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Technical Director  
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Financial Accounting Standards Board  
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PricewaterhouseCoopers LLP appreciates the opportunity to comment on the FASB's (the "board") Proposed Accounting Standards Update, *Real Estate-Investment Property Entities (Topic 973)* (the "proposed standard").

There are a wide range of entities that invest in real estate, including pension funds, real estate funds, public REITs, corporations and financial institutions, such as insurance companies and investment banks. There are also a variety of financial reporting practices used by such entities, with some reporting real estate investments at fair value and others at amortized cost. Some of that diversity may be appropriate based on the business objectives of the entities. We do not believe that measuring all real estate investments at fair value will necessarily yield better reporting for all types of investors. However, we do believe that fair value for entities that are fundamentally "investing entities," as opposed to "operating entities," would provide more relevant information to users of financial statements. Further, even among "investing entities" that account for their real estate investments at fair value, significant diversity in application exists with respect to presentation, measurement, consolidation and disclosure.

In order to reduce complexity, while still meeting the needs of investors in real estate "investing entities", we believe a single investment company standard should be used to define "investing entities" of all types, including those that invest in real estate. We believe this approach is preferable over continuing this proposed standard as a separate project. A single investment company standard would then govern which types of entities would qualify for fair value accounting. We also believe that the proposed investment company standard should address the diversity in application that exists today among real estate investment funds. In this regard, we support much of the specific fair value application and disclosure guidance the board has detailed in the proposed standard and recommend that certain aspects of such guidance be incorporated into the proposed investment company standard, specifically for real estate investments.

We also note the board's recent decision to exclude from the scope of the lease standard all lessors of investment property, irrespective of whether they account for such property at fair value. This decision eliminated one of the major objectives of the investment property entity project, which was to align U.S. GAAP with IFRS and promote greater use of fair value for those assets for certain types of property owners. The "receivable and residual" approach currently proposed in the lease project would result in derecognition of portions of a property and gain/loss recognition each time a lease commences. From a business perspective, most lessors of real estate do not believe that they have "sold" a portion of the asset. While fair value accounting for real estate investments may seem to provide more beneficial information to users than the proposed "receivable and residual" model, it is not because fair value information for real estate investments is the most useful metric in all cases, especially for "operating entities." Discussions with users of financial statements of real estate operating entities indicate they would generally prefer historical cost and current lease accounting over either fair value or the information provided by the



proposed “receivable and residual” model. Further, without the prerequisite of fair value accounting to obtain the leasing scope exception, we believe that most preparers of financial statements for real estate operating companies (e.g., public REITs that are lessors of real property) would prefer historical cost and current lease accounting. They do not believe fair value reporting would be an improvement over current accounting and would unjustifiably require significant cost and effort to apply.

As part of the convergence project on consolidation, the IASB recently issued an exposure draft on the definition of an investment entity, a designation that did not previously exist in IFRS. However, the IASB has no plan to create an investment property entity standard. As such, we believe the proposed standard would not advance the goal of international convergence and in fact would result in additional divergence in accounting models. We believe every effort should be made to converge before any new standards in this area are implemented. So, for entities that would not qualify as investment companies, we support the adoption of an IAS 40 *Investment Property* approach with an option to account for investment property at fair value.

#### **Interaction with Investment Company Project**

We recently provided our comments on the FASB's Proposed Accounting Standards Update, *Financial Services - Investment Companies (Topic 946)*. We believe many real estate investing entities could meet the scope of the proposed investment company standard and, subject to our comments on that project, appropriately delineate which entities should qualify for fair value accounting as investment companies and which should not. Accordingly, we believe that the real estate investing entities should be included in the investment companies proposed standard. Our comments in this letter should therefore be read in conjunction with our comments on the proposed investment company standard.

Today there is significant diversity in the application of fair value accounting by investment companies that invest in real estate. We believe the proposed investment company standard would be the best project to reduce that diversity. We also observe that in connection with its deliberations leading to this proposed standard, the board has made several significant decisions that are appropriate for “investing entities” that invest in real estate. Consistent with our view in the preceding paragraph, we believe these decisions also should be incorporated into the proposed investment company standard. We have provided a summary list of those items, attached as *Appendix B*.

#### **Interaction with the Lease project**

The continued scope exclusion from the "receivable and residual approach" for all lessors of investment property is significant to our views described herein. Any change in that tentative decision may cause us to fundamentally change our positions with respect to real estate operating companies.

If a separate investment property entity standard is not issued, as we have recommended, the board will need to decide where to locate a definition of investment property.

Further, as described in our response to question 3 in Appendix A, we have significant practical concerns about the interaction between the scope exclusion for lessors of investment property and the definition of investment property. These concerns include the lack of convergence and the impact of partial assets qualifying as investment property, which will affect a lessor's ability to qualify for the exemption. We understand there are ongoing discussions in these areas.



### **Interaction with the Financial Instruments project**

We observe that investment level debt for both direct property investments and consolidated investments would be presented separately from the investment asset. These liabilities are often non-recourse. The potential elimination of the option to elect fair value treatment for these liabilities may cause significant concerns for real estate entities that qualify as investment companies. Many real estate investors (especially those in open-end funds) consider the liability for property level debt to be a significant component of the real estate investment. For this reason and to achieve a better reflection of the true economics, we believe such investment related liabilities should be allowed to be accounted for on the same basis as the related real estate investments. Elimination of the fair value option for property level debt may affect an entity's ability to transact at the reported net asset value "NAV" prepared in accordance with U.S. GAAP and use of this NAV as a fair value practical expedient (refer to the discussion below). If the general fair value option is eliminated, we believe the board should consider inclusion of a fair value option for liabilities in the proposed investment company standard.

### **Use of NAV fair value as a practical expedient by investors in a real estate investment property entity/investment company**

We observe that current guidance for investment companies allows an entity to use the reported NAV as a practical expedient to measure the fair value of an investment if that reported NAV is calculated in a manner consistent with fair value measurement principles contained in U.S. GAAP. The proposed investment company standard does not change this existing guidance. However, the proposed investment property entity standard introduces an incremental requirement for an investment property entity to transact at the reported NAV in order to qualify for the practical expedient. We observe that certain entities (such as closed-end funds) do not transact at reported NAV at either the investor or entity level. Further, certain entities may make adjustments to the reported NAV for transaction purposes, including spreading organizational or property purchase transaction costs. Other adjustments are also often made at the discretion of the general partner. We believe an NAV practical expedient is appropriate if the reported NAV is a valid approximation of fair value, as contained in the current literature. We do not believe an incremental requirement for an entity to transact at the reported NAV is necessary.

### **Next steps**

The board and the IASB currently have a significant workload and a number of projects to be completed over the next year. We believe that the matters we have raised in this comment letter and our comment letter on the proposed investment company standard need to be addressed before the proposed investment company standard can be finalized. Further, the resolution of some of these issues is dependent on the resolution of issues in the projects on leases and financial instruments. As a consequence, we observe that it would be difficult to finalize the proposed investment company standard prior to, or at least concurrent with, reaching reasonably definitive conclusions for certain positions within those on-going projects. However, complete finalization and adoption of these other standards may not need to be concurrent with adoption of the proposed investment company standard.

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Attached to this letter as Appendix A are our responses to the Questions for Respondents included in the proposed standard. Our answers to the questions provide more insight into the rationale for the position and views expressed in this letter.



If you have any questions, please contact Paul Kepple at 973-236-5293, Donald Doran at 973-236-5280, or Tom Wilkin at 973-236-4251.

Sincerely,

*PricewaterhouseCoopers LLP*

PricewaterhouseCoopers LLP



## Appendix A

### Responses to detailed questions in the exposure draft

It should be noted that our responses to the questions are provided with the understanding that we support a single investment company standard, inclusive of entities investing in real estate, rather than pursuing a separate proposed standard.

#### 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.*

**Response:** As indicated in our cover letter, we do not believe there should be a separate standard for investment property entities ("IPEs"). We believe the nature of the entity and its investors' needs should drive the accounting model for investment property. But, in our view, the accounting can be more appropriately dealt with in the scope of the investment company model rather than in a separate investment property standard. In fact, many view investments in real estate as an asset class in which an investment company could invest. The investors in these real estate investment companies generally have a more significant need for fair value information to set transaction values to allow investors to enter and exit.

We do not believe that measuring all real estate investments at fair value will necessarily yield better reporting for all types of investors. Certain entities, such as self-managed property REITs, have characteristics that are more operating company in nature and do not view themselves as investment companies. For many of these entities, the stock price includes an element of "enterprise value" that represents the value of their management team and operations. Further, the property portfolio is managed on a strategic basis to create value that is greater than the sum of its individual property parts. Some investors in these entities, such as pension funds, may need fair value information about their investments in these entities. However, reporting only the real estate investments at fair value (typically a "level 3" value) is more subjective and would not capture the whole value of the equity. Consequently, such an approach would not provide better information and would result in substantially more cost to prepare. Publicly traded stock prices (typically a "level 1" value) for these entities are often available and are more representative of fair value for the investors' interests.

A principles-based evaluation of the nature of the entity and how it is operated/managed, not its legal or tax structure, should dictate whether fair value accounting should apply. Thus, an evaluation of the specific facts and circumstances should be required to make that determination. This is conceptually consistent with the views we expressed in our comment letter on the proposed investment companies ("IC") standard, in which we stated that we do not support the continuation of the existing REIT exclusion from the investment company model. We believe REITs should be included or excluded from the definition of an investment company based on the evaluation of specific facts and circumstances. Refer to our response to question 5.



In part, our view depends on whether there will be a scope exemption from the leasing standard that would apply to all lessors of investment property. If that scope exemption is not retained, we believe that fair value accounting would be favored by investors (not just entities that might be IPEs) in investment property over application of the "receivable and residual" approach being discussed in the joint IASB/FASB leasing project. As mentioned in our cover letter, the "receivable and residual" approach results in derecognition of portions of a property and gain/loss recognition each time a lease commences. Most investors in real estate do not believe that from a business perspective they have in fact "sold" a portion of the asset.

### 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.***

**Response:** We believe the nature of the entity and its investors' needs should drive the accounting model. In our view, the accounting is more appropriately dealt with in the IC model rather than in a separate investment property entity standard. Many view investments in real estate as an asset class in which an investment company could invest. For entities that qualify as an IC, we therefore believe fair value measurement should be required. For entities that would not qualify as an IC, we would support the adoption of a standard similar to IAS 40 *Investment Property* with an option to account for investment property at fair value.

### 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?***

**Response:** Based on the tentative decision reached by the board on October 19, 2011, all investment property will be excluded from the scope of the lessor accounting model in the proposed Update on lease accounting, irrespective of whether such investment property is measured at fair value. Thus, the proposed standard will not have the effect of promoting greater use of fair value for those assets for certain types of property owners. As a result, the need for a standard to identify entities that should be required to measure their investment property at fair value is now not as clear. However, how the term "investment property" is defined will be important since that will determine which asset types will be excluded from the lessor accounting model. As discussed in the next paragraph, we have concerns about the definition of investment property under both the proposed standard and IAS 40.

***Interaction with the lease project and the definition of investment property:*** The definitions of investment property in the proposed standard and in IAS 40 are not consistent. Thus, the lessor scope exclusion from applying the "receivable and residual" model may result in some unintended consequences. For example, power plants and captured manufacturing facilities may be considered land/buildings with integral equipment deemed subject to a lease under ASC 840-10-15 as a result of power purchase contracts and/or "take-or-pay" production contracts. As such, they might in some circumstances qualify unintentionally as investment property. Further, neither definition will resolve all the practical application issues that will result from the application of the receivable and residual approach by a lessor for non-investment property that represent a portion of a larger asset. For example, situations might include:



- A building. There are mixed views about whether, for example, cell towers should be land/building and hence investment property under IAS 40. Under the proposed definition, they would be buildings because they would represent real estate and integral equipment.
- A hotel, which would generally not be an investment property under the proposed definition as lessors may lease out only a portion of the property to third party retail, restaurants, and other users while the majority of the property is considered as used in the production of goods and services. (Partial assets cannot be investment properties under the proposed definition.)
- A property used in part by an owner for its own operations and in part leased to third parties (e.g., the owner of a 10-story office building leases out 3 floors to others).

We have also heard a number of concerns about why the exemption is being granted for investment property when similar issues affect other types of assets where only a portion of the asset is leased or only a small portion of the economic life of the asset is leased. Those assets include:

- Satellites
- Telecommunications cables
- Transportation terminals (e.g., retail concession space, airline desk, airline gates, docks)
- Transportation assets (e.g., portions of cargo ships or cargo ships/rail cars/airplanes with short lease terms relative to the life of the asset)

#### **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?*

**Response:** We believe that a requirement to reassess would be appropriate. However, similar to our comments on the proposed IC standard, we are concerned that the nature of the changes that would be considered a change in purpose and design is not well defined in the proposed standard. If the board proceeds with an IPE standard, we recommend that it clarify what would constitute such a change.

We have observed a circumstance where a reassessment based on an investee relationship could cause an entity to no longer qualify as an IPE, without there being a change in the purpose or design of the entity. Certain changes that are addressed by other GAAP (such as a change in consolidation considerations due to a triggering event) also could require the entity to reassess whether it continues to qualify as an IPE. For example, an entity may determine it is an IPE because it invests in real estate indirectly through a controlled joint venture. An event may occur that requires it to reconsider whether it continues to control the joint venture. If that reconsideration results in a determination that a loss of control has occurred, the joint venture is no longer consolidated. In that case, the entity as a whole may no longer qualify as an IPE based on the fact that it would have to ignore real estate investments made through its non-controlling interest in the venture. If the venture was the only vehicle used by the entity to invest in real estate, this situation may require the entire entity to reassess whether it qualifies as an IPE, even in the absence of a change in its business strategy. Refer to our response to question 7.



#### **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.*

**Response:** As we stated in our cover letter, we do not believe that a separate IPE standard should be created. We also believe that the guidance in the proposed IC standard generally will provide appropriate criteria for determining when entities should be considered investment companies, without arbitrary scope exclusions based on legal structure or tax elections.

In our comment letter on the proposed IC standard, we agreed that the scope exception for real estate investment trusts should be removed as we do not believe the entity's tax status is necessarily determinative of whether the entity is operating as an investment company or investment property entity. This determination should be based on the nature of the investment operations.

We also believe that the amendments in the proposed IC standard will provide further clarification on the population of real estate entities (e.g., real estate funds) that should be investment companies. We observe that private REIT subsidiaries are often utilized by many real estate funds solely for tax purposes. We do not believe that a fund that utilizes such vehicles should get different accounting than a fund that does not use such vehicles but has an identical investment strategy.

#### **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.*

**Response:** If the board takes our recommendation to not proceed with the issuance of an IPE standard, this question will no longer be relevant. In that case, an entity would first consider whether it qualifies as an investment company when evaluating how to measure its assets and liabilities. The distinction between investments made directly in real estate property or properties and real estate related investments (such as mortgage backed debt securities or mortgage receivables) would not impact the analysis of whether an entity is an investment company.



If an IPE standard is to be issued, we believe this requirement would be appropriate in order to prevent entities that originate loans secured by residential or commercial real estate from being scoped into the standard. We are not aware of any operational concerns in applying this requirement.

If an IPE standard is to be issued, we recommend clarifying what is meant by “substantially all.” “Business activities” may be different than assets/investments. For example, property management, leasing, or construction management services may not utilize significant physical assets, but may generate substantial revenues. How the significance of these activities should be measured (e.g., based on assets, revenues, or some combination of both) is unclear. We recommend the board considers allowing the use of judgment in evaluating this criterion. For example, if an entity purchases distressed debt securities with the intention of foreclosing on the properties, the entity might more appropriately be considered an IPE.

One other observation with respect to the nature-of-business-activities criterion relates to the number of investments required to qualify as an IPE versus an IC under the two proposals. We have noted that the proposed standard does not have a requirement for multiple investments, whereas the proposed IC standard requires multiple investments in order to qualify for this criterion. If the board does not issue an IPE standard, it may have to address whether a fund with only a single investment property would qualify as an IC, a point we raised in our comment letter on the proposed IC standard.

#### **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?*

**Response:** If an IPE standard were to be issued, we believe the evaluation of an entity’s business activities should consider properties held through noncontrolling financial interests. It is extremely common in the real estate industry for entities to invest in real estate indirectly with joint venture partners where the decisions by the joint venture involve shared control among the parties involved. Real estate entities do not view those investments any differently than their direct investments in real property and often utilize joint venture structures in order to pool resources with another party who may have particular expertise in either a geographic region of the country or in a particular type of property. Further, it is extremely common that such noncontrolling interests are included, on a pro rata basis, in measuring compliance with financial debt covenants. This indicates that banks and other users consider such interests similar to direct investments in real estate.

Depending on the significance of such noncontrolling interest, an entity might not meet the nature-of-business-activities criterion because it would not include such interests when measuring whether “substantially all” of the business activities are investing in real estate, even though all its risks and rewards stem from real estate activities. The rationale behind why such noncontrolling financial interests would not be included in that evaluation is unclear to us and we would not favor such a requirement.



**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.*

**Response:** We believe these situations can be adequately addressed through application of the proposed IC standard, in lieu of an IPE standard. However, we do not believe that the principles articulated in the proposed standard are sufficiently clear to provide operational guidance on when various types of properties are not qualified for purposes of making the assessment of whether the entity has an "express business purpose." There are suggestions in the basis for conclusions that certain property types are explicitly considered inconsistent with this criterion (e.g., hotel properties in BC15).

We recommend the board clarify the underlying principles and provide a table that describes common property types and identifies whether substantial investments in those properties are expected to be consistent with the “express business purpose” criterion based on the typical operations of such properties. Appropriate caveats should be included conveying that the table is meant for illustrative purposes and that the specific facts and circumstances for each entity and property type should be considered when making the overall determination of whether a property is consistent with the “express business purpose” criterion.

<b>Common Property Type</b>	<b>Operations Expected to be Consistent with “Express Business Purpose” Criterion</b>
<b>Rental Income Properties</b>	
Central business district office	Yes
Suburban office	Yes
Retail	Yes
Industrial	Yes
Medical office	Yes
Multi-family residential	Yes
Net lease hotels	Yes
<b>Operating Properties</b>	
Owner/operator hotels (or hotels managed by an operator on behalf of the owner)	No <sup>a</sup>
Nursing homes/assisted living	No <sup>a</sup>



Golf courses	No <sup>a</sup>
<b>Developmental Properties</b>	
Merchant builders	No <sup>b</sup>
Home builders/lot development	No <sup>b</sup>
Condo conversions	No <sup>b</sup>
Extraction entities (e.g., coal mines)	No <sup>b</sup>
Timber or agricultural investments	No <sup>b</sup>
<p><sup>a</sup> - <i>These property types typically include significant services to customers. As a result, they might not be consistent with the express business purpose criterion based on the significance of the service elements.</i></p> <p><sup>b</sup> - <i>These property types are developed for “sale in the ordinary course of business” or have product output that is sold, such as coal or timber.</i></p>	

Under the proposed standard, an entity would not be able to designate part of a building as an investment property. This differs from IAS 40, which allows a portion of an asset to be designated as investment property. This difference could create application issues under U.S. GAAP as it is common for a portion of certain asset types to be used for administrative purposes (e.g., headquarters of a public REIT in one of its properties or on-site property management/leasing offices within multifamily residential properties or regional shopping malls). Depending on the significance of such assets, it could be sufficient to disqualify the property from qualifying as investment property and/or the entity from being an IPE/IC. A possible solution would be for the board to provide an exception for portions of the property used to provide “administrative services” to the entity's own properties, similar to how the proposed standard would treat an operating entity in consolidation that provides services to the IPE. It is also similar to the proposed IC standard, which allows an entity to provide services that relate only to its own investment activities without being disqualified under the “nature of investment activities” criterion.

With respect to extractive and agricultural investments, we recommend the board clearly articulate whether these should be included in or excluded from the investment property entity analysis. Many investors in these property types do not view these as operating assets, even if a portion of the return is based on the sale of output, especially if it is renewable. For example, a portion of the return on land investments producing wheat may be from the sale of wheat during the holding period as well as the capital appreciation of the property. If the cash flow from the sales represents a substantial portion of the returns over the life of the investment, it would not appear that these assets would qualify as investment property.



#### 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.*

**Response:** We believe the board should clarify its intentions with respect to the need for an “exit strategy” in order to meet the express-business-purpose criterion based on the potential challenges in analyzing whether this criterion has been met as discussed below.

Many publicly traded property REITs would not qualify as investment companies. However, certain real estate entities, such as open-/closed-end real estate funds or non-traded externally managed REITs, may be considered investment companies. The requirement to have an adequately defined exit strategy other than liquidation of the entity might cause difficulty for many such REITs in qualifying as an IPE or IC if they do not plan on selling properties, especially in their core markets. Capital appreciation is often realized by investors in these entities through other means, including the sale/redemption of their interests (e.g., via appreciation in the equity value), property financing, merger, or liquidation of the entity, rather than by sale of the individual properties by the entity.

Entities may believe they can present themselves to investors one way or another depending on their desire to either qualify or not qualify as an IPE. We understand the intention of this language was not to scope out property REITs, but to draw a distinction between entities with business strategies to achieve a total return for investors and those with strategies other than a total return.

It appears that the board’s intention is that the “express business purpose” would be based on how the entity presents itself to investors. If entities attempt to view the wording as providing an option to qualify as an IPE, it will call into question the veracity of management’s assertion. While the business strategies described in public documents for many REITs may not specifically discuss disposal plans for their investments, most REITs have developed strategies through which they can realize appreciation from the sale of their investments. We believe the board should provide some clarifying language for this criterion in order to prevent the perception that there is an option.

Entities that could be scoped in because of the expansive definition of real estate, such as power plant ventures or pipeline syndications, may not qualify as IPEs or ICs because of a lack of exit strategies or because of transactions with affiliates.

Entities that invest in or hold real estate to obtain tax credits (e.g., low income housing credits) should also be carefully evaluated. They may not meet the express-business-purpose criterion because (i) the returns provided to many of the investors are primarily through the realization of the tax credits and not from the property (either limited or no participation in operating or appreciation cash flow) and (ii) the limitations necessary to obtain the credits without clawback may inhibit the entity from having a sufficiently defined exit strategy. Many of these structures have puts/calls on the limited partners’ interests as well as guarantees of the credits by the general partner, which significantly limit the upside potential and downside risk of the limited partners.



**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?*

**Response:** We believe this criterion is generally appropriate; however, refer to our response to question 11 for some suggested modifications to this criterion. Refer also to our response to the similar question within the proposed IC standard.

**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? Measurement*

**Response:** Yes. We believe this exception is appropriate for the reasons recognized by the board in the proposed standard. If an IPE standard is not issued, this exception should be included in the proposed IC standard, as indicated in our comment letter on that project. This issue may disproportionately impact real estate entities, as evidenced by the fact that this exception was included in the proposed standard. This further validates the necessity for the same exception in the proposed IC standard, particularly if the board does not proceed with an IPE standard. While we agree that this exemption may address many single investor entities, such as pension plans and not for profit entities, it may not address all situations. For a more detailed discussion, refer to our responses to questions 7 and 9 in our comment letter on the proposed IC standard.

**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?*

**Response:** We believe an IPE should be required to measure those properties at fair value with all changes in fair value recognized in net income rather than applying other U.S. GAAP. However, we do not believe the requirement to measure such non-investment property in accordance with other U.S. GAAP would apply often or be a concern. This is largely based on the fact that individual properties (e.g., operating properties such as hotels) are often held through separate legal entities for legal liability and tax purposes. If a non-investment property was held by an IPE, it would likely be in a separate legal entity. Therefore, even if such entity was 100% owned by the IPE, it would not be consolidated based on the guidance in the proposed standard. As such, an investment in such an asset would likely be recorded at fair value with all changes in fair value recognized in net income, because it was held in a separate legal entity. The only circumstance in which the IPE would need to apply other U.S. GAAP would be one in which the IPE held fee title to the hotel directly, which is uncommon.



The same would be true for a taxable REIT subsidiary that was performing “merchant building” activities, such as build-to-suit assets for immediate sale upon construction completion. Such activities would not give rise to investment properties. But because those activities would be occurring in a 100% owned subsidiary that would not be another IPE, an IC or an operating entity providing services to the IPE, the interest in the subsidiary would be reflected at fair value with changes in fair value recognized in net income. Therefore, based on the provisions in the proposed standard, we consider it highly unlikely that any asset would be required to be measured in accordance with other U.S. GAAP (i.e., measured at historical cost). Refer also to our response to question 14.

### **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?*

**Response:** Yes, we agree that such right-of-use assets should be measured at fair value with all changes in fair value recognized in net income. A common example would be a leasehold interest in land that is sub-leased. We believe such transactions should be measured at fair value under both an IPE and IC standard. However, we observe that the interaction between the revenue recognition patterns under two potentially different models (i.e., lease accounting and IPE standards) should be considered.

### **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?*

**Response:** As more fully discussed in our response to the proposed IC standard, in general, we do not believe that consolidation as described above necessarily provides better and more transparent information to investors in all cases. However, there are limited circumstances where we believe an investment company should be required to consolidate another investment company/IPE. We note that these circumstances may be more frequent in the real estate industry than elsewhere, such as for investment companies investing in other than real estate.

These limited circumstances would be when a subsidiary is created in conjunction with the parent company to facilitate investment strategies via separate legal or operating structures to achieve specific legal liability, regulatory, tax, legal, or other business objectives, such as providing financing. Absent these objectives, the parent would have made the investments directly and thus the underlying investment entity represents an extension of the parent's own operations. Because of the nature of this relationship, investors would be better served by the transparency of consolidating the underlying investment company. We believe this could be accomplished by expanding the exception in the proposed standard to allow consolidation of



entities that provide services to the properties. We believe an additional exception could be provided to allow for consolidation of controlled investment companies that are created in conjunction with other funds to facilitate investment strategies for regulatory, tax, legal liability or other business purposes, such as financing.

We also have a number of practical concerns relating to how the proposed standard would be applied as it is currently written. The application of the consolidation rules would impact whether the reporting entity qualifies as an IPE or an IC, which entities it should consolidate if it is an IPE or IC (entities that do not meet conditions a-c in the question are not consolidated even if they are controlled by the IPE or IC), and the accounting for the investment in the entity at fair value if it does not meet one of the consolidation criteria. If changes are made pursuant to the recommendations described above for how and when an IPE would consolidate investments, the board should consider the resulting impact on whether an entity qualifies as an IPE. Refer also to our response to question 7.

***Impact of investments in non-controlled real estate ventures on qualification:*** Many REITs, real estate operating companies, real estate funds, insurance company separate accounts, and other investors invest in real estate with joint venture partners, who often serve as the operating partners/property managers of such investments. In some cases, such as for funds, it is the predominant investment approach since the funds themselves do not have the operating platform to manage the properties.

Under the proposed standard, it appears that investments in real estate made through non-controlling interests could negatively impact the overall determination of whether an entity meets the "nature-of-the-business-activities" criterion. For example, if 60% of an entity's real estate portfolio consisted of direct investments in real estate with the other 40% representing investments through non-controlling joint ventures, it appears the entity would not qualify as an IPE because it would not meet the "substantially all" requirement since the investments through non-controlling interests would not qualify when evaluating the nature-of-the-business-activities criterion.

We recommend the board clarify whether this was an intended outcome and, if not, provide a mechanism to address this.

***Investments in service companies:*** An IPE would generally consolidate a controlled entity that is not an IPE or IC only if that entity is a service entity that provided services to the IPE's properties. We understand this exception to the consolidation rules was provided for REITs, which often use taxable REIT subsidiaries. However, it is not clear whether this was meant to include services *only* to the REIT's wholly-owned or consolidated properties. In many cases these taxable REIT subsidiaries are formed for tax purposes because the entities desire to generate property management, leasing, or construction management fees from non-wholly owned or third party properties (which would not be qualified income for tax purposes). It is not clear whether condition (c) in the question would apply when in addition the service organization is also providing services to non-controlled/consolidated or third party properties. We believe this is the more common situation and recommend the board clarify whether condition (c) applies to these circumstances.



**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?*

**Response:** Refer to our response to question 14 for certain of our views on practical implementation issues.

**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?*

**Response:** Refer to our response to question 14 for certain of our views on practical implementation issues.

**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?*

**Response:** As part of the board's broader financial instruments project, there have been recent discussions indicating that the fair value option may be eliminated. This has caused some concern for fair value real estate funds (especially open-ended funds). Many open-ended funds are concerned about the resulting volatility that stems from the fact that these entities would only measure one side of the balance sheet at fair value. As indicated in our cover letter, this would also cause the reported NAV for such funds to be disconnected from the value at which investors in such funds would likely transact.

Further, much of the investment level debt for real estate entities is non-recourse debt (such as specific mortgage debt outstanding related to a specific real estate property). As such, when property values fall below the book value of the non-recourse debt, real estate funds that report at fair value typically record a gain on valuation of the debt in the same period that they record a loss on the valuation of the property. The gain on debt partially offsets the loss upon valuation of the asset, which would appear appropriate based on the non-recourse nature of such debt. This information is more useful to users of fair value financial statements and more aligned with the NAV at which an investor in such a fund would transact. A requirement to record financial liabilities in accordance with other U.S. GAAP would be particularly concerning in these situations, especially if the fair value option would cease to exist. For these types of funds, an option to fair value debt, particularly investment level debt, would seem appropriate.



**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?*

**Response:** We agree that an IPE subject to a lease should recognize rental income related to such lease consistent with the contractual terms of the related lease agreements instead of on a straight-line or other basis. Thus, revenue would be recognized when the lease payments are received or become receivable under the contract. The fair value of an investment property includes the effects of prepaid rent, current rent concessions (e.g., so called "free rent periods"), and future rent increases. Thus, recognizing rental revenue on a straight-line basis would necessitate an adjustment to the fair value of the investment property in order to avoid double counting the impact of those items on both fair value and accrued rent receivable/prepaid rent.

Recognizing rental revenue based on the lease terms is fundamentally more consistent with fair value reporting for investment property. It also is consistent with how investors currently report property at fair value under the standards of the National Council of Real Estate Investment Fiduciaries and it is consistent with guidance contained in the proposed IC standard. A requirement to apply straight-line recognition and fair value accounting may represent an unnecessary and redundant application of effectively two different accounting models.

However, this will represent a significant change for many historical cost reporting entities, such as REITs. These reporting entities are concerned that revenue recognition applied to IPEs will differ substantially from non-IPEs investing in the same properties. They believe this will put them at an operational disadvantage in negotiating with tenants if, for example, their competitors can offer rent concessions (i.e., free rent periods) and realize current revenue while they cannot (even if such amounts would be included in a change in the fair value of the property, resulting in an "unrealized increase in value of the property" recorded in the income statement).

Further, given the proposed standard's prospective/cumulative effect transition method, discussed in our response to question 21, previously recognized accrued straight-line rent revenue will effectively be eliminated in transition through retained earnings and recognized again through escalating contractual rents in subsequent periods.



**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.***

**Response:** We believe a practical expedient should be allowed where the NAV is representative of the fair value of the investor's position. However, we believe that the requirement for the entity to transact at the net asset value per share may cause certain entities (such as closed-end funds) to no longer qualify for the practical expedient irrespective of whether the NAV is representative of fair value. The practical expedient for investment companies does not require an entity to transact at the reported NAV in order to qualify for the practical expedient. We observe that a potential reason the board included a requirement for investors to transact at NAV in this proposed standard is based on the potential that an entity could be an IPE and have certain investments that are not recorded at fair value. For such an entity, the reported NAV might not approximate fair value. However, a requirement for investors to transact at NAV under the proposed standard could have unintended consequences as further described below.

We also observe that many fund structures do not transact at the reported NAV determined in accordance with U.S. GAAP. For example, a common situation for a fund that is in the capital raising phase is to use a separate NAV for transaction purposes instead of the reported NAV. This is due to the fact that under U.S. GAAP organizational costs are required to be expensed as incurred upon start-up of a fund. However, in order to be equitable to all investors in the fund, management may recognize such organizational costs over some period of time (e.g., 3 years or 5 years) when calculating NAV for transaction purposes. Other examples of such adjustments may include spreading transaction costs (which are relatively higher for real estate transactions), fair valuing investment level debt (i.e., if the fair value option is not allowed), or adjustments made at the discretion of the general partner. If such differences exist between reported NAV and transactional NAV (or the entity does not transact at all, such as closed-end funds), the reported NAV should not be used as a fair value practical expedient. We believe an NAV practical expedient is appropriate if the reported NAV is a valid approximation of fair value.

**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?***

**Response:** If an IPE standard is issued, we believe the proposed disclosure requirements would generally be appropriate. In connection with leasing disclosures, because of differences in the revenue recognition model, we observe that the disclosures for a lessor's leasing activity will be different for IPE/IC investment property (contractual revenue basis) and non-IPE/IC investment property (presumably straight line basis).

There is no requirement in the proposed standard to present financial highlights. This may also represent a change for investors in real estate funds that are accustomed to receiving financial highlights as part of the financial statement presentation. We understand that the board would not object to the inclusion of financial highlights if investors are accustomed to such presentation, even though it would not be a formal



requirement of the proposed standard. However, we suggest providing guidance in the proposed IC standard to address financial highlights presentations for real estate funds that qualify as investment companies.

In particular, the guidance in the proposed IC standard includes a requirement for an investment company to disclose an additional expense ratio that excludes the effects of consolidating its investment property entity subsidiaries from the calculation. We believe only one expense ratio should be presented, which should exclude all property level expenses. The intent of the expense ratio disclosure is to present fund level asset management costs, not individual property expense ratios or investment level expense ratios. A calculated expense ratio including such amounts will not yield any relevant or comparable data for investors since the ratio will depend on the mix of property types. This is due to the fact that different property types have significantly different expense ratios. As such, we recommend only one expense ratio be presented that would exclude all property level expenses.

#### *Effective Date and Transition Issues*

##### **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?*

**Response:** We believe that different constituent groups would be affected in different ways by an IPE standard and that the impact on comparability needs to be considered. Initially there would be a lack of comparability between periods presented for any REITs or operating companies currently reporting under historical cost that qualify as IPEs. This is due to the fact that the investment property values for the comparative periods would be on a historical cost basis while the current period would be presented at fair value. While this lack of comparability is not optimal, it would be temporary. It also is likely to be viewed by many as preferable to having to do full retrospective application. Retrospective application may be substantially more cumbersome and costly, especially for those not using fair value today and those who report quarterly, which would necessitate multiple reporting period restatements.

In addition, for REITs, a portion of rental revenue from leases of investment property that were recognized on a straight line basis will be reclassified to retained earnings upon adoption. The portion of the revenue reclassified will essentially get double counted in the future since it will be recognized on a contractual basis from the period of adoption forward.

There could be similar comparability issues upon transition for some real estate funds, especially those previously reporting under the fair value dividend or fair value equity method presentations, which generally did not consolidate any investments, irrespective of the level of control. Having to go back and retrospectively apply this standard would require obtaining information from many different investee entities (often managed by and with records maintained by other parties), which may be onerous for some. Accordingly, if a separate IPE standard is issued, we believe the maximum amount of transition flexibility should be provided through an option to elect a "full retrospective" approach or "prospective only" approach to transition if the issuer had comparability concerns between periods presented. If an IPE standard did not exist, we would be less concerned with the amount of transition flexibility necessary as discussed in our response to the proposed IC standard.



**Question 22**

*How much time would be necessary to implement the proposed amendments?*

**Response:** We encourage the board to obtain input from preparers on the amount of time and effort required, and the potential operational challenges they might face, in order to implement these requirements before establishing an effective date for a final standard. This is particularly important in light of the interplay with the proposals dealing with *Financial Services - Investment Companies (Topic 946)* and *Consolidation (Topic 810): Principal vs. Agent Analysis*.

**Question 23**

*The proposed amendments would prohibit early adoption. Should early adoption be permitted? If yes, why? Nonpublic Entities*

**Response:** We believe early adoption of the final investment company standard should be permitted, with the further stipulation that entities must also adopt the related *Consolidation (Topic 810): Principal vs. Agent Analysis* proposal concurrently.

Because the final investment company standard would represent an improvement in financial reporting, we believe that preparers should be allowed to adopt early if they wish. This is especially true for newly formed entities that otherwise would be required to undergo a subsequent change if adoption is substantially delayed. New entity formation is common in the real estate closed-end fund industry, where vehicles have limited investment periods/lives and the next fund in a series is established to continue the investment strategies of the sponsor.

*Application to 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?*

**Response:** Yes, the recognition, measurement and consolidation guidance in the proposed standard should apply equally to non-public entities. We do not believe there are any substantive reasons for having different accounting for non-public entities or non-public holders of controlling financial interests in entities. While we also believe that the final disclosure requirements should apply equally to public and nonpublic entities, the board should consider feedback received from nonpublic entity constituents to determine whether specific exceptions should be permitted.



**Appendix B - Considerations related to real estate investments made by investment companies**

As previously indicated, we do not support the continuation of this proposed standard as a separate project. However, we believe certain decisions reflected in the proposed standard should be incorporated into the proposed investment company standard.

Description	Details or reference
Definition of investment property.	Refer to our response to question 3.
Scope – would there be a requirement for the entity to have multiple investments versus a single property investment?	Refer to our response to question 6 as well as our response letter for the IC proposal.
Scope – exclusion from pooling-of-funds and unit-ownership criteria for certain entities.	Refer to our response to question 11 as well as our response letter for the IC proposal.
Rental revenue recognition related to leases (contractual basis instead of straight line)	Refer to our response to question 18. It appears the board has already addressed this item based on proposed guidance included in the proposed IC standard at ASC 946-605-25-9.
<p>Initial and subsequent measurement of investment property, with a specific exclusion from business combination accounting for acquisitions of investment property.</p> <ul style="list-style-type: none"> <li>• Eliminating the requirement to allocate purchase price to intangible assets related to acquired leases</li> <li>• Providing consistent treatment of transaction costs (e.g., capitalization into the cost basis of investments resulting in a day one unrealized loss instead of immediate expensing as prescribed in business combination accounting)</li> </ul>	<p>In deliberations for this proposed standard, the board reached certain decisions with respect to providing a specific scope exclusion from business combination accounting. Those deliberations and conclusions reflected the unique conflict which exists when an investment company acquires a real estate property, because a real estate property typically meets the definition of a business under ASC Topic 805. Other investments made by investment companies are typically considered asset acquisitions. In BC42 of the proposed standard, the board decided to eliminate the potential conflict of initially measuring an investment property acquired in a business combination at fair value excluding the lease contract and then subsequently measuring the property considering the lease contract. The board decided that investment properties acquired in a business combination should be exempt from the requirement in Topic 805 to measure the acquisition date fair value of acquired properties excluding lease contracts. We believe this exemption from business combination accounting should be retained in the proposed investment company standard, specific to investments in real estate.</p>
Ability to measure investment level debt at fair value.	Refer to our response to question 17.



<b>Description</b>	<b>Details or reference</b>
<p>Presentation and disclosure requirements specific for real estate funds. The board should consider providing guidance in an effort to minimize the diversity in practice that exists today among real estate funds (i.e., consolidation and gross presentation versus net presentation under fair value dividend and fair value equity methods).</p>	<p>We believe the board should consider whether specific guidance is relevant for real estate funds that qualify as investment companies.</p>
<p>Financial highlights for real estate funds - we believe there should not be a requirement to present two separate ratios; one expense ratio should be presented that excludes all property level expenses.</p>	<p>Refer to our response to question 20.</p>
<p>Use of the NAV fair value as a practical expedient by investors in a real estate IPE/IC</p>	<p>Refer to our cover letter and response to question 19.</p>