RICS

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Dear Rachel and Danielle

Re: Lessor Accounting – Investment Property

I am writing on behalf of RICS regarding the current IASB/FASB deliberations over lease accounting. This letter follows our response to the IASB Discussion Paper on leases (DP/2009/1).

RICS welcomes the tentative decision of the Boards to exclude investment property from the scope of lessor accounting in its proposed future leasing standard. However it has come to our attention that not all participants in the project are yet convinced that investment property should be excluded and therefore I am writing to explain why it is important for investor confidence in the property market for this decision to be upheld and the provisions of IAS 40 to be retained. We are also concerned, as explained below, with the application of the 'right of use' model of accounting in the field of real estate, and how this will distort the presentation of investment properties in accounts in a manner which is not consistent with how they are actually valued and how the users of financial statements will view them.

I understand that a number of other property organisations are writing to you on this subject, but RICS wishes to reinforce its views on this matter, first set out in our response to the Discussion Paper last year. As the world's largest professional body in the property sector, with a total membership of some 140 000 worldwide, RICS is well qualified to comment. Large numbers of our members advise on the development, funding, sale and valuation of investment property or work for property companies or real estate investment trusts (REITs).

Property is a major investment class for both retail and institutional investors, through either direct ownership or by indirect means such as holding stocks in a REIT or units in dedicated open or close ended funds. RICS charter requires it to act in the public interest and it considers it fundamental that valuations of investment property that are to be relied upon by the investment community at large are transparent and easily understood.

In our experience, users of the financial statements published by property companies expect to be able to readily identify the value of the investments held. IAS 40 currently allows this and is well understood and accepted. Further, users have the comfort of knowing that the values reported relate to how the actual asset would be acquired or sold in the market. The alternative suggested in the 2009 Discussion Paper of applying the "Right of Use" model to lessor accounting would be a radical move away from disclosure of current values as reflected in the actual market for the investment.

Real estate investments always are valued having regard to their potential to be let and produce a rental income. When a lease is put into place, part of that potential is translated into reality but no new asset is created. As leases of property assets are usually only for a short period as compared with the economic life of the asset (which is infinite in the case of the land element) the overall effect on value of any one lease can be small. Further, because the 'receivable' will be reducing over time, the assessment of value will be volatile, reducing the usefulness of the information. To attempt to separately identify the receivable and the residual element of an investment property would require a notional apportionment of the current value of the entire asset. There would be no market based metrics for such an apportionment and therefore it would represent a step away from the reality of the simple statement of fair value under IAS40. A further consideration is that property is valued with an implicit regard for rental growth over time, whereas the treatment of contingent rents as a receivable might invoke other rules, leading to the situation where part of what a valuer considers to be the 'lease' value will have to be classified as the 'residual' value in the apportionment.

A fundamental distinction between a lease of an item of plant or equipment and a lease of property is that the latter is immoveable and may be subject to many different rights and interests. It is an entity's interest in the property, rather than the physical asset itself that defines value. While a property lease may transfer a right of use for a defined period from lessor to lessee, the transfer is often highly conditional, and the lessor may retain a high level of day to day control over the property. An example of this would be a shopping mall where the lessor would typically retain rights control the trading hours and type of retail activity undertaken by the lessee of an individual unit, and would retain responsibility for the common parts, eg parking, access ways etc and the provision of all shared services.

The value of an investment property can reflect a complex matrix of factors. Significantly this can include the strength and prospects of not only the sector (eg city centre offices) but also the strength and prospects of the particular tenant. With leases of real estate there are frequently synergies that could result from combining the lessor's and lessee's interest. Whereas the potential value of these can be reflected in the value of the lessor's overall interest, deciding whether elements of synergistic value should be allocated to the "receivable" or the "residual" would be a difficult task. We believe trying to apply the "Right of Use" approach to a complex multi-let investment property would require assumptions built upon assumptions and potentially result in highly hypothetical figures that would mean little to users.

Some specific examples of difficulties we have identified include:

- The value of an investment property with a lease in place may be less than the value without that lease, even if the lease is for the majority of the remaining useful economic life of the asset. This could arise for properties with development potential or for properties where the market or circumstances have changed since the lease in place was completed. It would not seem appropriate to allocate value between "the property" (i.e. the residual amount) and the lease in place in these circumstances. The residual amount would not reflect the fair value of the residual amount, It would merely be an notional apportionment reflecting the depressed value figure with the existing lease in place.

- For many properties the value of the property without the lease in place may not be much less than the value of the property with the lease in place. If the lease is for a long period then the calculated "value" of the rent payments (the receivable) may represent a substantial part of the whole value of the asset. To simply allocate the remaining balance as the remaining value of the property (i.e. the residual value) could be misleading. If the tenant were to fail and the lease was collapsed then the whole value of the lessor's asset would not be materially reduced.

- With regards to the discussion paper It is difficult to follow the logic of the table at para 10.23 (Example 11). It doesn't seem rational to show an asset which clearly has a fair value of 10,000 as total assets of 19,378 with a corresponding "performance obligation" of 9,378. We think this could be misleading or confusing for users of accounts, as it implies that the lease contract has created a new and additional asset. This is not the case – as explained above it is merely the codifying of the asset's potential value. Commentators who have regard to earnings as a percentage of total assets will find the proposed accounting treatment to be opaque.

- If the lease is transferred (the ability for a lessee to transfer or "assign" a lease is a particular feature of many property leases) to another entity this could have a material impact on the value of the lessor's interest. At re-measurement immediately following the transfer the contract terms would be the same and the figure for the lease in place might be the same but the residual value would be different. This would not seem logical.

In conclusion, to adopt the "Right of Use "model for investment property would create significant problems of interpretation for preparers and auditors. It would also be detrimental to the transparency and comprehension of financial statements and provide users with less useful information than a straightforward statement of the current value of the lessor's interest. RICS therefore considers it important that the Boards' tentative position to remove investment property from the scope of the new leases Standard is maintained.

Please feel free to contact us should you wish to discuss any of these issues in more detail.

Yours sincerely,

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