



**10 September 2013**

**Technical Director  
Financial Accounting Standards Board  
401 Merrit 7, PO Box 5116  
Norwalk, CT 06856**

**International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH United Kingdom**

**File Reference #2013-270**

**Dear Board Members,**

I greatly appreciate the opportunity to respond to the Financial Accounting Standards Board's and International Accounting Standards Board' Exposure Draft on Leases (Topic 842). The focus of this letter is on the potential application of the Exposure Draft to the offshore drilling industry.

The Exposure Draft is currently ambiguous with respect to how it will be interpreted for drilling contracts. As the Exposure Draft has been circulated to various industry participants, analysts, investors and public accounting firms, there has initially been an assumption for the worst and a concern that the final standard will be applied to drilling contracts. The feedback on this proposed application has been overwhelmingly negative towards the Exposure Draft. Applying lease account to drilling contracts would have significant negative consequences for the financial reporting practices in our industry.

As a matter of background, the contract drilling industry, and more specifically the offshore contract drilling segment, is a capital intensive service business. We contract our drilling rigs (\$200 million to \$800 million assets) to energy companies to perform various drilling and well service activities. The contracts are generally long-term in nature and the compensation is generally determined on a dayrate basis. The ability to invoice and collect the revenue/dayrate on our contracts is determined based the performance of services utilizing our drilling rigs.

All of the industry participants today report revenue using a highly standardized methodology resulting in high degree of comparability. This comparability allows all of the stakeholders to evaluate both the financial performance of our Company and make relevant comparisons across the industry. There is a high degree of correlation between revenue recognition, the completion of the "earnings" process and ultimately to cash collections. For the majority of our revenue, the basic methodology is simple; revenue is calculated on a daily basis, in a manner consistent with the contract terms. The use of estimates is limited to the amortization of "upfront fees" or "mobilization costs" which are amortized over the life of the contract.

Applying lease accounting principles to the contract drilling industry will create a great deal of disparity in the financial statements of the offshore drilling contractors. The application of the leasing standards requires significant judgment as to the estimates with respect to the fair values of the equipment and the future fair values of the equipment at the end of the contract; these estimates would be prone to a high degree of subjectivity as there is not an openly quoted market on offshore drilling rigs and the rigs have a significant degree of variability in equipment and operating condition. Furthermore, these estimates must be discounted using the incremental borrowing rates which vary greatly across the industry. Combining these factors would result in significant variability in profitability associated with drilling contracts and the related financial statement presentation.

Additionally, the application of lessor accounting to offshore drilling contracts conflicts with FASB Concepts Statement No. 5, which requires the revenue-earning process to be substantially complete before revenue can be recognized. In the offshore drilling industry, it is clear and consistent with our contracts that the revenue earning activities are not completed until the services are performed.

While the draft of the leasing standard provides that contracts may need to be bi-furcated into the leasing and nonleasing activities, I do not believe this adequately addresses or resolves the conflict. This point is not to be confused with traditional leasing or licensing arrangements which require incidental maintenance or services to be performed. For an offshore drilling contract, both the services performed and the drilling rig are integral parts of the contract with one hundred percent of the revenue being dependent upon the competent provision of drilling services. Furthermore, the contract can be terminated for failure to provide services in accordance with proper oilfield standards.

The Exposure Draft's balance sheet treatment would also have a negative impact on the presentation of the financial statements to the stakeholders. Derecognizing the assets from the balance sheets is inconsistent with the ownership of the assets as there has been no shift to the customer of the risk inherent in owning the assets. The drilling contracts do not shift the risk of loss or the burden of maintaining the assets to the customer. For significant stakeholders such as the bondholders, in evaluating a company's balance sheet, the assets collateralizing their loans would no longer be presented. Instead a bondholder would see lease receivables at discounted values, reduced fixed assets and deferred theoretical gains. In discussions with our bankers, adopting this accounting would greatly diminish our access to the capital markets and the majority of asset backed lenders would not participate in secured bond financing for drilling contractors whose balance sheets would not represent their underlying collateral.

In the Attachment to this letter, I have included responses to the Questions & Answers as put forth in the Exposure Draft.

While my comments in this letter are intended to present the position of an offshore drilling contractor to the Exposure Draft, I would also make the general observation that this accounting standard is going to have significant consequences for numerous industries and preparers of financial statements. In many industries, companies use leases to obtain machinery to perform services or manufacture goods. Historically, these transactions have been treated as operating

leases and the expenses have been considered operating expenses in a consistent manner which also had the benefit of cash expenses being consistent with operating expenses. For companies attempting to distort their financial statements to show more net income from operations and operating cash flow, this standard provides an incentive to enter into longer commitments for equipment or machinery in order to gain these perceived benefits. Similarly, service companies in capital intensive industries will be incentivized to enter into longer term agreements to show more lease profit at the inception of the agreement.

In summary, I believe strongly that it would be inappropriate to move forward with the new lease standard as currently drafted which leaves the matter of drilling contracts ambiguous. If lessor accounting is applied to drilling contracts, it will significantly reduce the comparability and reliability of the financial statements to our key stakeholders. Further, I believe the proposed lease standard will have significant unintended consequences as it potentially characterizes operating costs as financing costs, and increases the reported cash flow from operations.

Sincerely,

A handwritten signature in blue ink, appearing to read "Douglas G. Smith".

Douglas G. Smith  
Chief Financial Officer  
Vantage Drilling Company

## **Question 1: Identifying a Lease**

**Do you agree with the definition of a lease and the proposed requirements in paragraphs 842-10-15-2 through 15-16 for how an entity would determine whether a contract contains a lease?**

I do not agree with the definition of a lease and the proposed requirements in paragraphs 842-10-15-2 through 15-16.

### **Why or why not?**

The definition is too broad as it can include contracts requiring the use of substantial, technically specific equipment where the earnings process is completed by, and the principle purpose of the contract is, the provision of services.

### **If not, how would you define a lease?**

In order to appropriately define a lease, I would amend paragraph 842-10-15-3 to include in its criteria a provision that would be responsive to the revenue recognition guidelines as provided in Topic 605 Revenue Recognition paragraph 605-10-25-1 which provides that revenue should be recognized when the revenue-earning activities are substantially complete. A lease principally should be considered a contract for the provision of the specifically identified asset, under the control of the lessee whereby the earnings process is completed by providing the asset over time. If the revenues of the contract are completely or materially contingent upon the provision of services, I believe the contract is, in substance a service contract. Accordingly, treating such a contract as a lease is inappropriate and would have the effect of being misleading to stakeholders.

Paragraph 842-10-15-18 provides that entity shall account for the lease components separately from nonlease components of a contract. This is consistent in the guidance provided in Topic 605 Revenue Recognition, Multiple-Element Arrangements, paragraphs 605-25-25-1 through 25-6, which provides that such agreements should be evaluated for multiple units of accounting. Under this scenario there would be a lease and a services contract.

Paragraphs 605-25-30-1 through 30-7 of Topic 605 Revenue Recognition provides guidance on the initial valuation applied to multiple-element arrangements which I believe should also be applied in Topic 842. Pursuant to paragraph 605-25-30-5 the amount that can be allocated to the delivered unit is limited to the amount that is not contingent upon the delivery of additional items or meeting other specified conditions. The Exposure Draft would make an initial allocation for the valuation of the lease element of the contract, and corresponding de-recognition of the asset, at the inception of the agreement (valuing the delivered asset, though it will be amortized over the contract term). However, I believe application of paragraph 605-25-30-5 is appropriate and no allocation should be made in the event that the recognition of the resulting lease receivable is contingent upon the provision of additional material services.

**Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.**

Generally, under the terms of a drilling contract, the customer will contract with a drilling company for the provision of drilling services. The contract will specify the rig to be used to provide the services, the scope of services to be provided, other services potentially required to be provided and the daily rates to compensate the drilling contractor for the provision of services. These daily rates will included diminished rates and “zero” rates associated with operational conditions and performance measures associated with the provision of services. The contract will generally limit the operations to a geographic

region for the services and specify the duration of the contract either in terms of the number of wells to be drilled or a stated time period.

Based on the criteria in the Exposure Draft, this would appear to be a lease:

*Fulfillment of the contract depends on the use of an identified asset.* The asset will be specified in the drilling contract as this is a significant element of the service. The customer is responsible for the importation of the rig into the country of service and must be able to coordinate the equipment on the rig with other services that they are responsible for contracting. The additional guidance provided in paragraphs 842-10-15-5 through 15-8 is not applicable to this assessment as the drilling contractor does not have the right of substitution.

*The contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.* Under the terms of the drilling contract, the customer will have the right to determine the well locations and the nature of the services performed on the well. The drilling company will retain the control over basic operations of the rig such as drilling personnel, rig safety and remains responsible for the physical condition of the rig. The additional guidance provided in paragraphs 842-10-15-9 through 15-16 is ambiguous as to the definition of lease in respect of a drilling contract.

Under paragraph 842-10-15-11c., one of the decisions that “could most significantly affect economic benefits” is the decision to change the operator of the asset; in industry terminology, the “operator” is typically referring to the customer. Under the terms of the drilling contract, the customer may have ability to “farm-out” the rig to another customer, but does not retain the right to change the drilling contractor (physical operator) on the asset. The final lease standard should resolve the ambiguity of who is being defined as the operator (the customer contracting for the asset or the physical operator of the asset). The final lease standard should also provide greater clarity with respect the impact of this question on the final evaluation of the contract as a lease.

Despite the similarities between a drilling contract and the definition of a lease as noted, lease accounting does not reflect the economics of the drilling contract as the requirements under the contract and the performance necessary to earn the revenue have not been met simply by conveying the asset and providing the customer the right to determine where the asset works. The drilling contractor is responsible for providing a technically competent crew, performing the drilling services, maintaining the working condition of the rig, and supplying the operations with materials and supplies. If some or all of these responsibilities are not met, the drilling contract will provide for reduced or zero daily rates.

Another important element that should be considered is who retains the risk of loss associated with the asset. Under traditional leasing agreements, the risk of loss is generally transferred to the lessee who is responsible for maintaining the assets and contracting for insurance in the event of loss. No such transfer of a risk of loss happens under the terms of a drilling contract. The drilling company retains the risk of loss and is responsible for obtaining insurance for the rig and personnel. Furthermore, under the terms of the drilling contract, the drilling company will provide an indemnity to the customer for all losses associated with the drilling rig and its personnel. As the drilling contractor has retained all risk associated with asset ownership, it would be inappropriate to derecognize the asset on the balance sheet.

## **Question 2: Lessee Accounting**

**Do you agree that the recognition, measurement and presentation of expenses and cash flows arising from a lease should differ for different leases, depending up whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset?**

I do not agree.

**Why or why not?**

This provides an unnecessary level of subjectivity in determining what constitutes more than an insignificant portion of the economic benefits embedded in the underlying assets. Additionally, this provides the opportunity to structure lease commitments in such a way to obtain beneficial accounting treatment. For instance, the lease term, as defined in the Exposure Draft, includes periods covered by an option to extend the lease if the lessee has a significant economic incentive to exercise that option; however, a lessee often does not require a significant economic incentive to renew a lease as he is likely to exercise the option out of convenience. As long as the lessee has the unilateral ability to exercise the options, he would prefer to sign a lease for an insignificant portion of the economic life of an asset with several options.

**If not, what alternative would you propose and why?**

All leases would be accounted for consistent with Type B leases. This would provide a leasing standard significantly easier to apply, reduce the level and nature of the estimates needed to provide the financial statements and make financial statement more consistent among reporting entities. As companies have differing incremental borrowing rates, the proposed lease accounting standard utilizing the incremental borrowing rates to value lease liabilities distorts the financial presentation across industry peers. For instance, in the contract drilling business we may rent certain tools related to a drilling program. The rental company which retains ownership of the tools, does not differentiate among drilling contractors the rental rates for the tools. Why, under this scenario, would two different drilling contractors recognize different levels of asset amortization and interest expense?

**Question 3: Lessor Accounting**

**Do you agree that Lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset?**

I do not agree.

**Why or why not?**

See discussion in Question 2: Lessee Accounting

**If not, what alternative would you propose and why?**

See discussion in Question 2: Lessee Accounting

**Question 4: Classification of Leases**

**Do you agree that the principle on the lessee's expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set out in paragraphs 842-10-25-5 through 25-8, which differ depending upon whether the underlying asset is property?**

I do not agree.

**Why or why not?**

I believe that the final lease standard should remove as much subjectivity in accounting for leases as possible and attempt to conform the accounting results across entities engaged in similar activities. The Exposure Draft uses the incremental borrowing rate to discount the asset and liability, and while this will result in entities having a different level of “gross-up” on the balance sheet, these differences should not also result in differing results on the income statement and statement of cash flows.

**If not, what alternative approach would you propose and why?**

I would recommend utilizing the methodology proscribed for Type B leases for all leases. This would result in more consistent reporting through the income statement and cash flow statement providing a better representation of the cash requirements to operate the business.

**Question 5: Lease Term**

**Do you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors?**

I agree with the lease term provision.

**Why or why not?**

I believe it can be consistently applied and there is not a better alternative.

**If not, how do you propose that a lessee and a lessor should determine the lease term and why?**

Not applicable.

**Question 6: Variable Lease Payments**

**Do you agree with the proposal on the measurement of variable lease payments, including the reassessment if there is a change in an index or a rate used to determine lease payments?**

I do not agree with the proposal to reassess the variable lease payments when there is a change in the index.

**Why or why not?**

Indexes can move up and move down. I do not believe that the lease receivable and valuation of the right to use an asset should be re-evaluated when the underlying index changes, as changes in indexes can quickly reverse. The use of indexes in a contract is generally to protect one party from changes in economic conditions and not to incentivize the party to enter into the contract.

**If not, how do you propose that a lessee and a lessor should account for variable lease payments and why?**

The transaction should be evaluated at its fair value on the date that it was initiated. If the indexes move up or down, the impact to the cash flow for the period should be recognized as a current period increase or decrease in revenues. The amortization of the initial discounts should be accounted for as originally determined at inception.

One exception I would propose to this treatment would be in the event of a permanent change in an observable index such as a fixed currency exchange rate. For example, in Venezuela, the government requires local contracts to be in Bolivars and has a government controlled exchange rate. In the event of a currency devaluation by the government, then lease related assets and liabilities should be restated to reflect the change.

### **Question 7: Transition**

**Subparagraphs 842-10-65-1(b) through (h) and (k) through (y) stat that a lessee and a lessor would recognize and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not, what transition requirements do you propose and why?**

No comment.

**Are there any additional transition issues the Boards should consider? If yes, what are they and why?**

No comment.

### **Question 8: Disclosure**

**Paragraphs 842-10-50-1, 842-20-50-1 through 50-10, and 842-3-50-1 through 50-13 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments, reconciliations of amounts recognized in the statement of financial position, and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?**

No comment.