REALpac
Real Property Association of Canada
Association des biens immobiliers du Canada

January 10, 2008

International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH
United Kingdom

Re: Exposure Draft of Proposed Improvements to International Financial Reporting Standards

Dear Sir/Madam:

We are pleased to submit this comment letter on the IASB's exposure draft of Proposed Improvements to International Financial Reporting Standards. We are submitting these comments on behalf of the following real estate organizations:

European Public Real Estate Association (EPRA)
National Association of Real Estate Investment Trusts (NAREIT)®
Property Council of Australia (PCA)
Real Property Association of Canada (REALpac)

Members of the organizations identified above would be pleased to meet with the Board or its staff to discuss any questions regarding our comments.

We thank the IASB for this opportunity to comment on the proposal. Please contact Teresa Neto, REALpac's Vice President, Financial Reporting at tneto@realpac.ca or 1 (416) 642-2700 ext. 226 if you would like to discuss our comments.

Respectfully Submitted,

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Comment Letter Submitted by the

Real Property Association of Canada

On Behalf of the following Organizations:

European Public Real Estate Association (EPRA)
National Association of Real Estate Investment Trusts (NAREIT)®
Property Council of Australia (PCA)
Real Property Association of Canada (REALpac)

In response to the

Exposure Draft of Proposed

Improvements to International Financial Reporting Standards

Issued by the International Accounting Standards Board

October 11, 2007

January 10, 2008

International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH
United Kingdom

Re: Exposure Draft of Proposed Improvements to International Financial Reporting Standards

Dear Sir/Madam:

The undersigned real estate organizations welcome this opportunity to respond to the request from comments from the International Accounting Standards Board (IASB or Board) on the proposed amendments included in the Exposure Draft of *Proposed Improvements to International Financial Reporting Standards* (Exposure Draft). The undersigned organizations represent publicly traded real estate companies and Real Estate Investment Trusts (REITs) in Europe, Australia and North America. Our members are real estate companies and other businesses that develop, own, operate and finance investment property, as well as those firms and individuals who advise, study and service those businesses.

We are providing our comments on a select number (not all) of amendments to International Financial Reporting Standards (IFRSs) contained in the Exposure Draft and have clearly identified the questions in which we are providing comments.

Comments

1. IAS 7 – *Statement of Cash Flows* and IAS 16 *Property Plant & Equipment.* Question #10

Question 10
Do you agree with the proposal to amend paragraph 68 of IAS 16 and paragraph 14 of IAS 7? If not, why?

We do not believe this amendment was meant to relate to real estate properties accounted for per IAS 16. Paragraph 68A clearly states that this amendment impacts property plant and equipment that is routinely held for rental to others and subsequently sold when the property, plant and equipment ceases to be rented. Most real estate entities hold investment properties for long-term capital appreciation rather than for short-term sale in the ordinary course of business. However, real estate entities will from time to time sell long-term investment properties when such transactions meet their strategic and financial goals. The sale of an investment property is not an ordinary activity of the majority of real estate entities and therefore the sales of investment properties, when they occur, generally would not be considered to be ordinary in the course of business. We believe this amendment relates more to lessors of machinery and equipment, where they have equipment that is routinely returned to them under operating leases which they then subsequently sell.

We request that the Board clarify if it intended in any way, by the proposed amendments, to include real estate properties accounted for under IAS 16 either because they do not meet the definition of investment property per IAS 40 (e.g. hotels) or are properties measured at cost due to the accounting policy choice provided in IAS 40. Our discussion assumes that investment properties accounted for per IAS 40 will not be impacted by this proposed amendment.

In the cash flow statement, the cash payments to manufacture or acquire investment properties held for rental to others would be presented as investing activities as would any proceeds on the sale of investment properties, when they occur. If this amendment were interpreted to apply to real estate properties accounted for per IAS 16, it would result in a significant change in presentation to the cash flow statement. Such a change would result in a significant misrepresentation of a real estate entity's cash flows from operating activities and would not reflect the true nature of the entity's investment activities.

We believe that in order to make the amendment clear to all readers, the Board should clarify that investment properties accounted in accordance with IAS 16 are specifically exempt by stating such exemption in paragraph 14 of IAS 7.

2. IAS 17 – *Leases – Contingent Rent.* Question 12.

Question 12
Do you agree with the proposal that contingent rent relating to an operating lease should be recognized as incurred? If not why?

We support this proposed amendment. We believe this proposed amendment confirms how most entities have already been interpreting IAS 17, i.e. that contingent lease rentals should be recognized as incurred on operating leases.

3. IAS 23 – *Borrowing Costs – Definition.* Question 20.

Question 20
Do you agree with the proposal to amend paragraph 6 of IAS 23 to refer to the guidance in IAS 39 "F*inancial Instruments: Recognition and Measurement" relating to effective interest rate when describing the components of borrowing costs? If not, why?*

In general, we do not believe the proposed amendments to refine the definition of borrowing costs in paragraph 6 of IAS 23 to result in a significant change by which real estate entities define borrowing costs.

An outstanding question relates to whether the IASB intended to include in the definition of borrowing costs any fair value changes recognized on embedded derivatives that are separated from the debt and accounted for on a fair value basis (such as a pre-payment option on the debt when the exercise price and penalties do not approximate the loan's amortized cost). An entity has a choice to include the changes in fair value of the embedded derivatives in interest expense or on a separate line item of the income statement.

The proposed amendment states in IAS 23 paragraph 6a) "interest expense calculated using the effective interest rate method as described in IAS 39..." IAS 39, paragraph 9 defines the effective interest rate method and states that cash flows are estimated considering all contractual terms of the financial instrument including prepayment, call and similar options. Cash flows for any option associated with the financial instrument can only be considered in the effective interest rate method if it forms part of the financial instrument. In the case of an embedded derivative that must be separated and accounted for separately, it is not factored into the estimated cash flows in determining the effective interest rate method. Nevertheless, the changes in fair value of the embedded derivatives may be included in interest expense.

We believe that the fair value changes recognized on embedded derivatives that are separated from the debt, accounted for on a fair value basis and recognized as interest expense in the income statement should be considered part of the interest expense as described in paragraph 6a) of the proposed amendments to IAS 23.

4. IAS 39 – *Financial Instruments – Definition of a Derivative.* Question 30.

Question 30
Do you agree with the proposal to amend IAS 39 by removing from the definition of a derivative the exclusion relating to contracts linked to non-financial variables that are specific to a party to the contract? In not, why?

We are strongly opposed to the proposed amendment to remove from the definition of a derivative the exclusion relating to contracts linked to non-financial variables that are specific to a party to the contract.

The proposed amendment may have two potentially significant impacts to the real estate industry:

1) Under current practice, in the case of contingent rent, where the contingent lease payment is based on the tenant's net income or any other financial performance measure other than gross sales, some entities have viewed these financial performance measures to be non-financial variables. By doing so, the contingent rent portion of the lease contract is not accounted for as a derivative since it involves a non-financial variable that is specific to a party of the contract (the tenant). Under the proposed amendments to remove this exclusion in the definition of a derivative, any lease contract with contingent rent based on net income or any other financial

performance measure other than gross sales, may be required to isolate the contingent rent portion of the lease contract and treat it as a derivative. We believe that this would result in unnecessary complex accounting for operating leases that are commonly used throughout the globe, providing what we believe to be less useful information to financial statement users of real estate entities. In accordance with IAS 39, paragraph AG 33(f), contingent rent is not deemed an embedded derivative if it is based on "related sales" or "variable interest rates". In cases where contingent rent is based on net income, gross margin or any other financial performance measure other than the two specified in paragraph AG 33(f), it may result in the recognition of an embedded derivative for the contingent rent of the lease contract.

We feel that paragraph AG 33(f) should be modified such that it states and clarifies that an embedded derivative in a host lease contract is closely related to the host contract if the embedded derivative is contingent rentals based on <u>any financial performance measure</u> such as related sales, operating cash flows, net income, gross margin, etc.

2) Similar to point 1) above, by removing from the definition of a derivative the exclusion relating to contracts linked to non-financial variables that are specific to a party to the contract may cause property management contracts with payments based on income or other financial performance measures to possibly be treated as embedded derivatives. Property management agreements are widely used in the real estate industry. Property management contracts are generally entirely based on performance measures such as percentage of gross revenue, operating costs or in some cases net income. The performance payment under the management contract is currently not accounted for as an embedded derivative since it involves a non-financial variable that is specific to a party of the contract (the property manager). By removing this exclusion in the definition of a derivative, any property management contract with performance payment terms based on any financial performance measure may have to isolate the performance payment portion of the management contract and treat it as an embedded derivative. In most cases, the entire property management contract may be considered a derivative since the contract is solely based on a performance measure. Again, we feel this will add unnecessary complexity to the accounting of property management contracts that are common and widely used by the real estate industry.

If the Board does proceed with the proposed amendments to IAS 39, we would recommend that the Board provide an exemption for property management contracts in IAS 39 paragraph AG33 such that the performance payment portion of a property management contract is deemed an embedded derivative that is closely related to the economic characteristics and risks of the property management contract, and therefore would not require that the embedded derivative be accounted for separately from the host contract.

Summarizing, we recommend that the Board consider not proceeding with the proposed amendment to remove from the definition of a derivative the exclusion relating to contracts linked to non-financial variables that are specific to a party to the contract. However, at minimum, we would recommend the Board consider our suggested amendments to IAS 39 as outlined in points 1) and 2) above.

5. IAS 40 – *Investment Property – Property Under Construction.* Question 35.

Question 35
The exposure draft proposes to include property under construction or development for future use as an investment property within the scope of IAS 40. Do you agree with the proposal? If not, why?

We support this proposed amendment. We believe this amendment will provide consistency in how investment properties under construction or development are being measured.

We thank the IASB for this opportunity to comment on the Exposure Draft. Please contact Teresa Neto, REALpac's Vice President, Financial Reporting at tneto@realpac.ca or 1 (416) 642-2700 ext. 226 if you would like to discuss our comments.

Respectfully submitted,

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