



December 15, 2010

Technical Director, File Reference No. 1850-100  
Financial Accounting Standards Board  
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International Accounting Standards Board  
30 Cannon Street  
London, EC4M 6XH  
United Kingdom

**Re: Proposed Accounting Standards Update, Leases (Topic 840)**

To Whom It May Concern:

On behalf of the nearly 30,000 members of our respective professional appraisal organizations, we appreciate the opportunity to provide comments on Financial Accounting Standards Board (FASB) Exposure Draft, *Proposed Accounting Standards Update on Leases* (Topic 840) and International Accounting Standards Board (IASB) Exposure Draft, *Leases*.

As the largest professional organizations of real estate appraisers (valuers) in the United States, our organizations are strongly committed to improving the relevance and usefulness of financial reporting, particularly in the area of real estate. We commend and support the FASB and IASB's effort to continue to develop high-quality accounting standards that improve the transparency, usefulness, and credibility of financial reporting. We also strongly support the efforts to achieve additional convergences between Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS), particularly as they relate to the valuation of real estate.

There is a great deal of coordination and interaction between the lease accounting standard and other standards currently under review and development (IAS 40, Investment Property, and the FASB Investment Properties Project, as examples). As such, we offer our comments to a range of interrelated issues affecting real estate.

Upon review of the proposed lease accounting standards, we offer seven comments and recommendations relating to the exposure draft and associated issues:

1. Real estate property assets are different than other leased assets such as vehicles, machinery and equipment. The proposed rule significantly involves itself with capital leases wherein the lease results in the opportunity to purchase the residual at the end of the lease. We recognize this may be pertinent to leases of equipment which are alternatives to outright purchases. This type of lease has only miniscule applicability in the real estate world. Virtually all real estate leases are true leases, even those with long terms, due to absolute reversion of the residual to the property owner at the culmination of the lease. Rarely are leases referred to as lease-purchases.
2. The valuation of interests in real estate is a highly developed practice. Qualified appraisers value the interests of the leased fee landlord and the leasehold tenant in every day practice. These leasehold

and leased fee valuations form the basis for economic measurements of assets and liabilities in the real world. Investors, lenders and accountants rely on these valuations in making business decisions. The real world determination of whether a property interest is a net asset, net liability or simply an expense similar to a utility cost is well settled, but not based on the non economic formula mechanism proposed in the exposure draft. The exposure draft lease accounting standard applies a discounted cost model (i.e., an accounting approach) to real estate leasehold interests, when fair value measurements (i.e., a valuation approach) would provide a more accurate and transparent representation of real estate interests. We recognize that fair value is a dramatic change from cost based accounting. We believe, however, that the lease accounting rule should have options available that will enable the coming move to fair value reporting without significant future revisions.

3. We urge FASB to provide for lessors and lessees who adopt a more robust "fair value" accounting model, as is proposed by the IASB.
4. We urge FASB continue to develop an "Investment Property" standard in the United States that is comparable to IAS 40.
5. We recommend FASB and IASB highlight the importance of seeking out opinions from third party subject matter experts when examining real estate leases, including lease renewal options, and determining future rent projections, as asked for under the current exposure draft.
6. Beyond the lease accounting standard, as FASB and IASB seek to improve upon and update an Investment Property standard, we urge that the definition of "investment property" be expanded from what is currently found in IAS 40 to include lodging and health care facilities.
7. Lastly, we believe that current exemptions to IAS fair value rules for "small and medium sized entities" should be reviewed in light of recent changes to appraisal standards that allow appraisers to provide a wide range of services to clients.

Professional real estate appraisers worldwide, particularly those who have earned professional designations from our respective organizations, stand prepared to provide the cost competitive services to assist the development of more informative and relevant financial statements, and we look forward to working with you to implement these important rules.

Our more detailed comments are found below.

#### **Fair Value vs. Cost**

We can appreciate that the current reporting of the financial substance of operating leases is often not clear to the reader of a firm's financial statements. Separately stating a firm's obligations under lease contracts within financial statements will be an improvement. However, as the proposed standard is currently drafted, the stated amount of those assets and liabilities bears little resemblance to the Fair Value of those assets and liabilities and therefore could provide unreliable information to the users of financial statements. In fact, the Proposed Standard suggests that the assets and liabilities will be calculated (an accounting concept), rather than valued. Further, under the proposal, it appears that the asset calculation will essentially be the same calculation as found on the liability side. From an economic clarity standpoint, this mathematical calculation frequently will not be true or based in market realities.

The proposed discounted cost based model appears to have a weak thread of logic in the goal of disclosure of economic position. Lease assets do not always equal lease liabilities. It must also be acknowledged that lease interests can vary significantly over time as current market rents fluctuate and as the lease nears its end.

Rather than simply reporting two amounts on a balance sheet that will cancel each other out, the real net asset or liability to a lessee is the fair value of their leasehold interest in comparison to the availability of comparable space available in the market. We believe that our organizations can contribute to a more accurate policy for reporting these assets and liabilities.

The need for increased transparency is real. For instance, one recently bankrupted retail company had enormous liability for above market rented space before declaring bankruptcy<sup>1</sup>. The company's balance sheet was likely silent as to their real estate liability position<sup>2</sup>. In addition, other anchor retailers are paying below market rents in shopping centers. As a result, they have significant leasehold assets which probably are not booked correctly, if at all. This type of information would be helpful to investors as they analyze the health of companies and we believe was the message being sent by the Securities and Exchange Commission (SEC) in their communication on this subject.

Typically, the fair value of a leasehold interest includes some adjustment to account for current market rents. A grocery chain that has twenty years remaining on a thirty year lease for which the rent liability (contract rents) is below current market rents may have a "net asset" commonly regarded as a positive leasehold value or interest. That net asset will gradually fall to zero as the lease nears its expiration date. Similarly, a tenant that has rents that are significantly above current market rents may have a significant "net liability". Due to the volatile nature of market rents and demographic trends, the value of the tenant's leasehold interest and the value of the net asset/liability will vary over time and will have differing impact on the lessee's balance sheet. One example might be the net liability of a vacant grocery store at which the lessee is obligated to pay rent for an extended time period and has no market opportunity to sublet.

The most common leasehold interest is valued at zero where the rent obligation is equal to market rents in the neighborhood. Built in lease adjustments may keep the rents at market. Traditionally these rents have been noted as expenses and neither as an asset or liability. We can see no reason to change this practice if a practical method of estimating parity exists. Qualified appraisers perform this task every day.

A discounted cost based approach in allocating these leases to the balance sheet may not reflect the true economic health of a lessee which we believe is the goal of the SEC and others who called for the lease accounting project.

### **Exempt Lessors That Adopt Fair Value from Lease Accounting**

Currently, the proposed lease accounting standard is based on a discounted cost accounting model, rather than a fair value accounting model. As real estate appraisal organizations with vast experience and the development of a body of knowledge around valuation of tangible assets, we believe that fair value

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<sup>1</sup> Harrison, E. 2009 (January 21). *Circuit City as canary in the coalmine for commercial real estate*. Credit Writedowns. Available at <http://www.creditwritedowns.com/2009/01/circuit-city-as-canary-in-the-coalmine-for-commercial-real-estate.html>. See also Capital Lease Obligations at <http://www.google.com/finance?q=PINK:CCTYQ&fstype=ii>

<sup>2</sup> 2006 (September 6). *RateFinancials Assigns 'Poor' Rating to Circuit City's Financials and Questions Timing of Executive Option Awards*. BusinessWire. <http://www.thefreelibrary.com/RateFinancials+Assigns+%27Poor%27+Rating+to+Circuit+City%27s+Financials+and...-a0151103642>

measurements are clearly preferable in that they provide a more accurate snapshot of actual leasehold and leased fee assets and liabilities as of a particular date that can be reviewed by investors in understanding the true financial position of the company.

Importantly, the IASB version of the lease accounting exposure draft recognizes the widespread, international use of fair value measurement for investment property under IAS 40, "*Investment Property*," stating that, "a lessor shall apply IAS 40 and not this [draft] IFRS to leases of investment properties that are measured at fair value in accordance with IAS 40."<sup>3</sup> Under IAS 40, the value of real estate that is held by entities for investment purposes (including buildings that are leased out under operating leases) may be reported utilizing either a fair value model or a cost model. This includes properties held for investment purposes and leased out under operating leases but it is not limited to office buildings, apartment buildings, shopping malls, lodging establishments, health care facilities, etc. If an entity chooses to utilize the fair value model of reporting investment property under IAS 40, the entity is required to determine the "amount for which the property could be exchanged between knowledgeable, willing parties in an arm's length transaction".<sup>4</sup> Further, IAS 40.38 states that "Fair value should reflect the actual market state and circumstances as of the balance sheet date" (IAS 40.38).

Many companies that prepare financial reports in accordance with IFRS hold such investment property, and have chosen to utilize the fair value model. They are, therefore, required to determine an appropriate value for their investment property at each balance sheet date. Because of the complex nature of the ownership and the operating leases for investment properties, many financial statement preparers routinely retain the services of third party subject matter experts (qualified real estate appraisers), who have the knowledge and expertise to determine an accurate and reliable fair value of an entity's real estate held for investment purposes.

Unfortunately no similar exemption from the new cost based lease accounting standards is contained in the FASB Exposure Draft. This is likely because no comparable FASB fair value reporting standard for investment property currently exists. And, we recognize change of this magnitude does not come easy. However, we are aware that the FASB has undertaken an "Investment Property" project with the objective "to consider whether entities should be given the option (or be required) to measure an investment property at fair value. This project also will consider how an entity should consider a lease when measuring the fair value of a leased investment property."

As such, we urge FASB to complete the Investment Property project as soon as possible. Further, we support adoption of an exemption from the lease accounting standard for firms that adopt a fair value accounting model pursuant to an Investment Property standard, like the IASB has proposed.

Completion of these two initiatives will require extensive coordination, but we commit the resources of our organization to accomplish the goal of implementing an Investment Property standard in the United States, and providing an exemption from lease accounting rules for those firms that adopt fair value accounting.

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<sup>3</sup> International Accounting Standards Board (IASB), *Exposure Draft: Leases*, August 2010 page 18.

<sup>4</sup> Summary of International Accounting Standard 40: Investment Property available at <http://www.iasplus.com/standard/ias40.htm>

### **Lessee Accounting**

We strongly believe that economic financial transparency for lessees can best (only) be communicated to users of financial statements by a showing of whether their leasehold position has a positive, negative or neutral value. Determination of these positions are well established in the valuation industry and can be economically derived. We have concern that the proposed cost based approach does not accomplish this financial transparency.

For this to be accomplished, the asset side "right to occupy" should be based on market rents and the liability side "obligations" should be based on contract rents. Generally, where market rents are higher than contract rents, a net asset would result. Where contract rents exceed market rents, a net liability will be indicated. We believe that qualified real estate appraisers can help determine lease assets and liabilities under such an economically based framework.

We have reviewed the exposure draft and believe that even if the proposed methods were adopted, several additional refinements should be made. Under our interpretation of the exposure draft, the obligations of lessees should be enumerated using the following formula considerations:

*Rental rate + Lessee Property Expenses + Amortized leasehold improvements + Consideration of rental renewal options (using the "more likely than not" standard).*

Any consideration of leases under any methodology should be made on an apples-to-apples basis. For instance, in some full service leases the payment of property expenses is included in the base rental rate, while other lease forms impose additional requirements for property expenses to be paid by lessee either expressly in Triple Net leases or conditionally through operating expense surcharges. Recognition of the obligation for property expenses would allow for more consistent financial disclosure. .

The exposure draft identifies the cost to arrange the lease but does not consider leasehold improvements. We realize there may be a conflict in that leasehold improvements are already reported elsewhere but, they represent assets and liabilities associated with a lease and might better be merged into this discussion.

Renewal options and the concept of "more likely than not" are related to the market rent discussion. If contract rents are below market rent, the likelihood of renewal is positive while contract rents exceeding the market generally encourage tenants to relocate at renewal points.

Under the exposure draft, the discount rate used to determine the present value of lease payments for lessees is the lessee's incremental borrowing rate or the rate the lessor charges the lessee if that rate can be reliably determined. Professional real estate appraisers can reliably develop lessor charged discount rates using methods outlined in B-12 of the exposure draft. The market-based information needed for these opinions are readily available to professional appraisers.

However, we strongly suggest FASB consider an additional change to the options for assigning the discount rate outlined in B-11, should it proceed with the proposed framework. Rather than using the incremental borrowing rate (the mortgage rate at the inception of the lease), we believe a more appropriate methodology for this option would be a Weighted Average Cost of Capital (WACC) that reflects the expected return required on real estate investments to compensate the company for the required risk. This would be more consistent with

accounting procedures on the lessor side. Further, the exposure draft defined incremental borrowing rate only reflects one component of the WACC, which more properly reflects the overall required return to be considered in the company's decision making process.

Again, we believe FASB can and should emphasize the importance of retaining third party subject matter experts on topics such as this, wherever possible.

**Other Considerations - Investment Property Standard**

Currently, under IAS 40, if a lessor provides "ancillary" services to the occupants of a property held by the entity, the appropriateness of classification as investment property is determined by the significance of the services provided. If those services are a relatively insignificant component of the arrangement (Ex., normal property operating expenses such as utilities, security and maintenance services to the lessees), then the Lessor may treat the property as investment property. However, where the services provided are more significant (such as in the case of an owner-managed hotel), the property is classified as owner-occupied.

We understand that several national real estate trade organizations have suggested to FASB and IASB that the forthcoming Investment Property standard should include an expanded definition of investment property that includes lodging and health care properties. We concur with this recommendation, as it will help promote more transparency in financial reporting for lodging and health care facilities.

Further, we understand that several large, multi-national corporations have requested an exemption from any Investment Property fair value requirement. These firms would prefer the proposed lease accounting rule over a fair value model. In response to this, we understand at least one real estate trade organization has suggested that the Investment Property standard could include an exemption for companies where real estate contributes less than a certain percentage of the overall assets of the company. This solution requires further investigation, because there is no current economic reporting baseline for these companies. And, some multi-national companies with a significant real estate footprint may be viewed by many investors and readers of financial statements as real estate companies that simply sell a certain product (hamburgers, clothing, etc.).

We also understand that IFRS for Small and Medium Sized Entities (SME) includes an exemption for investment properties if there is "undue cost or effort" to reliably determine fair value. As roughly 98 percent of all real estate appraisal firms are classified as small businesses by the U.S. Small Business Administration, we understand the importance of considering compliance burdens on small businesses. However, we believe the IASB's SME policies are worth reviewing in light of recent changes to appraisal standards that allow appraisers to offer a range of cost-competitive services to firms of all sizes. This is particularly true if FASB is undertaking an Investment Property standard of its own.

Specifically, the Uniform Standards of Professional Appraisal Practice has been updated with a "Scope of Work" rule that provides great flexibility to an appraiser in developing services that suit the needs of clients. This change allows appraisers to more easily develop "phased assignments." Market Rent Studies are economically available. Further, initial, financial reporting appraisals can be completed, with subsequent lower cost updates, taking into account current market conditions. Such assignments are commonplace with appraisals for pension funds, life companies, and institutional investors, who already adhere to regular and

ongoing fair value requirements relative to real estate<sup>5</sup>. We strongly believe the development of the scope of work rule can positively address cost and compliance concerns that clients may have. The benefits of the use of third party experts greatly exceed the cost concerns.

### **Real Estate Valuation Profession**

Our organizations have been working over the last several years to prepare our members to meet the demand for valuation services in conjunction with fair value reporting. With more than 160 years of collective history, our organizations have developed a robust body of knowledge that is widely recognized by judicial and financial systems worldwide. Further, the valuation industry has successfully met the demand in countries which have adopted International Financial Reporting Standards (IFRS) and International Valuation Standards (IVS).

Real estate appraisers in the United States are well prepared to deliver cost effective valuation services as more and more entities are required, or choose, to report the value of their real estate using fair value measurements. For instance, the Appraisal Institute has two courses – *Introduction to Valuation for Financial Reporting* and *Advanced Valuation for Financial Reporting* that it offers to professional appraisers to train real estate appraisers in the relevant body of knowledge, issues, terminology, and valuation practices involved with valuation for financial reporting.

We encourage FASB and IASB to call on our organizations for assistance in these important endeavors. We look forward to increased coordination and communication between our respective professions, who both exist to protect the public interest.

We appreciate the opportunity to provide comments and input on these Proposed Standards. We look forward to providing further input at the FASB public roundtable meeting on January 5, 2011. In the meantime, if you should have any questions or if there is any additional information that we can provide, please do not hesitate to contact Bill Garber, Appraisal Institute Director of Government & External Relations at (202) 298-5586 or [bgarber@appraisalinstitute.org](mailto:bgarber@appraisalinstitute.org) or Scott DiBiasio, Manager of State and Industry Affairs at 202-298-5593 or [sdibiasio@appraisalinstitute.org](mailto:sdibiasio@appraisalinstitute.org).

Sincerely,

Appraisal Institute  
American Society of Farm Managers & Rural Appraisers

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<sup>5 5</sup> The National Council of Real Estate Fiduciaries and the Pension Real Estate Association recognize the Real Estate Information Standards, and the CFA Institute promulgates the Global Investment Performance Standards, both of which call for regular external valuation by competent, qualified appraisers. REIS is available at <http://www.prea.org/research/reis.cfm> and GIPS is available at [http://www.gipsstandards.org/standards/current/2010\\_edition\\_gips.html](http://www.gipsstandards.org/standards/current/2010_edition_gips.html)