October 29, 1999

Sir Bryan Carsberg
The Secretary-General
International Accounting Standards Committee
166 Fleet Street, London EC4A 2DY
United Kingdom

Re: Proposed International Accounting Standard – Investment Property – Exposure Draft E64

Dear Secretary-General Carsberg:

The National Association of Real Estate Investment Trusts (NAREIT) is pleased to have the opportunity to respond to the International Accounting Standards Committee's (IASC) Exposure Draft (ED) on accounting for investment property. NAREIT is the national trade association in the United States of America (USA) for real estate investment trusts (REITs) and publicly traded real estate companies that in aggregate have a total market capitalization in excess of $250 billion. Members include 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 these businesses.

Providing useful and relevant financial information related to investment property is of vital importance to the capital formation activities of companies involved in the business of developing, owning and operating income-producing property. NAREIT applauds the IASC's efforts to promulgate a policy governing the accounting for investment property that could produce more useful financial reports for real estate companies.

In the USA, generally accepted accounting principles (GAAP) require that investment property be carried on the balance sheet on a historical cost basis.[1] Moreover, NAREIT believes that current depreciation practice results in an excessive charge to earnings on the statement of operations. The combination of these practices leads to overstated reserves (understated net assets) on the balance sheet and a potential overstatement of gain (or understatement of loss) upon disposition of the property. Because the resulting net income alone is generally not accepted within the investment community as a meaningful performance measure for companies that own income-producing property, the real estate industry created and maintains a supplemental earnings performance measure known as "Funds From Operations" (FFO).

Clearly, adoption of fair value accounting for investment property would alleviate, if not eliminate, the related deficiencies associated with GAAP in the USA, as well as the need for a supplemental performance measure. In this regard, we support the direction of the IASC, but believe there are certain issues that must be more fully investigated before we would be a proponent of adopting fair value accounting for investment property in the USA. Issues of concern (in part addressed below) include credibility related to valuing assets above cost,

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[1] Certain tax-exempt pension fund organizations in the USA currently use fair value accounting for investment property. These organizations have real estate holdings valued in excess of $120 billion (estimate from PricewaterhouseCoopers and Lend Lease "Emerging Trends in Real Estate 1999").

inclusion of unrealized gains and losses in operating results, costs associated with implementation, and required disclosures to appropriately adopt a true "marked-to-market" fair value accounting approach.

In an attempt to address the above mentioned deficiencies associated with GAAP for investment property in the USA, in 1996 NAREIT and the National Association of Real Estate Companies (NAREC) jointly prepared a discussion paper, "Accounting for Depreciation of Income-Producing Property," which incorporated certain aspects of fair value accounting within the historical cost model. To address the overstatement of depreciation for investment property, the paper proposes the use of a salvage value measured as the fair market value of the property at the end of its useful life. To avoid any potential abuse, the salvage value could not exceed the fair market value of the property at the current balance sheet date or the historical cost. Subsequent expenditures that are revenue enhancing would be capitalized and depreciated over their estimated useful lives.

We acknowledge that the IASC's agenda includes the development of a core set of International Accounting Standards for an assessment by the International Organization of Securities Commissions. Notwithstanding our thoughts regarding near-term adoption of fair value accounting for investment property in the USA, assuming the IASC adopts a fair value standard for investment property, below we offer our responses to the questions outlined in the ED.

Question 1 – Scope and Definitions (paragraphs 1 – 15)
(a) NAREIT agrees that a distinction should be made in the proposed standard between property held for use in the production of goods and services and investment property (i.e., property held to earn rentals and for capital appreciation). Property that is integral to a production process adds value to the items produced from that process and the cost of the items produced should reflect an allocation of the cost of the property used. Further, property integral to a production process typically loses service potential as a result of such use in the production process. Therefore, the traditional notion of depreciation (a method of cost allocation) is appropriate for property generally held for use in the production of goods and services. Property held for rentals or capital appreciation generally does not suffer a similar loss of service potential due to use, and therefore a distinction should be made in the accounting literature for this difference.

(b) NAREIT agrees that the accounting for investment property should be the same regardless of the type of business in which the owner of the property is engaged. This is consistent with other accounting literature such as that for financial instruments, in which the accounting does not depend on the line of business of the holder of the instrument. Accounting results that are not the same for identical assets used in the same way by different owners would hinder the comparability and consistency of financial results.

(c) NAREIT disagrees that the definition of investment property should exclude owner-occupied property. The accounting treatment of owner-occupied property should be the same as investment property if the intent of the owner is to hold the property for capital appreciation.

We agree that property held by merchant builders for sale in the ordinary course of business, or properties constructed for sale to third parties, should be excluded from investment property accounting. However, we believe that land held for long-term development and sale by land developers should be accounted for as investment property since land developers hold property long-term for capital appreciation and/or to create value during long-term development processes.

(d) Although we agree with the general guidance on the definition of investment property in paragraphs 4-6 of the proposed standard, we have some issues with the proposed guidance with respect to ancillary services (paragraphs 8-10) and partially owner-occupied property (paragraph 12). Specifically, we do not agree that a hotel should be excluded from the accounting treatment for investment property merely because the owner is also the operator of the property. Hotels are properties owned to provide owners with income from rents as well as services, along with capital appreciation. The fact that the services constitute a significant portion of the entire return to the owner does not invalidate the need to measure the rental or capital appreciation component of such return. If the property values of an owner/operator’s hotel holdings change based on market conditions, we believe the owner/operator's financial statements would be more meaningful and relevant if such changes in value were reflected in those statements.

In addition, we disagree with the requirement that a partially-owner occupied asset can only be segmented between investment property and plant and equipment if the asset can be physically divided and sold separately. The existence of capital leases provides for financial transactions that are in-substance sales without an actual transfer of title or physical segregation taking place. Furthermore, existing accounting literature allows for parts of buildings being treated as individual assets for depreciable life and placed-in-service determinations despite the fact that these assets cannot be separately sold. Allocations of cost or value are routinely made in GAAP and we see no logical impediment to the use of allocation methods in the case of property owned for both production and capital appreciation purposes.

Question 2 – Scope: Property Held under Operating Leases (paragraphs 2 and 11)

(a) NAREIT agrees that leasehold interests in property held under an operating lease generally should not be treated as investment property as the leasehold interest does not entitle the lessee to any economic benefit after the lease term. However, we believe that buildings and improvements that are subject to a ground lease should be treated as investment property.

(b) NAREIT has no comments on the interaction of this standard with IAS 17.

Question 3 – Scope: Property Occupied by Another Enterprise in the Same Group (paragraph 13)

NAREIT believes that this standard should not differ from other accounting standards and that the accounting should be driven by the entity which is preparing the financial statements. Therefore, the accounting could be different in individual, stand-alone financial statements than in the consolidated financial statements.

Question 4 – Measurement Subsequent to Initial Recognition (paragraphs 26-38)
(a) If the IASC adopts a fair value standard for investment property, NAREIT agrees that all investment property should be measured at fair value.

(b) Valuation by a third party should not be required. Clearly, when an entity does not have valuation expertise it should consult with outside experts. We note that there are few situations when USA GAAP requires the use of an independent valuation. Lenders are assumed to be able to evaluate their loan portfolios, bankers value their debt and equity securities on a regular basis and are not required (or encouraged) to use an independent valuation, and investment companies are generally relied upon to report the values of their securities (not all of which are publicly traded). None of the recently issued accounting standards that rely on fair value measurements require the use of an independent valuation. Use of an independent appraiser is a valid valuation technique, but it is not always the preferred method. Disclosure of the valuation techniques and relevant assumptions utilized should be required.

(c) NAREIT believes that special terms or circumstances that transfer or accrue to the buyer (e.g., above- or below-market rents, maintenance contracts) and impact the income stream of the investment property should be considered in the calculation of fair value. In addition, NAREIT believes that atypical financing should be included in the calculation of fair value unless any related debt is also carried at its fair value.

If debt is not carried at its fair value, the following comments relating to the definition of fair value as discussed in paragraphs 34 and 35 should be considered. The ED provides that "fair value" is the most probable price obtainable in the market between "knowledgeable, willing parties." The statement goes on to say that a willing buyer is one that is motivated but not compelled to buy. NAREIT believes that a lender, in a non-recourse debt transaction with an owner, is implicitly a buyer. The non-recourse feature in a mortgage loan is a negotiated agreement between the parties at the inception of the mortgage transaction. The borrower does not obtain the non-recourse feature for free, it is an integral part of the financing package and one that the borrower will likely incur up-front and ongoing higher fees to obtain. Similarly, the lender is not "obligated" to provide a non-recourse loan. However, once the loan is extended on a non-recourse basis, the lender can only look to the underlying collateral for repayment of the loan. Therefore, the owner has an absolute right to relieve himself of the liability of the loan by abandoning the property to the lender. Because of the nature of such non-recourse lending, we believe the minimum fair value of a property financed by a non-recourse loan should be the outstanding principal balance of such loan.

Question 5 – Subsequent Measurement: Investment Property Under Construction
If the IASC adopts a fair value standard for investment property, NAREIT agrees that fair value should apply to all investment property, whether under construction or not. Using a marked-to-market valuation, developer profit should be recognized throughout the construction and lease-up process, not in a lump sum at the completion of construction. Disclosure of relevant assumptions should be required.

Question 6 – Inability to Measure Fair Value Reliably (paragraphs 3 and 14-15)
(a) NAREIT agrees with the rebuttable presumption that an enterprise will be able to determine reliably the fair value of property held to earn rentals or for capital appreciation.

(b) NAREIT agrees that the investment property accounting set out in the ED should not be used if evidence indicates clearly, when an enterprise acquires or constructs a property (or first holds a property to earn rentals or for capital appreciation), that fair value will not be determinable reliably on a continuing basis, because comparable market transactions are infrequent and alternative estimates of fair value (for example, based on discounted cash flow projections) are not available. In such cases, the enterprise should account for that property in accordance with IAS 16.

(c) NAREIT agrees that once an enterprise has begun accounting for a property as investment property, it should continue to do so regardless of any subsequent market changes or measurement difficulties. In addition, a change from the fair value model proposed in the ED to the depreciated cost or revaluation models in IAS 16 should be made only if the property becomes owner-occupied and the owner does not intend to hold the property for capital appreciation (see response to question 1(c)).

(d) NAREIT believes that specific disclosure should be required where property is held for rental or capital appreciation, but fails to meet the definition of investment property because of concerns about the ability to measure its fair value reliably on a continuing basis. Specific disclosures that should be required for these properties include historical cost, accumulated depreciation, current period depreciation, and the reason why the enterprise considers that fair value of the property is not reliably determinable.

Question 7 – Gains and Losses on Remeasurement to Fair Value (paragraph 26)
NAREIT does not agree that changes in the fair value of investment property should be recognized in net profit or loss for the period.

(a)(i) NAREIT believes that changes in fair value of investment property should be reported only in equity. Further, it should be reported separately in the Statement of Changes in Equity or below net profit or loss on the Statement of Operations. In the USA, the presentation of the unrealized change in value would be reported below net profit or loss as an element of "other comprehensive income."

(a)(ii) NAREIT believes that there should not be an option to report changes in fair value of investment property either in earnings or in equity – it should be one or the other to provide for uniformity and comparability.

(b) NAREIT agrees that fair value changes previously recognized in equity should be transferred ("recycled") to net profit or loss on disposal of investment property.

(c) NAREIT agrees that fair value changes previously recognized in equity should be transferred ("recycled") to net profit or loss when investment property is impaired. The impairment should be identified separately in the Statement of Operations.

(d) NAREIT believes that all maintenance expenditures should be recognized as an expense as long as the expenditure: (1) does not enable the asset to generate future economic benefit in excess of its originally assessed performance; and (2) the expenditure can be directly attributed to the property.

Question 8 – Subsequent Expenditure (paragraphs 24-25)
NAREIT agrees that subsequent expenditures that provide future utility should be capitalized.

Question 9 – Government Grants
NAREIT has no comment on this issue.

Question 10 – Transfers (paragraphs 39-42)
(a) NAREIT concurs with the ED's guidance regarding conversion to owner-occupancy when the owner does not intend to hold the property for capital appreciation (see response to question 1(c)). When an asset is converted from an investment property to use in the administration of a trade or business, it should be carried at its fair value at the date of change in use and be accounted for under applicable guidelines.

(b) and (c) NAREIT believes that changes in fair value related to the conversion of an owner-occupied asset or property held for sale in the ordinary course of business to investment property should not be recognized in net profit or loss for the period (see response to Question 7(a)(i)). To the extent that changes in fair value offset changes in value previously recognized in net profit or loss, they should again be recognized in net profit or loss. Otherwise, these changes in fair value should be reported pursuant to our response in Question 7(a)(i).

(d) NAREIT concurs with the proposed requirements on transfers from investment property to property held for sale in the ordinary course of business.

Question 11 – Disclosure (paragraphs 45-49)
NAREIT generally agrees with the disclosures required in paragraphs 45 and 46. However, we suggest that the following language be added to paragraph 46 (b): "such methods and assumptions should be provided in reasonable detail by market, geography, or property type." In addition, NAREIT believes that disclosures should be made on a comparative basis for all years presented in the financial statements. We also believe that there should be a reconciliation for investment property under construction showing significant changes to the carrying amount for each period presented.

Other comments:

- Disclosure requirements should include a summary aggregating assets held in unconsolidated partnerships or joint ventures.
- The standard should be clear that an investment property company may summarize asset disclosures and is not required to provide asset-by asset detail. Summarization should be permitted by market, geography, or property type.
- We disagree with the requirements in paragraphs 49 (a) and (c).

Question 12 – Transition and Effective Date (paragraph 50)
NAREIT has no comment.

Question 13 – Changes to Other International Accounting Standards
NAREIT agrees with the proposed changes to other International Accounting Standards, including the proposed withdrawal of IAS 25, Accounting for Investments.

Question 14 – Other Comments
If entities are required to include changes in fair value in investment property in net profit or loss for the period, both realized and unrealized gains and losses should be presented as separate line-items.

As an organization whose members are primarily focused on the business of developing, owning and operating income-producing property, NAREIT appreciates the opportunity to respond to the IASC's ED on accounting for investment property. If you should have any questions regarding this response, please contact George Yungmann at (202) 739-9432, David Taube at (202) 739-9442, or me at (610) 834-3469.

Sincerely,

Timothy A. Peterson
Executive Vice President and Chief Financial Officer, Keystone Property Trust
Co-Chair, NAREIT Accounting Committee