

Financial Accounting Standards Board  
Technical Director - File Reference No. 1850-100  
Financial Accounting Standards Board  
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International Accounting Standards Board  
30 Cannon Street  
London, EC4M 6XH  
United Kingdom

**Re: Proposed Accounting Standards Update, Topic 840: *Leases*; issued August 17, 2010**

Dear Board Members:

This letter represents the Real Estate Information Standards Board's (REIS Board) comments to the Financial Accounting Standards Board (the "FASB") regarding the exposure draft, *Leases*, jointly issued by the Financial Accounting Standards Board and the International Accounting Standards Board (the "Boards"). Our comments also reference the anticipated release of the FASB's exposure draft on the proposed accounting for *Investment Properties*. In our opinion, it is imperative that the FASB release an Investment Properties exposure draft in a timely manner so that it can be assessed in conjunction with the impact of the proposed lease accounting rules on the real estate industry. We request that the issuance and effective dates of the proposed standards be aligned.

We appreciate the opportunity provided by the Boards to comment on the exposure draft. We elected to do so in a format that includes a summary of our thoughts and concerns regarding the anticipated impact on our industry, as well as individual responses to the nineteen questions provided in the exposure draft which are contained at the end of this document. Our answers to these questions are prefaced by an overview of REIS, its mission, and a detailed explanation of our opinion regarding the impact of the exposure draft on lessors and lessees within our industry.

**REIS Overview:**

The Real Estate Information Standards (REIS) organization is co-sponsored by the National Council of Real Estate Investment Fiduciaries (NCREIF) and the Pension Real Estate Association (PREA).

NCREIF was established to serve the institutional real estate investment community as a non-partisan collector, processor, validator and disseminator of real estate performance information. NCREIF is a not-for-profit trade association representing institutional real estate investors and professionals, including investment managers, major pension funds, endowments, sovereign wealth funds, accountants, property appraisers, consultants, research analysts, and academics, who share a common interest for improved financial reporting, performance measurement, investment analysis, information standards (through its sponsorship of REIS), and education for the institutional real estate investment community. NCREIF produces several quarterly indices that show real estate performance returns using data submitted by its data contributing members, most notably the NCREIF Property Index (NPI) and the NCREIF Open-end Diversified Core Equity Index (ODCE). The NPI consists of approximately 10,000 investment properties with fair value of over \$300 billion. U.S. GAAP (“GAAP”) financial statements for the funds in this community are reported on a fair value basis.

PREA is a non-profit trade association for the global institutional real estate investment industry. PREA’s mission is to serve its members engaged in institutional real estate investment through the sponsorship of objective forums for education, research initiatives, membership interaction and the exchange of information. PREA currently lists over 600 corporate member firms across the United States, Canada, Europe and Asia. Its members include public and corporate pension funds, endowments, foundations, Taft-Hartley funds, insurance companies, investment advisory firms, REITs, developers, real estate operating companies and industry service providers.

The REIS standards were first published in 1995 in collaboration with NCREIF and PREA in order to provide standards for calculating, presenting and reporting investment results to the industry. The REIS Board is an established body which serves as the official governing body of REIS and provides leadership and expertise in establishing REIS as authoritative and verifiable for the institutional investment industry. The REIS Council is responsible for establishing transparency and open involvement in the REIS process and for communicating its activities to the industry,

The REIS standards represent an effort to codify a single set of desired industry practices and to improve standardization of valuation procedures, fair value financial accounting and reporting and reporting of investment performance return information. The REIS standards play an important part in the overall efficiency of the real estate investment industry as consistency, comparability, and transparency are critical for investment managers to make prudent investment decisions regarding their investments, investment managers and the asset class. The REIS standards depend upon, and are intended to supplement and in some cases, clarify, but not replace other established standard setting bodies including, but not limited to, valuation standards established through the Uniform Standards of Professional Appraisal Practice (USPAP), accounting standards established

by Generally Accepted Accounting Principles (GAAP) and the performance measurement and reporting standards known as the Global Investment Performance Standards (GIPS).

Through its ongoing collaboration, REIS and the NCREIF organizations' teams can provide critical insights into the information and reporting needs of the entire private institutional equity real estate investment industry including the perspectives of investors, investment managers, consultants, academics and related service providers.

In 1983, in response to the needs of the investor community, the NCREIF Accounting Committee developed guidelines for fair value accounting to be used by the institutional real estate investment industry. These guidelines, known as the REIS Fair Value Accounting Policy Manual are continuously reviewed and updated to align with changes to GAAP. The fundamental premise for fair value is based on existing U.S. accounting standards identified in Accounting Standards Codification ("ASC") Topic 960, *Plan Accounting – Define Benefit Pension Plans* (i.e. former FASB Statement of Financial Accounting Standards No. 35) and Governmental Accounting Standards Board ("GASB 25"), Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, which require that certain investments held by tax-exempt investors, including defined benefit pension plans and endowments be reported at fair value. For example, Topic 960 which applies to corporate plans, requires that all plan investments be reported at fair value because that reporting provides the most relevant information about the resources of a plan and its present and future ability to pay benefits when due. In addition, GASB 25 requires government-sponsored pension plans to present investments at fair value in their financial statements. Defined benefit and government-sponsored pension plans often invest in real estate and/or real estate companies. Accordingly, the more traditional historical cost basis of accounting used by other real estate companies, owners, and operators is not appropriate; as it does not provide tax-exempt investors with the financial information they require to comply with authoritative accounting standards and is not viewed as a faithful representation of their investment activity.

Additionally, over the years, investments made by fund managers have become increasingly complex and it has become apparent that many of these funds have attributes similar to those of an "investment company," as set forth in Topic 946, *Financial Services – Investment Companies*, (former AICPA Audit and Accounting Guide: *Investment Companies*). This authoritative guidance supports the use of a fair value accounting model for those real estate funds that have the attributes of an investment company, but does not apply to Real Estate Investment Trusts which continue to report directly-owned real estate at depreciated cost.

**Our Opinion on the Proposed Lease Accounting:**

Although we recognize and appreciate the overall objectives of the Boards which include the improvement of financial statement transparency, provision of a principles-based set of standards, and alignment of lease accounting with the Boards' conceptual framework as it applies to the definitions of assets and liabilities, we think the accounting for lessors proposed in the exposure draft, *Leases*, would distort the financial statements within our industry, rather than increase comparability and transparency. Real estate property assets are unique compared to other leased assets such as machinery and equipment as each asset typically has multiple lessees, values may appreciate over time, rather than only depreciate and are actively managed. . It is our view that the fair value reporting currently performed by lessors within our industry is a faithful representation of the economics of real estate investing, providing investors with reliable information upon which to make an informed investment decision and therefore lessor accounting for leases of real estate held for investment should be excluded from its scope. We also think the accounting proposed for both lessors and lessees may have significant unintended negative consequences to the business fundamentals of investing in real estate.

Our concerns and comments regarding real estate lessor accounting are as follows:

1. In order to meet institutional investors' needs and requirements, our industry has applied a fair value reporting model for investment properties under the accounting guidelines currently contained in ASC Topic 946 or ASC Topic 960 for almost 30 years. We are familiar with the comment letter, dated July 15<sup>th</sup>, 2009, submitted to you from the European Public Real Estate Association ("EPRA") on the joint Discussion Paper; *Leases-Preliminary Views*. The letter outlines strong views as to why lessor accounting for leases of real estate held for investment and reported at fair value should be excluded from the scope of the proposed new lease accounting. The U.S. institutional real estate investment community currently reporting on a fair value basis faces these same issues. We agree with the opinions expressed in the EPRA letter and would like to specifically draw your attention to the following joint concerns detailed in it:
  - Real estate is fundamentally different from other leased assets. The right to benefit from demand to occupy the space above or below ground on a specified plot is unlimited by time. The requirement for active asset management and its diverse nature distinguishes the real estate investment industry from leased equipment and financial assets.
  - Bifurcating the recognition and measurement of the fair value of an investment property into a financial asset (right to receive lease payments) and a non-financial asset (real estate asset), together with the proposal to reflect a component of the income by an interest credit, is far removed from the

business fundamentals of an investment property company or other entity which pursues real estate investment. In our view, these proposals would result in financial statements from which the industry-wide key performance indicators could not be extracted. For example, NPI component (i.e. income and appreciation) returns may not be comparable pre and post the proposed changes. To the extent these changes result in a shift between income and appreciation, comparability may be compromised.

- There are many precedents within GAAP where symmetry is not applied for good reason. The fact that tenants (lessees) and property owners (lessors) view leases very differently, leads to the conclusion that symmetry of accounting by lessees and lessors of investment property leases may not be appropriate.
- Reporting investment property at fair value and recording income on an accrual basis accurately depicts the economic characteristics of an investment property, the presentation of rental income, and fair value of the tangible real estate. These methods provide a valuable and widely supported approach for evaluating investment property performance in the light of changing market values for rents and valuation yields, and enables meaningful financial analysis to be undertaken.

The REIS organization also supports the FASB's anticipated release of a proposed update that would require investment properties to be reported at fair value under GAAP. We believe this proposed update should be analogous to IAS 40, *Investment Properties*, which in principle supports investment properties to be reported at fair value and would provide for such investment properties to be outside the scope of the proposed lessor accounting rules. We strongly urge the FASB to exclude investment properties reported at fair value from the scope of the proposed new lease accounting standard.

Additional reasons for our position are stated below:

- A convergence of GAAP with International Financial Reporting Standards ("IFRS"), specifically the reporting of investment properties at fair value under IAS 40 results in a consistent and informative basis of accounting for investment properties globally;
- A fair value accounting model improves the transparency of financial statements to investors by providing investment performance results indicative of current market conditions;
- The reporting of real estate investments at fair value result in a relevant measurement of a company's net asset value ("NAV") reported to investors;

- Investors with holdings in multiple asset classes can easily compare the performance results between real estate investments and other investments.
- Under a fair value accounting model a property's operating results are reported based on accrued rental income and managed expenses directly correlated to the property's day to day operations, performance metrics that are crucial to experienced real estate investors.

We will comment in detail on any proposed update regarding investment properties once the exposure draft is finalized and available for public comment. As indicated in the opening paragraph, if the finalization of the investment properties' exposure draft does not align with the finalization of the lease exposure draft, we request the effective date for applying the provisions of both be aligned. If the effective dates cannot be aligned, we urge the FASB to provide a temporary deferral for real estate lessors until such time as the investment properties' accounting guidance is also finalized.

2. As stated above, our industry reports investment property at fair value, which includes recording rental income on an accrual basis. Reporting a receivable asset under the right-to-use model on a lessor's balance sheet in addition to reporting the related leased investment property at fair value would, without adjustment, result in the double-counting of future expected cash flows from leases, a dominant valuation input when valuing real estate under a discounted cash flow method. Under the *Uniform Standards of Professional Appraisal Practice*, the application of a discounted cash flow analysis when valuing real estate under the income approach has prevailed for many years, whether for determining fair value for mark-to-market accounting or when recording another-than-temporary-impairment under Topic 360, *Property, Plant and Equipment* (i.e. depreciated cost model). As our financial statements, including any leases, are already presented at fair value, any additional asset or liability associated with the leases of a lessor recorded and reassessed as proposed in the exposure draft would introduce an additional asset or liability that has no additional value. As such, the resulting asset or liability would need to be immediately recorded as an unrealized gain or loss. Additionally, this would have implications for existing industry performance measures that investors rely on.
3. Unlike other asset classes, real estate is an actively managed asset. Amongst other factors, a lessor enhances property values through the preservation of tenant relationships and the management of costs associated with the operation of a brick and mortar structure. The lessor's active management surrounding real estate distinguishes this asset class from other leasable assets (e.g. equipment) that are less actively managed on a daily basis. Accordingly, we believe a real estate lessor should account for leasing activity so that accrued rental income and

property expenses are reported “above the line”, and not as a component of interest below the line. Providing such key metrics allows real estate investors and analysts to appropriately assess property and lessor performance. In our opinion, the accrual of interest income and amortization of a performance obligation liability is more akin to accounting for a financial asset and not that of real estate (i.e. non-financial asset). Although our proposal for lessor accounting may not be symmetrical to that of a lessee under the right-to-use model we believe this is acceptable since the business objectives of a lessor and lessee are not symmetrical when entering into a lease agreement.

4. Under the “derecognition” approach, a lessor who does not maintain significant exposure to risks and rewards associated with the leased asset is required to derecognize a portion of the asset even though a legal sale has not occurred. Such a presentation in a lessor’s financial statements would indicate a partial sale or the transfer of a portion of the property’s value to the lessee. We are of the opinion that the derecognition concepts under this approach are inconsistent with the derecognition concepts for real estate sales under the standing authoritative guidance in Topic 360-20, *Property, Plant and Equipment - Real Estate Sales*. The proposed derecognition model is far different than the legal and economic substance of the transaction and will confuse financial statement readers unfamiliar with the concepts of real estate ownership. Regardless of lease terms, it is unlikely that an owner/lessor of real estate will transfer their legal responsibility for a property without legally transferring title, wholly or partially, to a third-party. If the lessor continues to be legally liable for the property that it owns, a partial derecognition of a property will be misleading to financial statement readers. From this prospective, we disagree that the derecognition approach is appropriate for real estate lessors when a sale has not occurred in accordance with Topic 360-20 and propose that the derecognition approach include a scope exception for real estate lessors. In our opinion, existing guidance in Topic 360-20 should be applied when derecognizing real estate.

In addition to specific real estate lessor related concerns stated above, we are also concerned with the overall potential impact to real estate leasing activity (i.e. lessees and lessors), as well as the industry as a whole as outlined below. The propensity on the part of lessees to enter into shorter term leases as outlined in item 4 below may have a profound effect on how real estate is typically viewed as a long-term investment. For example, insurance companies tend to allocate a portion of their General Account assets to equity and debt (i.e. mortgage lending) investments in real estate in order to sustain consistent returns to their policyholders and also as a hedge against inflation. If the long-term investment perception of real estate were to dissipate over time, we could begin to see a mass liquidation by investors who no longer view the returns on real estate to align with the associated risks of short term leases. The following issues specifically outline other concerns of our industry:

1. The Boards' seek to achieve financial statement transparency through the issuance of the proposed lease accounting rules. However, as these proposed rules are applied within the real estate industry the transparency objective could be compromised by inconsistent practices among reporting entities. The proposed method to determine expected lease terms and expected lease payments is highly subjective in that lessors and lessees must consider lease renewal options and variable rent components (e.g. contingent rent, index-based rent adjustments). Such a requirement will result in inconsistent methodologies in determining the probability of lease renewals and future rent adjustments. Additionally, we believe that the inclusion of potential renewals and variable rent components does not meet the definition of an asset or liability until lease term renewals become legally contractual and rent components are clearly identifiable. Accordingly, we request the Boards to reconsider their definition of lease term and lease payment and require that the determination of lease term and lease payment be solely determined by such terms and amounts that are contractually enforceable and clearly identifiable, respectively, on the reporting date. The determination of a lease term should not include a renewal period until both parties are contractually obligated to extend the lease term. We understand and appreciate the Boards' concern to discourage future lease negotiations that could result in one-year lease terms with multiple one-year renewal options as a means to minimize the assets and liabilities recorded under the proposed lease accounting rules. However, the attributes and rights associated with a real estate lease contract have a far greater economic and legal impact than most other leasing contracts given the liabilities associated with real estate ownership and occupancy. The process to identify a viable space appropriate for leasing, the process to enter into a lease contact, and the build-out of leasehold improvements are a costly endeavor to lessees and lessors. Such costs are substantiated by several important factors, including the merits of a long-term lease, and therefore the negotiation of a one-year lease with one-year renewal options in the commercial real estate industry is not a feasible action, nor an economically sound transaction in most cases.
2. The proposed lease accounting rules will result in a financial statement presentation that is inconsistent with the economics of a real estate lease transaction. The front-loading effect of income statement activity by both the lessor and lessee due to interest method of amortization is a true distortion of cash flow associated with real estate leasing activity. Furthermore, financial statement metrics (i.e. financial ratios) will be inappropriately impacted by the additional assets and liabilities recorded by lessees and lessors, as well as corresponding changes to the reporting of capital appreciation and income returns. The unintended breaching of debt covenants due to an increase in liabilities can cause borrowers (lessees or lessors) and lenders to enter into costly negotiations in order to cure such breaches.

3. Since lessees would recognize leases on a gross basis as assets for the right to use leased assets and liabilities for the required lease payments, we urge the Boards to provide additional guidance on distinguishing lease components from components which should not be treated as part of the lease. Although the presentation is net on the balance sheet, the “distinctive service” aspect also impacts the calculation by the lessors. We believe that a triple net lease whereby the tenant pays certain expenses of the property directly and a lease whereby a landlord is reimbursed for those expenses (i.e. common area maintenance, insurance, and property taxes) should be treated the same. That is, any reimbursements to the landlord of such expenses should be recognized as incurred and not considered part of rental revenues for calculation of the lease asset or liability.
4. Lessees will likely begin to negotiate lease terms in such a way that additional assets and liabilities required under the right-to-use lease model would be minimized. Potentially, such strategies could result in shorter lease terms than currently witnessed in today’s leasing market and a reduction in future variable rent components, which may not be in the best interest of the company and/or shareholders. Furthermore, lessors and lessees are less likely to invest substantially into tenant improvements with shorter lease terms, and the pending increase to annual amortization expense given an accelerated amortization period. We are concerned that in certain instances an accounting driven change in leasing strategies could have a negative economic effect unintended under the proposed rules. We caution the Boards in issuing guidance that will strongly encourage businesses to structure transactions to accommodate preferable accounting and not for the best long-term economic outcome.
5. With the potential for short-term leases, the valuation industry will surely be impacted from the perspective of real estate investors and lenders. Real estate appraisers may be faced with assessing the fair value of a property (i.e. income approach) based on shorter leases terms (e.g. 3-5 years) in comparison to today’s customary lease terms which on average range 7-15 years depending on several factors such as the size of the leased space. The valuation process may be forced to rely less on reliable valuation inputs such as in-place long-term leases and rely more on short-term leases and future estimates of potential leasing activity. Reduced contractual cash flows that result from short-term leases can impact the underwriting of an investment property from a lender’s perspective and decrease the amount of financing proceeds. Additionally, short-term leases could lead to frequent lessee turnover and result in additional leasing costs incurred by property owners in order to stabilize occupancy levels, which the lack thereof could have a back-end effect by destabilizing property values and creating unwanted volatility in the real estate market.
6. Under the right-to-use model lessees and lessors will incur significant incremental costs to acquire, implement and maintain software that can accommodate the new

accounting and reporting requirements under the proposed update. Additional staffing will be necessary for the on-going assessment and control over leasing activity to ensure compliance with the proposed update and appropriateness of adjusting entries. Retrospective accounting requirements for in-place leases will magnify these costs and resource issues beyond reasonable means. An institutional real estate Fund could own many properties and a single property alone can be occupied by over one-hundred tenants, resulting in thousands of leases that must be reviewed each reporting period to assess renewal options and variable rent components.

Our responses to the specific questions proposed in the exposure draft are included at Appendix 1 to this letter.

We welcome the Boards' significant outreach activities relating to this exposure draft, but believe they should be further extended to explore the lessor model, which has not been sufficiently evaluated. There does not appear to be evidence to show the existing lessor accounting model is broken or ineffective. The introduction of two potential lessor models increases the confusion under a principal-based set of rules and does not meet the goal of providing financial statement transparency or faithful representation to investors.

For the model to be operational, the principles and implementation guidance must be shown to work effectively for all types of leases. We believe that issues will surface through this field testing that will provide financial reporting that both distorts the economics of the transaction and does not provide decision-useful information to the financial statement reader. We would be pleased to discuss our comments above or the answers to the specific questions at Appendix 1 with you at your convenience. , Please feel free to contact the undersigned at 978-887-3750 should you wish to discuss the contents of this letter.

Very truly yours,

A handwritten signature in blue ink that reads "John J. Baczewski". The signature is written in a cursive style with a large initial "J".

John J. Baczewski  
Chair, Real Estate Information Standards Board

**Question 1: Lessees**

(a) Do you agree that a lessee should recognize a right-of-use asset and a liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

Response:

We disagree. As explained in detail above there can be unintended negative and material consequences to the real estate leasing industry as a result of the proposed lessee accounting rules. If the Boards elect to proceed with the proposed lease accounting rules, notwithstanding the concerns of its constituents, we urge the Boards to revisit their definitions of *lease term* and *lease payment* and consider limiting inputs to their determination based on contractual terms and omit proposed requirements to consider potential lease renewals and variable rent components.

(b) Do you agree that a lessee should recognize amortization of the right-of-use asset and interest on the liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

Response:

We disagree with the proposed requirements for lessees to record amortization and interest expense in place of rental expense. We indicated above that these accounting requirements are indicative of a finance arrangement when in fact a lessee has specifically entered into a lease to occupy real estate as an alternative to acquiring direct ownership of a property through a finance arrangement; financial statement metrics in our opinion are negatively impacted given the loss of reporting rental expense. Given the perpetuity associated with the economic life of land, as well as the economic useful life of a brick and mortar structure which can easily exceed forty-years, the average term of 7-15 years for a commercial real estate lease is not indicative of a finance arrangement to acquire property.

We urge the Boards to reconsider the proposed guidance and allow lessees to continue to report rental expense under the previous Accounting for Leases Standard (SFAS 13). Right-to-use assets and liabilities to make lease payments can be amortized, or reduced equally on an effective yield method. Although the lessee would not record amortization or interest expense in the financial statements such amounts can be disclosed in the audited footnotes accompanied by the incremental borrowing rate.

**Question 2: Lessors**

(a) Do you agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term and (ii) the derecognition approach otherwise? Why or why not? If not, what alternative approach would you propose and why?

Response:

We disagree that a real estate lessor should apply either approach described in parts (i) and (ii) of 2(a). As indicated above, we anticipate that the FASB will require lessors to report investment properties at fair value, and accordingly lessors of investment properties should be excluded from the proposed lease accounting rules. The fair value accounting model is indicative of true economics associated with investments in real estate and provides more valuable and useful information in comparison to a depreciated cost model, accompanied by the proposed lease accounting rules.

We also disagree conceptually with the application of the derecognition approach to real estate leases. As indicated in the summary of our opinion above, this approach is inconsistent with the current derecognition guidance in ASC Topic 360: *Property, Plant, and Equipment*, which in our opinion provides a more accurate model regarding the real estate derecognition.

(b) Do you agree with the boards' proposals for the recognition of assets, liabilities, income and expenses for the performance obligation and derecognition approaches to lessor accounting? Why or why not? If not, what alternative model would you propose and why?

Response:

1. See response to Question 2(a) above;
2. Regarding the performance obligation approach, we disagree with the proposed requirement for lessors to record amortization and interest income in place of rental income. We indicated in the summary of our opinion above that these accounting requirements are indicative of a finance arrangement when in fact a real estate lessor has specifically entered into a leasing arrangement with no intention to dispose of the property under a finance arrangement with a lessee; financial statement metrics in our opinion are negatively impacted given the inability to report rental income and do not align with economics of a long-term real estate lease arrangement in which neither party intended for ownership of the leased property to transfer during the lease term, notwithstanding a purchase option term within the lease.

3. As stated in our response to Question 2(a), and in the summary of our opinion above we disagree that the derecognition approach can be applied to real estate leases.

(c) Do you agree that there should be no separate approach for lessors with leveraged leases, as is currently provided for under US GAAP (paragraph BC15)? If not, why not? What approach should be applied to those leases and why?

*Response:* We agree.

### **Question 3: Short-term leases**

Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?

*Response:*

Short term leases (leases with a term or 12 months or less) are not common in the commercial real estate industry, with the exception of residential real estate properties (for example, apartment properties). We agree that short-term leases should be accounted for in the proposal as the administrative burden of accounting for these leases that turnover quite frequently could be significant. Also, we believe that the proposed standard should be clarified to ensure that the accounting doesn't change for short-term leases that include language where the lessee could extend the term of the lease on a month-to-month basis after the initial term is complete.

### **Question 4: Definition of a lease**

(a) Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?

*Response:*

Yes. A lease is a contract in which the right to use a specified asset or assets is conveyed for a period of time in exchange for consideration. Leases for real property transfer the right to use a specific portion of the real property from the landlord to the tenant in exchange for rent.

(b) Do you agree with the criteria in paragraphs B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale? Why or why not? If not, what alternative criteria would you propose and why?

*Response:*

No. We do not agree with the criteria in paragraph B-9 or B-10 for distinguishing a lease from a contract that represents a purchase or sale as it relates to real estate.

Under the “derecognition” approach, a lessor who does not maintain significant exposure to risks and rewards associated with the leased asset is required to derecognize a portion of the asset. Such a presentation in a lessor’s financial statements would indicate a partial sale or the transfer of a portion of the property’s value to the lessee. This presentation would present a view far different than the economic and legal substance of the transaction. Regardless of the terms of a lease, it is unlikely that an owner/lessor of real estate would transfer their legal responsibility for a property without legally transferring title, in whole or partially, to a third-party. From this prospective, we disagree that the derecognition approach is appropriate for real estate leases where a bona fide sale has not occurred and propose that the derecognition approach include a scope exception for real estate lessors. In our opinion, the sale or derecognition of real estate should continue to be accounted for under existing guidance in Topic 360-20, *Real Estate Sales*, section 40-5 and related literature which require the following:

- a. A sale is consummated (see the following paragraph).
- b. The buyer's initial and continuing investments are adequate to demonstrate a commitment to pay for the property
- c. The seller's receivable is not subject to future subordination
- d. The seller has transferred to the buyer the usual risks and rewards of ownership in a transaction that is in substance a sale and does not have a substantial continuing involvement with the property

(c) Do you think that the guidance in paragraphs B1–B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?

Response:

Yes. We think that the guidance in paragraphs B1–B4 for distinguishing leases from service contracts is sufficient.

**Question 5: Scope exclusions**

Do you agree with the proposed scope of the proposed guidance? Why or why not? If not, what alternative scope would you propose and why?

Response:

No. We urge the Boards to exclude lessor accounting for leases of real estate held for investment from a GAAP perspective from the scope of the proposed new lease accounting in a similar fashion as to what was done for those reporting investment property at fair value under IAS 40.

The reasons for our position are stated below:

- A convergence of GAAP with International Financial Reporting Standards (“IFRS”), specifically IAS 40, *Investment Properties*, results in a consistent and informative basis of accounting for investment properties globally;
- A fair value accounting model improves transparency to financial statements by providing investment performance results indicative of current market conditions and made readily accessible to investors or other users of financial statements;
- The reporting of real estate investments at fair value will result in a more transparent measurement of a company’s net asset value (“NAV”);
- Investors with holdings in multiple asset classes can easily compare the performance results between real estate investments and other investments in financial assets, the latter of which are typically reported at fair value;
- Under a fair value accounting model a property’s operating results are reported to reflect gross contractual rental income and managed expenses directly correlated to the property’s day to day operations, performance metrics that are crucial to experienced real estate investors.
- Consistent with the current proposal under IFRS, lessors that report investment properties at fair value under GAAP should be exempt from applying the proposed right-of-use lease accounting model and be permitted to continue to record rental income on an accrual basis. Reporting a receivable asset under the right-to-use model on a lessor’s balance sheet while reporting an investment property at fair value would result in the double-counting of future expected cash flows from leases, a dominant valuation input when valuing real estate under a discounted cash flow method.

- Additionally, see our comments on the matter in our letter preceding this Appendix.

**Question 6: Contracts that contain services components and lease components.**

Do you agree with either approach to accounting for leases that contain service and lease components? Why or why not? If no, how would you account for contracts that contain both service and lease components and why?

*Response:*

The proposed lease guidance would require that lease payments be allocated between the lease component and any service component when the other services are distinct. If the service component is not distinct then the entire contract is accounted for as a lease. We believe that the service component should be treated as distinct and accounted for separately. Under that premise the principles in the joint FASB/IASB project on revenue recognition should apply. Given the volatility already built into the new lease probability model adding the additional effect of service contracts would further subject the recognition of the right to use asset and liability to constant change. We believe that service contracts such as maintenance, security and, janitorial services should be accounted for as they have been in the past as a separate component of income. Those contracts often are based on a predefined calculation in a lease subject to yearly changes. Constantly evaluating or predicting what that change would be would just add more volatility to the probability analysis used to come up with the right to use asset/liability.

Since lessees would recognize leases on a gross basis as assets for the right to use leased assets and liabilities for the required lease payments, we urge the Boards to provide additional guidance on distinguishing lease components from components which should not be treated as part of the lease. Although the presentation is net on the balance sheet, the “distinctive service” aspect also impacts the calculation of the lessors. We believe that a triple net lease whereby the tenant pays certain expenses of the property directly and a lease whereby a landlord is reimbursed for those expenses (i.e. common area maintenance, insurance, and property taxes) should be treated the same. That is, any reimbursements to the landlord of such expenses should be recognized as incurred and not considered part of rental revenues for calculation of the lease asset or liability.

**Question 7: Purchase Options**

Do you agree that a lessee or a lessor should account for purchase options only when they are exercised? Why or why not? If not, how do you think that a lessee or a lessor should account for purchase options and why?

*Response:* Yes, given the uncertainty of a lessee exercising a purchase option.

**Question 8: Lease term**

Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease?

*Response:* No. We believe that lease renewal options do not meet the definition of an asset or a liability until such options are exercised and become contractually enforceable. Accordingly, we request the Boards to reconsider the definition of “lease term” so that the definition is solely determined based on the contractually enforceable term of the executed lease which excludes unexercised options to extend or terminate the lease.

Secondarily, inclusion of unexercised lease renewal periods using the “longest possible term that is more likely than not to occur” approach is an attempt to reflect the “entity’s reasonable expectation of what the term will be” (BC 118). We believe that this approach does not avoid the measurement reliability problems inherent in the other approaches considered by the Boards (BC 120). While acknowledging the diversity and complexity of lease structures, the fact remains that real estate lease renewal options are typically unilateral in nature and the lessee can choose not to renew a lease despite economic motivations to the contrary. Given the long-term nature of real estate leases, determining renewal probabilities is highly subjective and results in probabilities that are highly uncertain due to the large number of uncontrollable and unforeseeable factors that come into play. The users of financial statements would be ill-served if unexercised lease renewal options are reflected as assets and liabilities inferring that the related future cash payments are reasonably predictable on the reporting date. Additionally, the high degree of subjectivity when calculating renewal probabilities opens the door to manipulation. These subjective estimates will most likely lead to lessors and lessees drawing different conclusions and thus different values for the same lease. We believe the proposed definition of lease term and the works against the Board’s transparency and comparability objectives.

If not, how do you propose that a lessee or a lessor should determine the lease term and why?

*Response:*

We propose that both the lessee and the lessor determine lease term based on the contractually enforceable term of the executed lease which excludes unexercised options to extend or terminate the lease. We take this position because only the contractually enforceable term of the executed lease gives rise to an asset and a liability for the lessee and lessor.

This definition of lease term accomplishes the Boards' transparency objectives relative to the term of the lease that can be reasonably predicted. This definition of lease term accomplishes the comparability objectives of the Boards providing:

- Comparability between lessee and lessor because the definition of "lease term" is based solely on non-subjective criteria relative to both parties of the lease (contractually enforceable term of the executed lease)
- Comparability between lease transactions without introducing the high degree of subjectivity required to estimate renewal probabilities relating to unexercised lease renewal options and without introducing the volatility created by updates to renewal probability estimates.

We believe that this proposed definition of "lease term" will result in unexercised lease renewal options being treated more consistently with similar types of unexercised options that do not utilize the "more likely than not to occur" recognition criterion under US GAAP.

**Question 9: Lease payments**

Do you agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique?

*Response:*

Contingent rentals, expected payments under term option penalties, and residual value guarantees should be included in the measurement of assets and liabilities using the expected outcome technique described in 14 (a)-(c) if such inclusion is

limited to the contractually enforceable term of the executed lease (for reasons stated in the answer to Question 8) and only for such lease payments that can be reliably measured.

Why or why not?

*Response:*

Relative to the contractually enforceable term of the executed lease, the liability to pay contingent rentals and the right to receive contingent rental payments exist at the date of inception of the lease. It is only the amount to be paid that is uncertain, thus the expected outcome technique should be used to reliably measure these assets and liabilities. As stated in our answer to Question 8, we believe that lease renewal options do not meet the definition of an asset or a liability until such options are exercised and become contractually enforceable, thus contingent rentals relating to unexercised lease renewal options should be excluded.

If not, how do you propose that a lessee or a lessor should account for contingent rentals and expected payments under term option penalties and residual value guarantees and why?

*Response:* See above.

Do you agree that lessors should only include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the right to receive lease payments if they can be reliably measured?

*Response:* Yes to the extent these could be reliably measured, however we think this will often not be the case.

Why or why not?

*Response:*

To do otherwise is to undermine the objective of providing reliable financial statements.

**Question 10: Reassessment:**

Do you agree that lessees and lessors should re-measure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous period? Why or why not? If not, what other basis would you propose for reassessment and why?

***Response:***

As indicated in our response to Questions 8 & 9, we believe the lease term should be based on the contractually enforceable term of the executed lease, and contingent rentals should be included only to the extent of the contractually enforceable lease term. Any reassessment should be limited to those assumptions. Additionally, with the significant number of leases that a lessor may have in a single building, any reassessment should allow for grouping or tranching of leases based on reasonable criteria and only required annually. Without consideration to these points, reassessment as proposed would be very burdensome and add undue volatility to the financial statements without any benefit, as the judgments and assumptions primarily being reassessed are highly subjective in nature and not based on any contractual commitments.

**Question 11: Sale and leaseback:**

Do you agree with the criteria for classification as a sale and leaseback transaction? Why or why not? If not, what alternative criteria would you propose and why?

***Response:***

No, we believe that the paragraphs 66-67, B9-10, B31 and BC160-167 list different requirements for a sale than the former SFAS 66 and SFAS 98, specifically in their definition of “continuing involvement”. The new requirements would allow transactions that previously were not considered sales to be recorded as a sale. The paragraph B31 a) limits the purchase option requirement only if that option price is not fair value. At the beginning of the lease term, how can fair value be determined at the end of the lease if the option price is a stated amount? This uncertainty could cause variance in the application of the standard and produce inconsistent results from similar transactions within the real estate industry.

We propose altering the paragraph B31a) to include a definition of “continuing involvement” which would not limit purchase options, which may or may not be

at fair value, since that determination cannot be made at the beginning of the lease for stated amount options.

**Question 12: Presentation, Statement of financial position:**

- (a) Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment, or investment property as appropriate, but separately from assets that the lessee does not lease (paragraphs 25 and BC143–BC145)? Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?

*Response:*

Notwithstanding the concerns previously outlined in our comments, we agree with this concept from a lessee perspective which seems in line with the business aspects of the arrangement and achieving transparency.

- (b) Do you agree that a lessor applying the performance obligation approach should present underlying assets, rights to receive lease payments and lease liabilities gross in the statement of financial position, totalling to a net lease asset or lease liability (paragraphs 42, BC148 and BC149)? Why or why not? If not, do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

*Response:*

As noted previously, we believe splitting the recognition and measurement of the fair value of an investment property into a financial asset and a non-financial asset is not aligned with the fundamentals of an investment property. We do not feel such information would be useful to investors in real estate funds since all such assets would have the business objective of being leased and investors are more concerned with the capital appreciation or depreciation of such assets.

- (c) Do you agree that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial assets and should present residual assets separately within property, plant and equipment (paragraphs 60, BC154 and BC155)? Why or why not? Do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

*Response:*

We do not believe this approach is appropriate for real estate transactions and also believe there should only be one model from a lessor perspective.

- (d) Do you agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position (paragraphs 43, 60, BC150 and BC156)? Why or why not? If not, do you think that an intermediate lessor should disclose this information in the notes instead?

*Response:* We do not feel this information would be useful in a fair value reporting environment and would be included within the underlying valuation of the real estate asset.

### **Question 13: Presentation, Income statement**

Do you think that lessees and lessor should present lease income and lease expense separately from other income and expenses in the income statement? Why or Why not?

*Response:*

For most entities, no we do not think that the lessees and lessor should present lease income and lease expense separately from other income and expenses in the income statement. A separate line for the amortization of the right-of-use asset and interest expense or income would not provide additional information to the reader of the income statement since the income or expense related to the leases would not be part of the main business purpose of the entity. However, we believe that for the lessor entities by which the lease income is the main business purpose, that separating the lease income and expense from other income and expense would provide additional information to the reader of the income statement.

If not, do you think that a lessee should disclose that information in the notes instead? Why or Why not?

*Response:*

For the entities that do not separate lease income and lease expense from other income and expense in the income statement, we do think that the lessees and lessor should disclose that information in the notes. By providing the information in the notes the readers who would find use for that information would be able to obtain the data from the notes if they are material to the total other income and expense amount.

### **Question 14: Presentation, Statement of cash flows**

Do you think that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows (paragraphs 27, 45, 63, BC147, BC153 and BC159)? Why or why not? If not, do you think that a lessee or a lessor should disclose this information in the notes instead? Why or why not?

Responses

*Paragraphs 27 and BC 147 (Lessee)*

Response:

No. We do not believe that the cash flows from leasing activities should be classified as financing activities. The lease cost should be included in the operating section as we believe that this is an operating cost rather than a financing cost.

*Paragraphs 45 and BC 153 (Lessor – Performance Obligation Approach)*

Response:

Yes. We agree that the lessor should classify cash receipts from lease payments as operating activities in the statement of cash flows.

*Paragraphs 63 and BC 159 (Lessor – Derecognition Approach)*

Response:

Yes. We agree that the lessor should classify cash receipts from lease payments as operating activities in the statement of cash flows.

**Questions 15: Disclosure:**

Do you agree that lessees and lessors should disclose quantitative and qualitative information that:

(a) identifies and explains the amounts recognized in the financial statements arising from leases; and

(b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows?

(paragraphs 70–86 and BC168–BC183)? Why or why not? If not, how would you amend the objectives and why?

Response:

We disagree with the proposed disclosures and believe the current disclosures required by GAAP are sufficient for real estate lessors. The proposed disclosures would be very burdensome for our industry without adding any significant value for users of our financial statements. A single fund could hold thousands of real estate leases that would be subject to the proposed requirements.

**Questions 16: Transition:**

(a) This exposure draft proposes that lessees and lessors should recognize and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88–96 and BC186–BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?

Response:

As indicated previously, we believe investment properties should be scoped out of the proposed accounting, however we agree with the simplified retrospective approach.

(b) Do you think full retrospective application of lease accounting requirements should be permitted? Why or why not?

Response:

No, it is too burdensome as a single fund can hold thousands of leases and it does not add useful information to the user of a real estate lessor's financial statements.

(c) Are there any additional transitional issues the boards need to consider? If yes, which ones and why?

Response: No

**Questions 17: Benefits and costs:**

Do you agree with the boards' assessment that the benefits of the proposals would outweigh the costs? Why or why not?

Response:

No. Under the right-to-use model lessees and lessors will incur extraneous costs to acquire, implement and maintain software that can accommodate the new accounting and reporting requirements under the proposed update. Additional staffing will be necessary for the on-going assessment and control over leasing activity to ensure compliance with the proposed update and appropriateness of

adjusting entries. Retrospective accounting requirements for in-place leases will intensify these costs and resource issues beyond reasonable means. An institutional real estate Fund could own many properties and a single property alone can be occupied by up to one-hundred tenants, resulting in thousands of leases that must be reviewed periodically to assess renewal options and variable rent components. Many lessees may currently lack appropriate lease accounting skills given the necessary focus on their primary business (e.g. retail) and therefore will be at a disadvantage regarding knowledgeable staff and expertise in complex leasing accounting concepts and accounting rules. These issues combined with our view that the resulting proposed accounting is not appropriate for real estate lessors lead to the “No” response.

**Question 18: Other comments:**

Do you have any other comments on the proposals?

*Response:*

Our additional comments have been outlined in the body of the letter preceding this Appendix.

**Questions 19: Non-public entities:**

Should any of the proposed guidance be different for non-public entities (private companies and not-for-profit organizations)? If so, which requirement(s) and why?

*Response:* No.