

September 28, 2017

Chairman Russell G. Golden
Financial Accounting Standards Board
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Delivered Electronically

SUBJECT: Treatment of Common Area Maintenance and Allocation of Consideration Between Lease and Non-Lease Components for Office Leases Under ASC 842 and ASC 606.

Dear Chairman Golden:

We are submitting this letter to the Financial Accounting Standards Board (“the Board”) with respect to Accounting Standards Update 2016-02 – Leases (“ASC 842”). We represent the largest Office Real Estate Investment Trusts (“REITs”) that own, develop, acquire and manage real estate assets, consisting primarily of Class A office properties located in major metropolitan areas in the U.S. including New York, Los Angeles, Boston, San Francisco, Washington D.C. and Seattle. Class A real estate encompasses significant and efficient buildings of high quality that are attractive to high-quality tenants, are well designed and constructed with above-average material, workmanship and finishes, command upper-tier rental rates and are well maintained and managed.

We are specifically requesting that the Board reconsider the applicability of the guidance in ASC 842-10-15-38 and paragraph BC 153 as it pertains to lessors of office real estate. Paragraph 842-10-55-144 and 145 requires the total consideration in a lease contract to be allocated between lease and non-lease components, and ASC 842 specifically requires real estate lessors to classify, account and report for common area maintenance (“CAM”) separately from “base rent” as a non-lease component on the face of consolidated income statements and within the financial statement footnote disclosures.

For the reasons outlined below and further enumerated in this document, we respectfully but strongly advocate that the requirement to classify, account and report for CAM as a separate non-lease component does not align with or accurately report or reflect the economics of how real estate transactions are negotiated or evaluated from a lessor perspective.

- Lessors of office real estate negotiate lease transactions on a total transaction price basis and do not separately evaluate or price CAM components since our tenants expect the lessor is obligated to maintain the property when entering into the lease. Neither lessors nor lessees view CAM actually or economically as a service that is separate and distinct under the lease.

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- There is no established market data or published evidence that is available to value the “base rent” and CAM components separately since as lessors of office real estate, we negotiate our leasing transactions on a total contract basis at a market price.

As a result we are requesting that the Board provide separate implementation guidance for lessors of office real estate that would: 1) not require the bifurcation of the CAM component on the face of the income statement; 2) not require the disclosures required by ASC 606 – *Revenue from Contracts with Customers* (“ASC 606”) for CAM to be reported as a non-lease performance obligation; and 3) not require property taxes and insurance reimbursements to be allocated and reported between lease and non-lease components, as two of the Big 4 firms have described in their interpretive guidance materials. We believe the following information further supports our request:

- The pattern and timing of recognizing total operating revenues, net income, and Funds From Operations, as defined by the National Association of Real Estate Trusts (“FFO”) will not change for lessors of office real estate regardless of whether CAM is reported as a lease or non-lease component.
- Users of our financial statements, including analysts and investors, are not requesting and will not benefit from classifying, reporting and accounting for CAM as a non-lease component since total revenues will not change and our financial statement users evaluate our leasing transactions on a total transaction basis.
- The lack of benefit to the users of our financial statements from reporting CAM as a separate non-lease component does not justify the significant on-going operational and accounting burden that will be required by lessor registrants.
- Bifurcation of lease and non-lease components would require lessors of office real estate to maintain two sets of accounting records, one for how we manage and operate our businesses and another one to meet the accounting and reporting requirements of ASC 842 and ASC 606. In order to do this, we will be required to expend significant resources to develop and implement new separate accounting systems, databases, and processes in order to track the allocation required by ASC 842 and ASC 606 since this is not how we operate our businesses. We will need to have one set of books and records to: (1) track and report the economics and payments based on the terms prescribed in the underlying lease; (2) bill and record cash payments from our tenants; and (3) have our property managers manage the tenant and to monitor outstanding receivables and tenant payments. We will then need to have a second set of accounting records to dissect the lease economics to report the allocation required by ASC 842 and ASC 606 for our financial statements and footnotes. Currently there are no known accounting systems available to run these calculations. As a group, we each individually have between approximately 1,000 - 2,600 leases to dissect, document, support, record and have audited in accordance with the guidance in ASC 842 and ASC 606.

- As office sector real estate lessors, our markets as a whole contain numerous different lease types such as gross, full service gross, and triple net leases, and many different variations of these three. In a gross lease, we charge the tenant one single amount which is inclusive of the “base rent”, CAM and property taxes and insurance. In a full service gross lease, the lease is similar to a gross lease in the first year (the “base year”) but in subsequent years, we annually bill/(reimburse) the tenant for their proportionate share of additional property taxes and insurance and CAM costs/(savings) incurred above/below the base year and each lease has its own mix and calculations of types of services and amounts of property taxes and insurance included in base year amounts. In a triple net lease, the tenant is required to reimburse us for their proportionate share of CAM, property taxes and insurance. Variations of the standard full service gross and triple net leases also exist where the tenant pays for certain expenses directly to the service provider. Differing lease structures within the office sector and the types of leases within any given lessors’ portfolio will create additional accounting and operational burden without significant additional benefit and could result in less comparability and increased divergence amongst the financial statements of office sector REITs.
- Allocating property taxes and insurance reimbursements between lease and non-lease components would negatively affect the reporting transparency of these significant costs since such costs would be bifurcated and reported in two separate line items on our consolidated income statements. Further, we believe property taxes and insurance are clearly lease related items and we do not understand the logic behind allocating a portion to non-lease revenue. In addition, the lack of a formally documented consensus amongst the Big 4 audit firms will result in decreased comparability of office real estate lessor financial statements.

Requirements of ASC 842-10-15-38

ASC 842-10-15-38 states, “A lessor shall allocate the consideration in the contract to the separate lease components and the non-lease components using the requirements in paragraphs 606-10-32-28 through 32-41.” Applying this revenue recognition guidance requires allocating the total consideration in a lease contract to each lease and non-lease component on a relative standalone selling price basis. To do so, an entity shall determine the standalone selling price at contract inception of each component and allocate the total consideration on a relative basis in proportion to those individual standalone selling prices. The standalone selling price is the price at which an entity would sell a promised good or service separately to a customer.

ASC 842 differs from the current lease accounting guidance in ASC 840 by specifically defining CAM as a non-lease component and requiring CAM to be accounted for separately under ASC 606. Example 12, Case C described in paragraphs 842-10-55-144 and 145 indicates that CAM represents services provided by a lessor to a lessee that a lessee would “otherwise have to undertake itself or pay another party to provide” if the lessor did not provide the service. While we

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acknowledge that one view of Example 12 Case C could be that CAM is a service for maintaining the common area (not the leased space within an office) during the life of the lease and thus could be viewed as a non-lease component, our industry sector does not believe CAM is a separate non-lease component. As lessors within the office sector, we view the costs associated with CAM as lease-related costs since our tenants expect us to maintain and operate the common areas in our properties in connection with our responsibility as the owner and lessor of the property. The expectation of a tenant that leases Class A office space within a multi-tenant building is that the building will be maintained in Class A condition by the lessor and not that the tenant will be required to contract with separate vendors. This is generally explicitly stated in the lease and multi-tenant office properties would not be able to be leased without this requirement in the lease. We do not provide CAM services in order to generate additional profit, we provide CAM services since that is what our tenants expect as lessees of office real estate. Furthermore, with very few limited exceptions, a tenant in a multi-tenant building cannot practically separately contract services for maintenance to a landlord's space. For example, a tenant in a multi-tenant office building is not going to contract out a snowplow for only their assigned parking spaces. That tenant is also not going to hire their own separate security, nor separately contract out a gardener to maintain the landscape for only the flora that is visible from their office space.

Proposed Implementation Solution – ASC 842 Paragraph BC 153

In the “Allocating Consideration in the Contract” section of ASU 2016-2’s Background Information and Basis for Conclusions, paragraph BC 153 states the following:

“Accordingly, it is appropriate for a lessor to allocate consideration to the lease and nonlease components as a seller allocates the transaction price (and changes in the transaction price) to performance obligations in a revenue contract and does not allocate consideration to activities or costs that do not transfer a good or service to the lessee. In reaching its decisions on lessor allocation, the Board noted that the basis for conclusions in Update 2014-09 states that an entity is not precluded from accounting for concurrently delivered goods or services that have the same pattern of transfer to the customer as if they were a single performance obligation, even if they are distinct from each other, because the outcome would be the same as accounting for the goods and services separately. Therefore, it similarly would be reasonable for lessors to account for multiple components of a contract as a single component if the outcome from doing so would be the same as accounting for the components separately (for example, a lessor may be able to conclude that accounting for an operating lease and a related service element as a single component results in the same accounting as treating those two elements as separate components). The previous sentence notwithstanding, a lessor may need to separately consider presentation and disclosure in accordance with other Topics.”

As discussed further in this document, we have evaluated the impact of ASC 842 and have concluded that the pattern and timing of total operating revenues, net income, and Funds From Operations will not change regardless of whether CAM is reported as a lease or non-lease

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component. As a result, we believe that ASC 842 paragraph BC153 is very relevant to and supports our position that it is appropriate for us to account for “base rent” and CAM together as one component in rental revenue since there is no change to the timing and pattern of revenue recognition. Additionally, the impact of reclassifying CAM from rental income to services income on the face of the consolidated income statements is not material or meaningful information to users of our financial statements and does not match the true economics of our leasing transactions.

As previously mentioned, we consider maintaining and securing the building and providing the space to the tenant to be a single performance obligation. If we were to evaluate a lease under ASC 606 and without regard to ASC 842, we would consider the obligation to provide space to be highly interrelated to and interdependent with the obligation to provide a well-maintained building. That is, we would find it difficult to rent out our office space if we also did not provide a clean lobby or a plowed parking lot or an operational elevator. Therefore, the nature of the promise in a lease contract is to transfer space in a well-maintained building. Thus, if we concluded a lease contract under ASC 606 had one performance obligation, it seems incongruent that we would arrive at a different conclusion under ASC 842.

We recognize that BC 153 states “... a lessor *may need* to separately consider presentation and disclosure in accordance with other Topics”. As stated in the “Disclosure” section of this letter, we do not believe that the disclosure requirements of ASC 606 are required, as they do not provide any additional useful information to an investor. We also believe this sentence and specifically the words “may need” indicates that the ASC 842 and ASC 606 disclosures are not required once we conclude that accounting for an operating lease and a related service element as a single component results in the same accounting as treating those two elements as separate components.

Materiality and Cost versus Benefit Analysis

In addition to our position above, we also believe that the value derived from separating CAM from “base rent” does not match the significant level of effort that our industry group will be required to perform to report this information. Implementing this guidance will require investments in separate systems, technology, and additional robust internal control documentation to document the preparation, review and approval of these estimates and calculations. These systems will require us to track “base rent” and CAM on a separate basis for accounting purposes as compared to our daily operations and how we bill, collect and record revenue from our tenants. Our auditors will require evidence proving that the estimated standalone selling price for the “base rent” and CAM each represent market prices. As mentioned earlier in this letter and discussed in further detail below, given the lack of available published and transparent market price information, we expect that we will incur a significant increase in the resources required to perform the calculations required by the standard, including a significant ongoing increase in related audit fees as compared to current state. The cost, operational burden and impracticality of separating out CAM from “base rent” simply to result in an income statement reclassification with no impact to total operating revenues, net income, and Funds From Operations does not appear to coincide

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with the Board's overall intention to improve financial reporting and align the accounting with the economics.

We greatly appreciate the time and effort that the Board has devoted to issuing ASC 842. With this in mind, we respectfully request that the Board consider the total economics of a leasing transaction as was done earlier this year with hedge accounting. As mentioned in Chairman Golden's "From the Chairman's Desk", the hedge accounting guidance was improved to "align hedge accounting more closely with an organization's risk management activities and to better reflect the economics of those risk management activities." We also recall a comment from Michael Crooch, in 2006 that stated, "If information is not relevant there is no need to strive for other informational qualities."

By eliminating 1) the requirement to classify CAM as a non-lease component and report it separately from base rent on the income statement and in our disclosures and 2) the need to allocate taxes and insurance to two different financial statement revenue line items, the accounting and reporting of our transactions remain aligned with the market economics. In addition, we believe this change would eliminate the significant amount of time and resources spent in developing financial statements that are not meaningful, non-comparable, and confusing to investors and other users of our financial statements.

Lack of Evidence of Separate Stand-Alone Selling Prices

We acknowledge the Board's "Separating Components and Consideration in a Contract" section of the Background Information and Basis for Conclusions in ASC 842 and commend the Board for providing expanded guidance on how entities should account for contracts that contain both lease and non-lease components and their intent to provide more accurate accounting that also is more consistent among entities. However, from the perspective of a lessor of office space, the rent charged to a tenant represents the market price for the leased space and the maintenance related to the leased space. When determining the rent to charge for a particular space, leasing managers base their decisions on the market rents and do not separately consider the costs of providing CAM services. It is not industry standard for market participants to separately price the "base rent" and CAM. We look at the entire transaction as a whole to determine market value.

The concept of not separately pricing the "base rent" and CAM is further supported by the fact that there are no independently published standalone market prices for "base rent" absent of CAM services, nor are there published standalone market prices of CAM. The lack of independently published data, which presents a significant challenge in both determining and auditing the separate standalone selling price for CAM and "base rent" further supports our assertion that real estate transactions are negotiated, evaluated and priced as one economic transaction by lessors, as well as users of our financial statements.

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Given there is no published data for “base rent” and CAM independent of each other, we believe that any attempt to estimate separate standalone selling prices and report “base rent” and CAM as separate revenue components on the face of our consolidated income statements would require management to use a significant amount of judgment, assumptions and estimates. These judgments and assumptions would most likely vary by building and even between floors within a building, thus requiring complex calculations with many variables, such as rentable square footage of the building, percentage of space occupied by the tenant, location of the tenant within the building, when the tenant leased the space, etc. Taken together, these variables do not allow a lessor to establish a consistent selling price for “base rent” and CAM separately. As a result, we believe that different Office REIT registrants would implement differing methodologies, which would produce non-comparable and non-meaningful economic data for our investors when comparing our financial results to our peers and would not reflect the true economics of how real estate deals are negotiated.

Property Taxes and Insurance

As the guidance currently stands, insurance that protects the lessor’s interest in the underlying asset and taxes related to such asset (e.g., real estate taxes on the underlying asset) are not separate components of the contract because they do not represent payments for goods or services (i.e., the payments are for the use of the leased asset.). As a result, payments for property taxes and insurance may be allocated between the lease and non-lease components. We strongly believe a lessee’s payments to reimburse a lessor for property taxes and insurance relate solely to the leased premises and not to CAM. A lessee’s payment to reimburse a lessor for property taxes and insurance does not at all relate or support the CAM services provided to the lessee.

Requiring lessors to allocate property taxes and insurance between “base rent” and CAM based on the relative standalone selling price of each component results in property taxes and insurance being reported in multiple line items, all of which are still reported within operating revenue, on our consolidated income statements. We feel this results in financial reporting that is not meaningful and does not faithfully represent the economics of the transaction, which we believe is not the Board’s intention.

Disclosure Requirements

Under ASC 606-10-50-13, lessors will be required to disclose the transaction price allocated to its remaining CAM related performance obligations and when it expects to recognize this amount as revenue. Under ASC 842-30-50-12, lessors will also still be required to disclose a maturity analysis of future minimum lease payments.

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We note that current lease accounting guidance in ASC 840-20-50-4, already requires lessors to disclose the minimum future rentals on non-cancelable leases as of the date of the latest balance sheet presented, in the aggregate and for each of the five succeeding fiscal years and thereafter. The amounts we as lessors of office space disclose currently represent the minimum lease payments contractually due from our tenants and are inclusive of CAM amounts that are not contingent and variable in nature.

Therefore, consistent with our position that CAM should not be required to be separately reported on the face of the income statement, we also believe that the requirement to separately disclose our remaining CAM related performance obligation separate from “base rent” is not meaningful information and that it will confuse our financial statement users. We believe that the current future minimum rent table already provides clear and adequate disclosure to our financial statement users of the amount and timing of the minimum non-cancelable consideration that we will receive from our tenants.

We therefore respectfully request that we continue to disclose information about future minimum amounts contractually due from our lessees consistent with current practice.

Constituent Support of Our Position

We have discussed the proposed standard with our executives, deal teams, asset managers, leasing managers, valuation experts, certain equity REIT research analysts, brokers and various industry groups including the National Association of Real Estate Investment Trusts (“NAREIT”), Building Owners and Managers Association (“BOMA”) and the Real Estate Board of New York (“REBNY”). All of these constituents agree that reporting CAM separately from “base rent” does not reflect or align with the economics of our industry leasing practices.

Allocation Methodology

We urge the Board to consider our proposal above. In the event that the Board cannot support our positions and recommendations, we request that the Board consider the following allocation methodology to allocate the total consideration in a lease contract between “base rent” and CAM. We have each worked with and consulted with our auditors (three of the Big Four firms) as we worked through this methodology, however no formal documented consensus has been reached by the firms. We request that the Board consider the following methodology in order for us to practically implement the guidance and to promote consistent reporting within our industry group.

Paragraph 842-10-15-38 states, “A lessor shall allocate the consideration in the contract to the separate lease components and the non-lease components using the requirements in paragraphs 606-10-32-28 through 32-41.” Applying this guidance requires us to allocate the total lease

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contract consideration to each lease and non-lease component on a relative standalone selling price basis and to determine at contract inception the standalone selling price of each component and allocate the total consideration in proportion to those standalone selling prices. Suitable methods for estimating the standalone selling price of a good or service per ASC 606 include, but are not limited to, the following: an adjusted market assessment approach, an expected cost plus a margin approach, and a residual approach.

As previously discussed in this document, as an industry group we have noted that there are no independently published standalone market prices for “base rent” absent of CAM services, nor are there published standalone market prices of CAM services. Each piece of real estate, including individual suites and floors, are unique and each lease can warrant a different standalone selling price. In addition, within a given market there will generally either be gross, modified gross or triple net leases and not a mix of all three for standalone selling price validation. We have noted, however, that each of our leasing contracts are negotiated and executed at market rates in the aggregate and therefore the standalone selling price of the “base rent” and CAM services must be equal to the total market value consideration of the lease contract.

Given this, we believe the most appropriate and reasonable method to determine the standalone selling price of “base rent” and CAM services is as follows:

- Determine standalone market price of CAM by estimating forecasted CAM expenditures and adding a cost margin. This method of estimating the standalone selling price for CAM most closely approximates a market transaction price and is permitted per ASC 842 and ASC 606. The cost margin added would be equivalent to the approximate 2-5% management fee we charge to our tenants to cover our property management overhead costs. We believe that forecasted CAM expenditures plus the management fee cost margin represents a reasonable market estimate of the CAM standalone selling price.
- Take the total leasing contract consideration, which is at market, and deduct the estimate of the CAM standalone selling price discussed above, which is at market.
- Since the total leasing contract consideration is at market, and since the estimate of CAM the standalone selling price is at market, any remainder from this calculation would also have to be at market and thus would represent the market standalone selling price of the “base rent”.

We believe this approach to determine the standalone selling price would result in each portion representing market without involving significant judgments and estimates by lessors with respect to the standalone selling price of the “base rent” since market + market must = market. In addition, this approach employs the concepts of the cost plus margin and residual approaches, two of the acceptable methods permitted in ASC 606-10-32-34.

ASC 606-10-32-35 describes the acceptability of using a combination of methods:

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“A combination of methods may need to be used to estimate the standalone selling prices of the goods or services promised in the contract if two or more of those goods or services have highly variable or uncertain standalone selling prices. For example, an entity may use a residual approach to estimate the aggregate standalone-selling price for those promised goods or services with highly variable or uncertain standalone selling prices and then use another method to estimate the standalone selling price determined by the residual approach. When an entity uses a combination of methods to estimate the standalone selling price of each promised good or service in the contract, the entity shall evaluate whether allocating the transaction price at those estimated standalone selling prices would be consistent with the allocation objective in paragraph 606-10-32-28 and the guidance on estimating standalone selling prices in paragraph 606-10-32-33.”

We believe this proposed methodology would provide for a rational and systematic method of bifurcating lease and non-lease components in the event the Board concludes it cannot support the positions we have outlined and our request for additional implementation guidance. It is important to note however that we firmly believe the best answer for our business and our financial statement users is to report “base rent” and CAM together as one lease contract component.

Conclusion

We thank the Board for the opportunity to seek additional guidance with respect to ASC 842 and ASC 606 as it pertains to lessors of office real estate.

In conclusion, we are requesting that the Board provide separate implementation guidance for lessors of office real estate that would: 1) not require the bifurcation of the CAM component on the face of the income statement; 2) not require the disclosures required by ASC 606 for CAM to be reported as a non-lease performance obligation; and 3) not require that property taxes and insurance be allocated between lease and non-lease components.

We respectfully request the Board to consider the technical, economic and practical merits of our position as outlined in detail in this letter. We also respectfully request the opportunity to meet in person with the Board members to discuss our position further and to answer any questions from the Board. Please contact our designated representative Merryl E. Werber, Senior Vice President and Controller, Kilroy Realty Corporation at 310-481-8400.

Respectfully submitted,

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Senior Vice President, Chief Accounting Officer
Boston Properties

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/s/ Heidi R. Roth
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Kilroy Realty Corporation

/s/ Maggie Hui
Chief Accounting Officer
SL Green Realty Corporation

/s/ Joseph Macnow
Executive Vice President - Chief Financial Officer and Chief Administrative Officer
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/s/ Matthew Iocco
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cc: Marc Siegel, Board Member, Financial Accounting Standards Board
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