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NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

July 11, 2011

Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Re: FASB Memorandum 193 / IASB Agenda Paper 5G - Lessor Accounting

Dear Sir/Madam:

We are pleased to submit this comment letter in response to the Financial Accounting Standards Board (FASB) Memorandum 193 and the International Accounting Standards Board (IASB) Agenda Paper 5G that address Lessor Accounting. NAREIT is submitting these comments on behalf of the Real Estate Equity Securitization Alliance (REESA). This alliance includes the following organizations:

- Asia Pacific Real Estate Association (APREA);
- British Property Federation (BPF);
- European Public Real Estate Association (EPRA);
- National Association of Real Estate Investment Trusts (NAREIT)® (United States);
- Property Council of Australia (PCA); and
- Real Property Association of Canada (REALpac).

The purpose and activities of REESA are discussed in Appendix I. Members of the organizations identified above would be pleased to meet with the Boards or staff to discuss any questions regarding our comments on the application of the Receivable and Residual Lessor accounting model to investment property reported at cost.

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We thank the FASB and the IASB (collectively, the Boards) for the opportunity to provide further input on the Leases proposal. If you would like to discuss our comments, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at 202-739-9432 or Christopher Drula, NAREIT's Senior Director, Financial Standards, at 202-739-9442.

Respectfully submitted,

George Yungmann
Senior Vice President, Financial Standards

Christopher T. Drula
Senior Director, Financial Standards

Comment Letter Submitted by the

National Association of Real Estate Investment Trusts (NAREIT)® (United States)

On behalf of the following members of the
Real Estate Equity Securitization Alliance (REESA):

Asia Pacific Real Estate Association (APREA)
British Property Federation (BPF)
European Public Real Estate Association (EPRA)
National Association of Real Estate Investment Trusts (NAREIT)® (United States)
Property Council of Australia (PCA)
Real Property Association of Canada (REALpac)

In response to the

FASB Memorandum 193 / IASB Agenda Paper 5G

Issued by the

Financial Accounting Standards Board and

International Accounting Standards Board

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United Kingdom

Re: FASB Memorandum 193 / IASB Agenda Paper 5G - Lessor Accounting

Dear Sir/Madam:

REESA is made up of seven representative real estate organizations around the world grounded in one or more facets of securitized real estate equity. REESA's broad mission is to improve the opportunities for investment in securitized real estate equity around the globe.

REESA strongly supports the harmonization of global accounting and financial reporting and understands the importance of achieving a high quality universal set of accounting standards. We have been fully engaged in the Boards' discussions on major convergence projects and have actively participated in meetings with the Boards and their staff with respect to these projects. REESA greatly appreciates the opportunities to express our global views through these meetings and comment letters.

Background

On December 14, 2010, REESA submitted a comment letter on behalf of its global members in response to the invitation to comment on the Leases exposure draft. Additionally, NAREIT submitted a comment letter on December 15, 2010, to the Boards on the Leases exposure draft. Both of these letters highlighted the following significant concerns with the accounting models proposed in the exposure draft:

- Changing the classification of a portion or all of the rental revenue from rental income/expense to interest income/expense;

- Modifying the revenue/expense recognition pattern on the income statement from straight-line to a method that would front-load revenue/expense in a pattern similar to interest income/expense on amortizing debt; and

- Replacing the existing lessor accounting model with a hybrid model that would require the recognition of a receivable for all payments to be received under a lease through the lease term and either:
  - A liability for the obligation to continuously provide the leased asset (*i.e.,* the performance obligation approach) or
  - Revenue as if the leased asset were sold (*i.e.,* the derecognition approach).

Over the past six months, the Boards have continued to debate the Leases accounting model. REESA is pleased that the Boards continue to provide an exemption for lessors of investment property reported at fair value in accordance with International Accounting Standard No. 40 *Investment Property* (IAS 40). The primary rationale for this conclusion is that the income stream that forms the basis for measuring the fair value of the property includes all rentals from in-place leases. However, in May, the FASB and IASB appeared to be headed toward a *diverged* accounting model for lessors who report investment property at cost. While the FASB supported no changes to the current lessor accounting model currently in practice, the IASB supported application of the derecognition model in the Leases exposure draft. In an attempt to arrive at a converged lessor accounting model, the Boards discussed a new alternative approach (the Receivable and Residual Method) on June 14, 2011. During their deliberations, the Boards questioned whether this approach could be applied by lessors of investment property who report under the cost method in IAS 40 and for those entities that fall outside of the scope of the FASB's Investment Properties Standard (currently being developed). All entities that fall within the scope of the FASB's proposed Investment Properties Standard would be *required* to report investment property at fair value.

REESA concurs with the views raised by some of the FASB and IASB members during the June 2011 joint Board meeting. Specifically, we do not believe that application of the Receivable and Residual Lessor Accounting Model to portions of a real estate asset (*e.g.,* investment property) provides meaningful financial statement information. Therefore, we are fully supportive of the staff recommendations to provide a scope exception for lessors that measure investment property at fair value, and thus be outside the scope of the proposed Leases standard. Additionally, due to the issues raised in this letter for lessors that measure investment property at cost, we are fully supportive of retaining the current lessor accounting model, with updates made for the tentative decisions made to date (*e.g.,* scope decisions, definition of a lease, accounting for variable lease payments, etc.) These views are expressed in FASB Memorandum 193 / IASB Agenda Paper 5G that is scheduled to be discussed during the next round of joint Board Meetings on July 20 to July 21, 2011.

Primary Concern: Usefulness of Financial Information

Applying the Receivable and Residual Method to an investment property is not operationally practical and would lead to arbitrary allocation methods, which would not result in useful financial statements. Our views on this have been expressed previously in our responses to discussion papers and exposure drafts (submitted on July 15, 2009 and December 14, 2010, respectively).

- Property lessors view investment property as an indivisible asset whose value reflects a wide range of elements (*i.e.,* in-place lease, infrastructure, common parts, development potential, surrounding area potential, quality of other tenants, general building condition, etc). To divide these elements into financial and non-financial assets would be arbitrary and would not result in more useful information compared to current reporting and disclosures by lessors that report their property at cost.

- The proposal would create residual assets that have no market bearing. Since transactions are executed in the ordinary course of business on the basis of the whole building, residual assets would be theoretical and, in our opinion, would not meet the FASB and the IASB definition of fair value, respectively (see detailed comments below.)

- The proposal would eliminate rental income, which represents a key financial metric for property companies. In a letter to the Boards dated November 5, 2010, signed by investors with EUR 325 Billion property assets, investors and analysts stated that:

  "These two metrics (market value and rent) are fundamental to investors in assessing the performance of investment property companies and removing them would have damaging consequences for the transparency of the market."

The views of the analyst community on the usefulness of either the performance obligation approach or the derecognition approach were also made clear to the Boards at a meeting of industry investors and analysts on August 25, 2009 in London. These views were summarized in paragraphs BC55, BC56 and BC57 of the exposure draft, which read:

> BC55 – The proposals in this exposure draft for leases of investment property differ for IFRS and US GAAP. In principle, a lease of investment property should be within the scope of the proposed standard.
>
> BC56 – However, IFRSs permit investment property to be accounted for using either a cost or a fair value model. Investment analysts have told the IASB that these requirements provide useful information, especially when the fair value model in IAS 40 *Investment Property* is used. In particular, they say that total rental income is an important measure for investment property analysts.
>
> BC57 – Neither the performance obligation approach nor the derecognition approach to lessor accounting would reflect in the statement of financial position the present value of total expected rental income…

Summary of Complexities and Challenges of Applying the Receivable and Residual Lessor Accounting Model

As stated above, REESA believes that the proposed model is both inoperable for multi-tenant property and would not provide meaningful financial statement information for financial statement users. In arriving at this conclusion, REESA considered the following factors:

- **Unit of account**

What is the underlying asset related to a lease of a portion of a building for a relatively short portion of the property's useful life (*e.g.*, a 10 year lease of a space having an economic life of 40+ years):

- the right-of-use (ROU),
- the entire useful life of the leased space, or
- the entire building?

- **Application of the Receivable and Residual Model would require lessors to make a fair value determination of portions of the building**

Companies would need to obtain a fair value measure, not at a *property* level, but for *portions of the asset* (i.e., floor of the building, or quarter of a floor). Consider the following examples:

- Office building - a penthouse of a 40-story building would have a higher fair value than a middle floor.
- Shopping mall – store fronts located near major anchor stores and center court would have a higher fair value than other locations in the mall.

Complicating this matter is that the fair value estimate would also need to take into account the duration of the lease contract. IAS 40 provides companies with the option to fair value the *entire asset* as opposed to *separate and distinct portions of the asset.* We do not believe that companies could measure the fair value of portions of investment property in a meaningful, controlled, and consistent manner. Thus, the resulting accounting for individual spaces in multi-tenant buildings would be both unreliable and inconsistent. Additionally, it seems odd that companies applying a cost method may need to engage fair value experts to comply with the new accounting model.

The range of inputs that contribute to the value of an entire investment property is not a "bottom up" analysis that results from the aggregation of each individual lease. It is a combination of external market factors, relative negotiating strength between the individual tenants and owner of the whole property, the overall building characteristics, surrounding infrastructure, as well as the specific characteristics of the individual lease. As a result, the true market negotiated price of an individual lease contract cannot be meaningfully related to a theoretical assessment of the value of the in-place lease/residual asset.

- **Tenant space is not generally held for sale; thus there is no fair value of tenant space that would comply with the Boards' joint Fair Value Measurement Standard**

The Boards define fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." The difficulty in applying this definition to multiple leases of office buildings and shopping malls is that the space is not for sale – there is no market participant on the sell side.

- **Allocation of costs to arrive at fair value would be arbitrary**

  The accounting treatment for the costs of common areas, parking lot, mechanical equipment (i.e., HVAC) would prove challenging. For example, on what basis should these costs be allocated to each tenant's space?

  - Square footage; or
  - Number of tenants.

  The allocation would not be on the basis of fair value as required by paragraph 7(b) of FASB Memorandum 193 / IASB Agenda paper 5G because there is no fair value for individual spaces – see discussion above.

- **Accounting treatment when there is no remaining basis in the underlying asset**

  Consider situations whereby companies repeatedly re-lease the office space. Eventually, over a period of time, companies will fully depreciate the property and/or allocate all of the costs to previous leases. How would companies apply the model to assets when there is no remaining basis? The result may be to report the present value of the rentals as day 1 gains with no associated *cost of sale*.

- **Accounting for Early Termination due to Bankruptcy or Recapture**

  It is not unusual for tenants to terminate space leases before the term ends. How would the lessor account for an early termination of a tenant lease? Would the lessor re-recognize the unused portion of the ROU as property and concurrently reverse a portion of gains recognized in previous periods?

- **Disproportionate Results from Theoretical Cost-Benefit Analysis**

  Application of the Receivable and Residual Lessor Accounting Model would impose material costs on preparers through added data maintenance and valuation requirements while providing no material benefit due to lack of improved financial information.

Conclusion

Over the past four years NAREIT, as well as its global partners as members of REESA, have explained to the Boards through written and oral communication that any approach to lessor accounting that results in:

- Bifurcating the carrying amount of an investment property on the balance sheet; or

- Obscuring the presentation of entire rents from tenant lease agreements in the income statement;

would not faithfully report the economics of owning and operating investment property and, therefore would not provide relevant information to the industry's financial statement users. We are fearful of these unintended consequences if the Boards continue to pursue the application of the Receivable and Residual Lessor Accounting Model to investment property reported at cost.

Therefore, we strongly believe that the Boards should pursue the staff view that the proposed Leases standard would include a scope exception for lessors who measure investment property at fair value, and thus be outside the scope of the proposed Leases standard. Further, we urge the Boards to retain the current lessor accounting model, with updates made for the tentative decisions to date (*e.g.*, scope decisions, definition of a lease, accounting for variable lease payments, etc.)

Again, REESA commends the Boards on developing a fully-converged, comprehensive standard on leases. We very much appreciate the Boards' focus on the application of the proposed standard to investment property and the opportunity to share our views with the Boards. We welcome the Boards' questions on our comments.

Respectfully submitted,

Asia Pacific Real Estate Association

British Property Federation

European Public Real Estate Association

National Association of Real Estate Investment Trusts (United States)

Property Council of Australia **Real Property Association of Canada**

Appendix I

REESA – The Real Estate Equity Securitization Alliance

REESA is made up of seven real estate organizations around the world grounded in one or more facets of securitized real estate equity. REESA's broad mission is to improve the opportunities for investment in securitized real estate equity around the globe. The REESA member organizations are:

- Asian Public Real Estate Association, APREA
- Association for Real Estate Securitization in Japan, ARES
- British Property Federation, BPF
- European Public Real Estate Association, EPRA
- National Association of Real Estate Investment Trusts, NAREIT®
- Property Council of Australia, PCA
- Real Property Association of Canada, REALpac

REESA has responded positively to the challenges presented by the developments in the global economy and, in particular, the global real estate markets. The benefits of collaboration on a global scale are increasingly valuable on major industry issues such as the sustainability of the built environment, tax treaties, corporate governance and research.

The formation of REESA was, in part, a direct response to the challenge and opportunity presented by the harmonization of accounting and financial reporting standards around the world. Given the size and importance of the real estate industry, our view is that there are considerable benefits to be gained by both accounting standard setters and the industry in developing consensus views on accounting and financial reporting matters, as well as on the application of accounting standards.

Since its formation REESA members have exchanged views on a number of accounting and tax related projects and shared these views with regulators and standards setters. These projects include:

- FASB/IASB Lease Accounting
- FASB/IASB Financial Statement Presentation
- FASB/IASB Reporting Discontinued Operations
- FASB/IASB Revenue Recognition
- FASB/IASB Effective Dates and Transition Methods
- IASB Fair Value Measurement
- IASB Income Tax
- IASB Real Estate Sales – IFRIC D21
- IASB Capitalization of Borrowing Costs – IAS 23
- IASB Accounting for Joint Arrangements – ED 9
- IASB Consolidated Financial Statements – ED 10
- IASB 2007/2008/2009 Annual Improvements to IFRS
- OECD developments on cross border real estate flows and international tax treaties