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Request for Comments on Leases (Topic 840)
(File Reference No. 1850-100)

Dear Board Members

McDonald’s Corporation appreciates the opportunity to comment on the Exposure Draft of the Proposed Accounting Standards Update of Topic 840, Leases (the “Proposed ASU”). Leasing is an important part of McDonald’s operations from both the lessee and lessor perspective and the proposed changes to the lease accounting standards would have a significant effect on the Company. Under our business model, McDonald’s owns the land and building or secures long-term leases for both Company-operated and conventional franchised restaurant sites. For conventional franchised sites, McDonald’s leases the property to the franchisee. The conventional franchise arrangement typically lasts 20 years, so we generally try to secure real estate for at least 20 years with the ability to extend the leases through multiple option periods. As of September 30, 2010, we were the lessee at about 14,000 restaurant locations through ground (land only) and improved (land & building) leases and we were the lessor at over 19,000 locations in more than 50 countries.

We believe it is important to recognize there are fundamental differences among the types of leases utilized in the market today. For example, long-term real estate leases are very different than short term equipment leases, as reflected under current accounting guidance. Unlike equipment leases, real estate leases generally are not considered financings as risks and rewards of ownership typically do not transfer. As a result, we believe that real estate contracts are more similar to other contracts like employment contracts that are accounted for as period costs. We believe the Boards should reexamine the underlying principle objective of the standard and then determine the appropriate scope of the standard.

Based on how the current Proposed ASU is written, we have significant concerns along with proposed alternatives related to various elements that we feel should be addressed in order for the changes to be effectively implemented. A summary of our primary concerns includes the following:

• The inclusion of all contingent rents and option renewal periods in the measurement of amounts recognized from both the lessee and lessor perspective creates assets/liabilities that are driven from significant estimation and judgment and may not meet the definition of an asset or liability.

• The measurement complexities currently included in the exposure draft impact many different systems and processes and will significantly increase the cost of the technology solution required for implementation of a change in lease accounting. In addition, there will be significant people resources, across many disciplines, required to assess, implement and monitor the resulting change in lease accounting. From our perspective, the significant costs to implement outweigh the benefits from the changes.
The proposal significantly changes the pattern of income/expense recognition from both the lessee and lessor perspective with the front loading of income/expense. We believe that the proposed approach will provide less relevant information to users of our financial statements and does not reflect the economics of the transactions. The pattern of recognition in the income statement under current accounting for leases is not broken today. We believe the “linked approach”, discussed in the previous Discussion Paper document, is a more reasonable solution to the recognition issue from both the income statement and balance sheet perspective.

From a lessee perspective, using the incremental cost of borrowing for companies with stronger creditworthiness may overstate the value of the asset and obligation while companies with weaker creditworthiness may understate the same asset and obligation. Key financial metrics such as margins, operating income and returns will also be impacted as the split between amortization and interest expense varies based on the discount rate assumption. The rate implicit in the lease would provide for the best estimate of the fair market value of the leased asset. Although not always readily available, estimation of this rate would result in a more accurate representation of the lease in the financial statements than use of a company’s incremental borrowing rate. There can be a fairly significant difference between the incremental cost of borrowing for a company with a strong credit rating and the implicit rate in the lease. In addition, the discount rate used for transition to the final standard should reflect a longer term average perspective to ensure that the current market rates do not distort the initial measurement of the asset and liability.

The proposed changes to lessor accounting create a significant change from existing accounting, which, from most accounts, works fairly well in providing decision-useful information to users of the financial statements. We believe the current recognition pattern of rental revenues at McDonald’s directly correlates to the economic success of our restaurant locations and global brand.

Our perspective, key concerns and possible alternatives regarding the Proposed ASU are described below.

**Measurement Concerns – Option Periods and Contingent Rents**

We believe several aspects of the Proposed ASU related to measurement need to be revisited, especially in determining the lease term and estimating contingent rentals. Addressing these concerns could significantly reduce the complexity and incremental cost of implementing the standard.

**Option Periods -**
When we enter into a lease for real estate, we seek longer term leases (generally 20 years) with numerous option periods (generally 4 five-year options) limited to what is customary for the local country or venue (e.g., shopping mall, etc.). This creates some security of having long real estate tenure with some flexibility if the site is less profitable in the future.

The level of judgment required to make an assessment of the expected lease term using the proposed approach will be significant and other disciplines, such as development and operations, will be required to weigh into this assessment. We believe the proposed approach for determining the lease term – estimating the probability of occurrence for each possible term, including potential options – is unnecessarily complex. We are not convinced that the inclusion of option periods in the assessment results in the true obligation of our company, given the flexibility we negotiated. However, we also recognize that our long term objective is to occupy those sites beyond the initial term.
If the lease term includes uncommitted option periods, we believe a “reasonably assured” threshold versus a “more likely than not” threshold should be used to determine the length of the lease term for measurement purposes.

To the extent that a lower threshold for including optional lease periods is retained, we suggest eliminating the very subjective estimation of the probability of occurrence of each possible lease term. We recommend that a best estimate approach be allowed in determining the length of the lease term. Every opportunity to eliminate complexities in the proposal without significantly changing the objective and results should be considered.

Better qualitative disclosures regarding initial lease terms and option periods could be required to mitigate structuring concerns. These disclosures could include a discussion of a company’s strategy regarding the negotiated lease terms and options and the thought process used in determining the expected lease term for measurement purposes.

Contingent Rents -
In regards to contingent rentals, the potential variability of the estimates causes us concern. The rent on a portion of our lease contracts as a lessee and all our contracts as a lessor is dependent on future sales. We do not believe any company has the ability to accurately predict sales over an extended lease term that may cover up to 20 years or beyond with option periods. Multiple business disciplines would have to weigh in on any estimated forecast and that would still not ensure a high level of precision. We also have contracts that escalate based on fair market value adjustments or CPI. Projecting these escalations may be more practical given external indices or historical information available. However, with the level of volatility in real estate markets and volatile economic trends globally, accurate estimations of future escalations may still be challenging.

We recommend that contingent rentals that are based on a percent of sales be excluded from the initial measurement for both the lessee and lessor. These future payments are not obligations or receivables until sales occur and; therefore, the income statement impact should be recorded at that time. Escalations based on fair market value adjustments or CPI can arguably be viewed differently; thus, we could support estimating contingent rentals for fair market value or CPI escalations in the initial measurement. We propose the measurement be based on a "best estimate" versus a “probability weighted” approach. Although judgment and subjectivity will be involved in either method, eliminating complexity will reduce the incremental cost to implement without a significant change to the usefulness of the information provided.

We believe that improved qualitative disclosure related to payment terms is important including why the negotiated terms make sense for a company’s business model and the resulting accounting impact. We don’t believe companies will structure or restructure real estate leases just to manipulate the accounting. Converting all rent payments to a percentage of sales would likely be a more expensive option and, therefore, not make business sense. In addition, landlords (especially those that are highly leveraged) are generally not able or willing to take on more significant risk.

Furthermore, as a company with many thousands of leases as both a lessee and lessor, we are anxious about the possibility of having to reassess the carrying amount of a liability or a receivable on a recurring basis including estimating contingent rentals that will never match actual results. Our preference would be to limit or eliminate the reassessment of any contingent rents included in the initial measurement and instead recognize any differences between actual results and the initial estimations in the period in which the actual contingent rent is determined. Again, there is added complexity and cost from a system and process perspective related to the proposed reassessment process especially if a “significant” change is viewed on an individual lease basis.
Pattern of Recognition

We have a strong opinion that the revenue and expense recognition guidance in the Proposed ASU does not accurately depict the economics of our leasing transactions. We understand the Boards’ viewpoint that leasing can be a method of financing so the effective interest method seems logical; however, real estate leases are not typically a financing as risks and rewards of ownership do not transfer. Also, it would seem more logical that companies would finance such purchases using corporate debt such as bonds, which do not require making principle payments with interest. As a result, the front-loaded nature of the expenses under the effective interest method does not effectively match a company’s true financing obligation or accurately match the fact that we obtain fairly consistent benefits from the property over the entire lease term.

Similarly, from a revenue recognition standpoint, the front-loading of the revenue when we lease a restaurant to a franchisee does not accurately represent how we believe we earn the revenue over the lease term. We believe the accounting guidance as it currently exists today more closely aligns the recognition of revenue with when it is earned. As a franchisor, we have certain obligations that we are required to perform throughout the life of the lease with the objective of strengthening the brand and helping drive incremental sales. Thus, it makes sense that the corresponding revenue should be recognized throughout the lease as these obligations are performed and sales are impacted. We do not believe that modifying the revenue recognition guidance related to leases provides any additional useful decision-making information than what exists today.

We believe that the “linked approach” described in the Discussion Paper should be further explored. This would solve the issue of the front loading income statement recognition, but still allow for recognition of an obligation by the lessee on the balance sheet. Based on the information in the Discussion Paper, we do not believe there was an overwhelming argument against this approach – primarily because we don’t view real estate leases as financings and differentiating between types of leases (i.e., having multiple approaches) is no more complex than other judgments required under the proposal. We feel this approach reflects the economics of the transaction in a more simplified and relevant manner for the Company as both the lessee and lessor.

Discount Rate

Regarding the discount rate, we are concerned that under the proposed accounting, companies like McDonald’s with a strong creditworthiness and thus a lower incremental cost of borrowing would reflect higher assets and obligations than most other companies and have a greater impact to key metrics such as margins and returns. To the extent a company’s incremental borrowing rate is lower than the rate implicit in the lease, a right to use asset will be created that is greater than the market value of the underlying lease. Furthermore, market rates for real estate leases are not dependent on the creditworthiness of a lessee, which is another indicator that all leases are not necessarily financings.

In addition, the incremental borrowing rate of a company is more readily available from a consolidated or global perspective than by country. Depending upon the currency of a financing, the terms of the financing can vary widely. For example, a U.S. dollar or Pound financing can be more long dated compared to a Euro financing and there are many other currencies where financing terms will be shorter. Thus, determining an incremental cost of borrowing may not be straightforward whether using a company’s global or country specific rate and even then, comparability between companies is unlikely.

Our experience is that the implicit rate in the lease may not always be readily available. However, we believe that the proposal should be modified to allow companies to reasonably estimate the implicit rate if not readily available given it is the discount rate that would provide the more appropriate estimate of an asset or obligation. For example, as part of making a real estate decision, companies may compile
market specific information that could allow for a reasonable estimate of a cap rate or rate implicit in the lease.

In terms of the impact to key metrics, a lower discount rate will result in more of the expense included in margins and operating income. Consideration of the “linked approach” would eliminate the split between interest and amortization and retain the comparability of income statements as it exists with current accounting.

In addition, the discount rate used for transition to the final standard should reflect a longer term average perspective to ensure that the current market rates do not distort the initial measurement of the asset and liability.

**Other Issues**

There are other elements related to measurement that we believe need additional clarification. First, we do not believe the Proposed ASU is clear in regards to whether executory costs, such as real estate taxes or other common area maintenance fees in real estate leases, should be included when determining the present value of lease payments. We recommend that these expenses continue to be treated as period costs that should be excluded from the measurement of the obligation. The treatment of these costs would be consistent with similar costs of owned real estate assets. In addition, these costs can be difficult to estimate over a long period of time.

We believe that application guidance for impairment assessment related to the right to use asset needs to be included in the standard. Also, if it is determined that only contracted lease terms are included in the measurement of the asset/obligation for lessees, it would be helpful to clarify whether the useful lives of owned assets related to a lease (owned building or leasehold improvements on leased land) can exceed the contractual lease term as long as option renewals exist. We believe the flexibility created with negotiated option renewals may be reason to allow for a useful life beyond the contractual lease term.

**Lessor Accounting**

We believe the current accounting standards for lessors provide decision useful information from the balance sheet and income statement perspective. McDonald’s generates rental income based on a percent of sales with minimum rent payments under our conventional franchise arrangements. These arrangements also require a royalty based on a percent of sales and initial fees. Our investors and creditors clearly understand how our revenues are generated and have the ability to assess expected results over a long period of time.

The proposal would have a significant impact on our reported income statement results. As mentioned previously, the measurement of the asset and obligation reflecting an estimate of future rent payments based on a percent of sales is likely to be inaccurate. Based on our experience in forecasting sales for our investment decisions, short term forecasts can vary widely from actual results. Basing accounting and financial reporting results on longer term estimates seems highly inappropriate due to the reliability of the forecasts.

As mentioned previously, the pattern of recognition called for in the proposal with the front loading of the income is a significant area of concern. We would be recognizing income in the early years based on forecasts of future sales. The timing of the accounting recognition does not reflect the economics of the longer term arrangements we enter into with our franchisees. In addition, the income statement results will vary significantly from the cash flow statement for these arrangements potentially creating confusion and unnecessary complexities for our investors.
We are also concerned that the direction of the Revenue Recognition project may not link up with the Leasing project and that rent revenues and royalty revenues, both generated based on a percent of sales, may have different accounting treatment.

While we believe current accounting standards are effective, if only one of the two proposed approaches is considered for adoption, we would not support the derecognition method as the sole method for lessor accounting. We do not believe that would be an improvement to the current lessor accounting requirements for leases that don’t transfer ownership of the assets to the lessee. We think that derecognizing an asset and recognizing income upfront even though ownership of the asset does not permanently transfer misrepresents the economics of the transaction.

**Presentation / Disclosure / Transition**

The proposal would change the income statement presentation of certain items (e.g., rent expense to amortization and interest expense) that would change the makeup of certain key metrics (e.g., margin %, EBITDA, etc.) that are commonly reviewed by various users of financial statement information. Much of this change relates to the use of the effective interest method. Using the “linked approach” discussed above would create a more consistent presentation of income and expense items with current reporting under the existing standards. If the linked approach is not incorporated into the final standard, we believe the income statement for a lessor should not reflect a presentation that forces lease income, interest income and depreciation expense to be grouped together. Each company should determine how these should best be presented in operating income to ensure that key metrics reviewed by their investors are maintained. We feel strongly that interest income resulting from the proposed lease accounting is different than other interest income from passive investments and should be part of operating income. From the lessee perspective, companies should have the option of disclosing the expenses related to the leases either on the face of the income statement or in the notes to the financial statements. We also believe that cash flows arising from lease activity should only be separately presented in the statement of cash flows when significant.

From a balance sheet perspective, we believe that lessees should present liabilities to make lease payments separately from other liabilities and that companies should be given the option of disclosing the right to use asset either on the face of the balance sheet or in the notes to the financial statements. We feel lessors applying the performance obligation approach should link the receivable and the performance obligation together for presentation purposes. Also, the guidance should clarify whether current and noncurrent amounts of assets and liabilities will be required to be presented. We also believe disclosure in the notes related to sublease assets and liabilities should be an option as opposed to separate presentation on the balance sheet.

In addition, we have concerns regarding the amount of quantitative disclosures that would be required under the proposal. We believe that certain qualitative and quantitative disclosures are important for financial statements users; however, there needs to be a balance between the effort required and the benefits obtained. For example, we believe that disclosing qualitative characteristics regarding the types of leases that we sign as well as the methodology we use to calculate our lease assets and liabilities would be useful to financial statement users. However, requiring reconciliations of opening and closing balances for the various assets and liabilities may place an undue burden on financial statement preparers without supplying substantially relevant information for financial statement users.

In terms of transition, we believe companies should be provided an option to choose between the simplified retrospective method and a full retrospective method for implementation. Given the length of our lease terms and if the “linked approach” is not used in the final standard, we would prefer making a decision on whether the cost of a full retrospective approach supports the benefit of mitigating the issues related to the pattern of recognition currently called for in the proposal.
Cost of Implementation

We are concerned with the lack of presently available technology solutions and the cost necessary to create these solutions. We believe the cost will be extensive, especially with the measurement complexities currently included in the proposal. There will be other significant costs for people resources required to assess, implement and monitor the resultant lease accounting. Given that we consolidate results from over 50 countries and operate in a very decentralized environment from both a system and business process perspective, the implementation of an accounting standard that has a significant impact on our business will be an enormous undertaking. We will be required to find a technology solution for a number of platforms prior to completing our long-term migration to a single global platform. The expertise from an accounting, process and control side will have to be replicated in each of our markets. This undertaking will require a significant people resource commitment from the Company. Based on a high level view of system and people resource requirements, we would expect the cost to implement the proposal to be in the $50 to $100 million range depending upon the complexities of the standard. We question whether the benefits of the proposal are in line with the level of significant costs to implement. We believe a more simplified approach that addressed the main criticisms of not reflecting an obligation for the lessee on the balance sheet is a more appropriate solution.

We believe alternatives proposed in our letter will reduce complexities that do not currently exist today and eliminate potential confusion for investors. The changes in the Proposed ASU appear to lead to greater divergence between the income statement and statement of cash flows, which we believe is not a beneficial outcome. Our business model is fairly straightforward, easily understood and fairly reflected in our financial reporting results. Significant changes to reported financial results without a change in our business will create confusion for users of our financial statements. It is difficult to evaluate the cost of this unintended consequence. In addition, we believe that we would have to maintain internal reporting under the current standards for our management to effectively run the business as the financial reporting results under the proposal would not provide them decision-useful information.

In addition, due to the significant changes that impact people, systems and processes, the proposal would require a substantial amount of time to implement and; therefore, we believe that companies will need a long lead-time to implement the new rules.

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In closing, we believe that some of the measurement and recognition requirements of the proposal are overly complex and don’t necessarily reflect the economics of the transactions. We understand the concern with structuring opportunities related to leases; however, principles-based standards should not reflect onerous rules just in an attempt to limit these opportunities. We believe the alternatives that are discussed in our letter reflect widespread views that should be considered to create a final principles-based standard that can be effectively and cost efficiently implemented.

We appreciate the opportunity to express our opinion on this matter and would be pleased to discuss our comments in greater detail if requested.

Sincerely,

/s/ Kevin M. Ozan
Kevin M. Ozan
Corporate Senior Vice President - Controller