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Re: Proposed Accounting Standards Update
Leases (Topic 840) – Exposure Draft (“ED”)

The National Association of Real Estate Companies (the “Association”) is composed of representatives from companies engaged in a broad range of real estate activities, as well as independent accountants, service providers to the real estate industry and others associated with real estate. The Association membership includes representatives from over 75 companies, including small, medium and large public and private companies. One of the major objectives of the Association since its inception in 1979 is to define and promote the use of sound accounting and financial reporting principles and practices that reflect the economic realities of the real estate business. In such regard, the Association has presented views to the FASB on a variety of topics and is pleased to respond to the request for comments on the ED. Our primary focus relates to lessors of investment property¹ and accordingly we have formatted our comments and the questions posed in the “Request for comments” section of the ED that are relevant to our membership or to the real estate industry as a whole.

We generally support the FASB’s overall efforts to improve lease accounting and improve transparency consistent with the conceptual framework for measuring assets and liabilities. However, we have substantial concerns regarding the conceptual consistency of the ED, particularly for lessors of investment property. Investment property operations are fundamentally different than those of most other leased assets, which are generally personal property, machinery and equipment. The Association strongly believes that the ED would substantially distort lessor investment property financial statements, decrease transparency, increase divergence of practice, and create unintended consequences in the conceptual framework. We believe these may have a cumulative negative impact on our industry’s ability to attract and compete for capital. The implementation and on-going requirements, particularly the continuous re-assessments will create a substantial burden on all lessees and many lessors, including investment property companies and their tenants. Most importantly, the Association does not believe:

¹The Association uses the term “investment property” in its broadest form, including properties held for cash flow and/or appreciation. It would include all entity forms, particularly REITs, which believe by their legal form should be included as an investment property. Conceptually it would also include investment companies, but due to specialized accounting, they are not applicable to this discussion. We do understand the FASB is considering the scope definition for investment properties. The Association would be pleased to assist in that discussion, but we generally believe it should be broad, including our definition, and in all cases, include REITs.

- That the primary users of our financial statements, which include internal management, investors, debt capital providers, appraisers, analysts and service providers to the real estate industry, will benefit from the ED proposals to lessor accounting, and
- That lessor revenue recognition should be dependent on whether investment properties are carried at fair value or not.

The basis of these opinions is as follows:

1. 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 the ownership of investment properties is not a finance business and that most arrangements involving investment properties are not financings. Accordingly, we believe that investment property contracts have different economics than arrangements with conventional leased assets. The differences between an investment property business model and their underlying lease contracts include the following key concepts:
 - a) *Investment property assets are value-creating investments.* As opposed to conventional asset lessors, investment property ownership provides a value creation that is the result of increasing the cash flow from the lease contracts over the life of the investment property. The primary return from a conventional leased asset is its ordinary cash return with few opportunities for value creation. Accordingly, investment property is considered one of the core investment platforms, along with other financial instruments such as equity and debt. Investment property also has a substantially greater life than conventional leased assets. These result in active asset management, focused on both cash returns and value creation of the investment property over extended time periods. These asset management activities generally go far beyond the maintenance activity generally related to conventional leased assets which is focused primarily on keeping the leased asset functioning. During the life of the investment property, the landlord would generally be expected to upgrade the property, both cosmetically and functionally, investing amounts that represent a substantial amount of the original or current carrying cost. Because of the business objective of value creation over the life of the investment property, the landlord would generally be actively involved in the operations of the investment property, including repairs, maintenance, cleaning, landscaping, and security. Rarely would a conventional equipment lessor make these kinds of cash outlays or be that involved in the day to day operations of the leased asset.
 - b) *Investment property assets have unique characteristics.* The lease contract for an investment property not only includes the demised premises (the area actually occupied by the tenant) but the entire, indivisible development of the investment property. Accordingly, the landlord’s investments and day-to-day operational

involvement also includes common areas, such as lobbies, parking lots, structural elements, infrastructure equipment and technology equipment. In addition, for the core real estate property types (retail, office, industrial and multifamily), landlords also actively develop a favorable business environment for their tenants. For example, shopping center landlords will incur marketing costs to promote the shopping center and attract customers. Office and industrial landlords will incur costs to facilitate their tenant's ability to attract customers through image marketing, access to transportation and technology, and other service components. Multifamily landlords will incur costs to create a lifestyle that attracts a certain demographic of residents. These costs are different than direct leasing costs to obtain new leases. Accordingly, an investment property landlord has more operating costs and asset management aspects than are generally found in conventional lease assets.

- c) *Lessees generally do not have the option to acquire similar assets.* Generally the long economic life of investment properties and the services noted above make it impracticable for tenants to replicate the leased asset through a purchase or to economically commit to a long-term direct ownership in the property. Accordingly, a critical aspect of an investment property contract is that the term is significantly less than the economic life of the investment property and tenants typically occupy only a small percentage of the entire investment property. While the actual demised premises that the tenant occupies is not unimportant, a tenant's analysis generally focuses on the overall aspects of the development and the commitment period. Very rarely are sub-divided units with similar business environment characteristics, services and terms available to tenants as are similar assets available for conventional leased assets.
- d) *Investment property lease terms fluctuate primarily based on demand and supply, not current interest rates.* In conventional lease assets, interest rates and cost of money are a primary factor in the contract pricing. Because an investment property competes based on the business environment and service factors noted above, investment property is priced based on its specific sub market (i.e. location) and its 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 properties, 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, interest is not any more of a factor in the contract pricing than for any other commercial entity. Debt financing is usually long term, and in the case of typical multi-tenant investment property, obtained independent of any individual lease arrangement (which is not the case for operating leases where there is usually a direct relationship between the asset financing and the lease), Further, pricing for investment property leases does not generally fluctuate based on interest rates as would be the case for equipment financing, but on demand and supply factors. A lessor accounting model as proposed that is focused on deriving interest income is totally inappropriate. We believe that an accounting model that recognizes rental

income on an accrual basis, as is current practice, is more appropriate for such a business model.

For these reasons, we believe that contracts involving most investment properties are not financing contracts and should not be accounted for under a finance accounting model. Similar conclusions were reached in the application of business combinations, where the acquisition of an operating investment property is considered the acquisition of a business and not the acquisition of an asset. For business combinations, the accounting framework necessitated a different accounting model for a business vs. an asset. Further, under a finance accounting model, there is the underlying concept that the lessee has an option to acquire and finance the asset or lease the asset. That is not the case for investment property contracts and we believe it is inconsistent to apply such an accounting model where direct ownership of a similar underlying asset is not feasible.

2. Paragraph 6 of the ED 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 B5 (b)) the lessor shall account for the whole of the contract as a lease. The ED makes no distinction for the significance of the service component, only addressing whether it can or cannot be separated. Most leases have a service component or executory costs incorporated into the rental rate structure. Gross leases, modified gross leases and net leases should not produce a different accounting result. Operating expenses should be excluded from calculating the lease assets and liabilities specified for the lessors and lessees in the Exposure Draft. These operating expenses and reimbursements of expenses should be recognized in the year incurred and earned.

The service components for most investment property companies are very significant. As discussed above, landlords incur operating costs for maintenance, repairs, landscaping, security, real estate taxes, insurance, etc. Service component collections could represent 20-50% of total contract collections. Where the service component is significant, we believe the ED 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. However, the operating expenses related to an investment property generally increase over the life of the contract. Accordingly, the overall income statement effect for investment property companies is to show higher net income in the early stages of the contract with declining net income trends thereafter. We believe this is fundamentally inconsistent with the underlying economics of investment property companies.

For contracts with material service components, transparency and analysis of an investment property company's financial statements will also be distorted. To do any relevant analysis, an in depth knowledge of the terms, age and treatment of service revenues would be required to gain any understanding of the financial results.

Further, similar investment property companies which may be in different life cycles for their leases, where new leasing may be increasing or decreasing, will not be comparable. Under current accounting guidance for investment property companies, comparability is considered good and we are not aware of any significant deficiencies.

3. The amount of judgment involved in applying lessor accounting will also result in increased divergence of practice, less comparability and less transparency. Areas that we are most concerned with include.
 - a) *Difficulty of estimating service component revenue.* Investment property lessors, per paragraph 52, must estimate service component revenue collections over the life of contract if they can be reliably measured (subsection (a)). Determining whether or which of these collections can be reliably measured requires considerable judgment. For investment properties, the largest of these are real estate taxes and insurance. Assessing estimates for periods of 5 to 10 years or longer is very difficult. The same is true for other service collections where reliability may depend on the size, complexity, location, age, functionality and other characteristics of the investment property. Different investment property companies and different property types may come to different conclusions concerning their ability to estimate the amount of future repairs, maintenance, landscaping, security and management. The same entity may come to different conclusions among their own investments, where certain properties would have substantially different accounting treatments than other properties. Where an individual investment property company is making different determinations, financial analysis is more difficult or would require substantially more information. Even if there were common conclusions for what was reliably measured, then there would be differences in how to estimate the collections over the life of the contract. These different applications would make analysis among the industry more difficult, if feasible at all.
 - b) *Difficulty in determining contingent rent and terms.* The ED requirement to include contingent rents and “more likely than not” contract terms are also problematic. For investment properties, contingent rent usually relates to percentage rent, where the exposure draft would essentially require tenant sales of tenants to be projected over a substantial period, generally between 5 and 20 years. The ED also requires lessors to estimate the “more likely than not” lease term for options that will not be exercised until far into the future, where periods of 10, 20, 30 years or longer are not uncommon. The tenant’s ability to make these projections 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, the tenant’s ability to execute those plans in light of economic and consumer trends, capital market availability, demand and supply interplay between investment properties and tenants, and projections of future general and tenant specific economic factors. Such evaluation requires substantial judgment and tenant data that are realistically beyond the reasonable accessibility of some lessors. Investment property companies with similar contractual terms could come to significantly different

conclusions related to contingent rental and terms. There would be considerable divergence in practice for these calculations between different entities that would result in lack of comparability. Consequently, investment property companies could have dramatically different balance sheets and operating results.

- c) *Determination of discount rates.* For investment properties, the ED proposes that the discount rate used be the internal rate of return for the investment property. An investment property is a long term asset. Such a return requires estimates for periods as long as 30-50 years, with longer periods not uncommon. 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. Because investment property contracts are not financings and do not have a traditional profit margins, the Association has further questions whether an internal rate of return is the appropriate discount rate.

Because of the complexity and pervasiveness of these judgements, the net result will most certainly be increased divergence of practice and financial reporting for what has historically been a relatively comparable industry.

4. 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 agree and are not aware of any user that would benefit from the accounting model proposed for investment property lessors. Substantial practice has developed among internal management, investors, debt capital providers and analysts over this presentation. This reporting provides for accrued rental income and property expenses classified “above the line”, netting to what is commonly referred to as net operating income. Net operating income is a crucial performance measurement for investment property companies. Alternatively, the accrual of interest income and amortization of a performance obligation is more consistent with financing operations and financial assets.

We believe this is more than just a so-called geography change in investment property financial statements, but rather a critical change in the economic presentation. We expect that additional information will have to be provided for users to understand the underlying economics, potentially leading to increased use of non-GAAP measurements. Although investment property companies have used such measurements (e.g. funds from operations (“FFO”), earnings before interest and taxes (“EBIDTA”), the pervasiveness of the changes that the ED would drive could affect the overall credibility of the industry. Adjusting for depreciation and straight line rents is relatively easy to understand and adjust for. However, making substantive adjustments to GAAP revenues could create questions and concerns for capital providers thus negatively affecting the industry’s ability to attract and compete for capital. Accordingly, we are seriously concerned that the ED will have negative implications to the real estate industry.

5. It appears that the impetus for the ED draft is asset and liability recognition for lessees. We generally agree that there should be no accounting presentation differences between the acquisition and financing of an asset or the leasing of similar asset on similar terms. However, we disagree that such a conclusion requires a symmetrical approach for lessors. Where the opposite parties to a transaction have different underlying economic characteristics, there is no theoretical basis or precedence that symmetry should override proper accounting. Conceptual issues that we believe need to be addressed include:
- a) *Lessor double counting of assets.* Under the performance obligation model for lessors, two assets are recognized: one for the present value of future collections and one for the leased asset. For all lessors, but particularly for investment properties, this is an economic overlap of the same cash flows. Investment properties, like other investments, are economically measured based on their ability to produce cash flows. Even if the performance obligation is netted against the receivable, because of the difference in amortization for the two accounts, there will most likely be a double counting of total assets. This asset would not have any economic basis.
 - b) *Conceptual support for lessor set off of assets and liabilities.* It appears that the lessor netting of the receivable with the performance obligation seems to be based more on alleviating the issue of grossing up the lessor's balance sheet rather than on the consistent application of a conceptual framework for assets and liabilities. If a lessor truly has a performance obligation and this should be recognized as a liability, then what is the basis for the set off against the receivable? Should other liabilities with deferred income characteristics be netted against receivables? However, if in fact the asset and liability represent the same benefit and obligation where set off is appropriate, then why are each amortized to the P&L differently? If set off of the leased asset, collection receivable and the obligation is acceptable for the lessor, should not the lessee's presentation include the same set off?
 - c) *Capitalization of executory costs.* Under current GAAP, the direct owner of an asset expenses real estate taxes, insurance and other operating expenses as incurred. Under the ED, if these executory costs are included in the contract collections/payments, lessees and lessors are effectively including these future ordinary expenses in their assets and liabilities. Similarly, the lessees and lessors are recording obligations for ordinary expenses which under current conceptual framework are not liabilities. In addition to the conceptual issues, this accounting treatment creates a significant accounting and presentation differences between directowners of assets and those transactions where the assets are leased. The Association believes this is an unnecessary difference and will create incentives for entities to create structures to achieve desired accounting results. As discussed below in our response to Question 6, the Association believes that service payments should be excluded from lease payments.
 - d) *Miss-matching of revenues and expenses.* As noted above, the front loading of net income in the early years will result in mismatching of investment property revenues and expenses. We are concerned with a lessor accounting model that has greater profit margins in the early years and declining trends going forward.

Similarly we are concerned that certain leases, where the service component (i.e. recovery of operating expenses) is very material and/or under a long term contract, a landlord could actually have a net operating loss in the later years of investment property contract. The Association strongly believes that any lessor accounting model be consistent with the matching principal of revenues and expenses.

- e) *Impairment.* The performance obligation model will create conceptual impairment issues. Investment property impairment is currently evaluated under long-lived GAAP guidance. Per paragraph 41, the ED calls for the right to receive lease payments to be evaluated for impairment based on Topic 310. We believe the use of two impairment models are inconsistent for investment properties. As noted above, both the investment property and the lease collections are based on the same contract collections. However, long-lived impairment currently requires an initial analysis on an undiscounted cash flow basis, while the collection receivable asset will require impairment using “discounted” cash flows. Accordingly, there could be situations where the collection receivable asset could be impaired before the long-lived asset. If they are both based on the same collection, this is inconsistent. Further, if circumstances do result in a long-lived impairment, then there is the potential for two impairment charges. Since there is no guidance and no precedent for impairing a liability, investment property companies could be faced with two impairment charges. It is possible, and current economic conditions would bear it out, that an investment property company could have double impairment charges in a single reporting period on the P&L with no asset on the balance sheet but still have a “credit/liability” on the balance sheet. (The ED is silent on lessor presentation if the lessor’s asset is fully impaired; would the performance obligation still be recorded as an asset?) We believe that consideration needs to be given to a comprehensive timing and measurement framework for all the assets and liabilities involved during an impairment recognition event. Impairment is an important concept for investment properties at all times, but during the current economic environment, the Association strongly encourages a well developed framework before making lessor accounting changes with impairment implications.
- f) Most liabilities are currently recognized if probable. Assets, particularly receivables, are generally recognized under conservative principals of collectability. Under the ED, lessees and lessors will now recognize liabilities and assets that include a lower threshold based on the concept of “more likely than not”. We are also concerned whether a liability or asset recognition for a potential renewal option or contingent rent even meets the definition of an asset or liability. Asset recognition for percentage rent may violate SEC guidance stating recognition should only occur when billable. Accordingly, rather than moving toward a common framework for asset and liability recognition, the ED creates conflicts with differing concepts.

We agree that a conceptual framework should be incorporated for lessors in general and investment properties specifically, but such accounting model requires significantly more vetting from users and investment property companies

to better align its conceptual framework with existing guidance and the underlying economics.

6. As noted above, the ED will cause substantial differences in financial presentation for investment property companies. We are concerned that such changes will have overreaching effects on the real estate industry.
 - a) Investment properties are capital intensive. The debt components are particularly significant with heavily negotiated agreements requiring extensive covenants. These covenants are generally based on leverage ratios, coverage of debt payments compared to net operating income, EBITDA or net worth requirements. The ED will significantly change these ratios requiring substantial modifications to many debt agreements.
 - b) Appraisals of investment properties are based on *Uniform Standards of Professional Appraisal Practice*. These standards involve, in part, the use of capitalization rates on net operating income, where net operating income is defined as total rental income less operating expenses. Under the ED presentation, net operating income will not be a readily available amount. Appraisers, due diligence models for acquisitions and valuation analysts will have to make significant adjustments to evaluate properties for appraisal.
 - c) A main reason that investors seek out real estate investments is the production of cash flow. The proposed lessor accounting will increase the differences between cash flow and GAAP net profits. Real estate could be placed in a competitive disadvantage if investors become concerned that financial statements do not represent underlying economics.

These issues could have a significant impact on the real estate industry and we believe are further evidence that more thoughtfulness is required before a new lessor standard is adopted.

7. For lessors of investment properties, we believe there is no benefit from the proposed lease accounting. No users, including management, investors, debt providers or analysts, consider a finance model useful. This is clearly demonstrated by the fact that investment property public companies (primarily REITs) do not refer to such a measurement in their public filings or press releases. If users wanted such information, it would be provided. However, despite a lack of benefit, the costs are substantial. These include:
 - a) Lessors will be required to implement new accounting systems, software and processes to provide the information necessary 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, consolidation accounting, noncontrolling interests and other accounting changes were very complicated but were limited to only certain transactions or periodic analysis. The changes to lessor accounting would affect core operations, required on every contract, for every reporting period.

- b) The Association is not aware of any investment property company that will use the lessor accounting model for its internal reporting. In addition, lessors will still be required to track contractual billing amounts and related uncollected amounts, each of which are different than amounts recognized in accordance with the ED. Accordingly, the proposed lessor proposal will require dual systems of accounting to capture information for internal management and external reporting.
- c) Continuous evaluation of estimates will require significant resources. Small investment property companies could have hundreds of leases, large companies could have thousands. To re-evaluate the estimates for all these leases is a huge burden. This will affect lessees and lessors, but for lessors where the assets and liabilities are netted, there is no correlation between the massive effort required and the benefit, if there is any.
- d) Conversion costs related to all of the above would be substantial.
- e) Audit costs to test the pervasive estimates required, primarily total projected collections, lease term and present value rates, would be substantial.
- f) The Association is concerned that the ED would drive certain contract terms that are not in the best interest of the real estate industry. Our primary concern is that the ED will lead lessees to shorter lease terms. Shorter lease terms would affect the stability of investment property cash flows and consequently lender and investor approach to the industry. Also, shorter lease terms will have increased lease administrative costs.
- g) The intangible cost related to investment property investors and analysts who will no longer depend on GAAP financial statements for their evaluation could be significant. This will require investment property entities to increase investor relation costs to fill in the missing information, and the related risk of higher cost of capital if there is increased user confusion.

For the reasons identified above, we believe there are substantial differences between investment properties and conventional lease assets, where a finance based, lessor accounting model is not appropriate. We are especially concerned about the decreased transparency and lack of comparability. The cost seems dramatically disproportionate to the perceived benefits, which we believe to be none. Accordingly, the Association strongly recommends that investment properties be scoped out of the ED, similar to scope exceptions for minerals, biological assets and intangibles.

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 believe such an approach is without merit for the following reasons:

- a) As noted above, the proposed lessor accounting does not provide useful financial information for any significant user: management, owners, lenders, analysts or appraisers. Investment properties should be scoped out of the proposed lease accounting because the proposed accounting model does not reflect the underlying economics of the business, not because of fair value treatment. The

Association strongly believes that proper revenue recognition should be irrelevant to whether lessors report on fair value.

- b) There is little (perhaps no) theoretical basis or precedent to support such a change in revenue treatment based on a fair value approach. Many assets and liabilities are recorded at fair value without any change in revenue recognition. Specifically, marketable securities and debt liabilities are recorded at fair value with fair value gains or losses charged to income but the basic revenue and expense recognition is not changed. When assets are impaired and recorded at fair value, there is no change to the basic revenue recognition model. When assets or liabilities are recognized at fair value as a part of a business combination, there is no change in the revenue recognition. We believe that revenue recognition should be based on underlying economics and not based on whether or not the related assets are recorded at fair value or the treatment of unrealized gains or losses. If fair value is adopted, then a revenue model for investment properties would need to be developed first. The Association generally supports revenue recognition as accrued under current guidance.
- c) While fair value may be appropriate for certain investment property entities, it is certainly not appropriate or needed for all entities. Investment property operations are generally long term investments and many entities, including private companies and users do not believe the effort and cost for periodic valuations is justified. For these investment property entities, their business model is not based on short movements in value. Furthermore, investment property financing is usually dependent on covenants related to operations and leverage. Fair value accounting, will affect these coverage ratios and fair value recognition may not be relevant or desirable. For these investment property entities, changes to fair value could have significant consequences. For these and other reasons, investment property accounting at fair value may not be desirable for all users, especially private companies.
- d) Fair value accounting creates volatility in earnings and financial position, which certain entities may conclude is undesirable. The FDIC chairman, Sheila Blair, expressed such a position in a speech on November 18, 2010 to security analysts, stating that plans to expand fair value accounting could “undermine financial stability”. This speech was a follow up from other financial regulatory agencies outlining their opposition to fair value measurements. If investment property entities take a similar position and fair value accounting for investment properties is mandated by GAAP, many of these entities will adopt other basis of accounting (primarily tax or cash basis). For many private investment property entities (i.e. entities other than SEC registrants and investment companies or those like NCREIF that report using fair value), GAAP may then not be the accounting principles of choice. The Association does not believe having more companies report using a non-GAAP basis of accounting is in the in best interests of the real estate industry. Such a result would also undermine the objectives of the FASB.

Accordingly, we do not believe that lessor accounting should be subject to an evaluation of whether the related assets are carried at fair value or not. Proper revenue recognition should be independent of the related asset’s presentation in the statement of financial

position and/or the treatment of fair value gains or losses. The Association does not oppose fair value accounting for investment properties, but as also provided by IFRS, we strongly recommend that it be optional.

In conclusion, the Association strongly believes that the adoption of this ED will not achieve the FASB's goals and instead will result in increased divergence of practice and less comparability and transparency. Under existing lessor accounting, which is primarily operating lease based, there is considered to be relevant comparability between companies and financial understanding of the operating results. Except for the straight lining of rents, which can be explained and relatively simply determined, the operating results substantially match the underlying economics for investment property companies. Our Association is not aware of any significant deficiency in current revenue reporting and related disclosures. While we understand that the focus of the ED was originally directed to lessee accounting, **we do not believe the FASB should finalize a comprehensive lease model without addressing the issues expressed and the development of a complete lessor accounting model.** Our Association would welcome the opportunity to participate in such a deliberation.

Additional information related to the specific questions from the invitation to comment is presented below. We have attempted to limit duplication from our comments above and focus on issues not addressed or provide alternative treatments.

Question 2: Lessors

For the reasons identified above, the Association does not believe that the performance obligation or derecognition approach is an appropriate accounting model for lessors. We believe that adoption of the ED would create divergence of practice and not present the underlying economics of investment property operations. The Association believes that revenue should be reported as accrued and it is unnecessary to create additional intangible assets or liabilities.

Question 5: Scope exclusions

As explained in more detail above, the Association strongly recommends that investment properties be scoped out of the ED.

We also do not believe that lessor accounting should be subject to an evaluation of whether the related assets are carried at fair value or not. Proper revenue recognition should be independent of the related asset's presentation in the statement of financial position and/or the treatment of fair value gains or losses.

In paragraph BC38, ground leases are discussed. The determination was that because title does not transfer and there is no conceptual difference between these agreements and other contracts that ground leases should not be scoped out. We believe this conclusion

merits additional review, particularly in the light of the financial results of that presentation. Ground leases are much longer than most other contracts, where 50 to 100 years or longer are not unusual. In addition, ground leases typically have escalation clauses. Many of these escalations are based on fixed interest rates or inflation factors. When lessees calculate the present values, amortize these amounts using the effective interest method and then add the amortization of the asset, the periodic charges are substantially greater than the current cash payment. While the FASB may believe this is theoretically supportable, the result is a P&L charge that would make the ground lease arrangement financially impracticable. As part of this charge is now included in interest expense, detailed analysis will be required to convert this presentation to its true, current economics. Financial measurements such as EBITDA would be materially distorted. The Association supports the need for a conceptual framework for ground lease transactions, but the proposed treatment in the ED would serve to only further distort the operations and financial position of investment property companies.

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 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.

Accordingly, we believe that the definition of a lease includes a further adjustment to the lease definition that would exclude contracts if:

- i) any services are not inseparable from the contract, and ii) such services are significant in relation to the lessors’ revenue during the life of the asset. Both tests must be met for the contract not to be defined as a lease. As guidance:
 - Services would be considered inseparable if they were specifically identified in the contract (thereby providing contractual obligations); the services were not available to the general public (thereby not a separate line of business); receipt of the services were not optional for the lessee or lessor (thereby providing the

importance of the service for both parties); and the implementation of the service was primarily at the discretion of the lessor (thereby the lessor was controlling the service further ensuring that the service was integral to the lessor's business and profitability).

- Significance to the lessor would be measured by the cost of services directly provided and beneficial to the lessee in comparison to total contract revenues.

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, failure to exclude contracts with significant services will provide significant implementation issues for investment properties.

Question 8: Lease Term

The ED also provides that lease terms be included using a "more likely than not" concept. As more fully discussed above, we believe this will be difficult to implement and create significant divergence of practice, particularly for investment properties. The Association would propose that the lease term be limited to the contractually obligated period. We understand that there is some chance for manipulation, but we believe that there are significant risks and exposures for both lessors and lessees that the small benefit received from such a concept would be minimal as compared to the estimates, divergence in practice and cost of including "more likely than not" terms in the lease. There will also be constraints from lenders, investors and analysts if options and lease terms are abused.

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 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.

As discussed above, where the service component is significant, we believe this treatment is inappropriate. In the specific case of investment properties, as noted above, landlords provide substantial services. These may include maintenance, cleaning of the demised premises and the common areas, security, landscaping, real estate taxes, insurance, repairs and day to day management of the investment property. In addition, the landlord incurs marketing expenses to create a business environment that produces additional revenues for the landlord. In the case of retail properties, this additional revenue is

directly attributable to percentage rent (rent based on a percentage of the sales generated in the investment property). For other properties these expenditures result in attracting other “lessees” which further add to the image and revenues of the investment property. Per paragraph B7, these services would generally not be considered distinct because the landlord does not generally sell identical or similar services or because the services do not have a distinct function separate from the investment property and the services do not have a distinct profit margin.

Accordingly, we believe that paragraph 6 (b) should be amended, as:

(b) a lessor shall apply the exposure draft on revenue from contracts with customers to a service component of a contract that contains service components and lease components if the service component is not significant to the contract, the service component is distinct and the lessor is able to do so. Where a service component is significant to the contract as a whole, revenues shall be recorded in accordance with other accounting guidance or on the accrual method of accounting. As guidance to this subsection (b):

- Significance to the lessor would be measured by the cost of services directly provided and beneficial to the lessee in comparison to total contract revenues. Only services that were truly of benefit to the lessee would be included.
- For investment properties, the rent component of the contract would be recognized on the accrual method of accounting. Incentive rents (for example percentage rent) and service revenues would be recognized as billable to the tenant.

We believe the addition of this provision would prevent mismatching of revenues and expenses, improve the usefulness of financial information, provide better comparability between investment property entities and improve the cost benefit of the proposed lease accounting when the service component of a contract is significant.

Question 9: Lease Payments

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. As discussed above, such estimates would require significant judgment and information not reasonably available to most lessors. 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 3: Short term leases

We agree that leases less than 12 months should be applied using the simplified requirements. However, the lessee should also use the methodology of recognizing the expense when incurred and not recording an undiscounted asset and liability to be amortized over the lease term. This is additional administration that provides no cost benefit to users.

Question 12: Statement of financial position

As discussed above regarding conceptual issues of double counting of assets, capitalization of executory expenses, liability recognition, set off of assets and liabilities for lessors and impairment, the Association has serious issues concerning the presentation of investment property balance sheets. We do not believe this will improve transparency or comparability within the industry, and instead will create confusion in the reporting of investment property company's statement of financial position.

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 10-15 years and perhaps longer if based on the functional life of investment properties, in which case it could be 30-50 years or longer. 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 beneficial. 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.

The Association appreciates the opportunity to participate in the FASB's consideration with respect to the ED. As noted above, our response is concentrated on the questions and issues that are of particular interest to the Association. If you should desire further clarification on any of the items addressed in this response, would like input to the opinions expressed or have any additional questions, please contact Howard Garfield at (214) 365-7183 or me at (312) 960-2627.

Sincerely,



John Los

Co-Chairman, NAREC Financial Accounting Standards Committee