NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

August 17, 2005

VIA E-MAIL

Mr. Lawrence W. Smith
Director-Technical Application and Implementation Activities and EITF Chair
Financial Accounting Standards Board
401 Merritt 7
Norwalk, Connecticut 06856-5116

Re: FAS 13-b, Accounting for Rental Costs Incurred During a Construction Period

Dear Mr. Smith:

The National Association of Real Estate Investment Trusts (NAREIT®) welcomes this opportunity to respond to the request for comments from the Financial Accounting Standards Board (FASB or Board) on the proposal contained in FASB Staff Position FAS 13-b, *Accounting for Rental Costs Incurred during a Construction Period* (FSP). NAREIT is the representative voice for U.S. REITs and publicly traded real estate companies worldwide. Members are real estate investment trusts (REITs) and other businesses that develop, own, operate and finance income-producing real estate, as well as those firms and individuals who advise study and service those businesses.

A Probable Accounting Whipsaw

In addition to NAREIT's views discussed below as to the inconsistency between the proposed expensing of all rental costs incurred during construction and the economics of developing a related asset, we strongly believe that the Board's proposal could revise accounting practice that, over the next several years, would probably be reversed. This concern does not relate narrowly to real estate but to all self-constructed or self-improved leased assets.

It is widely expected that the Board, as well as the International Accounting Standards Board (IASB), will develop a broad new lease accounting standard over the next several years. This expectation has been reinforced by the Securities and Exchange Commission's (SEC) recent *Report and Recommendations Pursuant to Section 401 (c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers* (the Report). Section IV A of the Report suggests that the FASB, possibly in collaboration with the IASB, should reconsider standards for accounting for leases. The report, implicitly if not explicitly, provides the SEC staff's views with respect to the direction of changes to the accounting for leases. Our reading indicates that such accounting changes could require that most of the estimated 1.25 trillion dollars of obligations under operating leases that are not currently reflected in balance sheets be recognized as liabilities.

In addition to the SEC staff's views, others would agree that certain leases that are not currently recognized as assets and related liabilities contribute to future economic inflows. In an interview with CFO magazine, Bob Herz, Chairman of the FASB, is quoted as saying, "my personal view is that lease-accounting rules provide the ability to make sure no leases go on the balance sheet. Yet you have the asset and an obligation to pay money that you can't get out of." A statement by Sir David Tweedie, IASB Chairman, puts it succinctly. He observed during U.S. Senate testimony after the Enron scandal, "A balance sheet that presents an airline without any aircraft is clearly not a faithful representation of economic reality."[1]

These views indicate that there is a strong probability that any new standard with respect to lease accounting would require that many of the rights and obligations under what are currently considered operating leases, be recognized as assets and liabilities on balance sheets.

If the future FASB/IASB lease accounting project results in the capitalization of what currently are accounted for as operating leases, especially long-term operating leases, many of the "rights to control the use of a leased asset"[2] would be capitalized as assets. A related liability would be recorded and the lease would no longer be within the scope of standards that guide the accounting for operating leases, including FASB Technical Bulletin No. 85-3, *Accounting for Operating Leases with Scheduled Rent Increases.* The lease obligation would be characterized as a financing for accounting purposes. This result would in turn require that the interest element in each payment be capitalized as a cost of the related asset pursuant to paragraph 2 of FAS 34.[3] While we understand that some believe that the accounting prescribed by FAS 34 should be revisited, such consideration seems to us to be far beyond the scope of this FSP.

[1] The quotes attributed to Bob Herz and Sir David Tweedie were taken from an article, *Rewriting Lease-Accounting Rules,* by Tim Reason in the August 4, 2005 issue of CFO Magazine.
[2] From Paragraph 6 of Proposed FASB Staff Position No. 13-b *Accounting for Rental Costs during a Construction Period.*
[3] Paragraph 2 of FAS 34 indicates that "paragraph 12 of Statement 13 provides that, during the term of a capital lease, a portion of each minimum lease payment shall be recorded as interest expanse" and that "the amount chargeable to interest expense under the provisions of those paragraphs is eligible for inclusion in the amount of interest cost capitalizable in accordance with this Statement."

It seems shortsighted that the Board would cause a dramatic and significant shift in the current practice of accounting for rental costs during construction when there is a high probability that accounting practice could revert back to the current practice of capitalizing these costs, at least for a good portion of the rental payments under long-term leases.

The Issue's Significance to Real Estate Companies

We have followed the developments leading up to the issuance of the FSP and view the Board's proposal as an expeditious response to what may have appeared to be a relatively narrow issue. The example provided in paragraph four of the proposed FSP supports our view – see further discussion under "other comments" below. We understand that a number of retailers, primarily restaurants, inquired as to whether rental costs paid or accrued during the "build-out" of leased space could be capitalized.

Accounting for rental costs is a very significant issue in the context of developing investment property on land that is controlled under a long-term ground lease. Real estate companies are constantly constructing office buildings, shopping malls, apartment complexes, and other forms of investment property. These construction projects generally extend over multiple years. Usually, companies acquire the underlying land for development, while in other cases, many times due to local or state imposed restrictions, they lease the land under a long-term ground lease. The terms of these ground leases are generally very long term, lasting as long as 100 or more years. This is especially true in foreign jurisdictions such as China and the United Kingdom. Obviously, a developer would not invest hundreds of millions of dollars in an investment property unless the underlying land could be controlled for very long periods of time.

Examples of major investment properties that have been developed on land controlled through ground leases include:

- retail centers like Faneuil Hall Market Place in Boston, portions of South Street Seaport in New York and Harborplace in Baltimore,
- the Crystal City complex adjacent to Reagan National Airport in Alexandria, Virginia, and
- major distribution facilities developed on the grounds of major airports.

To use a well known colloquial phrase, the three most important factors contributing to the success (future economic benefits) of an investment property are location, location and location. Therefore the land is an immeasurably important and integral part of the future cash flows and economic value of an investment property. While some may conclude that rental costs pursuant to ground leases may not, by themselves, meet the definition of an asset, they are clearly costs that are essential and that contribute to the probable future economic benefits of an investment property. See discussion below with reference to concepts in paragraph 11 of International

Financial Reporting Standard No.16, *Property, Plant and Equipment* (IFRS 16). Therefore, to expense these costs during the construction period of the related investment property, ignores a significant, direct and incremental cost of creating an integral economic unit defined as an investment property. Clearly, the right to control the land under an investment property contributes significantly to future cash inflows. Based on this analysis, NAREIT strongly believes that rental costs pursuant to ground rents that are incurred during the construction period represent part of the investment property asset and, therefore, should be capitalized.

The Industry's Consistent and Uniform Practice

Our experience indicates that virtually all real estate companies capitalize rental costs incurred during the construction period. The basis of this accounting practice is that these costs are direct and incremental to the development of the asset and, as discussed above, contribute to the future cash flow of the investment property. These practices have been further guided by analogy to paragraphs 6 and 7 of FAS 67, as well as paragraph 6 of FAS 34.

Further, real estate companies have analogized the capitalization of rents during construction to costs capitalized by oil and gas producing companies. Paragraph 15 of FAS 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, states that, "costs incurred to purchase, lease, or otherwise acquire a property (whether unproven or proved) shall be capitalized when incurred."

The SEC has accepted the practice of capitalizing rents incurred during construction and the major accounting firms have consistently agreed that the practice complies with generally accepted accounting principles for as long as we can remember.

Inconsistency with International Practice

We have discussed accounting for rents incurred during the construction period with certain accounting firms and real estate companies in Europe, including the United Kingdom. We understand that, while IFRS do not provide explicit guidance for accounting for rental costs during construction, these costs are generally capitalized by real estate companies – and possibly other companies.

We understand that those companies outside the U.S. that capitalize rents during construction under IFRS base this accounting practice primarily on paragraphs 11 and 16(b) of IFRS 16.

Paragraph 16 (b) includes as an element of the cost of property, plant and equipment, "any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management." Rental costs, particularly ground rents, clearly meet this description of this element of an asset's cost.

Further supporting the capitalization of rents during construction is the concept underlying guidance in Paragraph 11 of IFRS 16:

> The acquisition of such property, plant and equipment [PP&E acquired for safety or environmental reasons], although not directly increasing the future economic benefits of any particular existing item of property, plant and equipment, may be necessary for an entity to obtain the future economic benefits from its other assets. Such items of property, plant and equipment qualify for recognition as assets because they enable an entity to derive future economic benefits from related assets in excess of what could be derived had those items not been acquired.

Again, while some may conclude that rental costs may not, by themselves, meet the definition of an asset, they certainly are necessary to, contribute to and enhance the future economic benefits that flow from the related investment property. This is especially true of ground rents.

Major NAREIT member companies are rapidly expanding outside the U.S. They are increasingly competing in both the property markets and the capital markets with companies that we believe capitalize rental costs during construction. U.S. companies should not be disadvantaged by having to expense rental costs during construction. We suggest that the Board's staff investigate the degree to which rental costs are capitalized during construction outside the U.S.

Other Comments

Paragraph four of the proposed FSP provides a very narrow example of the issue around accounting for rental costs during construction. Further, based on our intimate experience over the past several months with the issues related to accounting for leasehold improvements, the example does not reflect all of the dimensions of the issues.

As we understand the positions of the major accounting firms, the date at which rents (both revenue and expense) should begin to be recognized depends on whether the landlord or the lessee recognizes the improvements as property. Further, this is not as simple as when a lessee is "given control of the leased asset to construct the leasehold improvements." We understand that, if the lessee constructs the leasehold improvements but the landlord concludes that it, the landlord, is the primary beneficiary of the improvements, the landlord should record the cost of the improvements as property and begin to recognize rental revenue only when the asset to be leased is considered substantially complete. This view is based on the principle that, if the landlord concludes that it "owns" the improvements, the leased asset includes the improvements and, therefore, is not complete until the improvements are substantially completed.

The example provided in the FSP suggests to us that the Board may be addressing what it believes to be a narrow issue in the format of an FSP when, in fact, the capitalization of rents during construction is a much larger issue that has a significant impact on major industries beyond retailing.

Summary

For the reasons discussed above, NAREIT respectfully urges the Board to not pursue a dramatic change to the widely-used practice of capitalizing rental costs incurred during the construction period until the accounting for rental costs is considered in the context of the planned broader evaluation of lease accounting principles. If the Board determines that it must respond to the question raised by certain constituents, NAREIT urges the Board to deal with this more narrow issue with respect to the capitalization of building rents and defer action on accounting for rental costs associated with ground leases – identified as View C in the minutes of the June 29, 2005 Board meeting.

NAREIT thanks the Board for this opportunity to comment on the proposal and requests an opportunity to meet with the Board and its staff to further discuss this matter. Please contact Gaurav Agarwal, NAREIT's Director, Financial Standards, at (202) 739-9442 or George at (202) 739-9432 if you would like to discuss our comments or our request to meet with the Board.

Respectfully submitted,

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President and CEO

George L. Yungmann
Vice President, Financial Standards

CC: Bob Herz, Chairman FASB
Scott Taub, Deputy Chief Accountant, SEC
Wayne Upton, Director of Research, IASB