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Re: *Discussion Paper: Leases – Preliminary Views (Response to Lessee/Tenant Aspects)*

Thank you for the opportunity to provide comments on this Discussion Paper.

Founded in 1957, the International Council of Shopping Centers (“ICSC”) is the premier global trade association of the shopping center industry. Its nearly 65,000 members in 90 countries include shopping center owners, developers, retailers, managers, marketing specialists, investors and brokers, as well as academics and public officials.

For purposes of this response to the Discussion Paper, we use the term “mall” to represent enclosed malls, open-air malls and shopping centers.

Also for purposes of this letter, we are responding to the aspects of the Discussion Paper that relate to real estate leases of space within malls and real estate leases of standalone buildings either within a mall perimeter or on a standalone parcel.

Our tenant members include a wide variety of shop owners who rent space, from the individually run store such as a small independent retailer, to the large chain store owners such as Walgreen’s, Starbucks, Macy’s or Safeway. The store sites that these ICSC members lease may be located within an open air mall or shopping center, within an enclosed mall or within a standalone building on the mall site.

Background on the Mall/Shopping Center Industry

Background

For purposes of this response to the Discussion Paper, we will refer to the lessees of space in malls as tenants and the lessors of space as landlords. We believe that the business nature of the relationship between tenants and landlords often is not fully understood, particularly in the context of the

lease accounting standards being proposed and feel that it is important to provide the FASB with some additional background into that relationship and the nature of the agreements between them.

Relationship between Mall Tenants and Landlords

- An essential element necessary for the success of any mall is its location, ambiance and general character, meant to attract a particular type of shopper. Some malls are upscale malls while others are targeted towards a more bargain-oriented clientele. To achieve a specific character and ambiance, landlords and developers work hard in designing concepts to attract shoppers for the benefit of the tenants and in establishing contractual guidelines to maintain the tone of the mall. Landlords spend much time and effort seeking and negotiating with the appropriate anchor tenants for the mall. Such anchor tenants set the tone for the type of the mall. For instance, an upscale store like Nordstrom's is typically found in malls positioned as upscale malls and the other associated tenants in the mall tend to be of a similar nature.
- Landlords are required to provide extensive services to the tenants of the mall in addition to providing the space in which the tenants operate their business. Landlords provide services including security, exterior, interior and common area lighting, parking facilities and indoor garage space, common area heat, power and air-conditioning, maintenance of external landscaping, interior maintenance and cleaning, store trash pick-up, escalator and elevator services and community entertainment events, such as indoor amusement rides, special events or live entertainment. The environment of a mall is designed almost as an entertainment facility so as to attract customers. For instance, the Danbury Fair Mall contains a carousel for children in its vast food court while the Mall of America has a roller coaster within its premises.
- Should the landlord fail to provide these services, tenants may withhold their rent payment and related contingent rent payments, citing the failure of the landlord to deliver the agreed upon services. When unforeseen events cause the services to be temporarily unavailable, such as a power blackout, the mall is closed and all the tenants are required to close their shops. Rents may be adjusted for periods when a mall is closed on an unscheduled basis. The tenants do not fully control the use of the space.
- Landlords set the hours of operation of the mall, including opening hours, closing hours and holiday schedules. As a condition of their leases, tenants are *required* to open at a certain hour and close by a certain hour.
- The majority of capital investments *made by tenants* in these mall store locations are invariably for leasehold improvements and fixtures within the stores. Often the leasehold improvements constitute a major capital investment and are the only expenditures made by the tenant for that space. If a tenant leaves a location, the leasehold improvements often become the property of the landlord if not removed and the landlord agrees to accept the improvements. Exiting tenants may be required to remove leasehold improvements that the landlord does not desire to keep. Tenant security deposits may be charged to restore the property to the condition specified in the lease.

- At a minimum the typical measurement of success of an individual store is its ability to cover its recurring *occupancy costs*, essentially its rents and overhead, and then to show a positive cash flow above and beyond those costs.

Characteristics of Individual Store Leases within a Mall

- A typical store lease is for a relatively short base period with multiple renewal options, often for a potential total period extending over 20 years. This structure is meant to provide flexibility with the lease for both the landlord and the tenant. Certain leases may be provided with initial longer terms because the tenant desires to lock in that space due to the extent of their investment in leasehold improvements required to transform the space to a specific function, for example a restaurant. Since such leasehold improvements would be written off if the restaurant closed or moved, tenants seek to ensure that they have the right to remain in that location for this longer period.
- Leases often contain a ‘*sales kick-out clause*’ which enables the *landlord* or *the tenant* to terminate the lease if the tenant does not achieve a targeted Gross Sales level. The targeted Gross Sales level triggers contingent rent escalation payments to be made by the tenant to the landlord, indicating the landlord’s success in making the mall popular by the growing success of the retailer. Additionally, if the stores do not achieve their targeted Gross Sales level, the tenants themselves may terminate the lease usually without penalty, placing the cause for the lack of sales on the landlord. The contingent rent payment structure demonstrates that the landlord is assuming a risk in providing the space and services to the tenant and managing the success of the mall, since a portion of the rents is contingent on the overall success of the tenant.
- Leases often contain ‘*co-tenancy*’ clauses which provide the *tenants* with certain rights should an anchor store leave the mall. These rights may include obtaining a reduction in rent or being allowed to terminate their lease and leave the location without penalty. Again the landlord is assuming the risk of success. Many malls are on the decline as tenants exercise their co-tenancy clauses when anchor tenants close.
- Anchor tenants may be offered leases for a longer time period and at a comparatively reduced rent in order to ensure that the mall itself attracts sufficient customer traffic so as to also attract other smaller tenants that pay higher relative rents to the property. Landlords often pay inducements to attract anchor tenants to help set the tone of the mall. For instance, Dave and Barry’s clothing stores was one such anchor retail store which earned a large share of its profits from landlord paid inducements.
- Mall leases do not provide the tenant with a purchase option to buy the mall space *at all*, since the store sites are integral to the entire mall and the size and configuration of internal stores often change as tenants leave the site. The tenants have *no rights* whatsoever to acquire the individual sites within a mall. Tenant’s rights are limited to renewals provided they maintain occupancy of the store.
- A mall is considered investment property by the landlord. Their objective is to increase the value of the mall by managing the portfolio of tenants and leases that comprise the mall.

- Leases usually contain a *tenant reimbursement* adjustments and an *overage rent* adjustment, meant to compensate the landlord for the additional expenses associated with the increased costs of common services being provided and to reflect the enhanced value of the mall to the landlord as measured by the increased sales the tenant has obtained as a result of the success of the mall. That is, as the mall traffic increases because of the success of the landlord in managing the mall, so to do the sales of the tenants and the landlord thus is able to obtain an increase in rents via the periodic overage adjustment, because the mall was successful in attracting the increased traffic.
- As the mall's intrinsic value increases, the *landlord* receives the direct benefits of the increased value through increased rent streams. Likewise if the value decreases, the landlord loses such intrinsic value. In fact, the value of an existing mall is highly dependent on the in-place leases of the mall. The in-place leases associated with the mall are considered integral components of the investment value of the mall to the landlord.
- Although tenants maintain some rights relative to selling or assigning their lease to another party should they decide to vacate the premises or if they enter bankruptcy, those rights are restricted by the terms and conditions of the lease, often with respect to the use of the property. For instance, a property site may be restricted as to its usage or type of follow-on tenant seeking to take over the space through a sublease, thus restricting the ability of the original tenant to sublease the location, control its usage or profit from it.¹
- Individual leases within a mall have no discernible fair market value on a standalone basis, since they are integral to the mall itself and are dependent on the mall's overall success. For instance, a store mall lease in a declining or empty mall has little intrinsic value while the same lease in mall with rising popularity has an increasing value. Since the tenant cannot trade on that value without the landlord's permission, the tenant has limited rights to any value of the lease.
- A developer usually owns the entire mall and finances the property based on the property's intrinsic ability to generate cash flow over the long term from its tenant leases, recognizing that individual tenants will come and go within the mall itself. Typical mall financing is provided for 20 years or more with a balloon payment due from the developer at a future date irrespective of the terms of the underlying tenant leases. The overall financing usually extends well beyond the term of the individual leases with a balloon payment, indicating an expectation by the lending source that the mall will have a very long life, for instance 50 years or more.
- When a mall developer files for bankruptcy the mall may not close, however the services provided usually decrease, sometimes starting a downward self-fulfilling spiral. Many malls are starting to close as tenants exercise their co-tenancy clauses to leave without penalty. In turn, as these tenants leave, more may also be entitled to leave by exercising their co-tenancy clauses. Ultimately the mall itself may close and the individual stores may be required to close. In today's recessionary environment, record numbers of malls are closing permanently.

¹ In re Trak Auto Corporation v. West Town Center, LLC 2004 WL 856859 (4th Cir.) decided April 22, 2004.

Executive Summary

Proposal Summary

- In the Discussion Paper, the FASB proposes to require tenants to capitalize virtually all leases at a value equal to the present value of the payments contractually obligated to be made or estimated that will be made by the tenant, based on the *most likely lease term* determined by management based on contractual, non-contractual and business factors, but not on past experience. The present value is calculated using the tenant's incremental borrowing rate.
- This capitalization of a lease as an asset and a liability is in answer to the conclusion reached by the FASB that by entering into a lease contract, the tenant has acquired an asset (the asset being the *right-to-use* the property) which the tenant could otherwise have acquired through the purchase of a portion of the entire mall property and has financed that property by entering into an *obligation to pay rents* in substitution of borrowing funds to finance it. The FASB concludes that the tenant has obtained an "*unrecognized financing*" that can be difficult to understand.²
- The *obligation to pay rent* is amortized using an interest method applied over the life of the lease, allocating a portion of each lease payment as between the imputed interest expense and the repayment of the "loan" principal.
- Note that the accounting prescribed for the *obligation to pay rent* presupposes that *all* individual properties are financed on an amortizing declining balance basis. This amortizing approach of the imputed debt creates recognition of a greater amount of interest expense in the early years of the obligation and lower interest expense in the later years, as the imputed obligation amortizes down to zero. In fact many financings are of a non-amortizing nature or with a significant balloon payment.
- The *right to use property* is depreciated over the shorter of its economic life and the term of the lease on a straight-line basis.
- Factors related to the lease, such as the *most likely lease term* and the *contingent rents* estimated, are periodically reassessed and incorporated into a re-measurement of the *obligation to pay rents* which is then increased or decreased, along with an offset either to the *right to use property* or to a *profit or loss account*.
- Although not contained in the Discussion Paper, subsequent FASB meeting minutes indicate that *initial direct costs* associated with entering the lease are to be *expensed* when incurred.

Summary ICSC Conclusions

- *Individual Mall Store Leases*
 - We believe that leases of stores within a mall should be excluded from the scope of the discussion paper because they are more akin to a *service arrangement* or

² FAS Discussion Paper "*Leases: Preliminary Views*", ¶ 1.12 (c)

purchase commitment and are neither a property of, nor a liability of the tenant, any more than when a tenant enters into a long-term power supply or outsourcing arrangement.

- The agreement between the tenant and landlord is of an *executory* nature requiring the delivery of a service by the landlord in exchange for compensation and compliance with the mall operating standards. The landlord is providing a series of services, one of which is providing a certain designated amount of space, and the tenant agrees to pay for the delivery of those services. If the landlord fails to provide those services, the tenant can (and often will) stop making payments until the service is restored.
 - We also do not believe that this service arrangement between a tenant and a landlord includes an embedded lease because the tenant does not have the complete ability to operate or control the property in a manner that it determines. The tenant must operate the property in a manner determined by the landlord, including being open within designated hours of operation and operating within certain standards. Further while the tenant does retain some rights to control physical access to the property, the landlord has overriding rights and the ability to control access to the individual property by exercising their ability to control overall access to the mall.
 - While we agree that transparency in financial reporting is highly desired, we believe that this can be accomplished for these types of true landlord/tenant leases with enhanced disclosures pertaining to the nature and tenor of any lease agreements and anticipated future rental payments. However we do not agree that either an *obligation to pay rent* nor a *right to use property asset* should be recorded by the tenant, owing to the executory nature of this type of agreement.
- *Single Tenant Standalone Buildings within a Mall Perimeter*

We do agree that leases of *single tenant standalone buildings* fall within the scope of this Discussion Paper because they are usually characterized by the tenant maintaining full control of the use of the building and being required to provide substantially all of their own services to maintain the building.

- Such leases within the scope of the Discussion Paper should also demonstrate characteristics of a triple-net lease, whereby the tenant is responsible for all or most of the costs of maintaining the property as if they were the owner, including site maintenance, property taxes and separate light, heat and power.
- We believe that these leases of standalone single tenant buildings should be accounted for based on whether or not the lease contains a fixed price purchase options (“FPPO”). If the lease contains a fixed price purchase option, we believe the lease should be accounted for as a *finance type* of lease as discussed below. If the lease does not contain a fixed price purchase option, we believe it should be accounted for as a *usage type* of lease. The fundamental different between the accounting for these leases pertain to the expense recognition pattern, which is discussed below.

- The interest rate used to capitalize the different types of leases (*finance type* versus *usage type*) should reflect a reasonable representation of the *obligation to pay rent* and *right to use asset* so that consistent values for identical leases are obtained regardless of the underlying incremental borrowing rate of the tenants. (A recommended approach is included herein.)
- *Differentiation between Finance Leases and Usage Rights Leases*
 - As stated above, we believe that the difference between a *financing* type of lease and a *usage rights* type of lease is that a *financing* type of lease contains a *fixed price purchase option* while a *usage rights* type of lease *does not* contain a *fixed price purchase option*.
 - A *financing lease* that contains a *fixed price purchase option* is an indication that the maximum amount that the tenant will ever pay to acquire the property is pre-determined and thus the tenant has obtained *ownership rights* that they may trade at will. The lease is clearly a *financing* mechanism.
 - Under a *usage rights* type of lease, the lease does not contain a *fixed price purchase option* and the tenant thus has no such rights to acquire the property. The tenant's rights are limited to the *usage* of the property plus the services and support of the landlord during the term of the lease. The lease represents an obligation to pay for the usage of the property and to receive the services.
 - While we acknowledge that both of these types of lease might be capitalized because they represent an *obligation to pay rent* and an offsetting *right to use asset*, we believe that the expense recognition pattern of the *finance lease* should be *different* than the expense recognition pattern of the *usage rights lease*.
 - The expense recognition pattern of a *finance* type of lease should reflect the *amortizing interest expense pattern* of the *obligation to pay rent* portion of the lease to recognize the financing nature of the lease.
 - A *usage rights* type of lease should present an overall *straight-line expense* recognition pattern consistent with the usage of the property. Alternative approaches are discussed below.
- *Initial Direct Costs*
 - For those leases included within the scope of the Discussion Paper, we disagree with the expensing of initial direct costs associated with entering such agreements. We believe that such costs would otherwise be capitalized if the transaction was structured as the acquisition of any asset or property, whether the asset being acquired is a physical asset or an intangible asset, and thus should also be capitalized as part of the value of the property.

Detailed Discussion of ICSC Response

- *Relevance of Existing U.S. GAAP Lease Accounting Standards*
 - Under existing US lease accounting standards, leases of store sites located in a mall are *always* classified as operating leases because (i) the lease does not meet any of the capital lease classification tests associated with FAS 13 and (ii) the characteristics of such properties and leases are more akin to a service arrangement where the landlord provides space and a multitude of additional services.
 - Briefly, a typical lease of a space in a mall is *not* classified as a capital lease by the tenant under FAS 13 because:
 - The lease *does not* provide for an automatic transfer of title (FAS 13 ¶ 7(a)).
 - The lease *does not* provide a bargain purchase option (FAS 13 ¶ 7(b)) (or for that matter, a purchase option of any kind).
 - The lease *does not* extend for more than 75% of the economic useful life of the property (FAS 13 ¶ 7(c)), since such economic useful life of an individual store is fully dependent on the life of the mall itself, something that is difficult to estimate because it is usually based on demographic changes rather than wear and tear.
 - The present value of the minimum lease payments *is not equal* to or greater than 90% of the fair value of the asset (FAS 13 ¶ 7(b)), because it is virtually impossible to estimate the fair market value of an individual store site within the surrounding mall.
 - The lease of a store location within a mall can also be compared with the lease of a parcel of land in which no automatic title transfer or bargain purchase option is provided in the lease.
 - Under FAS 13, a lease involving only land is often classified as an operating lease, unless the lease contains an automatic transfer of title (FAS 13 ¶ 7(a)) to the land or a bargain purchase option (FAS 13 ¶ 7(b)).³
 - FAS 13, paragraph 7(c) and 7(d) are not applicable for classifying a lease of land because the economic useful life of land is virtually impossible to measure and similarly the transfer of the “economic” ownership of land to a lessee is difficult to achieve because its life extends well beyond the term of any lease and the legal owner of the land has the opportunity to lease it again and again.

³ FAS 13 ¶ 25

- The economic ownership of the property location within a mall always remains with the landlord. Unlike the lease of a piece of equipment which eventually wears out, a location within a mall only ‘wears out’ when the mall is closed or torn down.
 - It is also virtually impossible to measure the economic useful life of an individual integral mall location (a store site) since it is essentially a parcel of land within the mall, segmented for the most part by walls that can be moved fairly easily to expand, contract or reconfigure the individual site. Internal mall sites are easier to reconfigure than external mall sites, simply because the internal mall is merely a large shell building holding numerous kiosks which happen to be contained in sheetrock and glass.
- With respect to viewing the lease as a service agreement with an embedded lease, we refer to EITF # 01-08, “*Determining Whether an Arrangement Contains a Lease*”. Under EITF 01-08, three characteristics are identified which may indicate that a lease is embedded within an arrangement. An arrangement conveys the *right to use* property, plant, or equipment if the arrangement conveys to the purchaser (the lessee or tenant) the right to control the use of the underlying property, plant, or equipment. Two of the three characteristics discussed in EITF 01-08 are relevant to this discussion.
 - The right to control the use of the underlying property, plant or equipment is conveyed if any of the following conditions are met:⁴
 - The purchaser has the ability to operate the property in a manner it determines while obtaining or controlling more than a minor amount of the output or other utility of the property.
 - The purchaser has the ability to control physical access to the underlying property.
- We believe that mall leases are tantamount to service agreements *without* an embedded lease because mall store leases:
 - restrict the type of store permissible by the tenant at the site,
 - control the manner (or type) in which the store can be operated,
 - dictate the hours that the store must operate and
 - places control of access to the mall and thus to the individual store, with the landlord.

General Comments on Discussion Paper

- *General*

- Our comments herein are directed to the application of the Discussion Paper with respect to situations where the transaction is within the scope of the Discussion Paper,

⁴ EITF 01-8, ¶ 12(a) and 12 (b)

specifically only *leases of single tenant standalone buildings* situated on mall property site but not the lease of a store that is integral to a mall, as discussed above.

- While we believe that the Discussion Paper has made progress towards providing for improved transparency of financial reporting, particularly with respect to off-balance sheet obligations of leases, we believe that numerous areas need to be further refined and considered in detail because of the significant financial reporting repercussions, which adoption of these standards will have on tenants of all kinds. We believe the FASB should strive to provide standards that provide transparency but also provide a true economic representation of the nature of the transaction. Our comments follow below.
- *Subjective Nature of Judgments Required*
 - We believe that the judgments required to be made by management in the approach outlined in the Discussion Paper as to the determination of key aspects of the lease and the value that is to be capitalized are unrealistic. Key factors required to be determined by the tenant, such as the *most likely lease term* and future sales levels used to calculate contingent rents, are nearly impossible to accurately predict in normal circumstances and are all the more difficult in an uncertain or rapidly changing economic environment.
 - Determination of the *most likely lease term* requires management to arrive at a conclusion of a future decision that they are not usually prepared to make at that time. The use of the *most likely* or *probability weighted estimate* of the amount of contingent rents included in the *obligation to pay rent* and the *right to use* asset value presupposes that such an estimate can be reasonably made. This level of judgment will invariably lead to inconsistent accounting for leases by similar companies for similar arrangements. Additionally, the risk exists that the required periodic reassessment of these estimates will provide companies an opportunity to influence their financial results and financial condition.
 - Accordingly, we believe that the lease term selected should be based on the same definition of lease term as contained in the existing FAS 13 accounting literature on leases, namely the lease term should be based on the contractual minimum lease term adjusted for any bargain purchase options, early termination options or economic compulsion factors that are known at the inception of the lease.
- *Differentiation between a firm obligation versus a contingent obligation*
 - We believe that there is a distinct difference between a *firm obligation* and a *contingent obligation*. In the case of many business arrangements and negotiations, whether an obligation is a firm commitment or contingent obligation is often determined by the negotiations between the parties to the arrangement.
 - Under FASB #13, the *minimum lease payments* were considered a firm obligation. There was no judgments required to determine the minimum payments, only whether other factors added to the minimum lease payments. Uncertain obligations were characterized as *contingent rents* which were not included in the lease classification test. Over time

accountants worked out which items were in fact *firm obligations* and which items were in fact *contingent obligations* based on their interpretations of the underlying accounting principles and facts and circumstances. Obviously some judgment was required, but at the end of the day, they looked towards what the contractual arrangement called for and assessed what obligation the tenant had contractually agreed to.

- *Treatment of Contingent Rents*

- We view contingent rents as falling into a few basic categories; (i) contingent rent based on *external factors*, such as underlying interest rate levels, (ii) contingent rent based on *related but uncontrollable factors*, such as contingent rents based on gross sales above a fixed level and (iii) contingent rent based on factors *directly associated* with the property's usage, such as contingent rents due to excessive mileage above a mileage allowance.

- *External factors*

- We do not believe that contingent rents as a result of changes in an underlying interest rate index should increase or decrease the *obligation to pay rent* or the *right to use asset* value, as it merely reflects a change in the underlying borrowing costs used to finance that property *by the lessor* being passed on to the tenant.

- *Related but uncontrollable factors*

- We believe that contingent rents such as those based on the tenant's sales levels should not be included in the initial capitalized value estimate of the *obligation to pay rent* nor the *right to use asset* value because such values have little relationship to the property's value and such estimates are virtually impossible to predict and can vary substantially.

- *Directly associated factors*

- We believe that contingent rent factors that are directly associated with the usage of the property, can be reasonably estimated and are regularly incurred should be included in the initial *obligation to pay rent* and *right to use asset* value. Changes in the amount of such contingent rents should be charged to earnings as incurred. These guidelines are substantially the same as are currently followed with respect to including such amounts within the determination of minimum lease payments under FAS 13. For instance, in the lease of a truck, the lease includes a standard mileage allowance plus a charge for excess mileage above that standard. If the standard mileage allowance is reasonable for that vehicle and its intended usage, then contingent rents should only be incurred when the usage is above the standard. If the standard is set too low, then contingent rents will always be incurred and an estimate of the amount of contingent rent should be included in the initial *obligation to pay rent* value and *right to use asset* value.

- *Effects of Changes in Assumptions*

- In certain cases the Discussion Paper requires that changes in facts and circumstances or assumptions should change the value of the *obligation to pay rent* and the value of the *right to use asset*. We are somewhat disturbed by the potential frequency of these changes and the potential misrepresentations that could occur, particularly on the asset side of the balance sheet.
- For example, if a tenant determines that they will be paying some additional contingent rent as a result of excess usage of the building's infrastructure, we do not believe that this contingent rent acts to increase the value of the building. On the contrary, we believe it acts to decrease the value of the building faster because of over-usage and thus we believe such contingent rents should be charged to expense when incurred. Further, we do not believe that a change in the estimate of the future excess usage represents an *obligation to pay rent*, but merely represents increased usage of the building at the time the usage occurs.
- We believe that the only time a change in *obligation to pay rents* or *right to use asset* value should be recorded is when the *contractual nature of the lease agreement* actually changes or when the tenant actually extends or renews the lease. We believe such a contractual change should be considered a new lease agreement as under the existing rules found in FAS #13 ¶ 9. In that case, if the tenant has determined that a new lease agreement has been created, the existing *right to use* asset and *obligation to pay rent* should be removed from the tenant's balance sheet and the new lease should be established as a new property.
- As such, we also do not believe that a tenant should reflect an increase in the gross property value each time a renewal is entered into. This would result in adding to the capitalized lease value several times over and would provide a meaningless gross asset value.
 - For instance, ABC Retail leases a \$1,000,000 building for 60 months under a lease with a present value that is equal to 75% of the property value and thus capitalizes the lease at \$750,000. ABC renews the lease based on the property's then current value of \$500,000, at a present value of \$400,000. ABC then grosses up its gross property value by \$400,000 to \$1,150,000, a gross amount that is greater than the original cost of the property as well as the present market value of the property.
 - We believe that the existing property should be de-recognized and reestablished based on the then calculated capitalized value.
- *Selection of Interest Rate for Discounting*
 - The use of a tenant's incremental borrowing rate for discounting purposes worked *reasonably* fine under existing FAS 13 for capitalizing leases when the majority of the property value (greater than 90%) was being paid by the tenant. In that case the use of the tenant's incremental borrowing rate or the implicit interest rate in the lease

represented a reasonable proxy for the borrowing rate that the tenant would otherwise incur to acquire the property.

- Applying this new lease accounting approach however, tenants with relatively better credit ratings and thus a lower incremental borrowing rate would report a *greater obligation to pay rent* and a *higher right to use asset value* on their balance sheet when compared to tenants with poorer credit ratings. Tenants with poorer credit ratings and thus higher borrowing costs would report a *lower right to use asset value* and *lower obligation to pay rent* compared to tenants with better credit ratings.
- Example – A \$100 million property is available for lease for 20 years for \$800,000 per month with the lessor assuming a 21% residual value and an 8% interest rate. Note that the lessor’s assumptions would not be available to the tenant. When two different tenants capitalize the same lease, the capitalized value is highly dependent of the incremental borrowing rate used to capitalize the lease. The table below presents a basic example of this phenomenon.

<u>Tenant rating</u>	<u>Incremental Borrowing rate</u>	<u>Present value of payments</u>
AAA	5.0%	\$121.2 million
BB	10.0%	\$82.9 million

- This basic example demonstrates a flaw in using the tenant’s incremental borrowing rate for capitalizing a lease. In both cases above, the lease is the same, the amount of rent to be paid is the same and the property is the same and yet the *obligation to pay rent* and *right to use asset values* differ by a material amount merely because the tenants have different incremental borrowing rates.
- We believe that the FASB should consider the following approach to selecting the interest rate to determine the present value of the lease payments.
 - For *financing types* of leases with a fixed price purchase option, tenants should calculate the implicit interest rate *assuming they exercise the fixed price purchase option* and utilize this rate as the rate used to capitalize the lease. Inclusion of the purchase option amount in the present value calculation provides a realistic actual interest rate offered to the tenant.
 - For instance, using the lease example above but assuming the tenant has a fixed price purchase option of 40%, the implicit interest rate in the lease is no more than 8.44%, because the tenant can acquire the property at the fixed price purchase option price. Calculating the present value of the lease payments produces a capitalized value of \$92.566 million. This value and the rate used to amortize it would be the same *regardless of the tenant’s credit rating* since this rate is the *maximum* implicit rate in the transaction.

- For *usage types* of leases we suggest the FASB consider using a hybrid approach that seeks to duplicate the lessor’s economic model. The tenant would estimate the future residual value of the property and determine an interest rate based on the initial fair market value of the property, the projected residual value and the contractual rents. In these cases the same lease of the same property would be recorded relatively similar as among different tenants.
- In the usage example described above and illustrated in the table below, the tenant calculated the interest rates when the appraised value of the property in 20 years ranged from 20% – 60% of its current value. As can be seen from the table below, the interest rate and present value of minimum lease payments did not vary as widely as was seen above as between the AAA rated tenant and the BB rated tenant.

Projected Residual Value	Calculated Implicit Interest Rate	Present value of lease payments
20%	7.96%	\$95.910 million
40%	8.44%	\$92.566 million
60%	8.87%	\$89.753 million

- Note that the 40% assumption in the *usage* lease (**bolded**) produces the same implicit interest rate and capitalized lease values as in the lease with the fixed price purchase option.
 - We believe that this approach would provide a more consistent balance sheet representation between different tenants in those cases where the tenant does not have any fixed price purchase option. Regardless of the underlying tenant’s credit rating, the capitalized value would be similar because the calculation was based on a residual value assumption which in this case has the least amount of effect on the calculation.
- *Expense Recognition Pattern*
 - We believe that the expense recognition pattern of the proposed approach is *appropriate* insofar as the lease represents the acquisition and financing of an ownership right in the property. This ownership right is evident when the lease contains a fixed price purchase option to buy the property at some time during the lease. In that case, the tenant could have obtained financing to acquire the property and the pro forma expense recognition pattern would have included the straight-line depreciation of the property plus the amortizing interest method applied to the declining balance of the loan.
 - However if the lease *does not contain a tenant right or option to acquire the asset for a fixed price*, then we believe that the lease more closely represents the acquisition of the *right to use* the property during that timeframe and we do not believe the *obligation to*

pay rent should be treated as a discounted financing. In those cases, the overall expense recognition pattern should be representative of the straight-line level of functionality provided by the property. Since the functionality provided is uniform throughout the lease term (as usually evidenced by the straight-line depreciation) and the tenant has no contractual option to acquire the property, the overall expense recognition should similarly be uniform throughout the lease term.

- We suggest one of two approaches to accomplish this straight-line overall expense recognition:
 - Approach 1 – Utilize an increasing amortization calculation to offset the interest rate expense, which is front-end loaded in an amortizing financing. The total of interest expense and depreciation would equal \$9.6 million, the 12 monthly payments of \$800,000.

Example (\$ in MM)

<u>Year</u>	<u>Interest Expense</u>	<u>Depreciation Expense</u>	<u>Total Lease Expense</u>
1	\$8,398	\$1.202	\$9.600
2	\$8.292	\$1.308	\$9.600
3	\$8.177	\$1.423	\$9.600
4	\$8.052	\$1.548	\$9.600

- Approach 2 - Assume that the amount imputed as being financed is amortized on a straight-line basis and that the *interest expense* also is also recognized on a straight-line basis. This approach can be supported by the fact that many financings are funded based on an aggregate level property value and thus for a property with a stable value, never amortizes. The actual present value of the payments would be calculated; however a level amortization and level interest expense would be recorded. In this manner the total interest expense plus right to use asset amortization would mimic the level rent payments commonly found in an operating lease, while reflecting the obligation to pay rents on the balance sheet of the tenant.

Example (\$ in MM)

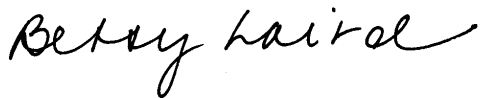
Total payments = \$800,000 x 240	=	\$ 192,000
Obligation to pay rent	=	(92,566)
Interest expense to spread	=	<u>99,434</u>
Monthly interest expense \$99.434 MM / 240	=	\$414,308
Monthly depreciation \$92.566 MM / 240	=	<u>385,692</u>
Monthly lease expense	=	<u>\$800,000</u>

- *Conclusion*

- We believe that the alternative approaches discussed herein satisfy the FASB's objective of reporting the *obligation to pay rents* on the balance sheet for all leases subject to the scope of the Discussion Paper. We also believe that our means of calculating the interest rates to use and the different amortization approaches represents the distinctly different nature of the leases as between a financing lease and a usage lease. The Attachments include a summary of the various lease options suggested in both this response and our response related to landlords.

We appreciate the opportunity to present our views on tenant accounting for leases and offer our assistance to the FASB for purposes of furthering the FASB's understanding of this industry.

Sincerely,



Betsy Laird
Senior Vice President
Office of Global Public Policy

Attachment A – Matrix of ICSC Tenant/Landlord Lease Positions
Attachment B – Discussion Paper Questions and Answers