

**Matrix of ICSC Tenant/Landlord Lease Positions**

**Attachment A**

<u>Type of Lease &amp; Asset</u>		<u>Tenant Treatment</u>	<u>Landlord Treatment</u>
<b>Lease of mall store</b>		<ul style="list-style-type: none"> <li>• Scope out of Discussion Paper</li> <li>• Treat as service agreement</li> </ul>	<ul style="list-style-type: none"> <li>• Consider following Revenue Recognition and Investment Property accounting</li> </ul>
Balance sheet		<ul style="list-style-type: none"> <li>• N/A</li> </ul>	<ul style="list-style-type: none"> <li>• Capital asset for mall</li> <li>• No change because of lease</li> </ul>
Income Statement		<ul style="list-style-type: none"> <li>• Straight line expense</li> </ul>	<ul style="list-style-type: none"> <li>• Straight line depreciation on mall</li> <li>• Interest expense on debt</li> <li>• Straight line revenue providing space &amp; services</li> </ul>
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<b>Standalone single tenant building / No Fixed Price Purchase Option</b>		<ul style="list-style-type: none"> <li>• Right to Use (Usage) Model</li> </ul>	<ul style="list-style-type: none"> <li>• Consider following Revenue Recognition and Investment Property accounting</li> </ul>
Balance sheet		<ul style="list-style-type: none"> <li>• Capitalize Obligation to Pay Rent using <i>calculated</i> interest rate (see Tenant letter)</li> <li>• Capitalize Asset offset Obligation</li> </ul>	<ul style="list-style-type: none"> <li>• Capital asset for standalone building</li> <li>• No change because of lease</li> </ul>
Income Statement		<ul style="list-style-type: none"> <li>• Amortize asset SL or increasing depreciation</li> <li>• Amortize obligation interest method or SL</li> </ul>	<ul style="list-style-type: none"> <li>• Straight line revenue on providing space</li> <li>• Straight line depreciation</li> <li>• Interest expense on debt</li> </ul>
	Interest rate	<ul style="list-style-type: none"> <li>• <i>Calculate</i> using assumed residual value</li> </ul>	<ul style="list-style-type: none"> <li>• N/A – use actual interest expense of debt</li> </ul>
	Interest item	<ul style="list-style-type: none"> <li>• Amortizing or straight line interest expense</li> </ul>	<ul style="list-style-type: none"> <li>• N/A</li> </ul>
	Depreciation expense	<ul style="list-style-type: none"> <li>• Reverse amortizing or Straight line</li> </ul>	<ul style="list-style-type: none"> <li>• Straight line</li> </ul>
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<b>Standalone single tenant building with Fixed Price Purchase Option (FPPO)</b>		<ul style="list-style-type: none"> <li>• Finance Model</li> </ul>	<ul style="list-style-type: none"> <li>• Transfer Model (Existing Direct Finance Lease or Sales Type Lease) for all leases</li> </ul>
	Balance Sheet	<ul style="list-style-type: none"> <li>• Capital asset; evaluate purchase option for exercise separately</li> </ul>	<ul style="list-style-type: none"> <li>• Lease payments receivable</li> <li>• Residual value equal to purchase option</li> <li>• Unearned finance income</li> </ul>
	Income statement	<ul style="list-style-type: none"> <li>• Depreciate capitalized asset</li> <li>• Amortize liability using interest method</li> </ul>	<ul style="list-style-type: none"> <li>• Finance income amortization</li> </ul>
	Interest rate	<ul style="list-style-type: none"> <li>• Calculate using FPPO as final payment</li> </ul>	<ul style="list-style-type: none"> <li>• Calculate using FPPO as final payment</li> </ul>

## ICSC Responses to Specific Questions

**Question 1**

The boards tentatively decided to base the scope of the proposed new lease accounting standard on the scope of the existing lease accounting standards. Do you agree with this proposed approach?

If you disagree with the proposed approach, please describe how you would define the scope of the proposed new standard.

**Answer 1**

We disagree with the proposed scope insofar as it includes leases of stores in malls. We believe such leases should be scoped out of the new lease standard and handled separately.

**Question 2**

Should the proposed new standard exclude non-core asset leases or short-term leases?

Please explain why. Please explain how you would define those leases to be excluded from the scope of the proposed new standard.

**Answer 2**

We believe that certain short-term leases should be excluded from the scope of the proposed new standard, provided such short-term leases do not include tenant provided residual value guarantees used as a means of circumventing the intent of the scope limitation. For instance, we would consider excluding leases with terms of one year or less and which do not have a material effect on the financial statements, provided the lease structure does not contain a residual value guarantee. If a residual value guarantee is included, the lease should be capitalized and the nature and extent of the guarantee should be disclosed in the footnotes to the financial statements.

**Question 3**

Do you agree with the boards' analysis of the rights and obligations, and assets and liabilities arising in a simple lease contract? If you disagree, please explain why.

**Answer 3**

This is not a simple question to answer. In the context of a tenant leasing equipment, we agree that the *right to use* is an asset and the *obligation to pay rent* is a liability, however we believe that the expense recognition pattern to be followed should vary based on the nature of the lease. In the context of a lessor, we believe that the *rights to receive rents* are an asset for a newly established lease, however when an asset is acquired which is subject to an existing lease, the purchaser is acquiring both the asset and the lease, and these facts need to be considered so as to avoid a "double-counting" of the asset.

In the context of tenants of a store within a mall, we believe that the *right to use* is not an asset. If the property is a standalone single tenant property and the lease does not contain a fixed price purchase option, we believe that the *right to use* is an asset and the *obligation to pay rent* is a liability, however the expense recognition pattern should be recorded on an overall straight line basis. In the case of a lease of a standalone single tenant building where the tenant has a fixed price

purchase option, we believe the tenant has a *right to use* asset and *obligation to pay rent* to be accounted for under the *transfer model*.

#### **Question 4**

The boards tentatively decided to adopt an approach to lessee accounting that would require the lessee to recognize:

- (a) an asset representing its right to use the leased item for the lease term (the right-of-use asset)
- (b) a liability for its obligation to pay rentals.

Appendix C of the Discussion Paper describes some possible accounting approaches that were rejected by the boards. Do you support the proposed approach? If you support an alternative approach, please describe the approach and explain why you support it.

#### **Answer 4**

We support the basic approach of reporting a *right to use asset* and *obligation to pay rentals*, however we believe this approach is applicable only for equipment and a standalone single tenant building. We do not agree such an approach is appropriate for leases of stores within malls.

#### **Question 5**

The boards tentatively decided not to adopt a components approach to lease contracts. Instead, the boards tentatively decided to adopt an approach whereby the lessee recognizes:

- (a) a single right-of-use asset that includes rights acquired under options
- (b) a single obligation to pay rentals that includes obligations arising under contingent rental arrangements and residual value guarantees.

Do you support this proposed approach? If not, why?

#### **Answer 5**

Yes, insofar as the inclusion of contingent rent amounts are handled according to the cause of the contingent rent and consistent with the approach currently followed by FAS 13. We have explained our approach above and believe that contingent rents fall into several categories that may or may not add to the obligation to pay rent.

For instance, contingent rent attributable to changes in an underlying interest rate should not be a factor that changes the obligation to pay rent or the capitalized right to use asset value, but should be accrued when incurred and charged to expense, provided the basis for measuring such contingent rent is reasonable. These standards and approaches have already been substantially vetted in existing US lease accounting literature. Contingent rent attributable to excess usage of the asset should likewise be charged to expense when incurred. We do not believe excess usage adds to the value of the underlying asset, and in fact will act to diminish the value of the asset more rapidly.

#### **Question 6**

Do you agree with the boards' tentative decision to measure the lessee's obligation to pay rentals at the present value of the lease payments discounted using the lessee's incremental borrowing rate?

If you disagree, please explain why and describe how you would initially measure the lessee's obligation to pay rentals.

**Answer 6**

Yes, insofar as the underlying lease represents a *right to acquire ownership* of a standalone single tenant building or equipment, as evidenced by the existence of a fixed purchase or renewal option.

No, insofar as the underlying lease is of a store within a mall and is merely a right to acquire the temporary use of property.

For leases of a standalone single tenant building where the lessee *does not have a fixed price purchase option* to acquire the ownership of the property and is merely acquiring the right to use it for a fixed period, we believe that the use of the lessee's incremental borrowing rate may create distortions in the obligation to pay rent obligation and the right to use asset value when compared to identical transactions recorded by lessees with substantially different incremental borrowing costs. Further, we believe that such a lease structure is not a financing per se but more akin to a straight line rental of the property. . While we acknowledge the FASB's desire to record the obligation on the lessee's balance sheet, we believe that the income recognition pattern materially distorts the true economic substance of the transaction.

**Question 7**

Do you agree with the boards' tentative decision to initially measure the lessee's right-of use asset at cost? If you disagree, please explain why and describe how you would initially measure the lessee's right-of-use asset.

**Answer 7**

Yes, provided the cost does not exceed the fair value of the asset at the time of measuring the value and limited to the lease of equipment or a standalone single tenant building.

**Question 8**

The boards tentatively decided to adopt an amortized cost-based approach to subsequent measurement of both the obligation to pay rentals and the right-of-use asset.

Do you agree with this proposed approach? If you disagree with the boards' proposed approach, please describe the approach to subsequent measurement you would favor and why.

**Answer 8**

Yes, however when the lease does not represent a financing, we believe that the amortization of the right to use asset should not be in a straight line approach but should be in a manner which when combined with the interest method used to amortize the obligation to pay rents, produces a level expense.

**Question 9**

Should a new lease accounting standard permit a lessee to elect to measure its obligation to pay rentals at fair value? Please explain your reasons.

**Answer 9**

No. We do not believe presenting a contractual obligation to pay rents at a fair value is representative of either the nature of the obligation nor of the value of the obligation. Leases are

non-cancelable obligations, so the lessee could neither terminate the lease, other than based on the conditions in the lease, nor assign it to another party without recourse and the permission of the lessor.

Further, lessees with poor credit ratings high incremental borrowing rates would report lower obligations to pay rent while lessees with better credit ratings and lower incremental borrowing rates would report higher obligations to pay rents.

Lastly, if a lessee desired to terminate a lease early, they would be required to pay a termination fee or breakage cost that would usually offset any fair value adjustment.

### **Question 10**

Should the lessee be required to revise its obligation to pay rentals to reflect changes in its incremental borrowing rate? Please explain your reasons. If the boards decide to require the obligation to pay rentals to be revised for changes in the incremental borrowing rate, should revision be made at each reporting date or only when there is a change in the estimated cash flows? Please explain your reasons.

### **Answer 10**

No. The actual obligation to pay rent has not changed and the theoretical financing rate has not changed. In a fixed rate lease where the rentals are based on a uniform dollar amount, the underlying financing rate is also fixed during the lease term. Assuming that the underlying financing rate has changed is tantamount to believing that the arrangement can be refinanced at a different rate. Fixed rate leases always include breakage charges to terminate the lease, and any lessor would include such a charge if the lessee requested a rent adjustment to reflect changes in current interest rates.

### **Question 11**

In developing their preliminary views the boards decided to specify the required accounting for the obligation to pay rentals. An alternative approach would have been for the boards to require lessees to account for the obligation to pay rentals in accordance with existing guidance for financial liabilities. Do you agree with the proposed approach taken by the boards? If you disagree, please explain why.

### **Answer 11**

We agree insofar as the underlying lease provides the lessee with the potential for ownership rights as evidenced for instance by the existence of a purchase option in the lease. As stated above in Answer 10, a lease financing is unlike an outright financing in that a leased asset contains numerous encumbering features that limit the flexibility for the lessee.

### **Question 12**

Some board members think that for some leases the decrease in value of the right-of-use asset should be described as rental expense rather than amortization or depreciation in the income statement. Would you support this approach? If so, for which leases? Please explain your reasons.

**Answer 12**

No. Rent expense is generally viewed as a component of cash flows and not adjusted for when measuring EBITDA. Classifying this charge as rent would mean that only the interest component is entered into the determination of EBITDA. We believe that the decrease in the right to use asset value should be reflected as either depreciation or amortization as the case may be.

**Question 13**

The boards tentatively decided that the lessee should recognize an obligation to pay rentals for a specified lease term, i.e., in a 10-year lease with an option to extend for five years, the lessee must decide whether its liability is an obligation to pay 10 or 15 years of rentals. The boards tentatively decided that the lease term should be the most likely lease term.

Do you support the proposed approach? If you disagree with the proposed approach, please describe what alternative approach you would support and why.

**Answer 13**

No. The most likely lease term injects an unacceptable level of management subjectivity into the analysis. The decision to renew a lease is made at a future date, not at the time the lease is entered into. In negotiating a lease term, a lessor will weigh the term of the lease with their expectation as to their ability to recoup the residual value of the asset should the asset be returned. The initial measurement point is the base lease term. The lessee seeks this minimum term so that they can have the flexibility to actually return the asset at that time, and in fact many lessees do exactly that. We believe the lease term should be defined as the minimum lease term in a manner consistent with FAS 13. Any lessee guarantees, lease payments or termination penalties would be added to the lease payments or affect the lease term in a manner similar to that found under FAS 13.

**Question 14**

The boards tentatively decided to require reassessment of the lease term at each reporting date on the basis of any new facts or circumstances. Changes in the obligation to pay rentals arising from a reassessment of the lease term should be recognized as an adjustment to the carrying amount of the right-of-use asset. Do you support the proposed approach?

If you disagree with the proposed approach, please describe what alternative approach you would support and why.

Would requiring reassessment of the lease term provide users of financial statements with more relevant information? Please explain why.

**Answer 14**

No. Reassessment of the most likely lease term would provide for too much subjectivity on the part of management and ignores the contractual terms and conditions of the lease.

If the facts and circumstances of the lease indicate that sufficient economic compulsion exists which lead to a *reasonably certain* conclusion that the lease will be renewed for another minimum term, then the lessee should record the facts as if a new lease agreement has been entered into, in a manner similar to that defined within the definition of a bargain purchase option under FAS 13. We believe that at that time, a new lease agreement is being entered into and the existing asset and obligation should be de-recognized and replaced with the new values of the new lease agreement.

**Question 15**

The boards tentatively concluded that purchase options should be accounted for in the same way as options to extend or terminate the lease. Do you agree with the proposed approach?

If you disagree with the proposed approach, please describe what alternative approach you would support and why.

**Answer 15**

No. We believe that the decision to exercise a purchase option is rendered when it occurs. If the purchase option is defined as a bargain, then that amount should be included in the initial lease measurement. Using a probability weighted approach or most likely approach provides too much subjectivity in the measurement process.

**Question 16**

The boards propose that the lessee's obligation to pay rentals should include amounts payable under contingent rental arrangements. Do you support the proposed approach?

If you disagree with the proposed approach, what alternative approach would you recommend and why?

**Answer 16**

No. Existing literature deals with the measurement of contingent rent. If a so-called contingent rent is determined to be reasonably certain to be paid, then it isn't really a contingent rent and accountants will require that these amounts be included in the measurement of the minimum lease payments under existing FAS 13 standards. At the time a contingent rent adjustment is identified, we believe that such amounts may be measured but should not be added to the obligation to pay rent or the right to use asset value, but should be charged or credited to expense as incurred. These items do not add to the value of an asset.

**Question 17**

The IASB tentatively decided that the measurement of the lessee's obligation to pay rentals should include a probability-weighted estimate of contingent rentals payable. The FASB tentatively decided that a lessee should measure contingent rentals on the basis of the most likely rental payment. A lessee would determine the most likely amount by considering the range of possible outcomes. However, this measure would not necessarily equal the probability-weighted sum of the possible outcomes. Which of these approaches to measuring the lessee's obligation to pay rentals do you support? Please explain your reasons.

**Answer 17**

Neither – By definition a rent is contingent because it is uncertain. If a portion of so called contingent rent becomes certain, then it should be recognized at that time.

**Question 18**

The FASB tentatively decided that if lease rentals are contingent on changes in an index or rate, such as the consumer price index or the prime interest rate, the lessee should measure the obligation to pay rentals using the index or rate existing at the inception of the lease.

Do you support the proposed approach? Please explain your reasons.

**Answer 18**

Yes. To the extent the lease represents a financing type of lease that conveys potential ownership rights, lessees may choose to finance the underlying asset using either a fixed or floating rate funding in a fashion similar to how they may choose to finance the acquisition of the asset itself.

**Question 19**

The boards tentatively decided to require remeasurement of the lessee's obligation to pay rentals for changes in estimated contingent rental payments. Do you support the proposed approach? If not, please explain why.

**Answer 19**

No. We do not believe that normal non-permanent changes in contingent rent amounts should be reflected in a change in the obligation to pay rentals, unless the initial estimate of the contingent rental amounts was materially in error and should have been recorded at the inception of the lease and also been included in the capitalized right to use asset value.

**Question 20**

The boards discussed two possible approaches to recognizing all changes in the lessee's obligation to pay rentals arising from changes in estimated contingent rental payments:

- (a) recognize any change in the liability in profit or loss
- (b) recognize any change in the liability as an adjustment to the carrying amount of the right-of-use asset.

Which of these two approaches do you support? Please explain your reasons. If you support neither approach, please describe any alternative approach you would prefer and why.

**Answer 20**

We do not believe that contingent rentals are one-dimensional. Rather we believe that the treatment of contingent rentals depends on the cause of the contingent rent which thus dictates the treatment of the item.

**Question 21**

The boards tentatively decided that the recognition and measurement requirements for contingent rentals and residual value guarantees should be the same. In particular, the boards tentatively decided not to require residual value guarantees to be separated from the lease contract and accounted for as derivatives. Do you agree with the proposed approach? If not, what alternative approach would you recommend and why?

**Answer 21**

Yes. We believe that these items represent a contingent guarantee similar to those identified under FIN 45. To the extent the guarantee is delinked to the specific asset value, then derivative accounting may be applicable, however traditional residual value guarantees usually take a more straight forward approach, for instance for those provided in vehicle TRAC leases.

We do believe that when a residual value guarantee is provided for 100% of the residual value, or for a substantial portion of the residual value, then consideration should be incorporated which

require the asset be capitalized at 100% of its value. To the extent the residual value guarantee is for a lesser first-loss amount (i.e. the first 10%) and the lessee is not legally obligated for anything but that first-loss, and it appears reasonable that the lessee may accept paying that amount, then such amount may be considered as a termination option and included in the capitalized amount based on an estimate of its fair value.

**Question 22**

Should the lessee's obligation to pay rentals be presented separately in the statement of financial position? Please explain your reasons. What additional information would separate presentation provide?

**Answer 22**

Yes. The obligation to pay rents is not an absolute obligation consistent with an obligation to pay back debt. Depending on the lease form, in bankruptcy a lessee may accept or reject a lease in which case the full absolute amount of the lease may not become an obligation of the lessee. This distinction is particularly evident in the airline industry where the obligation under leases can be treated differently than pure debt.

**Question 23**

This chapter describes three approaches to presentation of the right-of-use asset in the statement of financial position. How should the right-of-use asset be presented in the statement of financial position? Please explain your reasons.

What additional disclosures (if any) do you think are necessary under each of the approaches?

**Answer 23**

We believe that the right to use asset should be segregated from assets which are owned by the entity or which are capitalized under a financing type of lease. Under the financing type of lease as we propose it, the lessee has the option to acquire the asset by exercising a fixed price purchase. Since the purchase price is predetermined, the lease takes on the characteristic of a condition purchase.

**Question 24**

Are there any lessee issues not described in this discussion paper that should be addressed in this project? Please describe those issues.

**Answer**

As discussed above.