REALpac
Real Property Association of Canada
Association des biens immobiliers du Canada

June 19, 2009

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

Re: Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers*

Dear Sir/Madam:

We are pleased to submit this comment letter on the International Accounting Standards Board's (the Board) Discussion Paper of *Preliminary Views on Revenue Recognition in Contracts with Customers*. We are submitting these comments on behalf of the Real Estate Equity Securitization Alliance (REESA), which includes the following real estate organizations:

Asian Public Real Estate Association (APREA)
British Property Federation (BPF)
European Public Real Estate Association (EPRA)
National Association of Real Estate Investment Trusts (NAREIT)® (U.S.)
Property Council of Australia (PCA)
Real Property Association of Canada (REALpac)

Members of the organizations identified above would be pleased to meet with the Board or its staff to discuss any questions regarding our comments.

We thank the IASB for this opportunity to comment on the Discussion Paper. Please contact Teresa Neto, REALpac's VP, Financial Reporting at tneto@realpac.ca or 1-416-642-2700 ext. 226 if you would like to discuss our comments.

Respectfully submitted,

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Comment Letter Submitted by the

Real Property Association of Canada

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which includes the following organizations:

Asian Public Real Estate Association (APREA)
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Real Property Association of Canada (REALpac)

In response to the

Discussion Paper

Preliminary Views on Revenue Recognition in Contracts with Customers

Issued by the International Accounting Standards Board

December 2008

June 19, 2009

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

Re: Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers*

Dear Sir/Madam:

The undersigned real estate organizations welcome this opportunity to respond to the request from the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) (collectively the Boards) for comments on the preliminary views included in the Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers* (the Discussion Paper). The undersigned organizations represent publicly traded real estate companies and Real Estate Investment Trusts (REITs) around the world. Our members are real estate companies and other businesses that develop, own, operate and finance investment property, as well as those firms and individuals who advise, study and service those businesses.

The purpose and activities of REESA are discussed in Appendix I.

One of the major goals of REESA is to enhance the comparability of financial information between real estate companies worldwide. We, therefore, applaud the Boards for working jointly on the revenue recognition project and for seeking convergence on this critical global standard.

<u>Summary</u>

REESA understands the importance of developing a converged and consolidated revenue recognition standard. We note that the Boards have not yet decided how the proposed revenue recognition model would apply to lessor accounting. In order to assist the Boards with their considerations on this issue, in addition to our broader comments on the Discussion Paper from the perspective of the real estate industry, we have included below our views as to the applicability of the model to accounting for leases of investment property as defined in IAS 40 *Investment Property*.

1. Lessor Accounting

(i) The nature of the lease agreement

A lessor's lease agreement with a tenant is an agreement to provide a variety of interrelated services including:

- provision of exclusive access to a component of the investment property
- provision of non-exclusive access to other components of the investment property (e.g. common areas such as the lobby, elevators, etc.)

- provision of access to utilities (e.g. power, water)
- provision of ancillary services (e.g. security, repairs and maintenance)

A lessor's inability to provide one or any combination of these services may give the tenant the right to suspend or terminate payments under the lease.

We therefore strongly believe that the proposed revenue recognition model would only result in decision-useful information when applied to lessors of investment properties if it is clear that lessors should account for the lease as a service contract and thus apply the service income concepts outlined in the Discussion Paper.

(ii) The link between rental income and investment property fair values and the implications for industry analysis

Apart from the service nature of the lessor's agreement with the tenant, it is important for meaningful analysis of the real estate industry that owners of investment property recognize rental revenue on an appropriate basis over the term of the lease. There is a clear link between rental revenue, "net property income" (defined below) and the fair value of investment property. This link is critical to both reporting entities required to report the fair value of investment property in the financial statements under IAS 40, and to those investors and users of financial statements in assessing the value and performance of investment property companies that account for their investment properties at cost. This important link is widely understood and utilized by industry financial statement preparers and users and is recognized in IAS 40, which requires the disclosure of:

(i) rental income from investment property; and
(ii) direct operating expenses arising from investment property that generate rental income.

The difference between these two amounts represents net property income which is the basis for measuring the fair value of the investment property.

In REESA's comment letter submitted to the IASB and FASB on April 14, 2009 in response to the discussion paper *Preliminary Views on Financial Statement Presentation* we communicated the importance of two key metrics in measuring the operating performance and financial position of a real estate investment and development entity. These two key metrics which REESA has named "net property income" (NPI)[1] and "income from operations" (IFO)[2] in a model statement of comprehensive income for the global real estate industry, are determined by deducting direct property operating expenses from rental revenue. There is a fundamental and important link between rental revenue and NPI reported in a real estate entity's statement of comprehensive income and the fair value of investment property either reported directly in the financial statements of IFRS reporters (on the face of the statement of financial position or in the notes) or the fair value estimated by industry analysts or other users of the financial statements, for non-IFRS reporters. Rental revenue less direct operating expenses yields NPI. The fair value of investment property is measured by either capitalizing a given year's NPI or discounting

[1] NPI is a supplemental non-GAAP measure that is currently referred to as "net operating income" or "NOI".
[2] IFO is a supplemental non-GAAP measure that is currently referred to as "funds from operations" (FFO) or "EPRA Earnings".

projected NPI at current investors' yield requirements. The fair value of investment property is a significant factor in measuring the "net asset value" (NAV) of companies that own and operate portfolios of investment property. In turn, NAV is a significant factor used to price securities of these companies and to evaluate whether share prices are set at premiums or discounts relative to the entity's NAV. Therefore, there is an important link between accounting for lease contracts and the recognition of rental revenue and the investment property standard IAS 40. Financial statements that fail to present the full amount of rental revenue generated from leasing contracts on an appropriate basis over the term of the lease will fail to provide the necessary information for users to evaluate and assess the economics or performance of a real estate entity. These relationships are illustrated in Appendix II.

Note: We refer the staff of this Discussion Paper to the attached Appendices III and IV that provide additional background on the business and economic characteristics of the real estate industry as well as information on key supplemental metrics currently used by industry stakeholders.

(iii) Characterization of lease payments as rental income

We would make one further observation in relation to lessor accounting. We note that the Discussion Paper ignores the time value of money. We would note that as the typical investment property lease is a contract for services (and the provision of the services and the payment for same are generally in close proximity) there is no financing aspect to the lease payments.

We would therefore recommend that in applying the revenue recognition concepts outlined in the Discussion Paper to investment property, the contracted lease payments be used to value the performance obligation for the lease period. This would ensure recognition of rental revenue commensurate with the contracted lease payments (which is important for the valuation concepts discussed earlier).

(iv) Conclusion

Therefore, REESA urges the Boards to ensure the service nature of the lease agreement and the important linkage between rental revenue and investment property fair value are recognized in the application of the proposed revenue recognition and lease accounting concepts by lessors of investment property. For reasons provided in this comment letter and those outlined in REESA's soon to be submitted comment letter on the discussion paper *Leases Preliminary Views* (the Leases DP), REESA recommends that these concepts can best be supported by the inclusion in IAS 40 of a clarification of the applicability to lessors of the revenue recognition and lease accounting principles.

We would recommend that any such clarification state that:

- Leases of investment property are excluded from the provisions of the lease accounting concepts outlined in the Leases DP (refer to REESA's separate submission on the Leases DP);

- For leases of investment property, the lease agreement should be accounted for as a contract for services under the general revenue recognition concepts and within the framework of IAS 40; and
- For leases of investment property, the performance obligation for the lease period be measured by reference to the contracted lease payments.

2. Other Real Estate Transactions

Beyond our comments on lessor accounting, REESA believes that the proposals of the Discussion Paper may generally be appropriate for the majority of other real estate contracts however we do have concerns with the proposals in a number of areas:

- The proposals are based on a legal view of the transfer of control rather than the transfer of risks and rewards which may have a significant impact on the timing of revenue recognition on the sale of property and long term development contracts and may not reflect the actual economic substance of a contract.
- The Discussion Paper does not provide sufficient clarity on how the concept of "transferring control" can be applied to the transfer of title under most property sale transactions and construction contracts.
- The Discussion Paper does not provide clarity or even discuss the allocation of costs to revenue. In many industries, including property development and construction, margin and profitability are key performance indicators.
- There may be practical difficulties in segmenting contracts into multiple performance obligations. The proposals for allocating revenue to multiple performance obligations may result in significantly different outcomes depending on the method and estimates used by entities, likely resulting in less comparable information.
- It is unclear if the principles of IFRIC 15 *Agreements for the Construction of Real Estate* will be incorporated in the new revenue recognition standard to provide guidance in determining how contracts for the construction of real estate should be applied.

In addition, the Discussion Paper omits discussions on a number of important items which are still to be debated by the Boards. The Boards' views on these items may significantly impact the financial statements of real estate entities:

a) How to adjust the transaction price for any uncertainties in the amount and timing of consideration, i.e. contingent payments;
b) How the measurement of an entity's contract rights will be impacted by collectability;
c) When and how revenue should be recognized, if at all, in transactions where the vendor has a continuing involvement in a property to the degree associated with ownership, subsequent to a sale;
d) Contract renewals and cancellation options; and
e) Modifications to a contract's terms and conditions after contract inception.

3. Specific Comments on the Discussion Paper

The remainder of this comment letter provides additional views of REESA on the Discussion Paper. We address both specific questions of the Discussion Paper as well as raise other issues not dealt with by the questions. All questions have been answered with the exception of Question 7, Question 10 (c) and (d), where REESA has no specific comments.

Question 1

Do you agree with the boards' proposal to base a single revenue recognition principle on changes in an entity's contract asset or contract liability? Why or why not? If not, how would you address the inconsistency in existing standards that arises from having different revenue recognition principles?; and

Question 2

Are there any types of contracts for which the boards' proposed principle would not provide decision-useful information? Please provide examples and explain why. What alternative principle do you think is more useful in those examples?

As more fully discussed earlier in this letter, REESA believes that the Boards' proposal to base a single revenue recognition principle on changes in an entity's contract asset or contract liability may be appropriate for lease contracts relating to investment properties if it is clear that lessors should apply the service income concepts as outlined. We believe that this clarification should be included in an amended *Investment Properties* standard. For all other contracts, REESA could also support one revenue recognition principle that is based on changes in an entity's contract asset or contract liability.

Question 3

Do you agree with the boards' definition of a contract? Why or why not? Please provide examples of jurisdictions or circumstances in which it would be difficult to apply that definition.

REESA agrees with the Boards' definition of a contract.

Question 4

Do you think the boards' proposed definition of a performance obligation would help entities to identify consistently the deliverables in (or components of) a contract? Why or why not? If not, please provide examples of circumstances in which applying the proposed definition would inappropriately identify or omit deliverables in (or components of) the contract.

REESA believes that the definition of a performance obligation is appropriate and that it will help entities identify multiple components of a contract. Having said that, there are circumstances in the real estate industry where it will continue to be difficult to identify separate performance obligations, and in particular, in identifying if the performance obligation is a service or a good being transferred to the customer. These circumstances generally relate to the construction of real estate where it is difficult to determine if a good is being sold (i.e. a constructed building) or if a service is being rendered (i.e. services for the construction of a building). Guidance in assessing whether a development contract is a construction contract or the sale of a property was addressed in IFRIC Interpretation 15 *Agreements for the Construction of Real Estate* (IFRIC 15). The status of IFRIC 15, and whether it will continue to apply, is unclear in the Discussion Paper. REESA would recommend that similar guidance as to that provided in IFRIC 15 be incorporated within the Discussion Paper to assist entities in determining when the construction of real estate is a delivery of a good or a construction service.

Question 5

Do you agree that an entity should separate the performance obligations in a contract on the basis of when the entity transfers the promised assets to the customer? Why or why not? If not, what principle would you specify for separating performance obligations?

REESA agrees that a contract should be separated into its separate performance obligations based on when the promised assets are transferred to the customer. However, the practicality of this approach is very dependent on the interpretation of "transferring control" of the promised assets to the customer, which we have several concerns with, and which we address in Question 8 below.

Question 6

Do you think that an entity's obligation to accept a returned good and refund the customer's consideration is a performance obligation? Why or why not?

REESA believes that an entity's obligation to accept a returned good and refund the customer's consideration is not a performance obligation. In real estate transactions, a vendor may sell a property where the buyer may be able to put the property back to the vendor if certain performance or sales/development conditions are not met. Consistent with IFRS and U.S. GAAP, in most transactions of this nature, revenue would not be recognized as the risks and rewards of ownership have not substantively been transferred to the buyer (i.e. it is a failed sale). If the put on the property were to be recognized as a separate performance obligation, revenue would be allocated to both the property and to the put itself (assuming control of the property has been transferred to the buyer). It is our view that no revenue should be recognized on the sale of the property under this example until the put has expired.

Question 8

Do you agree that an entity transfers an asset to a customer (and satisfies a performance obligation) when the customer controls the promised good or when the customer receives the promised service? Why or why not? If not, please suggest an alternative for determining when a promised good or service is transferred; and

Question 9

The boards propose that an entity should recognise revenue only when a performance obligation is satisfied. Are there contracts for which that proposal would not provide decision-useful information? If so, please provide examples.

The concept of "transferring control" to a customer is a pivotal element of the revenue recognition principles of the Discussion Paper. REESA believes that the Discussion Paper does not adequately clarify how the concept of "transferring control" of a promised good would be applied to sales of "inventory property" (property that is developed for sale) or to construction contracts; and to the transfer of title under each.

<u>Sales of inventory property</u>

There are two issues arising from the lack of clarity around "transferring control" for sales of inventory property.

Paragraph 4.18 suggests that control would be defined by applicable laws in which an entity operates, thus providing a legalistic view. In a pure legal sense, *control* of property is not obtained until the *title* of property is obtained. For sales of inventory property, if applying a legalistic view, the same economic transaction could result in very different timing of the recognition of revenue depending on the jurisdiction in which an entity operates. For example, in certain jurisdictions it is very common for vendors of property to hold back the transfer of title of the property to ensure collection of the consideration received from the buyer, even though the buyer has obtained control, in substance, of the property and utilizes it in accordance with full ownership (for example the buyer may commence development of the property even though title has not yet passed). Another example that is common is the sale of condominium units where title may not pass to the buyer of the condominium unit until well after the buyer has taken possession of his/her unit (control in substance) and title passes only at that point in time when the building obtains confirmation of its condominium corporation status. In most cases under current standards, revenue is recognized in these transactions when the risks and rewards of ownership (control in substance) is transferred to the buyer, generally at the time when the buyer takes possession of the property and all significant acts have been completed such as the signing of a purchase and sale agreement, significant completion of construction and consideration has been transferred from the buyer to the vendor. Under the proposed legalistic view, revenue would not be recognized until title of the property has passed to the buyer which could be at a significantly later date. We do not agree that the simple fact that laws and practices vary from jurisdiction to jurisdiction should result is substantive differences in the timing of revenue recognition when in substance, the same economic transaction has occurred. REESA recommends that the principles under current accounting standards around the transfer of risks and rewards of ownership be carried forward into the new revenue recognition standard as factors to be considered in assessing whether control has transferred to the customer.

The second issue pertains to a weakness, in REESA’s view, of using the transfer of legal control principle over the transfer of risks and rewards principle to recognize revenue. The Discussion Paper does not address when revenue should be recognized, if at all, in transactions where the vendor has a continuing involvement in a property to the degree associated with ownership, subsequent to a sale. Current standards, specifically paragraph 14 (b) of IAS 18 and paragraphs 25 to 43 of SFAS 66, address this issue and REESA believes the new revenue recognition standard should consider including similar guidance.

REESA believes that the concept of transferring control of a promised asset or service to a customer should be more broadly developed so that more than a legal view can be considered and where the substance of the contract and judgment are also considered.

Construction Contracts

REESA also believes that the principles of the Discussion Paper regarding the “transfer of control” will have an impact on how construction contracts will be accounted for that may lead to materially different timing of revenue recognition for development contracts with multiple elements. Again, the Discussion Paper leans towards a legalistic view on the transfer of control and therefore title transfers, being a key determinant in the transfer of legal control, will result in varied revenue recognition dependent on the local laws in which developers operate.

Based on the Discussion Paper, construction contracts will need to be separated into a series of promises to transfer assets to the customer (performance obligations) during the construction period. The pattern of revenue recognition will depend on the delivery of those performance obligations at estimated selling prices and not necessarily on the status of construction, nor the costs incurred to date. This may create volatile margins being recognized in the statement of comprehensive income throughout the project if the input costs do not correlate to the transfer of control of the construction assets to the customer. Revenue is therefore measured on customer-determined outputs which may be completely disconnected from related input costs. For construction contracts, we disagree with the comment in paragraph 4.8 which states that revenue does not reflect the *activities* of the entity in producing goods and services. It is well understood that in relation to long term construction contracts, revenue is linked to activities performed, effort expended, and costs incurred during the contract period.

REESA notes that the Discussion Paper does not address the recognition of costs incurred in a contract, i.e. the costs incurred when a performance obligation is satisfied and how this may or may not be linked to the revenue recognized. We believe the recognition and measurement of costs is vital to providing decision useful information to users in assessing the economic performance of any contract and therefore should be incorporated into the revenue recognition model.

REESA would prefer that revenue recognized on construction contracts reflect the underlying substance of the transactions, generally reflecting the completion of key milestones in the contract or based on a percentage of completion method rather than when individual performance obligations are satisfied based on the legal interpretation of when control transfers to the customer in accordance with the contract.

It is not clear whether IAS 11 would continue to apply to construction contracts under the new revenue recognition model. IAS 11 allows the percentage of completion method of revenue recognition to apply which appears to be inconsistent with the revenue recognition model of the Discussion Paper. REESA would recommend that IAS 11 remain the relevant standard for construction contracts and that similar guidance as to that provided in IFRIC 15 be incorporated within the Discussion Paper to assist entities in determining when an agreement for the construction of real estate is within the scope of IAS 11 or the new revenue recognition standards.

Question 10 (a)

In the boards' proposed model, performance obligations are measured initially at the original transaction price. Subsequently, the measurement of a performance obligation is updated only if it is deemed onerous. (a) Do you agree that performance obligations should be measured initially at the transaction price? Why or why not?

REESA agrees that performance obligations should be measured initially at the transaction price as it remains the most objective input that will likely result in the most consistent initial recognition of performance obligations for all contracts. REESA supports the view that revenue should not be recognized at contract inception and we also believe that it would be extremely difficult and unnecessarily complex to measure performance obligations at their current fair value or exit price.

Question 10(b)
(b) Do you agree that a performance obligation should be deemed onerous and remeasured to the entity's expected cost of satisfying the performance obligation if that cost exceeds the carrying amount of the performance obligation? Why or why not?

REESA agrees with the proposals regarding the remeasurement of performance obligations.

Question 11
The boards propose that an entity should allocate the transaction price at contract inception to the performance obligations. Therefore, any amounts that an entity charges customers to recover any costs of obtaining the contract (eg selling costs) are included in the initial measurement of the performance obligations. The boards propose that an entity should recognise those costs as expenses, unless they qualify for recognition as an asset in accordance with other standards. Do you agree that any amounts an entity charges a customer to recover the costs of obtaining the contract should be included in the initial measurement of an entity's performance obligations? Why or why not? (b) In what cases would recognising contract origination costs as expenses as they are incurred not provide decision-useful information about an entity's financial position and financial performance? Please provide examples and explain why.

REESA agrees that any amounts an entity charges customers to recover costs of obtaining a contract should be included in the initial measurement of an entity's performance obligations as this is consistent in how most transactions are priced. This view is also consistent with our view in Question 10 (a) above where we agree that performance obligations should be measured initially at the transaction price rather than at exit price. We also agree these costs should be capitalized and recognized as an asset when it is probable that economic benefits will flow to the entity and as required by other standards.

Question 12
Do you agree that the transaction price should be allocated to the performance obligations on the basis of the entity's stand-alone selling prices of the goods or services underlying those performance obligations? Why or why not? If not, on what basis would you allocate the transaction price? and;

Question 13
Do you agree that if an entity does not sell a good or service separately, it should estimate the stand-alone selling price of that good or service for purposes of allocating the transaction price? Why or why not? When, if ever, should the use of estimates be constrained?

REESA generally supports the view that a contract may have different components that may result in separate recognition of revenue for each component based upon different timing of satisfying the performance obligation. We also support the view that the transaction price should be allocated to the performance obligation on the basis of the entity's stand-alone selling price, if available, or on the basis of an estimated stand-alone selling price. We are however concerned that the recognition and allocation of revenue to a contract's various components may be unnecessarily complex for some transactions, particularly where the contract has multiple components that are not generally sold separately and therefore the stand-alone selling price must be estimated. In transactions where a warranty obligation or other post-closing obligation exists, following the sale of an asset, it may be very difficult to estimate the revenue to be allocated to such items when no real market exists to price the items. This will require significant judgment in many cases and could lead to inconsistent application of the standard for similar transactions. In the real estate industry, a developer that sells inventory property, may offer warranties or be committed to the completion of certain work such as landscaping, following the sale. In accordance with the Discussion Paper, the warranties and post-sale work may be considered separate performance obligations and be required to be separated from the sale of the property and revenue would be separately recognized for each component. Estimates will be necessary to determine the amount of revenue to be allocated to each component since in most cases the developer would not have standard stand-alone pricing for warranties or other work. Our concern centres largely on the complexity in recognizing the revenue on warranty obligations. The example provided by paragraph A24 suggests that entities will need to assess the price of warranty coverage for each increment of time, on a stand-alone basis, based on expected claims over the specific period of warranty. For a developer, this could prove to be an onerous exercise in determining claim estimates. This approach appears overly complex versus the recognition of the warranty revenue on a straight-line basis over the term of the warranty, or based on costs incurred to service the warranty – both much simpler methods. We fail to see how the recognition of warranty revenue proposed by the Discussion Paper would result in significantly more useful information to users of the financial statements.

Other Issues Not Specific to Questions

Contingent Payments

REESA notes that in accordance with paragraph 5.25, footnote 11 of the Discussion Paper, the Boards have not yet expressed a preliminary view on how to adjust the transaction price for any uncertainties in the amount and timing of consideration. Contingent payments are very common elements of purchase and sale contracts of property. For example, a vendor may sell a property to a buyer where part of the consideration will include a percentage of profit or lease revenues of the property over a specified period. Contingent payments are also common under construction contracts where provisions in the contract require that the consideration be modified if the prices of raw materials change.

REESA encourages the Boards to develop a view on how contingent payments will impact the transaction price. We believe that contingent payments should be recognized when the contingency amount has been determined and it is probable that the contingent payment will be received. We believe this approach would result in the least volatile and most objective recognition of revenue. We understand that the Boards have tentatively decided that at contract inception, the transaction price should be an amount that is the expected customer consideration based on a probability-weighted estimate. After contract inception, any change to the probability-weighted estimate will flow through revenue or the performance obligation amount depending on whether the performance obligation has been satisfied. We believe this approach is less desirable due to its complexity and increased chance for volatility to the financial statements.

Collectability of Contract Rights

REESA notes paragraphs 6.13 and 6.14 of the Discussion Paper that states that when collectability is not reasonably assured, under the proposed model, revenue could be recognized sooner than under current standards. We also note that the Boards need to consider how the recognition of an entity's contract rights will be impacted by collectability. REESA is concerned that under the proposed model which is based on an assets and liabilities approach, the statement of comprehensive income may be compromised by overstating revenues for transactions that perhaps should not be recognized in the first place. Under many real estate transactions, collectability is often assessed by considering whether the customer has made a sufficient down payment of the total consideration of the contract, among other factors. We believe that collectability of contract rights should be considered in evaluating whether revenue is recognized.

Illustrative Examples

REESA members prefer that a final standard developed for Revenue Recognition contain a clear set of principles, without having to rely on numerous illustrative examples in order to clarify these principles. However, for the purposes of developing a set of principles for the final standard, we encourage the Boards to develop improved illustrative examples which enable a better understanding of the objectives behind the principles proposed in the Discussion Paper. The Discussion Paper contains very simple examples that do not demonstrate adequately how various contracts will be accounted for from inception to final delivery of the asset or service. It would be helpful to understand how the model impacts the financial statements, from balance sheet recognition/derecognition of assets and liabilities, to revenue and expense recognition, to ultimately cash flow presentation.

APPENDIX I

REESA – The Real Estate Equity Securitization Alliance

The real estate industry has responded positively to the challenges presented by the developments in the global economy and, in particular, the global real estate markets. Collectively the organizations in REESA are responsible for representing a large proportion of the global real estate market. 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. Associations represented thus far in the alliance include:

- Asian Public Real Estate Association, APREA
- 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
- Association for Real Estate Securitization (Japan), ARES

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

- Financial Statement Presentation
- Reporting Discontinued Operations
- Real Estate Sales – IFRIC D21
- Capitalization of Borrowing Costs - IAS 23
- Accounting for Joint Arrangements – ED 9
- Consolidated Financial Statements – ED 10
- IASB 2007/2008 Annual Improvements to IFRS
- FASB/IASB Leasing project
- OECD developments on cross border real estate flows and international tax treaties

Relationship of Rental Income to NPI, IFO and NAV

The measurement of operating performance, the fair value of investment property and the pricing of shares are linked in simple and direct relationships. Rental income less direct property operating costs provides “net property income” (NPI). Projected NPI discounted at current investor yield requirements or the capitalization of a given year’s NPI provides the property’s fair value – a factor in determining “net asset value”. Multiples applied to “income from operations” (IFO) provides an indication of the price of the company shares.

	Current Accounting	
Income Statement Caption:		
Lease/rental revenue	$	12,370
Total Lease Income	**$**	**12,370**
Direct operating costs	$	(4,000)
Net Property Income	**$**	**8,370**
Administrative costs	$	(2,000)
Interest on lease receivables		none
Interest expense		(4,370)
Income From Operations	**$**	**2,000**
Property Fair Value:		
Net property income	$	8,370
Capitalization rate		9%
Property fair value	$	93,000
Debt outstanding		(65,000)
Net Asset Value	**$**	**28,000**
Share Price:		
Income from operations	$	2,000
Earning multiple		13
Implied Share Price	**$**	**26,000**
Share Price Discount to NAV		**7.14%**

Overview of the Commercial Real Estate Industry

Developments over recent years have confirmed real estate's emergence as a mainstream global asset class. Estimated real estate transactions worldwide were over $523 billion in 2008 ($1.2 trillion in 2007)[3], with an estimated further $66 billion of funds with real estate assets under management. In 2008 real estate transactions in Europe were $215 billion (2007: $401 billion), In Asia Pacific region $151 billion (2007: $270 billion) and in the Americas $156 billion (2007: $554 billion).

Recent estimates identified $759 billion of worldwide commercial property transactions in 2007, a significant increase over 2006[4]. The United States has by far the largest real estate market, followed by Japan and the four major European economies. Almost 30 percent of the world's high quality commercial real estate is located in the United States. The Europe, Middle East and Africa (EMEA) region together represents more than 20%[5].

In recent years, there has been an emergence of the growth and number of international global real estate funds totaling 303 in 2008 (2007: 281)[6]. Due to the diverse opportunities in the private and public capital markets for domestic investors to participate in foreign real estate markets. Several factors are attributed to the increase in global real estate investment, including:

- The emergence of real estate as an asset class that is increasingly seen as an important solution to the ever growing retirement/savings needs of an aging global population.
- Real estate companies are themselves increasingly going global.
- More of the major industrialized countries are launching Real Estate Investment Trust (REIT) structures which are facilitating the transfer of ownership of real estate from the private to the public markets (China and India have recently announced the introduction of REITs in 2009). The top 10 real estate companies worldwide had a total market capitalization of €166 billion as at October 2007, with 55% of the value being represented by REITs.
- Investors in general are increasing their investment in global funds —attracted by what they perceive to be underdeveloped REIT markets overseas, with opportunities of achieving greater diversification and returns than that of domestic markets.

However, one important consistency between real estate and other major asset classes is that, because real estate competes in the broader capital markets, analysts use similar tools to estimate real estate values as with other assets. In particular, values are based on forecasts of future cash flows discounted back to the present at a rate of return that reflects the underlying risk associated with those cash flows. The process is relied upon by lenders in loan underwriting, by investors in determining expected returns, and security analysts when calculating net asset values (NAVs) of REITs.

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[3] Real Capital Analytics [www.rcanalytics.com].Based on independent reports of properties and portfolios $10 million and greater.
[4] Reuters – 31 Jan 2008
[5] Global listed real estate- EPRA
[6] Macquarie Global Property Securities Analytics Funds database (previously the AME Capital Funds database).

The Development and Use of Supplemental Metrics in the Investment Property Industry

Financial statement preparers, investors and financial analysts have long recognized the unique business and economic characteristics of owning and operating investment property. Over a number of years, market forces and industry cooperation has resulted in the development and adoption of supplemental metrics which measure operating results and financial position that more faithfully reflect these characteristics and thus provide more useful information to investors. This Appendix provides more information on the developments of these supplemental metrics and their usage by the global property investment community.

Examples of supplementary measures adopted for REITs and property investment companies around the world include:

US and Canada – funds from operations (FFO)

US REITs calculate funds from operations (FFO), as recommended by NAREIT, by adding real estate related depreciation and amortization expenses back to earnings, giving a measure of the a REIT's performance that more closely reflects economic profitability. This is considered to be a better measure of the REIT's performance than reported net earnings.

Europe – EPRA Earnings and NAV less fair value adjustments

Every year, EPRA publishes its Best Practices Recommendations (BPRs) which provide a framework for encouraging consistent and relevant financial information for real estate companies that own and operate investment property. EPRA recommends two key measures as described below:

<u>EPRA Earnings (equivalent to FFO)</u>
For real estate companies, EPRA Earnings is a key measure of a company's profitability and of its ability to make sustainable dividend payments to shareholders. This metric represents the level of recurring income generated from core operational activities and provides an indicator of the underlying performance of the property portfolio. Therefore, it excludes all income and expense elements, including any revaluation results and results from sales of investment properties that are not relevant to the on-going operating performance of the property portfolio.

<u>EPRA NAV</u>
The majority of European companies account for real estate at fair value and it has become common for industry analysts to calculate and publish a 'triple net' NAV per share. This is a key performance metric used in the European real estate industry and the majority of European REITs choose to voluntarily disclose this figure based on the balance sheet. The objective of the EPRA NAV measure is to highlight the fair value of equity on a long term basis.

Asian Public Real Estate Association
Singapore

British Property Federation
United Kingdom

European Public Real Estate Association
Netherlands

National Association of
Real Estate Investment Trusts
United States

Property Council of Australia
Australia

Real

Property Association of Canada
Canada