December 15, 2010

Ms. Leslie Seidman
Acting Chairman
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Sir David Tweedie
Chairman, IASB
30 Cannon Street
London, EC4M 6XH
United Kingdom

Re: Exposure Draft: Leases (Topic 840)
File Reference No. 1850-100

Dear Ms. Seidman:

The International Council of Shopping Centers (ICSC) welcomes the opportunity to respond to the request for comments from the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) regarding the Exposure Draft (ED) of the proposed Accounting Standards Update of Topic 840.

Founded in 1957, the International Council of Shopping Centers is the global trade association of the shopping center industry. Its 55,000 members in the U.S., Canada and more than 90 other countries include shopping center owners, developers, managers, marketing specialists, investors, lenders, retailers and other professionals as well as academics and public officials. In the context of the joint FASB/IASB Leases project, ICSC represents literally thousands of lessors and lessees of shopping centers. As the global industry trade association, ICSC links with more than 25 national and regional shopping center councils throughout the world.

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**Comments regarding the impact of proposed accounting on tenants:**
Within the shopping center industry, the majority of tenants use leasing to procure the use of retail space in shopping centers. The proposed rules will have a profound effect on our members and the industry at large. While we understand that the rules have been written to prevent "off balance sheet" financing and provide greater transparency for users of financial that they may result in unintended consequences to the future dynamics of lease negotiations and may actually serve to obfuscate the true financial standing of entities involved in leasing arrangements.

Under this proposed change, a lessee's income statement will be fundamentally altered. By replacing rent expense with amortization and interest expense, in the early years of a lease, lessees will see a significant reduction in their earnings (net income). Further, the rules will ultimately capture estimated payments that are not liabilities and will cause tremendous compliance burdens and income volatility as estimates are regularly readjusted over the term of the lease.

**Summary Comments:**
**Where we agree:**

- We agree with the Board's objective of capitalizing on the balance sheet the assets and liabilities arising from operating lease transactions.
- ICSC agrees that a "right-of-use" is an asset of the lessee and that "hell or high-water" obligations in the non-cancellable lease term are liabilities.
- Further, we agree that the contract is the most practical unit of account and that the value of the contract is the present value of the true liabilities created by the lease contract throughout the lease term.

**Where we disagree:**

- ICSC does not agree, however, with the proposed items to be capitalized. Specifically, it is not proper to capitalize likely renewal rents and probability weighted estimated contingent rents as they do not meet the definition of a liability.
- Further, ICSC objects to the proposed delinking of assets and liabilities created by the lease contract and the use of unique amortization schedules. This change will significantly accelerate cost recognition for lessees and will likely lead to unintended consequences for many stakeholders.

- Moreover, the proposed lease accounting model is unduly complex and imposes a costly compliance burden on lessees that will fail to result in an improvement in the quality or reliability of financial information.
- ICSC thinks the Investment Properties model should be further developed for U.S. real estate lessors as it best portrays the economics of our lessor members' actively managed lease business. The Performance Obligation model does not accurately reflect the retail industry because it presents the business as a finance leasing business.

The model in the ED seems to be overly concerned with preventing abuse, rather than focusing on reporting the economic effects of leasing transactions. This misdirected focus is the reason for the complexity and potentially huge financial impact on business. ICSC believes it would be more efficient and effective to merely amend FAS 13 to capitalize the real liabilities from operating leases for lessees where the term is greater than one year and leave the lessee profit and loss (P&L) accounting cost pattern for operating leases unchanged. The proposed rule will likely cause retail tenants to raise prices and lay off workers to offset the negative P&L impact at a time when businesses are struggling in a challenging economy.

**Comments regarding the impact of the proposed accounting on lessees:**
**Overall Approach:**
Given that the Board had to determine a basis for capitalizing lease obligations, ICSC agrees that the right-of-use approach is a logical basis for doing so. The Board has proposed an appropriate methodology for the initial recognition and measurement of right-of-use leases by the lessee; i.e., calculating the present value of the lease payments using the incremental borrowing rate to determine the value/amount of lease obligation and a corresponding asset to be booked. Most major rating agencies have published procedures for capitalizing leases to adjust financials for their credit analysis that use a similar approach. Other financial statement users have similar present value methods. This approach to financial analysis has been in place for some time, probably since FAS 13 was issued. We believe that this methodology is understandable and can be implemented quickly and accurately with nominal IT expenditures.

However, the proposed rule effectively capitalizes far more than these rating agencies and other financial statement users typically do. These agencies could have interviewed preparers with significant operating lease activities to make estimates of likely renewals and estimated contingent rents, but they have historically chosen not to do so.

Further, we believe the ED changes the definition of "minimum lease payments" in a significant way by including estimated payments that create much of the complexity and burdensome compliance costs. The "longest possible lease term that is more likely than not to occur" threshold to define the lease term is too low a threshold and means that payments will be included that do not meet the definition of a liability. Additionally, estimates of contingent rents included in capitalized lease payments do not meet the definition of a liability until the triggering event occurs. According to the Board's own definition of liability, "[a] *liability* of an entity is a present economic obligation for which the entity is the obligor". Further amplified, it includes "[a]n *economic obligation* is an unconditional promise or other requirement to provide or forgo economic resources". ICSC contends that the estimated renewals and contingent rents are <u>not present obligations and are not unconditional</u>. These estimates seem to fit the IAS 37 definition of contingent liability which is not to be recorded, but rather is disclosed.

Per IAS 37, a *contingent liability* is:

> *a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or*
> *a present obligation that arises from past events but is not recognized because: it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or*
> *the amount of the obligation cannot be measured with sufficient reliability*
>
> It continues: *"[a]n entity should not recognize a contingent liability. An entity should disclose a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote."*

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Along with the subjective determination of the likelihood of exercising lease renewal options, the estimation of complex contingent rent payments will impose excessively high compliance costs and stress lessees' administration personnel and information-related infrastructure.

The ED states that existing lease accounting GAAP is inconsistent with the conceptual framework, yet ICSC would argue that the proposed right-of-use model is inconsistent with the working definitions of assets and liabilities included in the conceptual framework.

The ED states that "the treatment of the liability to make lease payments would be inconsistent with the treatment of other financial liabilities". It is ICSC's contention that lease obligations are not like other financial liabilities. The Board used the example of the purchase of an asset funded by a mortgage loan in their discussions of the right-of-use concept. The analysis concluded that because the lease payments are typically due over time, a lessee borrowed from the lessor to acquire the right-of-use. It was reasoned that if the lessee could pay all the rent up front there would be no "borrowing/debt". This is only one theoretical viewpoint. However, it could be argued that a lease is an executory contract whereby the lessee pays for the right-of-use on a month-to-month basis. This is supported by the fact that in bankruptcy, often the lease is disavowed and the asset is returned to the lessor with the lessee freed of any obligation to pay rent thereafter.

The fact that the lessor delivers control of the underlying asset to the lessee allows the Board to claim that a lease is unlike other executory contracts which is used to justify capitalizing payments under a "right-of-use" model. In fact, the courts hold that it still is an executory contract despite delivery and the lessee's right to quiet enjoyment for the term (that gives them control). If the lessee misses a payment or otherwise defaults, the facts and circumstance change to make the contract like any other executory contract. ICSC understands that the

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Board is charged with taking action, but it is imperative that the rules are written to not only capitalize true liabilities, but to maintain the integrity of the financial reporting of leases as an economically representative model.

The Board does not recognize that other financial liabilities, like mortgages, can be settled separately from the asset they are financing. A lease is unique in that the asset and liability are linked throughout the term of the lease via the lease contract. The asset and liability cannot be settled separately. The right-of-use asset ceases to exist when the lease obligation is fully paid, whereas, other assets financed by debt survive after the debt is paid. A lease transaction is a two-party contract while the example of the mortgage funding of an asset purchase is comprised of two separate transactions involving a buyer and a seller negotiating a purchase and a buyer and a lender negotiating a loan. ICSC suggests that before continuing with the implementation of the rule as it is currently proposed, the Board should fully examine the differences between a lease contract and other assets financed by loans.

**Minimum Lease Payments**:
Minimum lease payments should be capitalized only up to the actual liabilities in the lease contract. Likely renewals and estimated contingent rents do not meet the definition of a liability - - past events have not occurred to create a liability and estimated payments are not legally enforceable. ICSC disagrees with the view that the signing of the lease contract is the obligating event for renewals or contingent rents unless the contingent rents are de facto minimum payments and occur in the non-cancellable lease term. ICSC believes the current GAAP definitions of minimum lease payments and the lease term and current practice should be retained. Specifically, renewals should be included in minimum lease payments if they are “binding” or “below market” or if the lessee will suffer a penalty for failure to renew.

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With respect to contingent rents, ICSC realizes that, on occasion, leases are written with non-cancellable lease terms comprised entirely of contingent rents with no minimum payment. In these instances we agree that the lessee should follow the principle of estimating contingent rents due in the lease term as defined under current GAAP and where the minimum contractual rents are below market. In current practice as applied by the major accounting firms, this situation is commonly called "disguised minimum lease payments". ICSC believes all other contingent rents are not such and should not be capitalized. Rather they should be accounted for on a cash basis when they become payable. Estimates will not be sufficiently reliable especially with long lease terms and additional "more likely than not" renewal periods.

Estimating payments to be capitalized creates undue complexity in this proposed lease accounting model as estimates are just that and will necessitate at least one adjustment (but most likely many adjustments) for each lease over its term. The estimates will not be reliable especially considering the long terms of real estate leases. The requirement to use the probability weighted method to estimate payments will be a tremendous burden on lessees. Many large lessees have in excess of 10,000 real estate leases and thousands of additional equipment leases (i.e., computers, faxes, copiers, cash registers, telephone systems, material handling equipment, fleet cars and trucks, etc.). Furthermore, estimates create inconsistencies among lessees in the same industry which could impair the ability of users of financial statements to make accurate comparisons among firms in the same peer group. Finally, due to the subjective nature of the estimations, it is likely that lessees and lessors will record different amounts for the same contract.

**Subsequent Accounting:**

The ED states although the value of the right-of-use asset and the liability to make lease payments are clearly linked at the inception of the lease, they are not necessarily linked subsequently. As stated, this is due to the fact that the value of the right-of-use asset *can* change with no corresponding change to the liability to make lease payments. The fact that the value of the right-of-use *can* change should not be a reason to delink as, in the normal course of virtually all equipment leases, the value of the right-of-use does not change with regard to

the value of the liability. The value of the asset and liability remain as the present value of the remaining rents as the lease moves through the term. One should first assume the leased asset continues to perform satisfactorily over the term. If its value does change due to impairment, it should be written down. If, however, the value does not change, then it seems that it would be more useful to use a "sinking fund" amortization (the same pattern as the debt amortization) rather than a straight line method to amortize the right-of-use. Using the straight line amortization method for the right-of-use asset creates a negative net value for the lease contract beginning in the first month of the lease as the asset amortizes faster than the liability. This does not reflect economic reality. The value of a lease contract should be zero (being the net of the right-of-use asset and liability) except for impairment and the effects of initial direct costs.

ICSC believes the linked approach would provide a more realistic representation of the periodic expense in the income statement (generally an equal cost allocation over the lease term). By using a linked approach we mean that the lessee should accrue the average rent expense, charge the amortization of the right-of-use asset to rent expense, credit the amortization of the lease liability to rent expense and charge actual rent paid to accrued expenses. The right-of-use asset would be amortized using "sinking fund" amortization, the same as the debt amortization pattern. We note the capitalization and adjustment methods used by rating agencies and other financial statement users do not involve changing the expensed amount (rent expense). Users expect to see rent expense in the P&L statement and rent paid as a deduction from operating cash flows in the cash flow statement. The proposed amortization of the right-of-use asset on a straight line basis and the imputing of interest on the lease obligation create an accelerated cost pattern. When a lease term estimate is shortened, as is the case when a renewal option is not exercised, the resulting adjustment will be a "gain" as expenses are recognized at a faster rate than they should be recognized. This would lead to confusion and create a high degree of volatility in earnings. Also, many leases contain a termination right based on a specific measuring period and a specific sales threshold. Many are unilateral to the tenant but the trend seems to be towards a mutual termination right. We believe the ED needs to address this common business practice.

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The front-loading of costs is exacerbated by longer lease terms and where significant contingent rents are included. Most of our members' leases include step-ups in rent every five years in the primary lease term and in the renewal periods. The results of the ED model mean that contingent rents and renewal assumptions (including step-ups) tied to the last month of the lease will begin to be charged to expenses in the first month of the lease. In this case, the revenues created by the use of the asset will be recognized during different periods than the expense recognition. Again, this is perplexing and we contend will not achieve the stated mission of the rule to provide greater transparency for readers of financial statements.

Further, the excess reported cost over the actual cash paid for rent is a non-cash expense and creates a deferred tax asset. This front-loading of costs and the associated deferred tax asset will, in effect, be permanent charges to equity and permanent inflated assets for companies that continue to lease at the same pace. The issues will be magnified if the lessee adds leased assets. This is a real problem for our members and the industry as a whole as retailers often have no alternative but to lease retail space to conduct their business.

We also note the proposed "delinked approach" in the ED will result in reporting the lease obligation in excess of the leased asset throughout the lease term. This implies that most leases are "underwater" and involve a disproportionate payment of the total consideration in the early years of the lease. Since most leases are not "underwater" and the consumption of the benefit is generally at the same rate throughout the contract, the proposed "delinked" approach does not reflect actual business practices.

ICSC retail members tend to have lease terms of ten years or more with renewal options that can go for 10, 20 and even 50 years. The leases contain many contingent rent variations and generally have step-ups as mentioned above. Based upon our estimates of the impact of the proposed rule, the first year lease cost for our members will likely be 20 to 60 percent higher than under current GAAP. As lease costs are among the largest expenses for our retail members, this change could effectively reduce overall profits by as much as 50 percent.

This will clearly distort the ability of analysts to accurately determine the true financial picture of a company. Further it is likely that our retail members will respond by offsetting the increased costs through increased pricing and/or cost cutting through layoffs and store closures.

Nearly all companies lease real estate and small and medium sized companies use leasing as their primary source of securing the use of equipment. Small and medium sized companies do not have the resources to conduct the complex initial accounting as well as subsequent accounting and remeasurement required. Even large companies will have difficulties with the requirements and will need to add staff and spend considerable resources developing new accounting systems capabilities. To simplify the compliance we recommend linked capitalization of “true” lease obligations at lease inception, linked subsequent accounting and adjustment only in the event of a change in the lease contract such as exercising a renewal option or restructuring a lease.

**Executory costs:**
Executory costs related to a lease have never been an issue under existing GAAP as our members’ leases were all operating leases and expensed in the same way executory costs were expensed. Many leases are billed on a gross/bundled basis. In these gross/bundled deals, landlords very rarely break out the charges. There is no guidance in the ED as to what portion of the bundle is devoted to rent, taxes or other charges, yet to avoid capitalizing costs that are executory these breakouts will have to occur. That will require lease-by-lease reviews and renegotiations with landlords to determine the proper division of executory expenses. This will be costly in staff time, legal fees and out of pocket costs. If the executory costs cannot be broken out, too much will be capitalized and the ED’s accelerated cost pattern will front-end the recognition of these costs. It seems onerous on lessees to estimate the amounts of executory costs in bundled lease payments. The default should not be to capitalize the whole payment; rather, we recommend using a “more likely than not” threshold for estimating and bifurcating executory costs that are not specifically broken out. In this case, common sense should be used as it is better to have an imprecise but “close enough” estimate of executory costs rather than grossly overstating the capitalized amount.

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**Comments regarding the impact of the proposed accounting on landlords**

While the comments above focus primarily on accounting by lessees of shopping center space, ICSC has similar concerns regarding the impact of the proposal on lessors' financial reporting. These concerns include:

- **Scope out lessor leases of investment property reported at fair value from the requirements of the proposed accounting rule**

ICSC strongly supports the IASB conclusion to exclude from the proposed standard's lessor accounting, leases of investment property reported at fair value. Further, ICSC urges the FASB to expeditiously develop a U.S. standard that would allow owners/operators of investment property to report shopping centers at fair value. This standard should be similar to International Accounting Standard 40 *Investment Property.*

- **Front-loading revenue over the life of a lease**

Most shopping center leases are designed in a manner that allows the lessor to capture a percentage of tenants' sales as rent. This allows the rental revenue to grow as tenants' retail sales grow. It also allows tenants' costs to follow a pattern over the term of the leases that mirrors a tenant's revenue stream. The proposed Performance Obligation accounting would yield a decreasing revenue stream over the term of a lease – not at all faithfully representing the business transaction between retail landlords and tenants. As a result we do not agree with the Performance Obligation model for our industry.

In other types of retail operations, such as the big box centers or power and community centers, percentage rent is a non-issue, therefore the expectation of contingent rent is minimal.

- **Including estimated renewal and contingent rents in the measurement of the lease asset and performance obligation**

We believe that estimated renewal rents and contingent rents do not meet the definition of an asset for the lessor. Our reasoning is the same as in the lessee discussion above. The proposed recognition approach does not reflect the flexibility provided in such contracts and assumes rights and obligations at the inception of the lease which are beyond the commitments of the parties.

There are substantive economic reasons why many leases include contingent rentals elements – namely to reduce risk for the property owner and the lessee or that the landlord is protecting the tenant on the downside but in a position to share in the upside. The proposed ED distorts the economic effect for both lessors and lessees in the form of a front loaded cost/revenue model. Consider, for example, the lease of space in a retail mall that has a term of 10 years and calls for minimum rents of $1 million per year plus 10% of all sales above $10 million in any given year. This arrangement reduces the risk to the property owner of setting the minimum rent too high in the early years of the term and too low at the back end of the term. It also reduces the tenant's risk by allowing the rent to grow only if sales grow. In addition, the property owner captures 10% of the tenant's sales even if the sales exceed all expectations. The result is that the property owner captures 10% of all tenant's sales and the tenant's rental expense grows only if and as the tenant's sales grow.

It would misrepresent the economics of this lease transaction to accrue the present value of all rents, including contingent rents, under this lease and amortize the tandem performance obligation before the triggering event – sales growing to more than $10 million in any one year. This proposed accounting exacerbates the issue of front-loading of revenue required under the Boards' proposed accounting.

The proposed lease accounting requires the use of a probability-weighted average approach in measuring the lease receivable and performance obligation. We do not support this proposal because it would require a large number of mechanistic calculations without resulting in more useful information. For example, a company with 3,000 leases (each with contingent rent elements) and taking account of 5 potential outcomes for each revenue element would need to consider 15,000 outcomes (3,000 x 5) at each reporting date. Simply put, there

is no way to assign a probability as there are too many factors impacting a store's performance, especially in the current volatile economy. We believe that a best estimate of cash flows would reflect the most probable scenario and would result in more accurate estimates. It would also have the benefit of requiring fewer measurements.

**Conclusion:**
The SEC indentified lessee operating lease obligations reported only in the footnotes as a major financial reporting deficiency and left it to the Board to resolve the issue. The proposed lease accounting standard goes much further than correcting the stated problem. The proposal capitalizes payments that are estimates (not true liabilities), accelerates costs for lessees, and creates a huge compliance burden for lessees. It would seem more appropriate to disclose the estimated payments rather than to put them on the balance sheet. In our opinion, over-capitalizing creates a financial reporting deficiency. Most comment letter respondents to date do not agree with many of the recommendations the Board has made. These far reaching changes are particularly damaging to our retail members who have no choice but to lease space in shopping centers. The ED creates a permanent charge to earnings and capital. It adds inflated right-of-use assets, lease liabilities and deferred tax assets to the balance sheet that are not understandable. It could alter the behavior of lessees and lenders/investors to such an extent that it will have far reaching negative impacts for the economy as a whole. ICSC believes the entire real estate process as we know it will need to be revamped. There are no allowances for changing market conditions that yield to relocation, downsizing and other realities so common in our business. The complexity of the contingencies for both parties will create an administrative nightmare for both lessees and lessors.

For lessors, not enough time was spent on deliberations and due process. We think the Investment Properties model provides the best information for lessors in our industry segment and look forward to commenting during the process of deliberating that model.

We know that there are numerous paths to achieve the objective of capitalizing operating leases and improving lessor accounting and encourage the Board to give serious consideration to the alternatives suggested by the comment letters.

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The various options offered appear to have merit and logic and do not conflict with the objective of capitalizing operating lease obligations. Most importantly, they will not create the distortions and unintended consequences cited in our letter and the others we have read.

ICSC appreciates this opportunity to comment and is available to assist in the continuing process of refining the lease proposal. In closing, ICSC urges the Board to create workable rules that accurately and transparently reflect the economic substance of lease transactions and provide the most useful information to users of financial reports.

Sincerely,

Betsy Laird

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