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Financial Accounting Standards Board  
Technical Director - File Reference No. 1850-100  
401 Merritt 7 - PO Box 5116  
Norwalk, CT 06856-5116

**Re: Proposed Accounting Standards Update, Topic 840: *Leases*; Exposure Draft**

Dear Board Members:

This letter represents the response of Teachers Insurance and Annuity Association of America (“TIAA”, or the “Company”) to the Financial Accounting Standards Board (the “FASB”) regarding the lease accounting exposure draft jointly issued by the Financial Accounting Standards Board and the International Accounting Standards Board (the “Boards”) on August 17, 2010.

TIAA was established in 1918 as a legal reserve life insurance company under the insurance laws of the State of New York and is regulated by the New York State Insurance Department (the “Department”). Accordingly, TIAA prepares financial statements on the basis of statutory accounting principles prescribed by the Department; a comprehensive basis of accounting that differs from generally accepted accounting principles in the United States (“GAAP”). The Department requires insurance companies domiciled in the State of New York to prepare their statutory-basis financial statements in accordance with the National Association of Insurance Commissioners’ (“NAIC”) Accounting Practices and Procedures Manual (“NAIC SAP”), subject to any deviation prescribed or permitted by the Department.

Investments in TIAA’s General Account include real estate investments held in wholly-owned subsidiaries of TIAA. Under NAIC SAP, TIAA is required to account for its investments in these subsidiaries based on the audited GAAP equity of each subsidiary. Accordingly, these subsidiaries account for their real estate investments in accordance with Topic 360, *Property, Plant and Equipment*, and Topic 840, *Leases*.

In addition to real estate investments held in the Company’s General Account, TIAA created The TIAA Real Estate Account (the “Account”) in 1995 as a segregated investment account for the purpose of investing in real estate investments and issuing tax-exempt variable annuity contracts to policyholders. As a registrant with the Securities and Exchange Commission, the Account is required to provide audited financial statements prepared in accordance with GAAP. The Account contains the attributes of an

investment company as described in Topic 946, *Financial Services – Investment Companies*, (former AICPA Audit and Accounting Guide: *Investment Companies*) and accordingly reports all real estate investments at fair value.

Real estate investments held by TIAA and the Account have a combined carrying value of approximately \$18 billion. Collectively this investment portfolio consists of approximately 455 directly-owned commercial, industrial, multi-family and retail property investments that are leased to third-party lessees under approximately 15,000 individual lease agreements, all of which will be subjected to the proposed lease accounting rules.

TIAA is also a key provider of debt financing within the commercial real estate industry. Borrowers are generally GAAP compliant entities and therefore would be impacted by the proposed lease accounting rules as they apply to lessors. The impact of these rules on future property valuations and the overall lending markets will also impact TIAA and other lenders in the industry.

The proposed lease accounting rules will have the greatest impact to TIAA in relation to the company's real estate investment and mortgage lending businesses and accordingly our comments will focus on the applicability of the proposed rules to the real estate industry. The management of TIAA appreciates the opportunity provided by the Boards to comment on the lease exposure draft. We elected to do so in a format that includes a detailed explanation of our concerns regarding the impact of the proposed rules, as well as individual responses to the nineteen questions provided in the exposure draft. Our comments will also address the anticipated release of the FASB's exposure draft on the proposed accounting for *Investment Properties*. In our opinion, it is imperative that the FASB release an investment properties exposure draft in a timely manner so its impact can be assessed in conjunction with the impact of the proposed lease accounting rules on the real estate industry. Given the correlation between the two potential accounting updates that are described in detail in this letter, the issuance and effective dates of the final accounting updates should be aligned with each other.

### **Fundamentals of Real Estate:**

Real estate is unique when compared to other leasable assets such as machinery and equipment as each property typically has multiple lessees, appreciates in value over time, and is actively managed on a day-to-day basis. We strongly believe the accounting proposed in the proposed lease exposure draft would distort the reporting of real estate leasing activity within the real estate industry, rather than increase comparability and transparency, and have significant unintended negative consequences to the business fundamentals of investing directly in real estate and commercial mortgage lending.

TIAA recognizes and appreciates the overall objectives of the Boards which include the improvement of financial statement transparency, provision of a principal-based set of standards, and alignment of lease accounting with the Boards' conceptual framework as it applies to the definitions of assets and liabilities. However, we request that the Boards consider the following facts, and the potential and unintended impact that the proposed lease accounting rules would have on the real estate industry:

- i. Real estate is fundamentally different from other leased assets. The requirement for active management over multiple leases affecting a single property distinguishes real estate from other leased equipment and financial assets.
- ii. A lessor's recognition and measurement of a real estate investment that includes a lease payment receivable and a performance obligation liability, in addition to long-lived assets, together with reporting a component of the lease income as interest income is contrary to the business fundamentals of a real estate investment.
- iii. Lessees and lessors enter into lease transactions for different business reasons. Therefore, a real estate lessor should not be required to conform its lease accounting model for the purpose of applying new accounting rules which are symmetrical to that of the lessee.
- iv. In comparison to the proposed lease accounting rules, a lessor's reporting of real estate (i.e. investment properties) at fair value and recording income on an accrual basis accurately depicts the economic characteristics of a real estate investment. A fair value reporting basis for lessors will provide an accounting model for evaluating investment property performance and consider changing market values for rents and valuation yields, while enabling meaningful financial analysis to be undertaken by financial statement users.

**Investment Property Exposure Draft; Lessor Impact:**

TIAA supports the FASB's anticipated release of a proposed update that would permit investment properties to be reported at fair value under GAAP. We believe this proposed update should be analogous to IAS 40, *Investment Properties*, which in principle supports investment properties to be reported at fair value and would provide for such investment properties to be outside the scope of the proposed lessor accounting rules.

We strongly urge the FASB to exclude investment properties reported at fair value from the scope of the proposed new lease accounting standard based on the following considerations:

- a. A convergence of GAAP with International Financial Reporting Standards (“IFRS”), specifically the reporting of investment properties at fair value under IAS 40 results in a consistent and informative basis of accounting for investment properties globally;
- b. A fair value accounting model improves the transparency of financial statements to investors by providing investment performance results indicative of current market conditions;
- c. The reporting of real estate investments at fair value results in a relevant measurement of a company’s net asset value (“NAV”) or comparable balance sheet measurement reported to investors;
- d. Investors with holdings in multiple asset classes can easily compare the performance results between real estate investments and other investments.
- e. Under a fair value accounting model a property’s operating results are reported based on accrued rental income and managed expenses directly correlated to the property’s day to day operations, performance metrics that are crucial to experienced real estate investors.

We intend to comment on the proposed update regarding investment properties once the exposure draft is finalized and available for public comment. It is our opinion that a timely issuance of an exposure draft on investment properties is necessary so that both proposed exposure drafts can be jointly accessed regarding the impact to real estate lessors. If this timing objective cannot be achieved, we urge the FASB to provide a temporary deferral for real estate lessors regarding the proposed lease accounting rules until such time as the investment properties’ accounting guidance is also finalized.

**Real Estate Lessor Concerns:**

Please consider the followings issues specifically related to real estate lessors:

- i. The TIAA Real Estate Account is one of many reporting entities within the real estate institutional investment community, as well as the private real estate investment community that contain the attributes of an investment company under Topic 946 and accordingly report investments in real estate at fair value, and rental income on an accrual basis. Given TIAA’s experience in the real estate valuation process, it is our opinion that reporting a lease receivable asset under the right-to-use model on a lessor’s balance sheet in addition to reporting the related leased property at fair value would result in a double-counting effect in relation to future expected cash flows from leases. These cash flows are a substantive valuation input when determining the fair value of a property under a discounted cash flow method (under the *Uniform*

*Standards of Professional Appraisal Practice* the application of a discounted cash flow analysis when valuing real estate under the income approach has prevailed for many years).

- ii. Unlike other asset classes, real estate is an actively managed asset. A lessor enhances property values through the preservation of multiple tenant relationships within a single leased property and the management of costs associated with the operation of a brick and mortar structure. The lessor's active management surrounding real estate distinguishes this asset class from other leasable assets (e.g. equipment) that are leased through a single lease agreement and are less actively managed on a daily basis. Accordingly, we believe a real estate lessor should continue to report leasing operations as rental income and rental expenses, and not bifurcate rental income to include an interest income component as proposed under lease exposure draft. Providing such key metrics allows financial statement users to assess investment property and lessor performance. Although our proposal for lessor accounting may not be symmetrical to that of a lessee under the proposed lease accounting rules we believe this is appropriate since the business objectives of a lessor and lessee are not symmetrical.
  
- iii. Under the "derecognition" approach a lessor is required to derecognize a portion of the leased asset when the lessor does not maintain significant exposure to risks and rewards of the leased asset during or after the lease term; derecognition would be required even though a legal sale has not occurred. The lessor would record a lease receivable and not record a performance obligation liability, while classifying the remaining carrying value of the leased asset as a *residual* asset. Such a presentation in a lessor's financial statements would indicate a partial sale or the transfer of a portion of the property's value to the lessee. We are of the opinion that the derecognition concepts under this approach are inconsistent with the derecognition concepts for real estate sales under the standing authoritative guidance in Topic 360-20, *Property, Plant and Equipment - Real Estate Sales*. The proposed derecognition model is far different than the legal and economic substance of the transaction and will confuse financial statement readers. Regardless of lease terms, it is unlikely that an owner/lessor of real estate will transfer their legal responsibility for a property without legally transferring title, in whole or partially, to a third-party. If the lessor continues to be legally liable for the property that it owns, a partial derecognition of a property will be misleading to financial statement readers. From this prospective, we disagree that the derecognition approach is appropriate for real estate lessors when a sale has not occurred in accordance with Topic 360-20 and propose that the derecognition approach include a scope exception for real estate lessors. In

our opinion, existing guidance in Topic 360-20 should be applied when derecognizing real estate investments or in substance real estate assets.

### **Other Real Estate-Related Concerns:**

In addition to specific real estate lessor related concerns stated above, we are also concerned with the overall potential impact to real estate leasing activity, as well as the industry as a whole as outlined below. The propensity on the part of lessees to enter into shorter term leases to minimize the impact of the proposed lease accounting rules on their balance sheet may have a profound effect on how real estate is typically viewed as a long-term investment. For example, insurance companies tend to allocate a portion of their General Account assets to equity and debt investments in real estate. If the long-term investment perception of real estate were to dissipate over time, we could begin to see a mass liquidation by investors who no longer view the returns on real estate to align with the associated risks of shorter term leases. The following issues outline additional concerns for the real estate industry:

- i. The Boards' seek to achieve financial statement transparency through the issuance of the proposed lease accounting rules. However, as these proposed rules are applied within the real estate industry the transparency objective could be compromised by inconsistent practices among reporting entities. The proposed method to determine expected lease terms and expected lease payments is highly subjective in that lessors and lessees must consider lease renewal options and variable rent components (e.g. contingent rent, index-based rent adjustments). Such requirements will result in inconsistent methodologies applied when determining the probability of lease renewals and future rent adjustments. Accordingly, we request the Boards to reconsider their definition of "lease term" and "lease payment" and require that the determination of lease term and lease payment to include renewal periods and variable rent components only when the results of a probability assessment can provide reasonable assurances for adjustments in the lease term or lease payments so that volatility in earnings can be minimized over the life of the lease. We understand and appreciate the Boards' concern to discourage future lease negotiations that could result in one-year lease terms with multiple one-year renewal options as a means to minimize the assets and liabilities recorded under the proposed lease accounting rules. However, the attributes and rights associated with a real estate lease contract have a far greater economic and legal impact than most other leasing contracts given the liabilities associated with real estate ownership and occupancy. The process to identify a viable space appropriate for leasing, the process to enter into a lease contract, and the build-out of leasehold improvements are a costly endeavor to lessees and lessors. Such costs are substantiated by several important factors, including

the merits of a long-term lease, and therefore the negotiation of a one-year lease with one-year renewal options in the commercial real estate industry is not a feasible action, nor an economically sound transaction in most cases.

- ii. The proposed lease accounting rules will result in a financial statement presentation that is inconsistent with the economics of a real estate lease transaction. The front-loading effect on the income statement by the lessor and lessee due to interest method of amortization is a further distortion of cash flow associated with real estate leasing activity, more so than the current straight-line rent method applied by reporting entities that report real estate at depreciated cost. Furthermore, financial statement metrics (i.e. financial ratios) will be inappropriately impacted by the additional lease assets and liabilities recorded by lessees and lessors. The potential for an unintended breaching of debt covenants due to an increase in liabilities can cause borrowers (lessees or lessors) and lenders to enter into costly negotiations in order to cure such breaches caused by adopting the proposed lease accounting guidance.
- iii. The real estate industry anticipates lessees will begin to negotiate shorter than customary lease terms in order to minimize the recording of lease assets and liabilities required under the proposed lease accounting rules. Potentially, such strategies could result in shorter lease terms than currently witnessed in today's real estate that may not be in the best interest of the lessee-company and/or its shareholders. Furthermore, lessors and lessees are less likely to invest substantially into tenant improvements with shorter lease terms, and the pending increase to annual amortization expense given an accelerated amortization period. We are concerned that an accounting-driven change in leasing strategies could have a negative economic effect unintended under the proposed rules. We caution the Boards in issuing guidance that will strongly encourage businesses to structure transactions to accommodate preferable accounting and not for the best economic outcome in the long-term.
- iv. Given the likelihood of shorter lease terms in the future, real estate valuations could be negatively impacted. Real estate appraisers are potentially faced with determining the fair value of a property based on shorter lease terms (e.g. 3-5 years) in comparison to today's customary lease terms, which on average range 7-15 years depending on several factors such as the size of the leased space. Valuation professionals will have to rely less on reliable valuation inputs such as in-place long-term leases and rely more on subjective leasing projections. The level of risk that a lender must assume will increase since shorter lease terms will lead to reduced contractual cash flows. Additionally, shorter lease terms will lead to frequent lessee turnover, increase risk to the lessor, and result in additional leasing costs incurred by the lessors

in order to stabilize occupancy levels, which the lack thereof could have a back-end effect by destabilizing property values and creating unwanted volatility in the real estate market. This series of events may potentially decrease the amount of future capital available for financing the purchase of real estate.

- v. Lessees and lessors will incur significant incremental costs to acquire, implement and maintain software that can accommodate the new accounting and reporting requirements under the proposed update. Additional staffing will be necessary for the on-going assessment and control over leasing activity to ensure compliance with the proposed update and appropriateness of adjusting entries. Retrospective accounting requirements for in-place leases will intensify these costs and resource issues beyond reasonable means. TIAA collectively owns approximately 455 real estate investments that are leased to third-party lessees under approximately 15,000 leases which will result in TIAA participants incurring significant incremental costs to acquire staff and data systems to implement the new accounting rules and apply those rules in subsequent periods.

We welcome the Boards' significant outreach activities relating to this exposure draft, but believe they should be further extended to explore the applicability of the proposed rules on the real estate leasing industry. Additionally, there does not appear to be evidence to demonstrate that the existing lessor accounting model is ineffective and should be replaced to achieve symmetrical accounting to that of lessees under the proposed rules.

The introduction of two potential lessor models increases the confusion under a principle-based set of rules and may not facilitate financial statement transparency or faithful representation to investors. For the model to be operational, the principles and implementation guidance must be shown to work effectively for all types of leases. We believe that issues will surface through field testing that will reveal financial reporting that both distorts the economics of the transaction and does not provide decision-useful information to the reader. We would be pleased to discuss our comments above or the answers to the specific questions in Appendix 1 with you at your convenience. Should you wish to discuss the contents of this letter, please contact either John Venezia at 212-916-4713 or [jvenezia@tiaa-cref.org](mailto:jvenezia@tiaa-cref.org), or Phillip Nickolenko at 704-988-6008 or [pnickolenko@tiaa-cref.org](mailto:pnickolenko@tiaa-cref.org)

Very truly yours,

John Venezia, CPA  
Accounting Policy, Director

Phillip Nickolenko, CPA  
VP, Real Estate Chief Financial Officer

### Question 1: Lessees

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

Response:

We disagree that lessees should recognize right-to-use assets and lease payment liabilities under the exposure draft given the potential for unintended negative and material consequences to the real estate leasing industry that are explained in detail above. If the board elects to proceed with the proposed lease accounting rules, notwithstanding the concerns of its constituents, we urge the Boards to revisit their definitions of *lease term* and *lease payment* (see answers to questions 8 and 9).

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

Response:

We disagree with the proposed requirements for lessees to record amortization and interest expense in place of rental expense. These accounting requirements are not indicative of the business fundamentals associated with a real estate lease transaction, particularly given the fact that a lessee has specifically entered into a lease to occupy real estate as an alternative to acquiring direct ownership of a property through a finance arrangement. We urge the Boards to reconsider and allow real estate lessees to continue to report rental expense under present GAAP.

### Question 2: Lessors

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

Response:

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

information in comparison to a depreciated cost model, accompanied by the proposed lease accounting rules.

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

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

Response:

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

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

Response: We agree.

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

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

*Response:*

Short term leases (leases with a term or 12 months or less) are not common in the commercial real estate industry, with the exception of residential real estate properties (for example, apartment properties). We agree that short-term leases should be accounted for as described in the proposal because the administrative burden of accounting for leases with yearly tenant turnover would be significant. Also, we believe that the proposed standard should be clarified to ensure that the accounting does not change for short-term leases that include language where residential lessees could continue to occupy the leased space on a month-to-month basis after the initial term is complete.

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

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

*Response:*

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

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

*Response:*

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

Under the “derecognition” approach, a lessor who does not maintain significant exposure to risks and rewards associated with the leased asset is required to derecognize a portion of the asset. Such a presentation in a lessor’s financial statements would indicate a partial sale or the transfer of a portion of the property’s value to the lessee. This presentation would present a view far different than the economic and legal substance of the transaction. Regardless of the terms of a lease, it is unlikely that an owner/lessor of real estate would transfer

their legal responsibility for a property without legally transferring title, in whole or partially, to a third-party. From this prospective, we disagree that the derecognition approach is appropriate for real estate leases where a bona fide sale has not occurred and propose that the derecognition approach include a scope exception for real estate lessors. In our opinion, the sale or derecognition of real estate should continue to be accounted for under existing guidance in Topic 360-20, *Real Estate Sales*, section 40-5 and related literature which require the following:

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

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

Response:

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

**Question 5: Scope exclusions**

This exposure draft proposes that a lessee or a lessor should apply the proposed guidance to all leases, including leases of right-of-use assets in a sublease, except leases of intangible assets, leases of biological assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (paragraphs 5 and BC33–BC46). Do you agree with the proposed scope of the proposed guidance? Why or why not? If not, what alternative scope would you propose and why?

Response:

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

The reasons for our position are stated below:

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

We agree that the scope executions indicated in the exposure draft are appropriate given the uniqueness of leases related to intangible, biological and oil and gas assets. We strongly feel real estate lessors should be excluded as well.

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

This exposure draft proposes that lessees and lessors should apply the guidance in proposed Accounting Standards Update, *Revenue Recognition* (Topic 605): *Revenue from Contracts with Customers*, to a distinct service component of a contract that contains service components and lease components (paragraphs 6, B38 and BC47–BC54). If the service component in a contract that contains service components and lease

components is not distinct, the FASB proposes the lessee and lessor should apply the lease accounting requirements to the combined contract.

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

*Response:*

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

We believe that a triple net lease whereby the tenant pays certain expenses of the property directly and a lease whereby a landlord is reimbursed for those expenses (i.e. common area maintenance, insurance, and property taxes) should be treated the same. That is, any reimbursements to the landlord of such expenses should be recognized as incurred and not considered part of rental revenues for calculation of the lease asset or liability.

**Question 7: Purchase Options**

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

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

### **Question 8: Lease term**

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

*Response:*

We believe the Boards should reconsider their definition of lease term and require that the determination of the longest possible lease term include renewal periods or terminations when the results of a probability assessment can provide reasonable assurances that these events will occur. We are concerned that the proposed rules may result in earnings volatility when renewals and terminations presumed to occur in fact do not occur. We believe that the proposed guidance will result in inconsistencies in financial reporting across the real estate industry as different companies apply various methodologies to determine the longest possible lease term.

Real estate lease renewal options are typically unilateral in nature and the lessee can choose not to renew a lease despite economic motivations to the contrary. Given the long-term nature of real estate leases, determining renewal probabilities is highly subjective and results in probabilities that are highly uncertain due to the large number of uncontrollable and unforeseeable factors that come into play. The users of financial statements would be ill-served if unexercised lease renewal options are reflected as assets and liabilities inferring that the related future cash payments are reasonably predictable on the reporting date.

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

*Response:*

We believe the Boards should reconsider their definition of lease term and require that the determination of the longest possible lease term include renewal periods or terminations when the results of a probability assessment can provide reasonable assurances that these events will occur.

### **Question 9: Lease payments**

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

Response:

Contingent rentals, expected payments under term option penalties, and residual value guarantees should be included in the measurement of assets and liabilities using the expected outcome technique described in 14 (a)-(c) if such inclusion is limited to the contractually enforceable term of the executed lease or a probability assessment can provide reason assurances of future rental income cash flows.

Why or why not?

Response:

We are concerned that the proposed rules may result in earnings volatility when assumptions for future cash flows differ from actual cash flows that result from future variable rental components.

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

Response:

Please see first response to question #9.

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

Response:

Yes, if they can be reliably measured and there is a high probability that assumptions can be monetized.

Why or why not?

Response:

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

**Question 10: Reassessment:**

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

*Response:*

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

**Question 11: Sale and leaseback:**

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

*Response:*

No, we believe that the paragraphs 66-67, B9-10, B31 and BC160-167 list different requirements for a sale than the former SFAS 66 and SFAS 98, specifically in their definition of “continuing involvement”. The new requirements would allow transactions that previously were not considered sales to be recorded as a sale. Paragraph B31a limits the purchase option requirement only if that option price is not fair value. At the beginning of the lease term, how can fair value be determined at the end of the lease if the option price is a stated amount? This uncertainty could cause variance in the application of the standard and produce inconsistent results from similar transactions within the real estate industry.

We propose altering the paragraph B31a) to include a definition of “continuing involvement” which would not limit purchase options, which may or may not be at fair value, since that determination cannot be made at the beginning of the lease for stated amount options.

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

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

*Response:*

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

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

*Response:*

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

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

Response:

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

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

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

**Question 13: Presentation, Income statement**

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

Response:

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

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

Response:

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

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

Do you think that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows (paragraphs 27, 45, 63, BC147, BC153 and

BC159)? Why or why not? If not, do you think that a lessee or a lessor should disclose this information in the notes instead? Why or why not?

*Paragraphs 27 and BC 147 (Lessee)*

Response:

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

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

Response:

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

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

Response:

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

**Questions 15: Disclosure:**

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

- (a) identifies and explains the amounts recognized in the financial statements arising from leases; and
- (b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows?

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

Response:

We disagree with the proposed disclosures and believe the current disclosures required by GAAP are sufficient, particularly given the arduous efforts necessary to comply with the proposed accounting requirements. The proposed disclosures

would be very burdensome for our industry without adding any significant value for users of our financial statements. A single fund could hold thousands of real estate leases that would be subject to the proposed requirements.

**Questions 16: Transition:**

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

*Response:*

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

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

*Response:*

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

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

*Response:* No

**Questions 17: Benefits and costs:**

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

*Response:*

No. Under the right-to-use model lessees and lessors will incur significant incremental costs to acquire, implement and maintain software that can accommodate the new accounting and reporting requirements under the proposed update. Additional staffing will be necessary for the on-going assessment and control over leasing activity to ensure compliance with the proposed update and appropriateness of adjusting entries. Retrospective accounting requirements for in-place leases will intensify these costs and resource issues beyond reasonable means. An institutional real estate fund could own many properties and a single

property alone can be occupied by up to one-hundred tenants, resulting in thousands of leases that must be reviewed periodically to assess renewal options and variable rent components. TIAA's owns and manages 455 real estate investments that are leased third-parties under approximately 15,000 leases and will incur material costs acquire staff and data systems to implement the new accounting rules and continually apply those rules in subsequent periods. These issues combined with our view that the resulting proposed accounting is not appropriate for real estate lessors lead to the "No" response.

**Question 18: Other comments:**

Do you have any other comments on the proposals?

*Response:*

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

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

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

*Response:*

No.