



**Marc E. Betesh**  
President | CEO  
732.750.4500 (ext. 400)  
917.623.3307 (mobile)



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

**RE: FASB Exposure Draft dated 8/17/2010, Leases (Topic 840)**

**To the Board:**

**Question 6: Contracts that contain service components and lease components**

This question pertains to the separation of service components from rights-of-use (ROU) components in leases. Our concern is how this requirement of the proposed standard will be applied to commercial real estate leases.

The March 19, 2009 Discussion Paper on Leases, Chapter 9, sections 9.23 – 9.25 “Leases that include service arrangements”, discusses the requirement of current accounting standards that payments for services be separated from rental payments. Paragraph 6 in the “Scope” section of the Exposure Draft appears to be maintaining this requirement.

There are many types of commercial real estate leases, including office, retail, industrial, land, etc. However, despite these differences, all have provisions that allocate responsibility to pay for (a) use of the space and (b) the costs to operate, repair and maintain it (“Operating Expenses”). The ways to treat these two components fall into three different lease structure types.

A “NET” lease – no Operating Expenses are included in the periodic lease payments, and instead are paid separately by the lessee. This is common for most industrial and retail leases throughout the United States.

A “GROSS” lease – all Operating Expenses are covered by the periodic lease payments. Only a very limited number of commercial real estate leases are structured on a Gross basis.

A “MODIFIED GROSS” lease – some of the Operating Expenses (the Base Amount) are included in the periodic lease payments, with a mechanism for payment to the lessor of additional amounts to cover increasing costs over time. The vast majority of multi-tenant commercial office building leases are structured on a Modified Gross basis. The following chart summarizes the differences in the foregoing lease types.



	Net Lease	Modified Gross Lease	Gross Lease
<b>Where Typically Used</b>	Industrial and Retail	Multi-Tenant Office	Short-term and residential
<b>Payment for use of premises</b>	Covered by rent	Covered by rent	
<b>Payment of operating expenses</b>	<ul style="list-style-type: none"> <li>• Paid by lessee directly to outside vendors, or</li> <li>• Lessor provides and reimbursed by lessee (without markup)</li> </ul>	Initial amounts included in the rent; mechanism to pay additional amounts as costs rise.	Both use of the premises and operating expenses are fully included in the rent (not segregated).

In Net leases, the Operating Expenses are paid separately from the “Net” rent. Depending on the type of building, these Operating Expenses might be paid to the lessor or to outside vendors. For example, in a lease for an entire building (e.g., warehouse or free-standing restaurant), the lessee would typically pay the lessor the rent, and the lessee would be responsible for operating the site. The lessee would separately contract with grounds maintenance vendors, utilities suppliers, etc. to operate the site. When the lease is not for the entire site but rather for only part of the site (e.g., a portion of a building or a store in a retail shopping center), these services are usually provided or contracted for by the lessor and the costs of the same are reimbursed by the lessee, almost always without markup.

***In the Net Lease scenario, under the Proposal, it appears that the ROU component could be easily separated from the Service components by following the Net Rent / Operating Expense distinction. Is this a reasonable basis for making such a separation?***

In Modified Gross leases, the separation of net rent from Operating Expenses is not as clear. In most Modified Gross Leases, the lessor provides the services as part of the rent (hence, these are “gross” leases). But unlike pure gross leases, the lessor only provides the first year’s costs in the rent (the “base year” costs). The lease will contain a mechanism to pass through to the lessee any subsequent increases in those costs over time.

At the time of execution of a Modified Gross Lease, the parties generally do not know the actual cost of the first year’s base year costs; these do not become evident until the year closes.

***In a Modified Gross Lease, is it appropriate to utilize the base year operating costs as the basis to separate the Service Component from the ROU Component?***

Finally, in some Modified Gross leases, the Base Amount is not the first year's expenses but rather a negotiated amount (an "Expense Stop") and the lessee is liable to lessor for its share of Operating Expenses over that amount. These leases, called Modified Gross Leases with an Expense Stop, function similarly, except that the amount in the rent representing the Operating Expenses can be segregated more easily because it is known at the time of lease negotiation.

***In a Modified Gross Lease with an Expense Stop, would it be appropriate to treat the rent net of the Expense Stop as the ROU asset and treat the Expense Stop and subsequent charges in Operating Expenses as the Service Components?***

Please consider the foregoing and provide further guidance and clarification.

#### **Question 8: Lease Term**

The Exposure Draft proposes that the assumed lease term should be 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. This proposal will require a lessee to record a value for its ROU asset and the corresponding liability to make lease payments even though it has no legal obligation to make such payments. While we understand the need to address the potential issue of entities attempting to avoid the new capitalization rules by structuring its leasing arrangements with terms of 12 months or less, inclusive of multiple extension options, we believe, especially for leases of real estate, that (1) the stated goal of preventing the mischaracterization of capital assets as operating expenses is already being achieved by existing market forces and (2) the inclusion of unexercised options distorts, rather than clarifies, the business terms.

#### **Market Forces Already Achieve the Stated Goal**

The relatively long-term length of commercial real estate leases is due to their inherent purpose: to provide a stable environment from which to conduct an ongoing business. Land leases often extend for decades, as do many retail store leases. Single use facilities are also usually leased for terms in excess of 10 years. It is difficult, costly and disruptive for a business to move to another location, and for some entities, moving will also impact the revenue generated by its business. In addition, lessors do not seek short-term leases. Most property owners must satisfy the lending requirements of their mortgagees who are looking for a stable long-term income stream. Thus, from a practical perspective, it would be very difficult for parties to structure short-term leases in an attempt to avoid the establishment of the right-of use asset and liability for lease payments.

#### **Proposal Distorts Business Terms**

Incorporating unexercised options in asset and liability values will lead to significant uncertainty and possible manipulation because of the speculation and subjectivity that will be introduced into an otherwise straightforward calculation. Multi-tenanted office building leases routinely extend for five to

ten years, and often provide flexibility to the lessee through a series of options, which may allow a lessee to extend or reduce the term, or expand or reduce the space.

*Options Merely Provide Leverage*

In commercial real estate, options are not used to create an alternative to a long-term lease or quasi-purchase. Rather, they are negotiated to provide the lessee with some leverage/protection should market conditions change by the time decisions need to be made regarding ongoing space needs. In almost all cases, the options are used as leverage to negotiate entirely new terms (reflecting current market conditions). It is rare that a lessee will simply send a notice to the lessor exercising the option as stated. The only exception to that is in the case of an extension option that is below market, either because the rate in the option happens to be less than the market rate at the time of exercise, or that the rate is stated as a discounted percentage of market (e.g., “95% of the market rate at the time of exercise of the option”). In the former case, the lessee will not know the likelihood of exercise until it is close enough in time to evaluate the market.

*Similar Business Alternatives Produce Vastly Different Treatment Alternatives*

Assuming that for business reasons a lessee wishes to remain in a certain general location, if the lessee has an option to extend its lease term, its alternatives would be (a) exercise the option, (b) seek alternative space in the general vicinity at market rates or (c) use the option to negotiate with the existing lessor to adjust the cost of remaining in the space at current market rates. These three alternatives would be evaluated and weighed to determine the greatest benefit to the lessee, and after negotiation, all three would likely yield relatively similar outcomes.

In all cases, the lessee would likely conclude that it is more likely than not that it will remain in the space. However, under the Proposal, as the lessee moved closer to the time of making a decision, the treatments would be different. If it were likely that it would exercise the option, the option period would be included in the “length of lease,” whereas if it were leaning toward seeking alternative space it would not. It is unclear as to the appropriate treatment if it were to use its option as leverage to negotiate new terms for staying in the same space.

Similar issues would be present if a lessee were to have the option to expand into additional space in a building (at market rates) as it became available. For the lessee, there is no material difference between (a) exercising the option to expand into that space, versus (b) not exercising the option and securing a separate lease for similar space in the building. However, under the proposal, the former would be treated as part of the assumed lease term while the latter would not.

This highly divergent treatment for economically equivalent choices creates difficulty for management, confusion and opportunity for manipulation.

*Logical Extension of Proposal Creates Illogical Results*

The problems inherent with valuing lease terms that are not legal obligations can be illustrated another way. If future option periods will be treated as real obligations, why limit the term of the underlying lease to only the stated option periods? If an entity is considered to be a going concern, why not look to periods beyond the stated option terms? As a going concern, the entity's real estate needs will not end after all options expire. They will continue perpetually into the future. If options are not exercised or a lease is simply allowed to terminate, the entity, still in need of real estate, will merely change leased locations (assuming it decides that leasing rather than purchasing is still the more favorable alternative). As the specific location is not relevant to the measurement of the right-of-use asset and liability to make lease payments, then why is the assumed lease term limited by the contracted option terms for each specific physical location? And if the need to lease an underlying asset for a going concern is perpetual, how can the present value of the lease payments be determined?

***Based on the above, we do not believe that the initial value of the ROU asset and the liability to make lease payments should include option periods for which a lessee has no current legal obligation. Once options are exercised or a lessee is legally obligated/entitled to change its lease payments, the recorded value of the ROU asset and liability to make lease payments should be adjusted to incorporate the new terms, similar to the current proposed reassessment requirements pursuant to paragraph 17 of the Exposure Draft.***

Please consider the foregoing and provide further guidance and clarification.

Thank you for your consideration.

Very truly yours,



Marc E. Betesh