

(Note: While the current exposure draft for Topic 946 would require consolidation of these entities, FinREC's response letter on this topic expresses support for consolidation only when such entities are wholly owned; in any event, as we have discussed earlier in this letter we believe it is necessary to establish consolidation guidance for real estate investment entities that is different than the consolidation guidance that would apply to investment companies),

- Presentation of the entity's share of income from equity investments in real estate investment entities over which the reporting entity can exercise significant influence to enable financial statement users to understand the portion of the total change in fair value of those investments that is derived from income return on investment properties, and
- Fair value measurement of the entity's debt, as we have proposed, to enable financial statement users to effectively evaluate the impact of debt associated with the investment properties and its impact on NAV.

We have detailed other guidance elsewhere in this letter that may be different than that ultimately required for Topic 946 entities. We believe these differences in needs by investors and other users of these real estate entities' financial statements are significant and warrant maintaining two separate ASC Topics. In addition, there are current scope differences between the two projects that would need to be resolved were the guidance to be incorporated in one ASC Topic. This may prove difficult without impacting other investment company accounting.

One of the significant concerns that some of the Board's constituents have raised should the FASB elect not to finalize a separate ASC Topic on IPEs is the possibility of changes in regulation and taxation for entities (such as certain REITs) that would newly be considered investment companies for financial reporting purposes as a result of the guidance in the final investment companies ASU. We believe these concerns also provide an appropriate basis for the Board to establish a separate ASC Topic on IPEs.

We recommend the Basis for Conclusions of both the IPE and investment company ASUs clearly explain why the Board created separate ASC Topics, if the Board proceeds in that direction, or alternatively, why one ASC Topic is appropriate. In addition, we believe it is critical for the FASB to describe the significant differences in the accounting and financial reporting by IPEs versus investment companies, and its rationale for those differences (i.e., the primary financial statement user considerations, investor needs and other objectives that prompted the need for the different accounting and financial reporting models). In addition, as previously discussed, we believe the FASB should develop a more comprehensive financial reporting framework specific to IPEs. For example, the final IPE ASU should clearly indicate whether an IPE would be required to present a schedule of investments and financial highlights.

Lastly, given the uncertainty surrounding how the IPE proposal will progress, the types of investments that may ultimately be held by an IPE (see above comments in this regard), and the accounting and financial reporting guidance that will be provided relative to investment properties, we are unable to form a view as to whether we agree with the aspect of this proposed ASU that would require application of Topic 973 to take precedence over Topic 946 for an entity that meets the criteria to be both an IPE and an investment company.

The Appendix to this letter includes our responses to the questions raised in the proposed ASU.



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We appreciate the opportunity to comment on the proposed ASU. Representatives of FinREC and Topic 973 comment letter task force are available to discuss our comments with Board members or staff at their convenience.

Sincerely,

Richard Paul
Chairman
Financial Reporting Executive Committee

Roy Rendino
Chairman
Topic 973 Comment Letter Task Force



Appendix

Questions for Respondents

Scope

Question 1: The proposed amendments would require an entity that meets the criteria to be an investment property entity to measure its investment property or properties at fair value rather than require all entities to measure their investment properties at fair value. Should all entities measure their investment properties at fair value or should only an investment property entity measure its investment properties at fair value? Why? Is fair value measurement of investment properties operational? Please describe any operational concerns.

A majority of FinREC members support the entity-based scope outlined in the proposed ASU because they believe only entities whose real estate investments comprise substantially all of their business activities should be required to measure investment properties at fair value. For other entities, such as diversified companies, fair value of investment properties may be costly to develop, complex to implement, and operationally difficult to comply with, particularly during interim reporting periods, and for small private diversified entities, such costs may be burdensome or even prohibitive.

A minority of FinREC members and majority of the Task Force, including those representing investors, believe that all investment properties, regardless of the nature of the entity that owns them, should be measured at fair value. Some believe an option would lead to different measurements by entities with similar investments. Others, however, would support an option to measure investment properties not held by an IPE at fair value.

However, as further discussed above, the Task Force and FinREC agreed that there are a number of scope and financial reporting issues related to the proposed amendments that should be addressed prior to issuing the final standard.

Question 2: The proposed amendments would require an investment property entity to measure its investment property or properties at fair value rather than provide an option to measure its investment property or properties at fair value or cost. Should fair value measurement of investment properties be required or permitted? Please explain.

A majority of FinREC members believe that fair value measurement of investment properties held by an IPE should be required. As mentioned above, a minority of FinREC believes such requirement should be extended to all investment properties, including those held outside of an IPE.

Question 3: Do the criteria in the proposed amendments appropriately identify those entities that should be required to measure their investment property or properties at fair value, and, therefore, should be excluded from the scope of the lessor accounting model in the proposed Update on leases? If not, what changes or additional criteria would you suggest, and why are those criteria more appropriate?



We believe there are substantial revisions that should be made to ensure that entities whose investors are investing principally due to the real estate investments held by the entity, such as REITs, are not excluded from the scope. We have provided detailed recommendations on improving the scope criteria in our response.

Question 4: The proposed amendments would require an entity to reassess whether it is an investment property entity if there is a change in the purpose and design of the entity. Is this proposed requirement appropriate and operational? If not, why?

We believe that the proposed requirement for reassessment is appropriate. We agree that an entity should reassess whether it is an IPE in certain instances; however, we believe the Board should provide additional guidance about what would constitute “a change in the purpose and design” of an entity.

Question 5: An entity that would be an investment property entity under the proposed amendments would be required to follow the accounting requirements in the proposed amendments even if that entity also would be an investment company under Topic 946. Is it appropriate for an entity that would meet the criteria to be both an investment property entity and an investment company under Topic 946 to be subject to the amendments in this proposed Update? If not, what alternative approach would you recommend if an entity would meet the criteria to be both an investment property entity and an investment company? Should the form of the entity (real estate fund versus real estate investment trust) dictate whether an entity should be an investment company or an investment property entity for accounting purposes? If yes, please describe the difference between the business activities of a real estate fund and a real estate investment trust to support your view.

We have commented on our views about the interaction between the IPE standard and the investment companies standard in our interaction with investment companies guidance discussion in the body of this letter. Given the uncertainty surrounding how the IPE proposal will progress, the types of investments that may ultimately be held by an IPE, and the accounting and reporting guidance that will be provided relative to investment properties, we are unable to form a view as to whether we agree with the aspect of this proposed ASU that would require application of Topic 973 take precedent over Topic 946 for an entity that meets the criteria to be both an IPE and an investment company.

Nature of the Business Activities

Question 6: To be an investment property entity, the proposed amendments would require substantially all of an entity’s business activities to be investing in a real estate property or properties. Should an entity’s business activities be limited to investing in a real estate property or properties rather than investing in real estate assets in general (such as real-estate-related debt securities and mortgage receivables) to be an investment property entity? If not, why? Is this requirement operational? Please describe any operational concerns.

We believe that the ‘substantially all’ test should consider all real estate investments and not just those related to real estate property or properties. Investors in real estate recognize that real estate investments take a number of different forms. These include full ownership, controlled interests, non-controlling interests, and debt interests (including beneficial interests in securitizations backed by real estate



collateral). It is common for a real estate investment entity to pursue a variety of different investment types to meet the risk and return parameters of the investor. We do not believe that holding a particular subset of these investments should preclude the real estate investment entity from being considered an IPE. To do so would preclude investors from receiving comparable information on these investments and not enable them to properly evaluate the investment performance returns among their various real estate holdings.

Question 7: The implementation guidance in this proposed Update specifies that when evaluating whether substantially all of the parent entity's business activities are investing in a real estate property or properties, the parent entity would not consider real estate properties held indirectly through investments in which the parent entity does not have a controlling financial interest. Should the evaluation of an entity's business activities consider properties held through noncontrolling financial interests (for example, investments in which the entity can exercise significant influence)? Why or why not?

As discussed in question 6, we believe that all real estate investments should be included in the 'substantially all' test. Many real estate companies finance operating properties through joint ventures with financial partners, where control may not exist. Without considering these properties, many such entities may not meet the "substantially all" test.

Express Business Purpose

Question 8: To be an investment property entity, the proposed amendments would require that the express business purpose of an entity is to invest in a real estate property or properties for total return with an objective to realize capital appreciation, for example, through disposal of its real estate property or properties. Real estate properties held by an entity for either of the following purposes would not meet this criterion:

- a. The entity's own use in the production or supply of goods or services or for administrative purposes
- b. Development for sale in the ordinary course of business upon completion (such as land developers and home builders).

Should an entity whose express business purpose is to hold real estate properties for the reasons listed above be excluded from the amendments in this proposed Update? If not, why? Is the express-business-purpose criterion operational? Please describe any operational concerns.

We generally agree with this conclusion. However, we would suggest a change in the wording of the second sentence to "real estate property or properties held predominantly". This would allow for instances where an internally managed entity may occupy a portion of the property for administrative or operating purposes. Alternatively, we recommend that the Board consider aligning the definition of investment property with the guidance in paragraph 10 of IAS 40, which provides an exception for use of an insignificant portion of the property by its owner in the production or supply of goods or services or for administrative purposes:



“Some properties comprise a portion that is held to earn rentals or for capital appreciation and another portion that is held for use in the production or supply of goods or services or for administrative purposes. If these portions could be sold separately (or leased out separately under a finance lease), an entity accounts for the portions separately. If the portions could not be sold separately, the property is investment property only if an insignificant portion is held for use in the production or supply of goods or services or for administrative purposes.”

Question 9: To meet the express-business-purpose criterion, the implementation guidance in this proposed Update would require that an investment property entity have an exit strategy to dispose of its real estate property or properties to realize capital appreciation to maximize total return. An entity that invests in a real estate property or properties to collect rental income long term and does not have an exit strategy for its real estate property or properties would not be an investment property entity under the proposed amendments. Should those entities be excluded from the amendments in this proposed Update? If not, why? Is the exit strategy requirement operational? Please describe any operational concerns.

As stated above, we believe an IPE should not be required to have an exit strategy for its investments. Owners and operators of investment property portfolios invest and operate properties to maximize total return. The entities may not have a defined exit strategy as disposition timing may be opportunistically driven by the maximization of total return. To exclude these entities from the scope of an IPE standard would lead to inconsistencies in application and not meet the needs of investors. In addition, the exit strategy criterion provides a perceived optionality to the application of the IPE guidance.

If the Board decides to retain this requirement, we believe disposal upon liquidation and to satisfy investor redemptions should be considered valid exit strategies, otherwise we do not believe that the requirement is operational. In addition, we believe the Board should include a provision in the final ASU that if an entity does not have an express exit strategy for realizing the appreciation in its investment property, but has a history of monetizing such appreciation, the requirement for an exit strategy would be met. We believe appreciation may be monetized through sale of the property or an interest in a property, contribution of a property to a joint venture, or refinancing a property.

Unit Ownership and Pooling of Funds

Question 10: To be an investment property entity, the proposed amendments would require an entity to have investors that are not related to the entity’s parent (if there is a parent) and those investors, in aggregate, must hold a significant ownership interest in the entity. Is this criterion appropriate? If not, why?

We believe that, as currently written, this criterion is unclear and may imply that more than two unrelated investors must hold a significant ownership interest in the entity. We recommend changing this proposed requirement to “an entity that has one or more investors that are not related to the entity’s parent (if there is a parent) and that investor or investors, in aggregate, must hold a significant ownership interest in the entity”. This revised wording is consistent with paragraph BC26 of the proposed ASU.



Question 11: To be an investment property entity, the proposed amendments would provide an exemption from the unit-ownership and pooling-of-funds criteria for a subsidiary entity that (a) has a parent entity that is required to account for its investments at fair value with all changes in fair value recognized in net income in accordance with U.S. GAAP or (b) has a parent entity that is a not-for-profit entity under Topic 958 that measures its investments at fair value. Should this exemption be available only to a subsidiary entity with a parent entity that is (a) required to account for its investments at fair value in accordance with U.S. GAAP or (b) a not-for-profit entity under Topic 958 that measures its investments at fair value? If not, which entities should be permitted to apply the exemption and why?

We support providing an exemption from the unit-ownership and pooling-of-funds criteria for a subsidiary entity whose parent accounts for its investments at fair value in accordance with U.S. GAAP. We also believe the Board should provide an exemption to the reporting entity criterion's requirement for an entity to provide financial results about its investing activities to its investors when the entity is a wholly owned subsidiary of an IPE.

Measurement

Question 12: The proposed amendments would require real estate properties other than investment properties that are held by an investment property entity to be measured in accordance with other U.S. GAAP. Should an investment property entity be required to measure those properties at fair value with all changes in fair value recognized in net income instead of applying other U.S. GAAP? Why or why not?

We believe that all real estate properties held by an IPE, other than those used predominantly for the production of goods or services, or for administrative purposes, should be considered investment properties and measured at fair value. As discussed above, we believe all other investment assets and all financial liabilities should also be recorded at fair value.

Question 13: The proposed amendments would require a right-of-use asset in which the underlying asset meets the definition of an investment property to be measured at fair value with all changes in fair value recognized in net income. Should those right-of-use assets be measured at fair value with all changes in fair value recognized in net income? If not, why and which measurement attribute would you recommend for those right-of-use assets?

Yes, such right-of-use assets should be measured at fair value with changes in fair value recognized in net income. However, as previously discussed, it is unclear as to whether right-of-use assets would be included in evaluating the *substantially all* requirement of the nature of business activities criterion. We believe these types of assets should represent a qualifying form of real estate investment for purposes of that test.

Interests in Other Entities

Question 14: The proposed amendments would require an investment property entity to evaluate whether an interest in (a) another investment property entity, (b) an investment company as defined in Topic 946, or (c) an



operating entity that provides services to the investment property entity should be consolidated under Topic 810. Should an investment property entity consolidate controlling financial interests in those entities? If not, why? Should an investment property entity consolidate controlling financial interests in other entities? If yes, why?

We believe an IPE should not be required or permitted to consolidate investees that are not IPEs, and should measure all non-consolidated investees at fair value. Given the substantially all requirement of the nature of business activities criterion, an investment company investee in which an IPE holds a controlling financial interest could not, by definition, be significant to the IPE. As a result, we believe presenting an investment company investee in which an IPE holds a controlling financial interest on a consolidated basis would reduce, rather than increase, the transparency of the IPE's financial statements to its investors. The Board has already acknowledged that an IPE is different from a commercial entity by concluding that an IPE should not consolidate a non-IPE or non-investment company investee. We believe a similar rationale for not consolidating an investment company investee is applicable.

We have commented on our views on consolidation of IPEs in our financial statement presentation discussion in the body of this letter.

Question 15: The proposed amendments would prohibit an investment property entity from applying the equity method of accounting in Topic 323 unless the investee is an operating entity that provides services to the investment property entity. Is that exception to the equity method of accounting requirements in Topic 323 appropriate for investment property entities? If not, why?

We agree that IPEs should not apply the equity method of accounting to investees over which they have significant influence unless the investee is an operating entity that provides services to the IPE. However, we believe that IPEs with equity interests in other IPEs over which they have significant influence should report their share of the IPE investee's operating income for the period as a separate component of earnings in the income statement, with any remaining share of the change in value of the investment reported in the income statement as an increase or decrease in unrealized gain or loss on the investment. We believe the increase or decrease in unrealized gain or loss reported in the income statement should include the effects of any distributions from the investee entity during the reporting period.

We further believe it would be beneficial to investors for IPEs to disclose a reconciliation of the change in value in the investments described in the previous paragraph from the beginning to the end of the reporting period. We would expect this to include any realized gain or loss, share of operating income earned during the period, distributions received from the investee entity and other increases or decreases in the unrealized gain or loss on the investment for the period. Alternatively, if all of the reconciling items, other than distributions, are reflected separately on the income statement, distributions could be disclosed in lieu of a separate schedule.

Question 16: The proposed amendments would require an investment property entity to measure investments in which it does not have a controlling financial interest or cannot exercise significant influence in accordance with U.S. GAAP. For example, that would currently require held-to-maturity debt securities to be measured at



amortized cost and would permit certain equity securities to be measured using the cost method, unless the fair value option in Topic 825, Financial Instruments, is elected. Should an investment property entity be required to measure those investments at fair value with all changes in fair value recognized in net income instead of applying other U.S. GAAP? Why or why not?

As indicated in our previous comments, we believe the importance of a high quality NAV measure cannot be underestimated because of the manner in which the NAV measure influences capital flows in the capital markets. Requiring certain investments to be measured using the cost method will reduce the quality of the NAV measure and will negatively impact the proper functioning and efficiency of capital markets. Accordingly, we recommend that an IPE be required to measure all of its investments at fair value because it would improve the quality of the NAV measure reported to the investors.

Financial Liabilities

Question 17: The proposed amendments would require an investment property entity to measure its financial liabilities (such as its own debt) in accordance with other U.S. GAAP, which currently requires amortized cost measurement unless the fair value option in Topic 825 is elected. Should an investment property entity be required to measure its financial liabilities at fair value with all changes in fair value (including changes in an entity's own credit) recognized in net income instead of applying other U.S. GAAP? Why or why not?

As described above, we recommend that an IPE be required to measure its financial liabilities at fair value. Unlike other investment vehicles, IPEs must have substantially all of their assets invested in real estate. Therefore, all of the debt is effectively secured directly or indirectly by the real estate investment assets that would be measured at fair value. We believe that a fair value NAV is the relevant measure for investors evaluating their real estate investments. Measuring financial liabilities associated with such real estate investments at amortized cost would not provide investors and other users of the financial statements with decision-useful information.

Rental Revenue Recognition

Question 18: The proposed amendments would require an investment property entity to recognize rental income on investment properties subject to a lease when lease payments are received or as the lease payments become receivable in accordance with the contractual terms of the related lease rather than on a straight-line or other basis. Is that basis of recognizing rental revenue appropriate for investment properties measured at fair value? If not, why?

We agree with the proposal for IPEs to recognize rental income as the lease payments become receivable in accordance with the contractual terms of the related lease rather than on a straight-line or other basis. However, we do not agree that income should necessarily be reported when lease payments are received. To do so would be to follow a cash basis accounting concept for income, which would deviate from the accounting for the contractual terms of the lease which is used in appraisal theory. An appraiser utilizing a discounted cash flow model to determine the fair value of an investment property, which is common in valuing real estate, would base the future cash flow stream on lease payments contractually due under



the lease agreement. Any difference in the timing of payments would result in a prepaid rent liability (if rent is paid prior to the contractual requirement) or as accounts receivable (if rent due under the contractual terms was not yet paid) and would be separate from the determination of fair value by the appraiser. We recommend further clarification that the amount of income recorded in the income statement be in accordance with the contractual terms, which would be consistent with the assumptions used by the appraiser in arriving at fair value for the investment property at the period end.

Practical Expedient for Measurement of an Interest in an Investment Property Entity

Question 19: The proposed amendments would permit, as a practical expedient, an entity to estimate the fair value of its investment in an investment property entity using the net asset value per share (or its equivalent) of the investment if the entity would transact at the net asset value per share. Are there investments that currently qualify for the practical expedient that would no longer qualify for the practical expedient because of the proposed amendments? If so, please identify those types of investments.

Based on guidance included in the proposed ASU, we believe there are investments that would no longer qualify for the practical expedient (e.g., IPEs with non-investment property investments that are not measured at fair value or with debt measured at amortized cost for which the carrying amount and fair value are significantly different). If the Board accepts our recommendations regarding measurement of an IPE's financial liabilities and non-investment property investments, we believe investments that currently qualify for the practical expedient would continue to qualify.

Disclosure

Question 20: Are the proposed disclosures appropriate for an investment property entity? If not, which disclosures do you disagree with? Should any additional disclosures be required? If so, why?

We do not understand the reason for the differentiation between properties that generated rental revenue during the period and those that did not in proposed paragraph ASC 973-360-50-1 and suggest that the Board further clarify such distinction.

The proposed ASU also would require contractual obligations related to an investment property to be disclosed. Many operational obligations, such as maintenance, cleaning and other contracts are entered into in the normal course of managing and operating investment property. We recommend the Board differentiate contractual obligations related to operating expenditures that are commonplace in the course of managing the property from other obligations and exclude them from this disclosure requirement.

As described in our general observations on the financial reporting model above, we believe it would be beneficial to investors for IPEs to disclose a reconciliation of the change in value of the investments from the beginning to the end of the reporting period. We would expect this to include any realized gain or loss, share of operating income earned during the period, distributions received from the investee entity and other increases or decreases in the unrealized gain or loss on the investment for the period.



Alternatively, if all of the reconciling items, other than distributions, are reflected separately on the income statement, distributions could be disclosed in lieu of a separate schedule.

If the Board decides to exclude IPEs from the scope of its standard on accounting for leases, we recommend that the Board consider the disclosure requirements of that standard that would be useful to an IPE's investors and include them as requirements of the IPE standard. We also believe that certain disclosure guidance currently contained in IAS 40 may be helpful.

Effective Date and Transition

Question 21: Should an entity recognize the effect of adopting the requirements in this proposed Update as an adjustment to the beginning balance of retained earnings in the period of adoption? If not, what transition requirements would you recommend and why?

We agree with the transition requirements.

Question 22: How much time would be necessary to implement the proposed amendments?

We recommend two years for implementation of the proposed amendments to provide the affected entities with sufficient time to set up valuation systems and controls for reporting of fair value.

Question 23: The proposed amendments would prohibit early adoption. Should early adoption be permitted? If yes, why?

We agree that early adoption should be prohibited.

Nonpublic Entities

Question 24: The proposed amendments would apply to both public and nonpublic entities. Should the proposed amendments apply to nonpublic entities (such as private companies and not-for-profit organizations)? If not, how should the proposed requirements differ for nonpublic entities and why?

We do not believe that the proposed guidance should apply differently to public and nonpublic entities. Investors invest in investment properties via a variety of forms of ownership, both public and private. Different reporting by private entities would lead to inconsistencies in reporting to investors.

There are small, private closely-held real estate investment entities for which the proposed accounting may be of little benefit to their investors. We considered whether an asset threshold in the scope might reduce the burden on these entities. However, we concluded there are other factors, such as the nature of the investor that would also need to be considered to determine the appropriate reporting for the investment entity and, ultimately, such a test may not be a workable solution.