, and debt financing represent different financial structures with different capabilities and implications.

One of our primary concerns with the FASB and IASB proposal is that the mechanics of the accounting are attempting to bridge the spectrum between rental and ownership with the primary use of a debt-centric accounting logic. **Forwards, puts, and calls are not debt instruments. They are derivatives.** We believe that it is highly inappropriate to apply debt accounting to derivatives contracts and to ignore some derivatives that are present simply because the proposed model has not been designed to account for the inherent complexity of their contractual elements in an appropriate manner.

3. Is there a natural dividing line between rental and ownership?

Yes, we believe there is a natural dividing line between rental and ownership contracts, and this dividing line is not at all ambiguous. It is a dividing line that can be determined with *absolute certainty*. We illustrate this boundary in the exhibit below.

Exhibit 5. Boundary between Capital and Operating Leases



Source: Dane Mott Research LLC

When a party owns an asset, they are initially exposed to *all* of the risks and rewards of ownership. A lease contract is a financial contract that provides the owner with the ability to unbundle and categorize all of its risks and rewards of ownership into three basic classes:

- Rights and obligations to be **sold** to other parties,
- Rights and obligations to be **optioned** to other parties, and
- Rights and obligations to be **retained** by the owner.

If there are rights and obligations that the owner is retaining and is not including in the lease contract, the contract is an operating lease. For the lease contract to be a capital lease and to be an asset-purchase financing, the previous owner must be selling or optioning to sell all of its risks and rewards of ownership.

In an asset purchase, the bundle of risks and rewards being transferred between parties are equivalent to **all** of the rights and obligations inherent in the tangible property. When an asset is purchased, the new owner is generally buying an asset with either an **unknown and imprecise life** or **an infinite life**. When the length of the life of the asset is unknown or infinite, the owner faces the problem of not knowing the precise period over which to allocate the utilization of benefits associated with the purchased property. Traditional asset purchase accounting recognizes that the exact life is unknown and the costs of ownership are assigned over an estimated useful life.

A rental of an asset does not present the same price allocation problem. In an operating lease, the parties of the contract are negotiating over the sale of a ***finite*** and ***specific*** number of right-of-use time units. The number of units of time is an ***explicit*** term of the contract. Units that are associated with different time periods can sell for different prices.

These right-of-use units are depleted over the term of the contract. As stated earlier, we view these time units as commodities. When the number of time units is finite and explicit, costs can be allocated based on a unit basis and the specific value of the units can be known and be specifically assigned. Knowing the specific value and cost of each time unit means that depletion accounting is possible. Given that the assets acquired by the renter in an operating lease contract are time units, the renter's time units should be fully depleted at the end of the contract so that the renter will have no assets with any value at the end of the contract. **That is, by definition, the value of the renter's intangible asset is always zero at the end of the operating lease contract because all of its purchased and optioned time units have been exhausted.** While the tangible asset that is being rented may still have value at the end of the operating lease contract, that portion of the tangible property's value has been retained by the owner and was never contracted for sale to the renter as part of the operating lease contract.

4. What is the lease asset in an operating lease?

It is our belief that part of the problem that has inhibited the boards from coming to the correct answer for operating lease accounting over the decades can be attributed to an inarticulate identification of the lease asset. *The underlying tangible asset that is discussed in an operating lease contract is not the lease asset. The lease assets are the depleting rental time units associated with the right to use the tangible property.* The rental time units are in*tangible rights* to use tangible property. It is a gross conceptual error to think of the tangible property as a proxy for the lease asset. While the rental time units derive their value from the value of the tangible asset, they are not the equivalent of the tangible property.

An analogy is to think of the tangible property as a gold mine and to think of the rental time units as the gold extracted from the mine. The tangible property is simply the source of the lease intangible asset.

Just as owners use licensing and royalty arrangements to extract value from intangible property such as trademarks, copyrights, and patents, tangible property owners can use rental arrangements to extract value from tangible property.

5. Does it make sense for the FASB and IASB to introduce different accounting for real estate and equipment leases?

No. If the proposed Type A and Type B lease accounting is introduced into the accounting literature, it will be very unfortunate because the boards have not provided an analytically sound argument for why this bifurcation of operating leases is justified.

The boards have decided that there should be two types of accounting:

1) **Type A - Most equipment/vehicles:** leases where the asset consumption is more than significant, and
2) **Type B - Most real estate:** leases where the asset consumption is not more than insignificant.

This distinction is completely arbitrary. As we mentioned in the answer to the previous question, the lease asset in an operating lease is not the underlying tangible property. Regardless of whether the underlying property is a piece of equipment or a piece of real estate, an operating lease provides the owner with the opportunity to carve out a specific number of rental time units to sell or option to sell to the renter. The operating lease assets are the rental time units and the mechanics of their depletion works in the identical manner regardless of whether they are related to real estate or equipment. Any excess value in the tangible property at the end of the operating lease contract is irrelevant to the

mechanics of the lease contract because the whole point of the excess value is that it represents value in the tangible property that was not offered for sale to the renter in the operating lease contract.

We believe it is very misguided to define Type A and Type B leases based on the nature of the underlying property. There is no fundamental reason that most equipment and vehicles subject to operating leases should be broken out into amortization and interest expense on the income statement and cash paid for principal and interest on the cash flow statement. Derivatives (forward contracts) do not produce principal and interest, nor are they amortized. The right-of-use units (lease assets) deplete with identical mechanics for equipment and real estate. At the end of a real estate lease and at the end of an equipment lease, the renter holds no rental units which means the value of its lease asset is zero regardless of the residual value of the piece of property returned to the owner.

6. Does the boards' proposal reduce structuring opportunities?

We do not believe the boards' proposed standard reduces structuring opportunities. Terms such as "significant" and "substantially all" are ambiguous terms and the operation of the boards' proposal is highly dependent on these ambiguous terms. Thus, instead of the "bright lines" of current lease accounting that establish the border between operating and capital leases, these ambiguous terms will create a subjective, blurry line that will make it difficult to determine lease categorization. Further, variable lease payment and renewal option treatment in the proposal are also very large structuring opportunities.

7. Do you believe the boards are correct in their decision to treat leases as non-financial assets?

While we believe rental time unit rights are intangible assets, the forward contracts (operating leases) written to dictate the pricing of rental units in future time periods are derivatives which makes operating leases a form of financial contract. As such, we do not support the boards' decision to classify leases as non-financial assets.

Forward contracts are used to lock in pricing for commodities that will be available in future periods. Rental markets exist. Operating leases are used to lock in pricing for rental time units in future periods. Thus, "operating lease" is a term that describes a class of forward contract.

We view operating leases as financial contracts written to sell a subset of intangible rights that exist as part of piece of tangible property. As stated earlier, the operating lease carries out the function of a **bundle of forward contracts**. If there are renewal options embedded in the operating lease contract, the contract is a **bundle of forward contracts** and **options on forward contracts**. To this end, operating leases are financial assets rather than non-financial assets as the boards contend.

8. Why are operating leases a form of forward contract?

We believe operating leases satisfy all the elements of the definition of a forward contract. Forward contracts are often used as a form of hedge. Forward contracts are non-standardized contracts between two parties to buy and sell an asset at a specified future time at a price agreed upon today.[1] Spot contracts are agreements to buy or sell an asset at today's price. A current rental at the current market rental price is a spot contract, and an operating lease is a bundle of forward contracts.

[1] John C. Hull, (2000), Options, Futures and other Derivatives, Prentice-Hall.

Rental prices in the future are uncertain. The risk for the owner is that it has set the schedule of future aggregate lease payments in the operating lease contract at prices that will ultimately prove to be below spot market rental rates that it could have demanded from market participants over the contractual period if it had not committed to the operating lease forward contract. The risk for the renter is that it is agreeing to make aggregate rental payments in the lease contract at prices that will ultimately prove to be above spot market rental rates that it could have gotten in the market over the contractual period without the commitments made in the operating lease forward contract. The ultimate winning and losing parties will be established at the end of the contract.

The intrinsic value of the forward contract can be expressed as:

$$V_t(0,T) = S_t - F(0,T)/(1 + r)(T - t)$$

S_t represents the asset's current price for the bundle of rental units based on expectation about future rental prices over the course of the contract.

$F(0,T)/(1 + r)(T - t)$ is a proxy for the fair value of the contractual payments under the lease (the present value of the strike price) that the parties have agreed to in the rental contract.

r is the risk-free rate

In the context of a forward contract on rent (operating lease), we could express this equation as:

Fair Value of Forward Contract = Fair Value of Right-of-Use Asset minus Fair Value of Right-of-Use Liability

From the perspective of the renter, the right-of-use asset is the intangible right to use the asset and the right-of-use liability is the commitment to make contractual payments. From the perspective of the owner, the asset is the payments it will receive from the renter due to the contract and the liability is the commitment to deliver the intangible right-to-use units at the appropriate time.

9. Are rental units continuously delivered or are they delivered all at once at the beginning of the contract?

Rental units are continuously delivered throughout the rental term.

The assets being sold in the operating lease are time units associated with specific time periods. As a result, the owner of the physical asset cannot begin to make delivery of a specific intangible rental time unit until that specific right-of-use period begins. That is, the rental time units are not all immediately delivered at the beginning of the operating lease contract. They are continuously delivered over the contractual period. In addition, in most operating leases, the renter makes payment to the asset owner over the contractual period rather than at the beginning of the contract. So delivery and payment generally both take place over the life of the contract.

The reality that rental units are continuously delivered to the renter over the life of the contract can be seen by analyzing failed operating lease contracts. Each future time interval of a rental relationship is dependent on the outcome of previously expended time units. If the renter does not deliver its payments for current time units or if the owner does not make its tangible property available to the renter for use in the condition that is contractually agreed upon, then access to future time units becomes at risk. For example, a renter who does not pay rent is often evicted so the owner has the ability to either use the asset itself or rent it to another party. Similarly, if the asset is destroyed due

to no fault of the renter, the renter is under no obligation to continue to pay rent as the owner is not in a position to deliver on its obligations under the contract.

10. What is the appropriate discount rate to use in operating lease contracts?

Given that operating leases are forward contracts, the appropriate discount rate for operating leases is the risk-free rate. The standard formula for forward contract pricing employs the risk-free rate.

The operating lease payment schedule does not represent the repayment of an upfront loan. It represents a commitment to pay a contractually-defined price for rent at a contractually-agreed-upon date in the future. In theory, the credit risk associated with that commitment could be eliminated if the renter invests cash at the beginning of the contractual period in risk-free instruments that will mature on the dates when the contractual payments are due to the asset owner.

In addition, the use of the risk-free rate simplifies lease accounting. The risk-free rate is not ambiguous and is not based on the company-specific credit condition of the renter or owner. Treasury curves are published on a daily basis, and consistent, standardized interest rates can be applied on all forward contracts. If all companies were using the same discount rate curve each quarter, the comparability in lease balances across the universe of reporting companies would be very consistent.

The use of the risk-free rate would also eliminate the double-counting of credit risk in leases. Owners already have the ability to adjust the dollar amount of the rental payments to compensate for perceived credit risk of the renter on day one of the contract. Further, owners have the right to build in incremental contingent rent to compensate for changes in the renter's credit condition over the course of the contract. Given that the owner has the ability to build in compensation for credit risk into the rental payment (regardless of whether the owner does in fact choose to exercise this right), it is double counting to also build in a credit adjustment into the discount rate.

Further, it is inappropriate to freeze the interest rate on the operating lease at the rate at the beginning of the contract. The parties should continuously re-price the contract using the current risk-free rate curve at the balance sheet date. Given that some leases have lives of 30 years or more, we see no relevance to applying stale interest rates from many decades ago into calculations that produce values that appear on current balance sheets. Historical discount rates have components that are the result of specific macroeconomic factors that were present in the economy at the time of those contract signings, and those specific macroeconomic factors are not necessarily present in today's market environment. The use of stale discount rates in the boards' proposal leads to further mispricing of the operating lease derivatives over their lifetimes. The boards are fully capable of avoiding the insertion of this mispricing if they require companies to use the current risk-free rate curve on each balance sheet date as the discount rate.

While GAAP accounting has multiple basis approaches for asset and liability measurement, markets have only one approach – fair value. When accounting does not present balance sheet information on a fair value basis, the standard setters are transferring the responsibility for those calculations to members of the investment community who must make those estimates on their own otherwise they are trading in markets based on insufficient information. Stocks trade daily based on market participants' perceptions of fair value. When stocks trade in markets, buyers and sellers must ultimately convert all perceived assets and liabilities of the company to estimates of current fair values, and often those judgments are made based on insufficient public information. It is not the GAAP holding basis of the corporate entity that is relevant (to anyone), it is the fair value as perceived by market participants that matters.

To accurately calculate the fair value of equity securities, the equity investor has to make informed estimates of the fair values of all assets and liabilities since the equity value is the remaining value in the entity after consideration of all other stakeholders. The corporate entity itself is only a legal concept, but it is not a real stakeholder. The stakeholders are counterparties and capital providers (human capital, debt capital, and equity capital) to the entity. Given the modern era of high-frequency trading, it is our belief that a very small percentage of shareholders of most corporate entities hold stocks for the thirty years or more of contractual term of some lease contracts. From that perspective, there would be a very small subset of capital providers that would have a basis in the operating leases that is identical to the holding basis of the corporate entity.

Investors need to be in a position to make reasonable estimates of the values of operating leases when they first purchase stocks in markets and also when they are selling the stocks in markets. From this perspective, financial statements need to be representative of economic reality at each balance sheet date because the fair value of the balance sheet on the date of security acquisition is a security holder's true holding basis in the assets and liabilities of an entity. The use of stale and inappropriate discount rates inhibits this process and presents financial statement users with misleading information that destroys investors' capital and creates unnecessary and avoidable capital market inefficiency. If the management of the company was attempting to sell the entire company, the management would reference the fair value of the leases rather than book value based on stale measurements. If the managements would not use the book values in a sales transaction, why is it appropriate for all other users?

11. What is the harm in replacing rent expense with interest expense and amortization expense on the income statement?

The disaggregation of rental expense into separate amortization expense and interest expense components is not a decision-useful exercise.

As we illustrate in our roll-forward example in Exhibit 2 of this comment letter, both the lease asset and lease liability begin as net-present-value calculations. There is a time-value-of-money effect (interest income) on the net present value of the lease asset that offsets the time-value-of-money effect (interest expense) on the lease liability. If the lease asset and lease liability are equal in value, these "interest" effects which are really time-value-of-money effects, that would be described as fair value changes if they described other financial instruments, would net to zero.

Think about this issue in the context of forward contracts on other commodities. We do not split forward contract expenses and payments into interest, principal, and amortization for currency, oil, steel, agriculture products, and other commodities that are commonly subjects of forward contracts because it is understood that such treatment does not make sense and would contaminate operating margins. The change in value of a forward contract from period to period is caused by the time value of money, changes in spot prices, and changes in interest rates. We believe the board's approach is inappropriate, adds unnecessary complexity, and is not helpful to financial statement users.

To illustrate this point, consider two hospitals that decide to rent the same model of medical equipment on the same date. Hospital A decides to rent the machine month to month for $10,000 per month, and Hospital B signs a 10-year operating lease and pays a fixed monthly rent of $8,000 for the duration of the 10 years. It is further assumed that both hospitals will need the machine or a similar machine as a vital piece of equipment as long as the hospitals exist.

Hospital A is initially paying more than Hospital B, but its month-to-month arrangement offers it more flexibility. The owner of the machine needs to be compensated for accommodating this flexibility because it may need to place the

machine with another renter when Hospital A decides that it no longer wants the machine and the owner will incur additional transaction costs to place it with new parties in the future. If new technology or better-priced competing technology becomes available, Hospital A is in a position to change machines because it has not made a long-term commitment to the equipment owner. As a result, Hospital A can justify the initial premium it pays as the cost of purchasing flexibility.

Hospital B is able to get its initial monthly cost down from the $10,000 spot rate to the $8,000 contractual rate by promising to purchase 120 units of rent (12 months X 10 years) instead of one month of rent. Hospital B has secured initial pricing for the use of the machine that is lower than the spot price in a month-to-month arrangement, but it is locked into using the machine for 10 years at the contractual pricing. This arrangement is less flexible than renting month to month. However, by committing to 10-years of use, Hospital B has secured a predictable, stable pricing schedule throughout the 10-year term.

Under the board's proposal, Hospital A would have an operating cost of $10,000 in month 1, but Hospital B would have its $8,000 payment for the same machine split up into interest cost and principal on the cash flow statement and interest expense and amortization expense would be shown on the income statement.

For both Hospitals A and B, the piece of equipment is a necessary input in its day-to-day operations as a hospital, but with very different accounting implications. Certain aspects of the hospitals' operations cannot be accomplished unless they have this equipment. Therefore, the interest and amortization approach leads to the understatement of true operating costs.

In our view, Hospital A's treatment of the $10,000 rent payment as an operating cost is appropriate and representative of economic reality. For the hospital to make a real economic profit during the period and justify the $10,000 payment for use of the piece of equipment for the month, it needs to earn more than $10,000 of operating revenue during the month as a result of its use of that piece of equipment. The integrity of the operating margin metric for Hospital A is maintained.

In our view, the proposal's accounting for Hospital B is highly inappropriate because it contaminates the operating profit margin. A lot of analysts focus on metrics such as EBITDA, and the interest expense and amortization expense approach would essentially result in the entire cost of the use of the piece of equipment being excluded from EBITDA despite the facts that 1) the piece of medical equipment is a necessary instrument that the hospital needs to carry out its operating activities as a hospital and 2) it is a cash cost.

Given that the boards and other market participants are very familiar with the popularity of metrics like EBITDA in the valuation process, it is inappropriate to develop accounting that is going to make metrics such as EBITDA into even larger distorted expressions of economic reality.

Hospital B and the owner of the equipment are both using the operating lease to **reduce pricing risk**. The risk for the equipment owner is that it might not be able to collect an average monthly rental rate above $8,000 per month over the next 10 years. The risk for Hospital B is that it might cost it more than an average monthly rental rate of $8,000 per month over the next 10 years if it engages in month-to-month rental at the spot rate. Hospital B has used the operating lease to make its payments into **predictable operating cost** of $8,000 per month for the next 10 years. The owner of the equipment has contracted with a party that has agreed to use the equipment for the next ten years at a **predictable rental price** of $8,000 per month and helped the owner avoid the need of placing the equipment with new renters every

month and helped reduce the risk that the machine will have periods when the machine is not used. The forward contract enables both parties to hedge their relative pricing risk and lock-in longer-term economics over a specific period of time.

12. How could the joint proposal produce misleading results?

We already discussed in our previous answer to Question 11 how we believe disaggregation into interest and amortization contaminates operating margins. The interest expense produced by the proposal is based on a fixed rate established at the beginning of the contract, and this approach is not consistent with forward accounting. Further, we believe the risk-free rate is the appropriate discount rate given operating leases are forward contracts. **The amortization when applicable is a *straight-line amortization applied to a net present value using an inappropriate discount rate set at the beginning of the contract* which means it is devoid of fundamental integrity.** The lease asset should be reduced each period by the value of the depleted time unit used and necessary fair value adjustments each period. The implication is that we are concerned that the operating lease accounting proposed by the boards will produce completely arbitrary accounting.

The flawed interest expense and amortization expense approach in the model ultimately lead to balance sheet contamination.

In our Question 11, Hospital B used its operating lease to secure 120 rental units to be utilized over 10 years. Let's explore three scenarios:

- **Scenario 1:** Assume that the spot-rental rate of $10,000 that is offered to Hospital A ends up being the spot rental rate for the next 10 years. In this case, Hospital B will realize a profit of $2,000 in each of the next 120 months as a result of its rental forward contract that lead to it paying $8,000 per month. Hospital B is the clear winner in the forward contract with the equipment owner because it was able to reduce its operating costs by $2,000 per month for each of the next 120 months due to its hedging strategy on rental time units.
- **Scenario 2:** Assume that $8,000 per month ended up to be perfect pricing on the part of the equipment owner and Hospital B. While the spot price was $10,000 in the first month, it fell to $6,000 in the second month and then averaged out to an average monthly spot rent of $8,000 for the next 118 months. In this situation, there is no winner or loser in the forward contract. Hospital B had contracted to pay $8,000 per month, and that is the same price it could have secured if it had rented the item each month over the 10-years at the spot market price of $8,000 on each of those given months.
- **Scenario 3:** Assume that a new machine comes out just after Hospital B enters its operating lease with the equipment owner and it is technologically superior and less expensive to purchase and operate so it can be rented in the market at an average price of $5,000 per month over the next 120 months. In this situation, the equipment owner is the clear winner. It has contracted to rent a technologically obsolete piece of equipment to a renter at an above-market rent for $8,000 per month even though a better piece of equipment is available at a spot rental rate of $5,000 per month.

In Scenario 2, we want to see the rental asset and rental liability be recorded at equal amounts to one another in months 3-120. Each month, a rental unit with a spot market value of $8,000 is exhausted and each month a rental payment of $8,000 is made. For an economic reality perspective, we would want to see the rental asset and rental liability decline at identical rates over the 10-year period. If we apply forward contract accounting, the asset and liability

are embedded into one instrument and the value of the forward contract stays at zero in months 3-120. Said differently, the spot market price and exercise price are identical.

In the case of Scenario 1, the rental asset is 120 units each with a spot value of $10,000. The rental liability for the renter is 120 rental payments of $8,000 each. The forward should have an undiscounted value of $2,000 ($10,000 - $8,000) times 120 units for an undiscounted gain of $240,000 for Hospital B. From the perspective of the renter, the rental asset maintains a value that exceeds the value of the lease liability throughout its life. The owner's stake in the asset is the fair value of the equipment minus the fair value of forward contract loss.

In the case of Scenario 3, the rental asset is one unit at $10,000 and 119 units each with a spot value of $5,000. The renter's liability is 120 rental payments of $8,000 each. The bundle of forwards should have an undiscounted value of $3,000 ($5,000 - $8,000) times 119 units minus $2,000 ($10,000 – $8,000) for an undiscounted gain of $355,000 for the equipment owner. From the perspective of the renter, the rental liability maintains a value that exceeds the value of the lease asset throughout its life. From the owner's perspective, while the value of its equipment was permanently impaired by the release of a technologically-superior and cheaper product, the operating lease forward gain has provided the owner partial protection from the deterioration in the asset value that was caused by its technological obsolescence. The owner's stake in the asset is the fair value of the equipment plus the fair value of its forward contract gain.

13. **How do you view contractual terms that allow the owner or renter the opportunity to exit the contract at an earlier date than the end of the contract?**

Renters that have the ability to exit contracts early hold put options. Owners that have the ability to end rental contracts early hold call options. If these derivatives can be exercised anytime over the life of the contract, there is no minimum lease term.

14. **Would the forward approach produce consistent accounting for owners and renters?**

Yes. The forward contact approach simply determines who holds the gain and who holds the loss in the operating lease contract. Opposite and equal gains and losses are assigned to the contractual counterparties. The forward contract approach also has the benefit of avoiding the illogical situation where the same asset is shown on two separate balance sheets with two separate sets of leverage (these types of outcomes are indications of broken accounting).

For the renter, the forward gain or loss will alter the rent expense so it deviates from the market rent expense. For the owner, its aggregate position in its owned property will either be above the fair value of the property (if the owner has a forward gain) or below the fair value of the property (if the owner has a forward loss). Again, all a forward contract does is change prices so they deviate from market prices.

15. **Some see operating leases simply as a means for structuring to avoid formal ownership in an effort to keep balance sheets lean. Is this an accurate depiction of why companies enter operating leases?**

There are real business reasons to enter operating leases. Generally speaking, we believe operating leases make more sense for companies in periods of hyper growth, and ownership makes sense when a mature company is attempting to lock-down access to key strategic assets that it believes should be permanent parts of its business and can be purchased for prices below the long-term cost of rental.

We like to think about the legitimate business purposes for an operating lease strategy in the context of companies like Starbucks. It is our understanding that Starbucks tends to enter into operating leases with initial contractual terms of 5 or 10 years and then has multiple renewal options that typically result in Starbucks having the opportunity to lease properties for a total of approximately 30 years if all the renewal options are exercised.

Starbucks makes the majority of its revenues through the sale of drinks and food items. It is a transactional business. To be in a position to sell drinks and food items, the company needs employees, coffee and other beverage inputs, food, electricity, cups, napkins, sugar, straws, etc. Most importantly, it needs a venue to sell its products. None of these items can be sold without access to real estate. There is no Starbucks without access to real estate.

Retailers have a choice, they can rent their real estate or they can purchase it. Starbucks rents the vast majority of its real estate. We believe the decision to rent real estate is a key strategic element of their business strategy. According to Starbucks' 2012 10K, it had 18,066 stores as of September 30, 2012. According to Starbucks' 2002 10K, it had 5,886 stores as of September 30, 2002. Therefore, Starbucks increased its store count by 12,180 stores (207%) over the course of the decade. This growth implies that the company opened approximately 3.33 stores each day throughout the decade.

We believe Starbucks would not have a store count anywhere near 18,066 stores if it had pursued a strategy of purchasing all of its properties.

There are a number of reasons that real estate purchases do not seem to fit Starbucks' current business strategy:

- A real estate purchase typically requires a down payment and additional financing which implies a larger upfront investment to purchase a new store relative to renting/leasing it.
- Some store locations are in malls, banks, office buildings, or other large real estate complexes where property owners only offer operating leases and it is not practical for Starbucks to consider purchasing the venue because that is not an option.
- Even when acquisition of a property could be feasible, some real estate owners do not want to sell their property or do not want to sell it at a reasonable price.
- There are no guarantees that prospective locations for new stores will have the appropriate demographics to provide the company with adequate assurances that new store locations will be successful. The lease provides the company an opportunity for an exit from the location either through non-renewal or subleasing the premises.
- Starbucks is a very successful brand, and a number of real estate owners are likely to be willing to offer Starbucks below-market rental terms to attract Starbucks to their buildings because the presence of a Starbucks store can help the owner of the complex attract other tenants at higher rental rates than would be possible if there was not a Starbucks at the location. Therefore, Starbucks pulls traffic to the owner's property, and Starbucks is rewarded for this benefit.

The goal of Starbucks is to conduct as many retail transactions around the world at a profit as possible. We assume that Starbucks has a team whose sole purpose is to look at maps, demographics, and traffic patterns and scout locations where they believe it is possible to insert a store and operate it for an acceptable profit. Property scouting can be thought of as a core competency of successful chains like Starbucks.

We believe companies like Starbucks thinks about monthly rental payments similarly to the monthly cost of coffee beans, cups, pastries, electricity, employee wages and benefits, etc. If rent at a location is $10,000 a month and the location does 25,000 transactions a month, then rent represents an operating cost of $.40 per transaction. As long as the monthly receipts cover the regular operating costs, the $0.40 per transaction rent operating cost, and an acceptable profit, it makes sense for a store to exist at the location.

An initial 5 or 10 year lease term makes sense for a chain like Starbucks. It gives the company an opportunity to justify setting up the store and testing the market. If the location proves to be unsuccessful at attracting adequate transactions and revenues, the company can be nimble and close the store and move to another location. If during the initial lease term a better location in proximity to the leased location becomes available, Starbucks can move its store and it might have the ability to sub-lease its initial location to another renter or break its lease if that is permitted under the terms of the contract.

The initial lease term with the addition of the renewal options with pre-determined, negotiated future rental prices also protects the company from the real estate owner attempting to increase the rent prices on Starbucks over the term of the lease if the owner sees that the store has been very successful and wants to attempt to negotiate higher monthly rental rates with Starbucks and thus attempts to claim a share of Starbucks' operating margin.

Based on all these reasons, it is very clear to see why ownership does not make sense for a company like Starbucks. Ownership is a much larger commitment than the operating lease relationship and it ultimately slows growth.

Ownership makes more sense in the mature phase of a company. If at some point, Starbucks' management team becomes highly confident that the company has some stores in locations where it wishes to remain for the very long-term, it may make sense to acquire store locations that are available at reasonable prices. When the firm starts to view particular stores as existing in perpetuity, those are store locations that the company should consider acquiring. Rent payments never stop for as long as a location is occupied, and they are subject to inflation and market forces which make renting and leasing more expensive than ownership when viewed as a perpetuity. If a location is going to be a permanent part of company operations, ownership with periodic capital expenditures should be cheaper than perpetual rent because it provides the company the opportunity to eliminate the landlord's profit margin which is built into market prices of rent.

McDonalds is a company that owns a lot of its store locations, and it is also a much more mature company that has likely found key locations over decades where it believes it can be successful over a very long period of time. From that perspective, McDonalds has two important operating units: its food/franchising businesses and its real estate portfolio. While certain McDonalds stores that the company owns are likely very successful and produce large margins, part of these large margins exist because the stores' cost of occupying these prime locations is well-below market rental rates given that many of the stores were purchased decades ago when real estate was much cheaper to acquire. The real estate portfolio providing locations to the stores at below-market rental rates results in the real estate portfolio subsidizing the food segment. While McDonalds may do very well in the prime locations that it owns, the shareholders of McDonalds could potentially secure more free cash flows if these stores were closed or moved and the locations were rented at the current market rent, the properties were sold, or the properties were bundled to create a REIT. McDonald's operating margin over the long-term should be higher than a comparable chain with a strategy of renting all of its stores since part of its margins are really gains from property ownership.

16. How do you think about variable rents?

When thinking about operating leases as forward contracts, we view the rent payments as the strike prices embedded in the forwards. The strike price could be expressed as a fixed price, or it could be determined based on a contractually-agreed formula. We see variable rents as an agreement to use an equation-based strike price in the forward contract.

Variable rent is a way for the owner of the property to maintain more potential upside if the renter is successful in its use of the owner's tangible property. A variable rent term provides the owner of the property the opportunity to collect rental revenues that are closer to market rental prices. In other words, if the renter is the winner on the forward contract, the variable rental payments help the owner reclaim some of the renter's gain.

17. Why is it important that cash rent outflows be disclosed?

An ownership strategy is different than a renting/leasing business strategy. To that end, it makes sense to assume that the company will continue the same rent/own strategy in future years unless there is adequate evidence to the contrary.

We consider rent payments to be operating costs. The presence of operating leases does not change the fact that rent is an operating cost; operating leases only alter the amount of rent paid so it is not necessarily consistent with market prices. On a cash flow basis, investors need to have the rental payments associated with operating leases disclosed in the operating cash flow section of the cash flow statement as their own separate line item. This information is necessary to establish the trend in the rent cash outflows over time. The rent cash outflow should remain a component of operating cash flow so it stays in free cash flow calculations for valuation purposes.

The rent cash outflow (typically not provided by companies) is superior information to traditional rent expense information in the valuation process. Typically GAAP rent expense is averaged over the term of the contract, so it is not a proxy for the actual cash flow during the period. If the rent expense is associated with a 10-year contract, the growth in rent payments over the years is partially compensation for inflation, so the accounting treatment that results in the rent expense being presented as the average rent expense over the contractual period contaminates the informational value of the rent expense. If rent expense is an average of an inflation adjusted rent expense over a term, it has a weak relationship with the actual cash rent payment and analysts have the additional difficulty of assigning growth rates to rent expense in future years since some of the inflation effects are already factored in and averaged into rent expense through GAAP accounting.

For example, consider a coffee shop chain with 100 stores and annual rent cash outflows of $2,000,000 per year. The average cash rent per store is $20,000 per year. If investors have expectations about how rent prices will increase over time and the number of stores will grow, the investor can estimate the rent cash outflows in perpetuity. This approach captures all anticipated future rental expenditures in the firm valuation rather than some portion of contractual commitments as the boards' proposal seeks to do.

18. Is an operating lease liability on the balance sheet calculated based off of the contractual commitments of the company relevant to investors?

From a valuation perspective, the contractual liabilities are largely irrelevant. They represent only a portion of the rental payments that the company will have to make in future years. We believe the amount of lease commitments has some informational value, but most of that value is of a qualitative nature. In our view, the contractual liability of an operating

lease should not factor into valuations. If the fair value of the operating lease forward contract could be calculated accurately, the gain or loss would translate to a direct increase or decrease to a company's market value in recognition of the forward contracts changing its market rent cost to a contractually agreed upon cost that may vary from the market rent cost. Given that we see the operating lease payment liability as a notional amount for the forward contract, there is qualitative value to knowing the size of a company's operating lease forward contract portfolio. The larger the amount of future lease payments, the more rent hedging being attempted by the counterparties.

To understand why contractual operating lease commitments usually should not factor into valuations, consider the following example. Assume a restaurant chain's business strategy is to never own its stores and it is its standard policy to sign 10-year operating leases. Let's assume that the duration of the balance sheet obligation under the contractual approach has a 5-year duration since contracts are signed at different times and they are continuously expiring and new contracts are continuously entered. From a valuation perspective, the 5-year contractual notional obligation should not be relevant to the valuation. The relevance of the operating lease is restricted to the gain or loss of the forward contract. If the company is going to exist on a going-concern basis, the base assumption is that new contracts will have to be signed for the indefinite future to maintain and grow the business. Growing rental cash outflows for rent on all of the chain's existing stores as well as new stores to be opened in the future need to be assumed in the calculation of future free cash flow which means that projected rental payments for all future periods rather than just the contractual period of operating leases will need to be factored into the valuation. Without the rented store locations in perpetuity, the chain has nowhere to do business at the end of the operating lease period, thus there is no business. This implies thinking about the contractual lease payments as being debt that is subtracted from firm value to get to the equity value is overly simplistic and deficient.

The focus on the contractual liability might lead one to think that the contractual obligation approach is geared more towards liquidation valuations, but the contractual liability would not be a direct input in a liquidation valuation either. Operating leases are essentially asset-backed, because the rental right-of-use assets can never be separated from the obligation to make contractual payments. Therefore, in the case of liquidation, the owner would get its asset back upon default and the asset can be re-leased by the owner to another renter to mitigate the damages it suffers as a result of the renter's default.

For example, if a renter defaults two year after starting a 10 year lease and the owner evicts the renter and regains control of the property and leases it to another party within a year of the original renter's default, the damages to the owner are for the one year of non-payment of rent, the costs of re-leasing the property, and any deficit in the rental rate from the new renter relative to the original renter. The owner's loss is not the eight years of unpaid rental commitments. The owner would receive undue enrichment if it collected eight years of payments from both the old renter and the new renter. Further, if the renter becomes distressed and sub-leasing is permitted, the renter could potentially sub-lease the property to avoid a default. In a sub-lease scenario, the risk to the renter is the difference between the contractual payment it must make to the asset owner and the rental payments it can secure from its sub-lease renter.

19. If the boards accept that operating leases are forward contracts, what should the accounting look like for such leases?

Throughout this comment letter we have argued that operating leases are forward contracts. That said, we do not believe the boards are prepared to adopt full scale forward accounting for these contracts. In our view, the accounting

should be designed around the reality that operating leases are forward contracts, but we acknowledge that the boards would likely seek to include some simplifications to make the standard cost-effective if they were to pursue an approach that acknowledges these contracts as derivatives. To that end, here are some suggestions about how the boards could design a standard with mechanics that are an evolutionary step towards forward accounting.

If we were to adopt full-scale forward accounting, companies would need to check the market rent rates on each rented item. If we think about a company like Starbucks with 18,000 stores, we can see how it could be a very time intensive and costly exercise to calculate the fair values of the forward contracts given that would require the company to gather market rent rates on each rented item each balance sheet date to calculate the forward gain or loss.

We propose the following accounting:

- On the comprehensive income statement, we believe it is enough to show rent expense net of the forward contract gain or loss as one line item of the operating income section of the income statement. The cash rent expense is essentially the equivalent of the market rent price net of the forward contract gain or loss. Said another way, without an operating lease, the renter would pay rent that is equivalent to the spot price of rent. Cash rent in an operating lease is the market rent adjusted for the operating lease hedge to arrive at the contractual rent. While we traditionally prefer gross numbers to net numbers, the amount of level 3 fair value valuations that would be necessary to calculate the value of operating lease gains or losses probably would not justify the expense of calculation in most instances. That said, companies that can provide estimates of market rents for current periods that we could compare to contractual rents would be providing investors information that would help us estimate the gain or loss of operating lease forwards and price their equity securities more efficiently.
- On the balance sheet, we believe the renter's lease asset (the rental time-units) and the renter's lease liability (the lease payments) should be presented together as separate line items to net to the forward contract using linked presentation. If the boards believe it would add too much additional cost and complexity to the standard to fair value the rent time units each period, we believe the base assumption should be that the rental time units maintain their value relative to the lease payments. This base assumption of no gain or loss on the operating lease forwards would need to be disclosed in lease footnotes as a simplifying assumption under the accounting standard. The implication is that the lease asset and lease liability are assumed to be equal and opposite throughout the duration of the contract and net to zero. *The lease asset and lease liability which together form the forward contract would be calculated each balance sheet period as the net present value of the remaining lease payments with the current yield curve of risk-free rates as discount rates.*
- On the cash flow statement, minimum cash rents paid and variable cash rents paid should be required separate line items in the operating cash flow section. Cash rent is needed to calculate the rent perpetuity so the valuation is adjusted for rent in all future periods. It is important that investors are in a position to see trends over time in both historical minimum payments and historical variable payments. Trend analysis of historical payments helps investors assign appropriate growth rates to both variables in free cash flow forecasting for valuation purposes.

20. Can you provide an example of the type of lease payment disclosure you would want to see in the footnotes and why the information you are requesting is necessary?

Below are two examples. The first example illustrates a company with one operating lease. The second example illustrates a company with 30 operating leases (one entered over each of the last 30 years).

Example 1:

Assume Coffee Shop signed an operating lease in 2010 with an initial lease term of 10 years and four 5-year renewal options. Coffee Shop has a weighted-average cost of capital (WACC) of 10%. The initial annual rent in 2010 is $100,000 and is scheduled to grow at 3% each year in the initial lease term and renewal option periods. The risk-free rate yield curve and time value of money discount factors are presented in the table that follows.

In the 2012 10K, the remaining undiscounted lease payments are $4.449 million between 2013 and 2039 (27 years). If we ignore the company's disclosed probabilities of lease renewal, then the lease payments inclusive of all renewals would have a net present value of $2.469 million. When discounting and probability-weightings are considered, the fair value of the operating lease obligation is $1.7 million. If the renewal options are ignored, the net present value of the lease obligation associated with minimum lease payments for 2013-2019 is $713,800.

Given the calculations in the lease table, an operating lease asset of $1.7 million and an operating lease commitment of $1.7 million are shown on adjacent line items on the balance sheet and net to an operating lease forward gain/loss of zero given GAAP does not measure the fair value of operating lease forward contracts. The company discloses in its lease footnote that it believes that the market rate of rent in 2012 was approximately $115,000 and the cash rent payment in 2012 was $106,000. Based on this information, investors are likely to expect that the operating lease forward contract is currently in the money.

Coffee Shop will need to maintain a location to remain in existence. If the $109,000 cash rent payment in 2013 is treated as a regular operating cost and continues to grow at a 3% annual growth rate, the firm value is reduced by $1.557 million in the valuation based on the growing perpetuity formula ($109,000/(10% WAAC – 3% growth)). With the firm value already reduced by $1.557 million for all future rent payments, there is no need to make an additional valuation adjustment of $1.7 million for the contractual liability. To make this adjustment would be redundant.

In this situation, the $1.557 million valuation adjustment is less than the $1.7 million contractual liability primarily because the two calculations call for the use of different discount rates. Forward contracts (operating leases) call for the use of the risk-free rate. Free cash flow to the firm and free cash flow to equity require the use of a company's weighted average cost of capital and cost of equity, respectively. The valuation will always call for a different discount rate than the rate associated with the lease contract. In valuations, the cost of equity and the weighted average cost of capital are relevant. In calculations involving financial derivatives such as forward contracts, risk-free rates are relevant.

If the fair value of those rental time units is $3 million because market rents have gone up since the operating lease was signed in 2010, then the gain on the operating lease is $531,000 ($3 million value of rental time units - $2.469 million lease payments). The gain from the lease is already reflected in the results of Coffee Shop because the company would be showing a higher spot rent expense than $109,000 on its income statement in 2013 if it had not used the operating lease to cap the rent expense at $109,000 (a rate established by the operating lease rather than by market rents).

The table below provides a very clear illustration of the company's operating lease activities. By definition the probability of renewal of each successive renewal option has to be equal to or lower than the probability of renewal of the previous renewal option because access to future renewals is dependent on the exercise of prior renewals. Some

users could infer from the table that renewal options that are assigned high probabilities of renewal are likely to be at-the-money, in-the-money, immaterial, or of high strategic importance to the renter. If the economy were to go through a severe recession during the following year, such an event could trigger a severe decrease in spot market rental prices, and we might expect to see the probabilities of renewal at much lower rates in next year's annual report lease footnote table.

Exhibit 6. Operating Lease Payment Schedule for Minimum Lease Commitments and Renewal Options for Coffee Shop with 1 Store ($ in thousands)

	Year	Risk-free Rate	Time Value of Money Discount Factor	Rental Price Inflation	Minimum Lease Commitment	Renewal Options										Undiscounted Cash Commitment Before Probability Weighting	Discounted Cash Commitment Before Probability Weighting	**Discounted and Probability-Weighted Cash Commitment**
						Likelihood of Payment												
					100%	90%	80%	70%	60%	50%	40%	30%	20%	10%	0%			
Historical Payments	2010				100	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	100		**100.0**
	2011				103	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	103		**103.0**
	2012				106	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	106		**106.0**
Estimated Future Payments	2013	4.00%	0.962	3%	109											109	105	**105.1**
	2014	4.02%	0.924	3%	113											113	104	**104.0**
	2015	4.03%	0.889	3%	116											116	103	**103.0**
	2016	4.05%	0.854	3%	119											119	102	**102.0**
	2017	4.06%	0.821	3%	123											123	101	**100.9**
	2018	4.08%	0.789	3%	127											127	100	**99.9**
	2019	4.09%	0.758	3%	130											130	99	**98.9**
	2020	4.11%	0.728	3%			134									134	98	**78.2**
	2021	4.12%	0.699	3%			138									138	97	**77.4**
	2022	4.14%	0.671	3%			143									143	96	**76.6**
	2023	4.15%	0.644	3%			147									147	95	**75.7**
	2024	4.17%	0.619	3%			151									151	94	**74.9**
	2025	4.18%	0.594	3%					156							156	93	**55.5**
	2026	4.20%	0.570	3%					160							160	91	**54.9**
	2027	4.21%	0.547	3%					165							165	90	**54.2**
	2028	4.23%	0.525	3%					170							170	89	**53.6**
	2029	4.24%	0.503	3%					175							175	88	**53.0**
	2030	4.26%	0.483	3%						181						181	87	**43.6**
	2031	4.27%	0.463	3%						186						186	86	**43.1**
	2032	4.29%	0.444	3%						192						192	85	**42.5**
	2033	4.30%	0.426	3%						197						197	84	**42.0**
	2034	4.31%	0.408	3%						203						203	83	**41.5**
	2035	4.33%	0.391	3%								209				209	82	**24.6**
	2036	4.34%	0.375	3%								216				216	81	**24.3**
	2037	4.36%	0.359	3%								222				222	80	**23.9**
	2038	4.37%	0.344	3%								229				229	79	**23.6**
	2039	4.39%	0.330	3%								236				236	78	**23.3**
TOTAL					**837**	**-**	**714**	**-**	**827**	**959**	**-**	**1,112**	**-**	**-**	**-**	**4,448**	**2,469**	**1,700**

Source: Dane Mott Research LLC

Example 2:

Rather than a company with one store, assume Coffee Shop was a 30 store chain and was expected to grow substantially over the next decade. The disclosures below would help financial users make much better predictions about future rent cash outflows.

In the example below, Coffee Shop made $3.183 million in rent payments on 30 stores during 2012. This implies that the average cost of rent per store in 2012 was $106,000.

Based on contractual operating lease payment estimates for 2013, the company anticipates that it will have minimum lease payments of $1.858 million and renewal options that have an 80% chance of renewal that would trigger another $1.311 million in operating lease payments. These payments are only associated with 29 stores since one store lease ended on January 10, 2013, and a new lease for that store was not signed until January 6, 2013. Based on current contracts, there is only one store in the lease commitment calculation for 2041 since all other contracts have expired.

While the schedule below does provide a lot of interesting qualitative information that is helpful in understanding Coffee Shop's business, the 2012 historical information is the most relevant information for estimating the implications of the company's renting strategy on the company's valuation. If the analyst expected the company to have 500 stores by the end of 2022, he or she would start with the average cost of rent per store in 2012 of $106,000 and grow it by anticipated rent inflation and the anticipated annual growth in store count to get a better sense of rent exposure in future years. The calculated rent cash outflows based on a total of 500 stores is many multiples of the lease commitments disclosed based on a 30 store count with stores rolling off of contract each year. Never the less, the analyst would still be interested in how leases are traditionally structured, and the lease payment schedule below would provide helpful qualitative insights about Coffee Shop's leasing behavior.

Exhibit 7. Operating Lease Payment Schedule for Minimum Lease Commitments and Renewal Options for Coffee Shop with 30 Stores ($ in thousands)

	Year	Risk-free Rate	Time Value of Money Discount Factor	Rental Price Inflation	Minimum Lease Commitments	Renewal Options										Undiscounted Cash Commitment Before Probability Weighting	Discounted Cash Commitment Before Probability Weighting	Discounted and Probability-Weighted Cash Commitment	Number of Stores in Total
						Likelihood of Payment													
					100%	90%	80%	70%	60%	50%	40%	30%	20%	10%	0%				
Historical Payments	2010				2,800	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	2,800	N/A	**N/A**	**28**
	2011				2,987	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	2,987	N/A	**N/A**	**29**
	2012				3,183	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	3,183	N/A	**N/A**	**30**
Estimated Future Payments	2013	4.00%	0.962	3%	1,858	-	1,311	-	-	-	-	-	-	-	-	3,169	3,047	**2,795**	**29**
	2014	4.02%	0.924	3%	1,351	-	1,801	-	-	-	-	-	-	-	-	3,152	2,913	**2,580**	**28**
	2015	4.03%	0.889	3%	812	-	2,319	-	-	-	-	-	-	-	-	3,130	2,781	**2,369**	**27**
	2016	4.05%	0.854	3%	716	-	2,030	-	358	-	-	-	-	-	-	3,105	2,652	**2,182**	**26**
	2017	4.06%	0.821	3%	615	-	1,722	-	738	-	-	-	-	-	-	3,075	2,524	**1,999**	**25**
	2018	4.08%	0.789	3%	507	-	1,393	-	1,140	-	-	-	-	-	-	3,040	2,398	**1,818**	**24**
	2019	4.09%	0.758	3%	391	-	1,044	-	1,566	-	-	-	-	-	-	3,001	2,274	**1,641**	**23**
	2020	4.11%	0.728	3%	269	-	672	-	2,016	-	-	-	-	-	-	2,957	2,152	**1,467**	**22**
	2021	4.12%	0.699	3%	138	-	692	-	1,800	277	-	-	-	-	-	2,907	2,032	**1,335**	**21**
	2022	4.14%	0.671	3%	-	-	713	-	1,568	570	-	-	-	-	-	2,852	1,914	**1,206**	**20**
	2023	4.15%	0.644	3%	-	-	587	-	1,322	881	-	-	-	-	-	2,790	1,798	**1,098**	**19**
	2024	4.17%	0.619	3%	-	-	454	-	1,059	1,210	-	-	-	-	-	2,723	1,685	**992**	**18**
	2025	4.18%	0.594	3%	-	-	312	-	779	1,558	-	-	-	-	-	2,649	1,573	**888**	**17**
	2026	4.20%	0.570	3%	-	-	160	-	802	1,444	-	160	-	-	-	2,568	1,463	**787**	**16**
	2027	4.21%	0.547	3%	-	-	-	-	826	1,322	-	331	-	-	-	2,479	1,356	**687**	**15**
	2028	4.23%	0.525	3%	-	-	-	-	681	1,192	-	511	-	-	-	2,383	1,251	**607**	**14**
	2029	4.24%	0.503	3%	-	-	-	-	526	1,052	-	701	-	-	-	2,280	1,148	**530**	**13**
	2030	4.26%	0.483	3%	-	-	-	-	361	903	-	903	-	-	-	2,167	1,047	**454**	**12**
	2031	4.27%	0.463	3%	-	-	-	-	186	930	-	930	-	-	-	2,046	948	**396**	**11**
	2032	4.29%	0.444	3%	-	-	-	-	-	958	-	958	-	-	-	1,916	851	**340**	**10**
	2033	4.30%	0.426	3%	-	-	-	-	-	789	-	987	-	-	-	1,776	756	**294**	**9**
	2034	4.31%	0.408	3%	-	-	-	-	-	610	-	1,016	-	-	-	1,626	664	**249**	**8**
	2035	4.33%	0.391	3%	-	-	-	-	-	419	-	1,047	-	-	-	1,466	573	**205**	**7**
	2036	4.34%	0.375	3%	-	-	-	-	-	216	-	1,078	-	-	-	1,294	485	**162**	**6**
	2037	4.36%	0.359	3%	-	-	-	-	-	-	-	1,111	-	-	-	1,111	399	**120**	**5**
	2038	4.37%	0.344	3%	-	-	-	-	-	-	-	915	-	-	-	915	315	**95**	**4**
	2039	4.39%	0.330	3%	-	-	-	-	-	-	-	707	-	-	-	707	233	**70**	**3**
	2040	4.40%	0.316	3%	-	-	-	-	-	-	-	485	-	-	-	485	153	**46**	**2**
	2041	4.42%	0.302	3%	-	-	-	-	-	-	-	250	-	-	-	250	76	**23**	**1**
	2042	4.43%		3%	-	-	-	-	-	-	-	-	-	-	-	-	-	**-**	**-**
TOTAL					**6,657**	**-**	**15,210**	**-**	**15,729**	**14,332**	**-**	**12,091**	**-**	**-**	**-**	**64,019**	**41,459**	**27,434**	

Source: Dane Mott Research LLC

In the table below, we estimate the rent payments that will need to be included in the free cash flow estimates for the store growth projections of 500 stores by 2022. We start with the average rent of $106,000 per store in 2012 and grow it at 3% each year for inflation. We also need to grow the store count from 30 stores at the end of 2012 to 500 stores at the end of 2022. This assumption is necessary if the revenue projections for the company are to be realistically achieved. This assumption implies that the number of stores will grow at approximately 32.5% for each of the next 10 years. We further assume as a simplifying assumption that Coffee Shop will not grow its store count beyond 500 stores and that rent expense will continue to grow at 3% for inflation. The company's WACC is 10%. This implies that the net present value of future free cash flow to the firm estimates would be decreased by $529.3 million for all future rent payments. A growing perpetuity calculation is used to calculate terminal value at the end of 2022. The reduction of free cash flows of $529.3 million far exceeds the $41.5 million discounted amounts that would be made if we assume all renewal options are exercised on the contracts disclosed in the previous table.

Exhibit 8. Estimated Net Present Value of Lease Commitments based on the Growing Perpetuity Calculation

Year	Store Count Growth Rate	BOY Store Count	New Stores Opened During Year	EOY Store Count	Rent Inflation	Rent Per Store	Estimated Annual Rent	Estimated Terminal value from 3% growing perpetuity	WACC assumption	Time Value of Money Discount Factor	Net Present Value of Future Rent Expense
2012				30		$106,000	$ 3,180,000				
2013	32.50%	30	10	40	3%	$109,180	$ 4,367,200		10.00%	0.909	$ 3,970,181.82
2014	32.50%	40	13	53	3%	$112,455	$ 5,960,136		10.00%	0.826	$ 4,925,732.40
2015	32.50%	53	17	70	3%	$115,829	$ 8,108,034		10.00%	0.751	$ 6,091,686.21
2016	32.50%	70	22	92	3%	$119,304	$ 10,975,962		10.00%	0.683	$ 7,496,729.67
2017	32.50%	92	31	123	3%	$122,883	$ 15,114,615		10.00%	0.621	$ 9,384,986.98
2018	32.50%	123	39	162	3%	$126,570	$ 20,504,266		10.00%	0.564	$ 11,574,123.63
2019	32.50%	162	53	215	3%	$130,367	$ 28,028,825		10.00%	0.513	$ 14,383,219.29
2020	32.50%	215	70	285	3%	$134,278	$ 38,269,124		10.00%	0.467	$ 17,852,828.85
2021	32.50%	285	92	377	3%	$138,306	$ 52,141,346		10.00%	0.424	$ 22,113,020.65
2022	32.50%	377	123	500	3%	$142,455	$ 71,227,568	$ 1,048,062,788	10.00%	0.386	$ 431,534,885.66
2023	0%	500	0	500	3%	$146,729	$ 73,364,395				
										Total:	**$ 529,327,395.16**

Source: Dane Mott Research LLC

As **Exhibit 8** illustrates, popular analyst approaches to lease analysis are fundamentally unsound. If we had used the 8x rent approach using cash rent payments of $3.183 million in fiscal 2012, we would have projected "lease obligations" of $25.5 million. If we would have performed the net present valued minimum lease payment commitment approach, we would have had "lease obligations" of $5.9 million. Given that fundamental analysis indicates that rental payments are projected to reduce future free cash flows by more than half a billion dollars over the life of the entity, we are at a loss to understand how any analyst would actually bring the $25.5 million under the 8x-rent approach or the $5.9 million into meaningful analysis. A review of minimum lease payment commitments and potential payments under the renewal options illustrate that both of these approaches do not provide decision-useful information relative to the underlying reality that stores need to be rented in perpetuity and operating leases are derivatives that do not create leverage. These popular approaches fail to appropriately deal with factors such as growth, contractual renewals, changes in the discount rate environment, and inflation. Given that cash rent expense and lease contractual schedules beyond 5 years are not required disclosures, it is not surprising that these highly flawed approaches have gained popularity. If the boards want to improve market efficiency so investors can price lease exposure more accurately (instead of the current market practice of essentially guessing), we are going to need better disclosures.

21. What are some disclosures that you would like to be provided as part of a minimum required lease disclosure package?

Some of the disclosures that we believe are necessary for competent lease analysis by financial statement users include:

- The minimum lease payment and renewal option table that we presented in **Exhibit 7** of our comment letter;
- The roll-forward table of the lease asset and liability we present in **Exhibit 2** of our comment letter;
- Disclosure of discount rate and inflation rate assumptions;
- Sensitivity analysis regarding how the lease asset and lease liability would change based on a 25 basis point change up or down to the discount rate and inflation rate;
- Historical minimum cash rent payments for the last three years;
- Historical variable cash rent payments for the last three years; and

- An estimate of what cash rent payments would have been for the last three historical years if the company did not have operating leases and paid rent at the spot rent rate (unless it is not feasible to calculate such information).

Some companies participate in hundreds or thousands of operating leases. We view each contract as a bundle of derivatives, and we believe large scale operating lease relationships can be organized into derivatives portfolios. We believe financial statement users need broad statistical information to understand these derivatives portfolios. When companies' real estate or equipment lease portfolios become large enough that statistically-relevant information can be produced to analyze the portfolio, this information should be provided to financial statement users. Statistics training is part of business schools' required curriculums, statistical analysis is a significant part of the Chartered Financial Analyst (CFA) exam program, and quantitative strategies represent a large segment of market trading volumes. Our point here is that financial statement users are highly capable of interpreting statistical analysis as part of their investment decision-making process, and statistics can help users to better refine their forecasts of future rent cashflows and unlock insights about historical rental practices.

It would be very helpful if companies with very large operating lease portfolios provided relevant mean, median, mode, and standard deviation statistics on historical data. For example, for chains such as Starbucks, it would be very helpful to see the operating leases first divided into separate portfolios based on full-service stores versus kiosks and other fast –service formats with no seating. Once the separate lease portfolios are established by store class, per-store statistics such mean, median, mode, and standard deviation for minimum and variable monthly rent payments, square footage, and store occupancy capacities should be calculated for each major portfolio. For equipment users such as airlines, it would be helpful to have information on the leased fleet broken down into separate portfolios by type of plane with per-plane mean, median, mode, and standard deviation for monthly rental cost and equipment age.

22. Why is it important to have companies disclose contractual payments that arise from renewal options of operating leases?

We acknowledge that there are valid business reasons to build renewal options into operating leases. That said, we believe that the current accounting and the boards' proposal do not introduce enough transparency regarding renewal options.

While some companies have relatively short initial minimum lease terms and load up their operating leases with a number of renewal options, other companies enter into much longer initial lease terms.

It is our understanding that firms like Walgreens often have initial lease terms of 25 years followed by 50 one-year renewal options to potentially have access to locations for as long as 75 years. As mentioned earlier, companies like Starbucks often have initial lease terms of 5 or 10 years and then have four 5-year lease renewals that result in the company potentially having access to a location for as long as 30 years under the contract.

If the boards do not properly account for and disclose renewal options, there will be incentive for companies to engineer lease contracts to have very small initial lease terms and to have a very high number of renewal options. The companies that adopt longer lease terms and do not use as many renewal options as comparable firms will appear to be much more exposed to operating leases under the proposed accounting. The reality is that whether a company uses renewal options or not, the renter has the ability to attempt to mitigate future exposure to an operating lease commitment

through the use of subleasing. Further, unless these companies make radical business model changes, they will incur rent payments for as long as they exist (regardless of the lengths of current contractual commitments).

If renters begin to request shorter initial terms and a high number of renewal options in an effort to minimize the amount of lease exposure shown on balance sheets, our sense is that this will make leasing transactions more expensive, because owners of property will want to be compensated for the additional flexibility being requested by the renters.

In our view, requiring the full disclosure of the renewal schedules would reduce the incentives for companies to structure contracts in creative ways primarily for accounting purposes such as the avoidance of balance sheet exposure.

Given that we see operating leases as forwards and options on forwards, we do not interpret large notional amounts of operating lease exposure as leverage. Long-tailed lease commitments could actually be interpreted as a positive indicator because it is a signal that the company has taken more steps to hedge rent exposure out into future periods and it has secured longer access to potentially key properties or equipment that are important to its business.

Probability-weighting the net present value of renewal option payments is a fair and simple way to bring the renewal options onto the balance sheet to be incorporated into the forward that will ultimately net to zero if the boards take a simplified approach to forward accounting. Financial statement users will be able to evaluate how faithful the probability estimates are over time by evaluating actual renewal behavior relative to footnote projections.

23. In Question 20, you propose a large table disclosing contractual payments for minimum contracts and renewal options. Why do you need this information? Can it be collected in a cost-effective manner?

Financial statement users need to understand the general nature of a company's operating lease agreements inclusive of renewal options. Investors are misled when companies only provide their minimum lease payments. The contractual maneuver of dividing a lease term up into a number of renewal options is an opportunity for companies to manipulate current lease disclosures as well as the proposed model.

A table categorizing potential lease payments under renewal options by their probability of renewal provides investors with a better understanding of the nature of a company's leasing strategy. Further, if probabilities of renewal change from period to period, these changes in probability can be early indicators to investors about positive or negative changes in a company's business environment. We would anticipate that estimates of probabilities of renewal could be based off of a combination of a company's historical renewal behavior as well as its current expectations.

We do not believe that the collection of this information will create unnecessary costs for companies. Given that payment schedules are basic terms of signed contracts, this data is information that companies would already have available and should be tracking in forecasts. Management should be evaluating this information to plan for their businesses in future periods. If managers were to say that they did not use this information, we would have serious questions as to why it is not used and how they can commit to contracts without contemplating such terms. Further, our use of a standardized discount rate based on the current risk-free rate curve would simplify the net present value calculations process. If we consider a company such as Starbucks with its 18,000 leases, it is much easier to use one standard discount rate schedule rather than to collect 18,000 irrelevant discount rates from separate contracts. Not only is using the risk-free rate easier and more cost effective for companies, it produces information with analytical value for financial statement users. Given that some companies are still engaged in operating leases signed in the

1970s, 1980s, or earlier, we fail to understand why the discount rates from those historical eras should continue to factor into current values. Given that discount rates have fallen hundreds of basis points over the decades, the interest rates in those contracts are historical artifacts of an economic environment that has nothing to do with today's environment.

Lastly, our approach eliminates the concept of a Type A and Type B lease as found in the boards' current proposal. We believe the elimination of these concepts would avoid a lot of needless cost for companies and the shareholders that own them. We believe that the forward approach for all operating leases is simpler, more cost effective, more decision-useful, and more transparent than the Type A and Type B approaches.

24. How should the boards think about leases offered by equipment manufacturers?

For equipment, the manufacturer often controls the supply of new product released into the marketplace and often dictates a suggested retail price to resellers in the market rather than allowing the fair value price to be established by supply and demand. Sometimes manufacturers want to reduce the number of units available to the new equipment market to keep the suggested retail price higher.

Assume a luxury car manufacturer assigns a manufacturer's suggested retail price (MSRP) of $80,000 to its new luxury sedan, and it believes that there are 75,000 consumers who will purchase the product at that price and another 25,000 consumers who desire the new car but will not purchase the vehicle at that price. Assume further that the company realizes a large economy of scale savings if its factory can produce over 85,000 units of production. If the manufacturer can increase production from 75,000 units to 100,000 units, the unit cost will go down from $40,000 per unit to $35,000 per unit. A manufacturer leasing program makes sense in this scenario because it allows the manufacturer to stratify the market into two separate segments with two separate sets of economics and it increases the manufacturer's profit.

If the car manufacturer floods the new car sale market with all 100,000 units produced, it will not be able to sustain its $80,000 MSRP across the new car market because the last 25,000 units will need to be sold at prices well below $80,000. This is particularly bad for luxury brands because price cuts damage their brand image and make them less desirable. A manufacturer leasing program can fix this problem because it results in the manufacturer leasing the 25,000 cars for the first several years and then selling them into the used car market at a later date instead of flooding the new car market and placing downward pressure on the MSRP. The size of the new car market is 75,000 units, and the size of the used car market is 100,000 units. This stratification gives the car manufacturer the ability to retain an artificially high sale price for new car sales in the market that it *controls* and demands premium prices, but it also means that the used car market fair value is lower than it would have been if only 75,000 units had been produced.

The leased cars should actually have a fair value well below the $80,000 retail price. To calculate the leased car value as a new car, we would add the estimated net present value of all expected lease payments to be collected on the vehicle to the net present value of the estimated salvage value when the manufacturer sells the vehicle into the used car market. As long as the net present value of cash flows from leasing and the eventual sale of the used vehicle exceed the manufacturer's $35,000 cost of manufacturing the car plus the financing of the holding the car and avoids causing a large drop in the $80,000 MSRP, the leasing program creates incremental profits.

Let's assume that the luxury car manufacturer includes a limit on the number of miles the renter can drive the car while it is under lease. The car is leased for 4 year (48 months at $750 per month) and the renter is entitled to drive the vehicle a total of 50,000 miles during the 4-year period. If the renter exceeds the maximum number of miles granted

under the lease, then the renter must pay an additional fee of $1 for each mile over the contractual quota. The mileage quota is inserted into the contract to preserve the estimated resale value of the vehicle in the used car market at the end of the lease. Used cars with higher mileage have lower resale values. The mileage penalties are meant to compensate the owner for a lower residual value of the asset as a result of the mileage overage. While the luxury car manufacture will receive a lower price for the cars with mileage overages, the mileage penalty is intended to offset that decline in the vehicle resale value. This lease contract has multiple embedded derivatives. The 48 right-of-use units are forward contracts on time units. The mileage over 50,000 miles represents call options on miles. If the renter returned the car at the end of the 4-year rental period having utilized 60,000 miles, the renter has exercised 10,000 1-mile call options with exercise prices of $1 each.

25. How would the forward contract approach deal with embedded servicing contracts that are part of some operating leases?

We have doubts that service components can be separated from the other contractual elements of leases in a meaningful and precise way. We believe that the service component is often nothing more than an allocation.

Under the forward contract approach to operating leases, it would not be necessary to bifurcate the rental and service components of operating leases. Under the forward contract approach, both the exhaustion of rental time units and services associated with the tangible property being rented are operating costs that are assigned to specific periods. Just as operating leases can be used to purchase rental time units at predefined prices that may differ from the spot market price of the units at the time of depletion, the pricing of services for that same period can be agreed to in advance in an operating lease and those prices may differ from the spot market price at the time of service. Since the accounting consequences for rental time units and services are the same under the forward contract operating lease approach, there is no need for companies to spend resources disaggregating them into separate components for disclosure purposes. The valuation implications are the same for the company regardless of whether the rent payment is all rent, all services, or a mixture of both.

26. Should operating leases be included in weighted-average cost of capital (WACC)?

Operating leases are not debt, they are derivatives. The gains and losses on derivatives affect the market value of equity, therefore, operating leases should be reflected in the equity weighting in the WACC calculation.

If operating leases were accounted for correctly and the gain or loss on the operating lease forward contract was explicitly disclosed in financial statements, then we would know how the operating leases are affecting the market value of equity. For example, if a company with a $1 billion market capitalization and formal debt with a market value of $500 million had operating leases that were in-the-money by $300 million, then the market value of the company's equity if it were renting at spot market rent rates rather than its contractual rates in its operating leases would have been $800 million (if we assume the $300 million gain on the operating lease forwards is taxed at a 33% corporate tax rate).

If a renter wanted to convert its operating leases to real leverage with cash interest expense, it could raise debt financing and use the debt financing to fund the purchase of risk-free instruments that mature on operating lease payment dates. Even in this situation, the cash interest expense at the company's cost of debt will be partially offset by the return on its investment in risk-free instruments.

All of this said, neither financial statements nor disclosures are sufficient today to allow financial statement users to estimate the gain or loss associated with operating lease forward contracts. Given that investors do not have sufficient information to price operating leases, the accounting standards create market inefficiency in this area. Treating leases as debt will not correct this market inefficiency. The only way to address this problem is to provide better information so fair values of operating lease gains or losses can either be provided by companies or reasonably estimated by financial statement users.

27. Are right-of-use rental time units the only intangible rights that can be extracted from operating leases?

As shown in our answer to our comment letter Question 23, rental time units are not the only intangible assets that can be extracted from tangible assets through operating lease contracts. If the renter wishes to use intangible right-of-use units that are above and beyond the package of rights sold along with the time units, excess units of non-time-based intangible rights can be extracted for sale. Excess mileage units sold through call options included in the overall lease contract are an example of non-time-unit intangible assets that can be extracted and sold from the asset owner to the renter. In this case, the operating lease has both forward contracts on intangible right-of-use time units and call options on intangible mileage unit rights.

28. How can tax policy and other external influences affect leasing terms?

We do not believe these types of arrangements need to be expressed or accounted for in a complicate manner. The owner and renter have the opportunity and ability to adjust the strike prices of rent away from their perceptions of spot market rental prices for a variety of reasons including tax treatment or interdependence with other contracts.

In a “true lease”, the owner (lessor) claims benefits of ownership such as depreciation deductions for tax purposes. This accounting treatment makes sense to us as it is our position that the renter is only purchasing time units with the asset and not the actual physical asset. The owner has the ability to share some of these tax benefits of ownership with the renter by reducing contractual rental rates if the owner is profitable and in a position to realize the tax benefits from the depreciation expense deductions. These adjustments can be made with a lower fixed strike price or a formula-based strike price on the forward that adjusts the rate for different scenarios. Therefore, the strike price of the rent embedded in the forward contract often can be adjusted down to allow the renter to share in some of the owner’s tax benefits associated with the lease transaction. For example, real estate owners are sometimes offered municipal and state tax concessions on blocks of office space as an inducement to attract businesses to communities. These tax incentives result in the owner offering companies below-market rental terms in their leases. Similar arrangements are often made with airplane owners and airline renters. Airplane owners receive accelerated depreciation on planes for tax purposes, and airline renters treat their rent expense as a current operating expense for tax purposes. The airplane owner has the ability to adjust down the rent expense and share some of its realized tax benefit from depreciating its asset with the airline renter. Ultimately, the owner has the ability to change contractual rental rates away from market spot rental rates for any reasons that it sees fit.

29. Does the presence of economic friction in the operating lease contract relationship result in a lease's derivative elements breaking down and converting to conventional debt?

In our responses to several of the questions that we have posed here, we have mentioned that renters can take steps to offset the exposure to operating leases through actions such as subleasing. We have also mentioned that renewal options are a means to use structuring to reduce the minimum lease commitment while maintaining similar long-term exposures in an owner-renter relationship. Our statements could be perceived as intellectually dishonest if we did not address the role of economic friction within leasing relationships. The reality is that some lease contracts forbid subleasing. Other times, even if subleasing is permitted, the renter may have difficulty subleasing if there is no demand from other parties to sublease to acquire the renter's right-of-use time unit exposure. Other external factors such as local, state, or national laws on issues such as tenant rights may also impact the ability of owners to repossess access to their property in an efficient manner. The implication is that the operating lease market is naturally not as efficient as more liquid derivative markets for more standardized commodities.

When we identify operating leases as portfolios of derivatives, this position may lead readers to initially attempt to compare operating leases to highly-liquid, market-traded derivatives. The reality is that not all derivatives are liquid, and a very large portion of derivatives that are created between counterparties are non-standard and do not trade in markets. We believe that operating leases fall in this latter category of derivatives. The acknowledgment that operating leases are illiquid, non-standard derivatives that do not always trade efficiently does not lead to a break down in their underlying characteristics as derivatives. Like with other Level 3 financial instruments, the valuation and accounting of operating lease derivatives are difficult. The complexity and illiquidity that are inherent characteristics of the financial instrument has the consequence of creating unavoidable economic friction and accounting and valuation complexity.

We fully acknowledge that there are commitments that are embedded in operating leases, but we also acknowledge that all forward contracts have commitments embedded within them. Unlike with call options where the holder is under no obligation to exercise its rights, the holder of a forward derivative contract is committing to make a contractual payment in the future. Describing the instrument as a forward contract is not ignoring that the embedded commitment exists, it is acknowledging that there is more inherent complexity in the contractual relationship than traditional debt and it attempts to capture all the economics of that contractual relationship rather than picking and choosing which elements to acknowledge and which elements to ignore.

We believe that our linked presentation approach on the balance sheet, our disaggregation of minimum contract amounts from renewal options in our proposed roll-forward disclosure, and our proposed payment table that separates required payments from possible payments make the appropriate acknowledgments for economic friction. All forward contracts contain embedded commitments, and a roll-forward that separates minimum lease commitments from renewal options helps emphasize the appropriate distinctions between the forward contracts and call options in operating leases. Further, linked presentation highlights that the derivatives have inseparable and linked embedded assets and liabilities that users must consider in investment decisions.

Economic friction and the granting of restricted rights are ultimately fully considered in option pricing theory. For example, American-style call options where the holder can exercise at any time during the duration of the contract trade for higher prices than European-style call options were the holder can only exercise at the end of the contract. The inclusion or exclusion of incremental rights affects instrument pricing. Liquidity and duration of the contract will also affect pricing. These inherent characteristics of the desired relationship between the renter and owner and the

underlying characteristics of the tangible property lead to adjustments in the makeup or pricing of the derivatives portfolios, but they do not change the reality that they are still derivatives.

Special thanks to my friend Rebecca McEnally for her considerable time, effort, and valuable insights in the review of this comment letter.