December 15, 2010

Technical Director
File Reference No. 1850-100
FASB
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Re: Proposed Accounting Standards Update
Leases (Topic 840)

Behringer Harvard creates and manages global institutional-quality investment programs for individual and institutional investors through its real estate investment trusts, joint ventures and proprietary program structures. The company also offers strategic advisory, asset management and capital market solutions. Behringer Harvard has interests in or manages more than $10 billion in assets, which include public and private entities. Accordingly, we have substantial exposure to both lessor and lease accounting, particularly as it relates to real estate investment properties.

We are providing the following comments for your consideration regarding the proposed accounting standards update, leases – topic 840. As requested, we are responding to the questions identified, primarily as they relate to lessor accounting for real estate investment properties.

Summary
We support the FASB lease proposal for arrangements that are primarily financings. Such arrangements should have the same accounting effect as purchases and financings. This is particularly true for lessees and lessors, where similar assets can be purchased and used for similar terms and where service components are not significant.

However, for lessors in general, and investment property entities specifically, the proposed lease accounting would not benefit users of lessor financial information, particularly management, investors, debt providers, appraisers and analysts because investment property arrangements are not financing contracts. We disagree that lessee and lessor accounting treatment should be similar. We disagree that contracts with significant service components should be treated as leases and the related collections or contingent rentals should be included in the asset recognition for lessors. We do believe:

- the proposed lessor accounting will result in substantial divergence of practice due to the material estimates required, particularly for investment property entities;
- the financing model for lessor accounting will result in material mismatching of lessor revenues and expenses, particularly for investment property entities; and
- the proposed lease accounting will provide no benefit to users of lessor financial information but lessors will incur substantial costs.
Last, and most important, we do not believe the FASB should rely on fair value accounting exceptions for investment property entities as justification for a lessor accounting standard that does not meet the underlying economics of investment property entities. We recommend that for lessors in general, and investment property lessors specifically, that current accounting, particularly accrual revenue accounting be maintained regardless of whether fair value reporting is included or not.

**If the lease proposal is issued as drafted, we would strongly consider adopting non-GAAP basis of accounting (e.g. income tax basis) or present non-GAAP measurements. We believe other real estate companies will consider similar approaches. This will have the effect of marginalizing GAAP financial statements. We do not believe this is best for the real estate industry and users of financial information.**

**Question 5: Scope exclusions**

The current exposure draft does not provide a scope exclusion for investment properties. We define investment properties and investment property entities very broadly, including properties held for cash flow and value creation. We believe that fundamentally, all REITs should be included in the definition without exception. We believe that the statutory requirements for REIT status (e.g. requirements for holding real estate assets, requirements for receiving revenue from real estate activities, requirements for distributions) will prevent any abuses in financial reporting.

Per paragraph BC55, the exposure draft states that a “lease of investment property should be within the scope of the proposed standard”. We disagree with that conclusion due to the fundamental nature of investment property operations. As provided in the opening sentence in the exposure draft “Introduction and Invitation to Comment”, leasing is an important source of finance. Our disagreement is that not all arrangements with tangible assets have a primary function of providing financing. We believe that most arrangements involving investment properties are not financings and accordingly have different economics than arrangements with conventional leased assets, primarily operating equipment. Our reasoning is based on the following analysis of conventional leasing and investment property analysis.

**Analysis of conventional leasing – Proposed lease accounting is appropriate**

When seeking the use of an asset in a conventional lease arrangement, the lessee entity\(^1\) has an option to either acquire the asset or lease the asset (or a very similar asset). With availability of similar assets, where the base price of the asset is known, the lessee entity’s decision is generally based on the interest rate and financing terms available for leasing the asset or alternatively purchasing the asset and obtaining financing. The lessee entity should then select the arrangement form that provides the most beneficial net present value (and not the accounting treatment). Further, in these arrangements, the lessee generally takes most of the responsibility for the maintenance of the asset. At the end of the lease, the lessee generally must return the asset.

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\(^1\) To avoid confusion, our comment letter refers to the “lessee entity” as the entity obtaining use of the asset. It may be from purchase or lease. The reference does not imply that the form of the agreement is more appropriate as a lease or a purchase. Similarly, our comment letter refers to the “lessor entity” as the entity providing the asset and does not imply either a sale or lease.
in a similar condition, excepting normal wear and tear, or pay for the decline in the value of the asset. In this context, we agree that the form of the transaction, whether as a lease or a purchase with a financing, should not have different accounting.

For the lessor in a conventional leasing arrangement, the lessor entity’s business model is to act as an intermediary between the manufacturer and the lessee. The lessor's access to capital provides an ability to provide financing which allows the lessor to compete on financing terms. Since the asset cost information is generally available to the lessee, the cost of financing at the time of arrangement is a critical factor in the lessor’s pricing. When interest rates are increasing, the lease payment increases and vice versa. The lessor generally has little responsibility for the maintenance of the property, although the lessor may provide maintenance services, usually for a profit. However, in either case, a critical aspect of the lessor’s services is that it is generally focused on continuing the operation of the asset, not adding value to the asset. At the end of lease, the lessor takes possession as is, in some cases with a payment compensating for the decline in value and attempts to re-lease as used equipment with another entity, or the lessee takes possession.

**Analysis of investment property leasing – Proposed lease accounting is NOT appropriate**

This traditional equipment lease is fundamentally different than the arrangement for most real estate investment properties, both for the lessee and the lessor. For the lessee entity (i.e. the tenant), there is generally no option to acquire a similar asset at similar terms. This is due to several factors, primary of which is that the specific asset conveyed, in this case the demised premise that the lessee actually occupies, is not the primary characteristic of the arrangement. Although not totally insignificant to the arrangement, the demised premise is generally very generic, certainly within a given price range. What differentiates a particular arrangement are the intangible factors and services provided surrounding the demised premises. A property investment has been part of a development that includes its location, common areas and the business environment. In the case of retail space, the business environment includes the attraction of customers to the tenant’s space as well as to other retailers in the development, the marketing of the development and the appeal of the common areas. In the case of office and industrial space, the business environment particularly includes the location, convenience to other businesses or customers, access to transportation, security and promotion of the lessee’s business image. For residential properties, the business environment includes the location, demographics of other tenants and common area amenities (pool, club house, utilities, security, etc.). For each of these property types, it is rare that the lessee entity could acquire a similar asset with similar characteristics.

Another important factor for lessees is the term of the arrangement. While there are circumstances where a lessee entity is willing and able to commit to a long term investment in a property investment, in most cases an important aspect is the limited term. A lessee entity generally is not able to commit to a real property arrangement for a term that would make a purchase of the asset practicable. Part of this is due to the large cost of such an investment, but it is also due to the unwillingness to create the needed business environment. While a retailer may

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2 The lessor in some circumstances is the manufacturer. Although less common, serving as the manufacturer and the intermediary does not change the economics where the similar asset is available from other sources. In this context, the lessor is distributing the product and receiving terms for the collection.
have the business skills to physically construct a building, few retailers have the skills to create a development that will create the needed business environment. It is also difficult for lessee entities to forecast their property investment needs sufficiently far enough in the future to justify such an investment. Retailers’ needs may change over time requiring different locations and markets. Office and industrial users may need more or less space for their operations over time. Accordingly, the time period of the arrangement, which is generally for a commitment period far less than that required for a purchase, is an important feature of the arrangement and by definition cannot be replicated by a purchase.

As a lessee entity’s decision is substantially based more on business environment factors than financing considerations, the proposed lease accounting, where interest expense is a main component of the accounting treatment, is inappropriate. We believe existing accounting which recognizes occupancy cost on an accrual basis over the life of the arrangement is a better matching of the business environment and service factors to the entity’s business model. Only when a lessee entity obtains exposure to significant risks or benefits associated with the underlying asset should the lessee recognize an asset and obligation. While such an accounting approach would create two classifications of leases, we believe the fundamental economic differences between a financing arrangement and a business/service arrangement warrant a lessee accounting approach that matches the underlying economics. We do believe there are only limited circumstances, primarily real estate arrangements, where such facts and circumstances would exist for lessees.

The differentiating factors are even more apparent for the landlord, lessor entity. For most operating equipment leases, the lessor is relatively passive in the management of the use and investment in the asset. However, for the landlord, the asset is an investment that is actively managed. The landlord maintains the asset not just to keep it functioning but in most cases to increase its value. This is particularly true for substantially all investment properties that are multi-tenant or where the lease terms are relatively short compared to the life of the investment property. Most investment properties have physical lives of 30 to 50 years, in some cases longer. Typical leases are 5 to 10 years and in many cases longer. During this life the landlord would be expected to upgrade the property, both cosmetically and functionally, investing amounts that represent a substantial amount of the original or current carrying cost. Rarely would an operating equipment lessee make such investments, let alone capital investments in an operating equipment asset other than routine maintenance. This operational concept is so widely accepted that in business combination accounting the acquisition of an operating real estate asset or a real estate asset that even has the potential to be operating is treated as a business, not as an asset purchase. That is not true for the acquisitions of most assets, particularly operating equipment assets.

The lessor’s revenue pricing model for an investment property is substantially different than for an operating equipment lease, where as noted above cost of money is an integral factor in the determining the payment schedule for equipment leases. Because an investment property competes based on the business environment and service factors noted above, investment property is priced based on its location and the quality and class of amenities and business environment. High quality retail developments, which can attract more customers, will demand higher rates. The same is true for office, industrial and residential, where rates are based on
availability of transportation facilities, customers or clients and common areas. These factors are different than the mere functionality of equipment assets and instead are business factors that the landlord must continually upgrade, invest in, and actively manage. Although financing is important to investment properties, because debt financing is usually for a longer term than the lease and obtained independent of any individual lease arrangement, finance costs are not an integral factor in the lease pricing. This is not the case for operating leases where there is usually a direct relationship between the asset financing and the lease terms. Pricing for investment property leases does not generally fluctuate based on interest rates as would be the case for an equipment financing, but on demand and supply factors. A lease accounting model as proposed that is focused on deriving interest income is totally inappropriate. We believe that an accounting model that reflects the accrued earning of payments, as is current practice, is more appropriate for such a business model.

Last, all of the users of investment property financial information depend on the reporting of accrual earnings which reflects the economics of the periodic payments. Management uses accrual earnings to determine billable amounts, uncollected rents, operating trends and adequacy of revenues to determine strategy and sustainable returns for investors. The proposed lease accounting model for lessors distorts this analysis by attributing more interest income during the early periods of the arrangement and less earnings as time passes. Although straight lining of rents also distorts this analysis, the differences are generally smaller and are more easily separated. However, under the proposed lessor accounting model these differences are not easily separated and management will have to provide for two entirely separate accounting systems. The same distortions are true for other users of investment property financial information. Owners and lenders will have to make adjustments to underwrite cash flow and investment returns. If investors and lenders have issues making these adjustments, the cost of capital for investment properties could increase. Appraisers, who are a critical service provider for investment properties, use methodologies that require cash flow analysis. The adjustments required could increase the cost of this service.

As noted in paragraph BC56 of the exposure draft, “[investment analysts] say that total rental income is an important measure for investment property analysts. Neither the performance obligation approach nor the derecognition approach to lessor accounting would reflect ... total expected rental income.” We are not aware of any user that would benefit from the accounting model proposed for investment property lessor accounting. Accordingly, we strongly urge that investment properties be scoped out of the proposed lessor accounting and investment properties maintain its current accounting practices.

Paragraph BC58
We understand from paragraph BC58 that the FASB is considering whether investment property entities should be given the option (or be required) to measure an investment property at fair value through earnings. If measured at fair value, then, and only then would investment properties be scoped out of the proposed lessor accounting. We disagree with that approach. Proper revenue accounting for lessors should be independent of whether or not assets or liabilities are recorded at fair value and instead based on the underlying economics of the business. We are not aware of other industries where fair value accounting would so significantly affect revenue recognition. Fair value would have consequences on debt covenant terms and
costs, which may cause those investment property entities to choose other basis of accounting other than GAAP. We do not believe that is the best interests of the real estate industry. Accordingly, we believe that measuring investment properties at fair value should be an option, consistent with IFRS guidance. As discussed above, we believe that the definition of investment property should be very broad.

For all of these reasons, primary of which is that investment property entities are not finance companies, but businesses, we urge the FASB to scope out investment properties from the proposed lessor accounting.

**Question 4 – Definition of a lease**

Per the above discussion, we believe investment properties, particularly for lessors, should be scoped out of the leasing proposal. If the FASB elects not to make that change, we would make the following comments to the definition of the lease.

The exposure draft lease definition includes all contracts in which the right to use a specified asset is conveyed, subject to scope limitations. Contracts that provide service components are included as leases, even if the service component is not separable. We agree with this approach for insignificant service components; however, we believe that at some point the service component is so fundamental or so significant to the contract and the operations of the lessor that the contract should no longer be considered a lease as defined in the exposure draft.

There are a number of services that convey the use of an asset, for a period of time, in exchange for consideration. There are short term contracts such as a commercial airline ticket, hotels or entertainment events or long term contracts such as club memberships, athletic facilities, assisted living facilities that meet this definition. In each case, the “lessee” has use of an asset (the airplane seat, club privileges to a club house, exercise equipment, assisted living unit) on an exclusive basis, for a period of time, in exchange for consideration. Few would consider these leases, because the service component is significant compared to the use of the asset.

In the case of investment properties, the service component is also significant. The landlord provides common areas, amenities, grounds maintenance, cleaning, repairs, and security and, as noted above, operates in a manner to create a business environment that is favorable to the tenant. These services are integral to the overall contract that is not only inseparable from the conveyance of the demised premises, but fundamental to the long term profitability of the investment property entity.

Accordingly, we believe that the definition of a lease include a further definition that would exclude contracts “if such services are significant in relation to the lessors’ revenue during the life of the asset”.

Because the proposed lease accounting is based on a financing model, we believe this addition to the lease definition is important so to include only contracts where the main economic activity is financing, not providing services that cannot be separated. Also as noted below, failure to
exclude contracts with significant services will provide significant implementation issues for investment property entities.

Question 6: Contracts that contain service components and lease components

Per the above discussion, we believe investment properties, particularly for lessors, should be scoped out of the leasing proposal or the definition of leases include provisions that would exclude leases with significant service components. If the FASB elects not to make either of these changes, we would make the following comments to the provisions related to service components.

Paragraph 6 provides guidance where service revenue from a lease should be reported separately if the service component is distinct and the lessor is able to do so. If the service component is not distinct, then (per paragraph B5 (b)) the lessor shall account for the whole of the contract as a lease. This provision makes no distinction for the significance of the service component, only addressing whether it can or cannot be separated.

Where the service component is significant, we believe this treatment is inappropriate. The proposed lease accounting is based on a financing model. The revenue implications of a financing model is that increased interest income is reported in the early years of the contract, with declining revenue over the life of the contract. Where the contract is not primarily finance based and the service component is significant, the consequences are an inappropriate matching of revenue and expenses. These services are generally charged to the lessee on an annual basis. By recognizing these revenues through a finance model, where revenues decline over time\(^3\), but expenses are generally stable or increasing, there is a mismatch of revenues and expenses. For longer term leases, where the service components are large, it is very possible that the revenue recognition at the latter stages of the lease could be less than the operating expenses. We believe this is a complete distortion of the underlying economics of the investment property entity, where the lessor is receiving a base rent and is recovering service costs as they are incurred. For GAAP to present that as a net loss is not meaningful. Accordingly, we believe service components, when significant should be recognized as incurred.

In addition the judgment required to make estimates of the service component collections are substantial. Differences entities will use different assumptions which increase divergence in practice and results within the real estate industry.

As further noted below, the accounting cost of making these estimates and accumulating the information will be significant. If the entity is audited, the cost of audits will also increase.

Question 9: Lease Payments

In addition to the comments above regarding that significant service payments should be excluded from lease payments, we make the following additional comments.

\(^3\) Different accounting firms have provided analysis of how revenues and expenses would be recognized over time under the proposed lease accounting as compared to current lease accounting model. All have concluded that revenue is front loaded and would decline over time.
For all lessor contracts and particularly for contracts related to investment properties, we do not believe contingent rentals should be included in the measurement of the lessor receivable. Similar to the comment to question 6, projecting contingent rentals requires significant judgment. For investment properties, contingent rent usually relates to percentage rent, where the exposure draft would require sales of tenants to be projected over a substantial period, generally between 5 and 20 years. The tenant’s ability to make this projection would be difficult enough, but to require the landlord to do so requires information not readily available to the landlord. Such a projection would require knowledge of the tenant’s business plans and the tenant’s ability to execute those plans in light of economic, capital market, and consumer trends. There would be considerable divergence in practice for these calculations between different entities that would result in lack of comparability. Per the exposure draft, the resulting estimates would require continuous adjustments that would create further divergence and volatility in the investment companies financial statements.

The cost of obtaining this information and, if the entity is audited, for the auditors to obtain objective information to test the accounting would not be cost benefit to users of financial statements and owners.

If investment properties are not scoped out of the proposed lease standard, then we would recommend that contingent rentals should be recorded under current accounting standards, which for investment properties is as billable by the lessor.

**Question 2: Lessors**

We generally agree that for lessee contracts that are in essence financings there should be consistent reporting that presents the substance of the transactions. However, for all of the reasons noted above, we do not agree that the proposed lessor accounting is appropriate. The FASB is of the belief that there needs to be consistency between lessee and lessor accounting. We do not believe there is sufficient theoretical support and precedent for such a position. There are a number of examples where the opposite parties to a transaction use different accounting. Marketable securities can be recorded at fair value with fair value adjustments recorded through earnings or equity; however, the issuer generally records the securities at cost and in most cases recognizes P&L items without referencing fair value amounts. Equity investments are recorded under different accountings (cost, equity and consolidated) with different revenue presentations or treatments. The issuers of these investments then may record them under different accountings (minority interest in equity, liability, in equity) with different income statement treatments. Interest paid may be expensed or capitalized, but the same interest income may be recognized by the lender on an effective interest method or may be deferred or not recognized at all if collection is in doubt. Accordingly, we believe there is not any fundamental reason that lessee and lessor accounting should be the same. (It should be noted that even if the proposed lease accounting is adopted, there will still not be symmetry between lessees and lessors due to different requirements for lessors.)

For lessors, rental income is recorded as earned (which generally relates to collections) and is the universal measurement for investment property entities. We are not aware of any significant
effort by any investment property entities to report their earnings as proposed in any filings or management reports, particularly for public companies which provide management discussion and analysis of their operations. If this was considered a useful measurement, there would be evidence of management using such an approach. Capital providers and analysts do not use this approach. As noted above, appraisers, who are an important service provider for investment properties do not use this approach.

We strongly recommend that the FASB scope out investment properties from the proposed lease accounting. As noted above, we do not believe that this scope exemption should be contingent on fair value accounting. Inappropriate revenue accounting that does not recognize the underlying economics of a business or an industry should not be justified based on its fair value treatment. Failure to scope out investment properties from the proposed lease accounting will only serve to cause those not required to follow GAAP to consider and possibly adopt other basis of accounting or for those that are required to use GAAP to rely more on non-GAAP measurements to allow proper analysis of their financial results. This is not beneficial for users of financial statements to have this divergence in practice or increased usage of non-GAAP measurements.

Existing accounting principals for lessors that recognize revenue on an accrual basis has served the industry reasonably well. While most investment property entities do not agree with the straight lining of rents, those adjustments are fairly easy to isolate and explain. The proposed accounting, at best, will fundamentally change the presentation in the income statement through the recognition of interest income and the timing and trends of amounts. At worst, the proposed accounting will create miss-matches in revenues and expenses. These changes will not be easily calculated without a separate accounting system and will not be easily explained to users, which will undermine the credibility of GAAP financial statements. The ability for investment property companies to compete for capital will be needlessly stressed.

We recommend that current accounting for lessors be retained, particularly the accounting for investment properties.

**Question 3: Short term leases**

We agree that leases less than 12 months should be applied using the simplified requirements.

**Question 17: Benefits and costs**

For lessors of investment properties, we believe there is no benefit to the proposed lease accounting. No users, including management, investors, debt providers or analysts, consider this presentation useful. However, the costs are substantial. These include:

- Lessors will be required to implement new accounting systems, software and processes to provide the information necessary information to implement the proposed accounting. We are not aware of another accounting change that would be so pervasive to affected entities. This applies to all lessors, not just investment property entities, and would dramatically change all of their revenue accounting. Tax accounting, hedge accounting, VIE, noncontrolling interests and other changes were very complicated but were
relegated to only certain transactions or periodic analysis. The changes to lessor
accounting would affect core operations.

- Because most lessors will still report internally as before in order to analyze operations
correctly, to bill tenants correctly and to determine correct collections, the proposed
lessor proposal will require dual systems of accounting.
- Conversion costs would be substantial.
- The re-evaluation of actual results as compared to estimates will be substantial. Our
investment properties have thousands of leases. The staffing to monitor these
reconciliations will be costly.
- Audit costs to test the pervasive estimates required, primarily total projected collections,
lease term and present value rates, would be substantial.
- The intangible cost related to investment property investors and analysts who will no
longer depend on GAAP financial statements for their evaluation. This will require
investment property entities to increase investor relation costs to fill in the missing
information, and some risk of higher cost of capital.
- Additional information will have to be provided to appraisers when investment properties
are bought or sold will increase transaction costs.

As explained above, we do not believe the FASB should rely on fair value accounting for
investment properties as justification not modifying the proposed lessor accounting. In addition
to the issues and costs noted, implementing fair value accounting is very expensive to investment
property entities. The ultimate amount is dependent on the frequency of such fair value
information and the required use of third party appraisals; however costs will be significant.

Perhaps there is some theoretical support for treating all lessors as finance companies and
recognizing receivables for rights to collect rents and liabilities for providing the right of use;
however, any such position cannot compare to the lack of benefits for users or providers of
financial information and the costs to comply.

**Question 18: Other comments**

For investment properties we do not believe the internal rate of return is appropriate for
measuring present value for lessors. An investment property is a long term asset. Such a return
requires estimates for periods as long as 10-20 years, perhaps longer if the intent is to hold the
property for its entire life. Such calculations are very subjective and depend on estimates of
future rental rates, occupancy, expenses, financing amounts and rates, and eventual sales prices.
As entities will use different assumptions, there will be significant divergence in practice. Also
the cost of obtaining this information, and if the entity is audited, the cost of auditors testing such
information is not cost benefit. We recommend using a more objective rate. This could include
the entities average cost of debt or debt available on similar properties. Even a stated rate, say
10%, would improve comparability between entities, where the differences between different
entity operations would be minor.

We are concerned over the application of impairment for lessors. The proposal indicates that the
lease collection asset is to be tested for impairment based on discounted cash flows. However,
for investment properties, impairment is initially tested using an undiscounted cash flow model.
Since both the long-lived asset and the lease collection asset are economically derived from the same cash flows, we believe these two impairment approaches are inconsistent. We believe there could be instances where the lease collection asset could be impaired but the long-lived asset not. We also can envision situations where the investment property entity could have two impairment charges; then, if there is still a legal obligation to provide the tenant the leased premises, there could still be a “credit” hung up on the balance sheet. We believe there needs to be a unified impairment for lessors that consider all assets and credits.

In conclusion, we strongly believe that the proposal will not achieve the FASB’s goals. The proposal does not present lessors in general, and investment property operations in particular, consistent with their underlying economics. We are concerned that the lessor accounting proposal will distort operations, reporting greater net income in the early years and less net income, possible losses, in the later years of a lease. We believe the lessor proposal will increase divergence in practice and produce less comparability. We are not aware of significant issues in current lessor accounting that would warrant such a change and accordingly, the proposed changes will result in no perceived benefit to internal or external users of the financial statements. While we generally understand the treatment and approach for lessee accounting, we do not feel that this warrants a change to lessor accounting. Accordingly, we strongly urge that the FASB finalize a comprehensive lessor accounting and revenue model before finalizing the lease proposal. We generally support the real estate industry trade group comment letters, particularly the National Association of Real Estate Companies (NAREC) and encourage the FASB to include these groups in the deliberation process.

Sincerely,

Howard Garfield
Senior Vice President