Wendy's International, Inc.

Tim Hortons. Wendy's Baja Fresh Mexican Grill Cafe Express

Via e-mail to director@fasb.org

Letter of Comment No: 17
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Director, TAI - FSP
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Proposed FASB Staff Position ("FSP"), No. FAS 13-b, Accounting for Rental Costs Incurred during a Construction Period

Wendy's International, Inc. (the "Company") appreciates the FASB staff addressing this issue and the opportunity to provide comments on the above referenced FSP. The Company, however, disagrees with the conclusions of the proposed FSP because:

- Lease costs recognized during the construction period of a restaurant on leased property are incremental costs incurred by a company for the purpose of constructing long lived assets.
- It is the nature and purpose for which costs are incurred, not the cost itself, that determine whether costs should be capitalized or expensed. For restaurant companies, incremental lease costs are incurred for the purpose of constructing new long lived assets.
- Financing decisions with similar economic characteristics should not have substantively different accounting treatments.
- Expensing all operating lease payments is contrary to guidance provided in Statement No. 67.

In addition to the above, and assuming the FASB staff agrees with the generally accepted interpretation that rental costs can be capitalized during the development of property under the scope of Statement No. 67, the Company requests that, as part of its deliberations on the above referenced FSP, the FASB staff also considers and provides guidance on the capitalization of rental costs under the two scenarios outlined on page five.

Rationale supporting the Company's view follows.

Lease costs recognized during the construction period of a restaurant on leased property are incremental costs incurred by a company for the purpose of constructing long lived assets.

Lessees that do not need to construct leasehold improvements will rent leased space for a shorter period of time than lessees that need to make extensive leasehold improvements. As a result, the former will pay less rent to operate its business from the leased site for a given period of time than the lessee requiring time to construct extensive leasehold improvements. Obviously, lessors charge rent for the period of time a lessee is granted control of the property, including the construction period.

As the FASB staff is aware, FTB 85-3 requires rent to be recognized generally on a straight line basis consistent with the time pattern in which the leased asset is physically employed. Under FTB 85-3, the straight line rent recognition also applies to "rent holiday" periods. It is the Company's experience that substantially all lessors include a "rent holiday" period at the beginning of the lease while the Company constructs leasehold improvements required to develop leased property for its intended use. If a company desires to operate a restaurant at a leased site for ten years, it must rent the site for ten years plus the period of time required to make to ready the site for its intended use – thereby incurring additional rent costs during the construction period (e.g. three months).

The Company incurs additional rent cost only for the purpose of constructing long lived assets. This is not only economically and intuitively correct, but consistent with the straight line premise underlying FTB 85-3 for the treatment of "rent holiday" periods.

It is the <u>nature and purpose</u> for which costs are incurred, not the cost itself, that determine whether costs should be capitalized or expensed. For restaurant companies, incremental lease costs are incurred for the purpose of constructing new long lived assets.

Currently, the determination of whether a cost should be capitalized or expensed under U.S. GAAP is dependent on the nature and purpose for which the cost is incurred. The conclusion reached in the proposed FSP, however, focuses only on the right to control an asset, but not the nature or purpose for which a leased asset is employed. This is contrary to numerous examples in established U.S. GAAP where the nature and purpose of the expense, and not the expense itself, determine when amounts are capitalized or expensed. For example:

- Interest expense incurred during a construction project is capitalized. Interest expense incurred to fund ongoing operations is expensed. As stated in paragraph 7 of Statement No. 34, one of the primary objectives in reaching the conclusion to capitalize interest is ".

. . to obtain a measure of acquisition cost that more closely reflects the enterprise's total investment in the asset . . .".

- Shipping costs incurred to put a new long lived asset into production is capitalized. Shipping costs incurred to move inventory from one warehouse to another warehouse is often expensed.
- The cost to lease a helicopter to lift steel girders for the construction of a skyscraper is capitalized. The cost to lease a helicopter to transport employees from one location to another is expensed.
- Property and insurance costs incurred while preparing a real estate project to be rented are capitalized. Property and insurance costs incurred after a real estate project is rented are expensed.
- Costs related to contractors to build a manufacturing plant are capitalized. Costs related to the same contractors to maintain the manufacturing plant are expensed.
- Lease payments for leases that meet the capital lease criteria of Statement No. 13 are capitalized. Except for the issue being addressed by this FSP, lease payments for operating leases under Statement No. 13 are expensed.

Instead of looking to the nature and purpose for which the leased asset is employed, the conclusion reached in the proposed FSP looks only to the right to use the leased asset. All of the above well established examples within U.S. GAAP include the right to use assets. It is not "the right to use" each of the assets that determines the capital versus lease classification.

In the case of a restaurant company, improvements made to any building space (whether owned or leased) are extensive and include all of the necessary expenditures to construct and install a full kitchen, refrigeration units, dining facilities and often a full bar. As a result, a restaurant company makes such substantive improvements that the finished space is almost indistinguishable from the original space being leased, with leasehold improvement expenditures sometimes approaching or exceeding the cost to originally construct the space being leased. These significant expenditures are necessary to transform the leased space from entirely unusable for its intended use to usable. Clearly for a leased site, the incremental lease costs incurred during the construction of a restaurant are necessary for the construction of long lived assets.

Financing decisions with similar economic characteristics should not have substantively different accounting treatments.

If a company decides to purchase a real estate location, FASB Statement No. 34, *Capitalization of Interest Costs*, generally requires the capitalization of interest cost that theoretically could have been avoided during a construction period. The decision to enter into a lease is also a financing decision that involves the time value of money and interest. The Company does not understand why a theoretical interest cost related to debt should be included in an asset's capitalized value under FASB Statement No. 34, while a very tangible financing expense paid for in cash (rent) should not be included in the same asset's capitalized value - particularly since both types of costs share similar financing and interest characteristics. That is, if interest is (correctly) considered a component of an enterprise's investment in an asset when an asset is purchased, the Company does not understand why similar holding and finance costs should not be considered as a component of an enterprise's investment simply because a different financing decision is made.

Expensing all operating lease payments is contrary to guidance provided in Statement No. 67.

Paragraphs 6 and 7 of FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, states, *"Costs incurred on real estate for property taxes and insurance shall be capitalized as property cost only during periods in which activities necessary to get the property ready for its intended use are in progress."* The FASB staff is hopefully aware that most interpretations of Statement No. 67 include the capitalization of rent costs based on guidance provided for property taxes and insurance costs. The conclusion in the proposed FSP is contrary to Statement No. 67 unless it is the intention of the FASB staff to provide a distinction between property taxes, property insurance and property rents. All three costs relate to "the right to use a leased asset". If the conclusions in the proposed FSP are included in the final FSP, the Company believes it appropriate that the accounting treatment for lease costs under Statement No. 67 also be addressed by the FSP.

Clarification is required on the application of Statement No. 67 relative to rental costs when preparing real estate to be leased.

Assuming the FASB staff agrees with the generally held interpretation that rental costs can be capitalized during the development of property under the scope of Statement No. 67, the Company requests that, as part of its deliberations on the above referenced FSP, the FASB staff also considers and provides guidance on the capitalization of rental costs under the two scenarios outlined below.

Paragraph 22 of Statement No. 67 states:

> *"A real estate project shall be considered substantially completed and held available for occupancy upon completion of tenant improvements by the developer but no later than one year from the cessation of major construction activities (as distinguished from activities such as routine maintenance and cleanup)."*

In the above referenced Statement No. 67 excerpt, it is clear that costs may be capitalized during the construction of leasehold improvements necessary to rent the property. However, questions have arisen in the application of Statement No. 67 that can be illustrated using two scenarios.

<u>Scenario 1</u>
Under this scenario, a restaurant franchisor enters into a ground lease with a landlord and constructs a building on the leased land and makes all necessary tenant improvements in order for the property to be rented to a franchisee.

<u>Scenario 2</u>
Under this scenario, the same restaurant franchisor enters into a lease of a building (consisting essentially of a structural building shell) and the franchisor constructs all necessary tenant improvements including, a full kitchen, refrigeration units, a full bar and dining facilities in order for the property to be rented to a franchisee.

Under the first scenario, most appear to agree that Statement No. 67 supports the capitalization of rental costs during construction of both the building structure and necessary interior restaurant improvements. There is disagreement, however, as to whether rental and other costs can be capitalized by the franchisor under the second scenario.

Paragraph 22 and the summary to Statement No. 67 clearly define a rental project, during which time costs can be capitalized, to include the completion of tenant improvements. Questions related to the classification of costs under scenario 2 appear to revolve around whether the franchisor can be considered the "developer" under paragraph 22. If the franchisor is the "developer", costs may be capitalized. If the franchisor is not the "developer", some believe Statement No. 67 does not allow capitalization of rent and other costs.

To date, the distinction as to whether the franchisor in the above two scenarios is a "developer" seems rather arbitrary. Most of the costs and activities to prepare the location for its intended use under both scenarios are identical and the franchisor is certainly developing real estate for the purpose of renting it. Some have pointed to Illustration 3 of SOP 98-5 to support the view that rental costs should not be capitalized under scenario 2. However, paragraph 43 of SOP 98-5 clearly states that the guidance in Statement No. 67 is not affected by the SOP.

The Company believes a franchisor operating under both scenario 1 and scenario 2 meets the substantive intent and spirit of real estate developer developing real estate projects intended to be within the scope of Statement No. 67, but requests clarification from the FASB staff as to the classification of rental costs incurred.

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Given the significant expenditures and substantive improvements made by restaurant franchisors to leased space, the Company believes capitalization of rental costs during the construction period is supported by well established principles of U.S. GAAP and reflects the economic substance and cost to construct long lived assets. We appreciate the opportunity to express our views and concerns on this topic and would be happy to supplement our comments in writing or discussion at your request.

Respectfully Submitted,

Dan Boone

Daniel L. Boone
Senior Vice President, General Controller