2013-270
Comment Letter No. 248

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September 13, 2013

Technical Director, File Reference No. 2013-270
Financial Accounting Standards Board
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International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH
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Re: FASB Proposed Accounting Standards Update (Revised), ***Leases (Topic 842)*** and **IASB Exposure Draft ED/2013/6, "Leases"**

The Appraisal Institute (AI) appreciates the opportunity to provide comments on the Financial Accounting Standards Board's (FASB) **Proposed Accounting Standards Update (Revised),** ***Leases (Topic 842): A revision of the 2010 Proposed FASB Accounting Standards Update, Leases (Topic 840)*** and the International Accounting Standards Board's (IASB) **Exposure Draft ED/2013/6, "Leases".**

The Appraisal Institute is a global association of real estate appraisers with nearly 23,000 valuation professionals in almost 60 countries throughout the world. Its mission is to advance professionalism and ethics, global standards, methodologies, and practices through the professional development of property economics worldwide. Appraisal Institute professionals benefit from an array of education and advocacy programs, and may hold the prestigious MAI, SRPA and SRA designations.

As the largest professional organization of real estate valuers in the world, we are strongly committed to improving the relevance and usefulness of financial reporting as it relates to real estate assets. 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 the U.S. Accounting Standards Codification (ASC) and International Accounting Standards (IAS).

Upon review of the FASB and IASB's revised Exposure Drafts, we offer the following General Comments and responses to the "Questions for Respondents" contained in both that are real estate valuation related.

1. Most importantly, we strongly urge the FASB to continue its work on the development of an investment property standard that is similar to IAS 40, *"Investment Property"*, and to issue such a standard in a timely manner. Under IAS 40, investment properties are initially measured at cost and, with some exceptions, may be subsequently reported on the balance sheet using a cost or fair value model, with changes in the fair value under the fair value model being recognized in profit or loss. IAS 40 further requires disclosure of the methods and significant assumptions applied in determining the fair value of investment property. The extent to which the fair value of investment property is based on a valuation by a qualified independent valuer must be disclosed, and if there has been no such

valuation that fact must also be disclosed. If an entity adopts the cost model of reporting, the entity must also disclose the fair value of the investment property.

The fair value model has been widely adopted by issuers of financial statements reporting under the International Financial Reporting Standards. As the IASB states in its Basis for Conclusion on the lease accounting standard, "Investment property analysts had informed the IASB that the requirements in IAS 40 provide useful information about the leasing activities of a lessor, especially when the fair value model is used. In particular, analysts said that both total rental income and fair value changes are important measures of performance of the lessor." Because of the usefulness of the information related to investment property that is contained in financial statements prepared in accordance with IAS 40, particularly if the fair value model is adopted, we strongly urge FASB to adopt a similar investment property standard as soon as possible.

2. <u>In general, we question the need for the accounting standards setting bodies to establish new requirements for lease accounting when adequate and appropriate information regarding an issuer's lease obligations (both as lessor and lessee) are already contained within the required financial statement disclosures.</u> Under IAS 40, lessors of investment property that utilize the fair value model are required to disclose the amounts recognized for rental income, direct operating expenses, and any restrictions on the reliability of investment property or the remittance of income and proceeds of disposal. Lessors of real property that do not qualify as investment property are required under both IAS 17, *"Leases"* and FAS 13, *"Leases"* to disclose the future minimum lease payments under non-cancellable operating leases in the aggregate and at one and five year intervals. In addition, lessors are required to disclose total contingent rents and a general description of the lessor's leasing arrangements. Lessors of all real estate subject to lease obligations are required to report the value of the asset on the balance sheet utilizing either the fair value or cost models. It appears that very little, if anything, related to lessor accounting will change under the FASB and IASB proposed lease accounting standards.

   Under both IAS 17 and FAS 13, lessees of property held under operating leases, including most leases of real estate, are required to disclose the total future minimum lease payments under non-cancellable operating leases at required intervals, as well as a general description of the lessee's significant leasing arrangements. The only thing that would change in relation to lessee accounting for real estate held under an operating lease is that the lessee will be required to report a right-of-use asset and a liability that are equal to the value of the stream of required rent payments over the term of the lease.

   <u>We believe that the information currently contained within the financial statements, particularly for lessors of investment property who utilize the fair value model under IAS 40, is sufficient for investors and analysts to be able to adequately evaluate the lease obligations of the reporting entity.</u>

However, one potential consequence of the proposal is a significant modification in the way that real estate leases are consummated. To this point, we do not believe that accounting policy should serve as a driver of economic activity, nor should it introduce confusion into real estate markets. Professional real estate valuers currently provide significant third-party expertise to the preparers of financial statements, including the valuation of investment property, discounted cash flow analysis, investment analysis and feasibility studies, highest and best use studies, market rent surveys, and much more. The provision of these services to both lessors and lessees will continue with, or without, the adoption of a new lease accounting standard. Certainly, the information presented in the financial statements of lessors is currently adequate. We do not believe that the addition of right of use assets and liabilities to the balance sheet of a lessee is necessary for the users of financial statements to have an accurate representation of the lease obligations of the lessee.

3. While we question the overall need for new lease accounting standards, we appreciate both the FASB and IASB's recognition in the Exposure Drafts of the fact that leases of real estate assets (Type B leases) are different from leases of vehicles, machinery and equipment (Type A leases). As it relates to Type B leases, we can understand the establishment of a right-to-use asset and a corresponding liability for property held under an operating lease, both of which are equal to the present value of the stream of rent payments at lease obligation. This is the only significant change related to lessee accounting for real estate held under an operating lease that is contained in both of the Exposure Drafts. We also recognize that lessees of real estate will report a single lease cost that is comprised of the unwinding of the discount on the lease liability combined with the amortization of the right-of-use asset on a straight-line basis over the term of the lease. This appears to be a reasonable way to recognize that most real estate leases are operating leases, and consume an insignificant portion of the real estate asset, and the holder of real estate under an operating lease does not obtain any of the benefits of ownership of the asset. Therefore, it is appropriate for a lessee to report a single lease expense. This is not significantly different than what is required currently under FAS 13 and IAS 17.

4. The IASB Exposure Draft proposes the revaluation of a right-of-use asset utilizing the fair value model contained in IAS 40 if the right-of-use asset is subsequently converted to investment property. There is no similar requirement for the revaluation of the right-of-use asset included within the FASB proposal, presumably because the concept of investment property does not currently exist within the ASC. We agree with the requirement contained in the IASB proposal to revalue right-of-use assets that subsequently become investment property, and urge the FASB to adopt a similar requirement.

However, we also believe that there should be some periodic revaluation of a right-of-use asset to evaluate the contract rents associated with the right-of-use asset in relation to current market rents. Currently, there is no recognition of the value (or lack thereof) that is inherent in a leasehold interest as a result of contract rents that are above or below market rents in the financial statements, except when the property is converted by the lessee into investment property for sale, assignment, or transfer.

For example, when a well known "big box" retailer in the U.S. filed for bankruptcy in 2002, they attempted to sell many of the properties that they held under operating leases. They discovered, however, that there was no value in many of these leases because the required contract rent payments were significantly above current market rents. As such, they were unable to sell, assign, or transfer these "right-of-use" assets (as defined in the proposed new lease accounting standards) to generate income or cash. [1]

Under the proposed IASB lease accounting standards, this retailer would have been required to establish the fair value of these "right-of-use" assets at the time the retailer decided to sell, assign or transfer them as investment properties. The FASB lease accounting proposal would not have required the same revaluation. However, there is no requirement contained in either of the proposals for this retailer to have revalued these right-of-use assets prior to their conversion to investment property.

We believe that better information would have been available to investors and users of this retailer's financial statements if they had been required to perform a periodic revaluation of these "right-of-use" assets to consider the relationship of the contract rents versus market rents. In doing so, they would have had a better indication as to whether or not there was any value inherent in these leases due to contract rents that were above or below current market rents *prior* to the time that they were put up for sale, assignment, or transfer. At a minimum, the value (or lack thereof) inherent in a right-of-use asset that is due to above or below market rents should be disclosed within the financial statements, or preferably included as part of the calculation of the right-of-use asset and liability.

We strongly urge both the FASB and the IASB to consider requiring the periodic revaluation of right-of use-assets over the life of a lease to evaluate the contract rents contained in the lease versus current market rents, even in the absence of a conversion of the property held under an operating lease to investment property. Professional real estate valuers are best able to assist the preparers of financial statements in conducting this complicated "over/under" market analysis when a right-of-use asset is revalued, either as a result of a conversion of the lease as investment property, or as a result of a periodic revaluation.

[1] From *"Kmart's Ten Deadly Sins: How Incompetence Tainted An American Icon"* by Marcia Layton Turner available at http://theconstitutionalistblog.com/wp-content/uploads/Kmart%E2%80%99s-Ten-Deadly-Sins.pdf

5. We also appreciate and support the boards' modification of the lessor accounting proposals in the 2013 Exposure Drafts to more closely reflect how a lessor of real estate prices its leases. Specifically, we strongly support the continued recognition of the underlying asset by a lessor (preferably using the fair value model in IAS 40) and the recognition of lease income over the life of the lease. Most leases of real property – a suite in an office building, for example – are for the use of an insignificant portion of the underlying asset, and the lessee does not enjoy the benefits that are embedded in ownership of the asset. It is appropriate for the lessor to continue to recognize the value of the underlying real estate asset, and any liabilities associated with that asset, and to realize rental income over the life of the leases. This would be a minimum change from the current method of accounting for leases of investment property under IAS 40 and leases of real estate that is not investment property under FAS 13, and IAS 17. Again, we question the need to modify existing lease accounting standards particularly as it relates to lessors of real estate assets, but support the method of lessor accounting for most real estate assets subject to lease obligations that is contained in the FASB and IASB Exposure Drafts as it is very similar to what is already required under ASC and IAS.

6. Generally, we do not believe that payments to be made in optional periods should be included in the calculation of the value of the right-of-use asset and the corresponding liability for lease payments by lessees. For all intents and purposes, the exercise of a lease option is the initiation of a new lease obligation and this action should result in the calculation of a new right-of-use asset and a new liability that correspond to the newly initiated lease. This is especially true if the exercise of the option results in a change in the value of the right-of-use asset and liability to reflect current market rents.

7. We do not support the IASB's removal of the exclusion from the lease accounting requirements for lessors of investment property that report the value of those assets at fair value pursuant to IAS 40. This exclusion was included in the IASB's 2010 Exposure Draft. We believe that this exclusion from the scope of the lease accounting standards for adopters of the fair value model would serve as a strong incentive for owners of investment property to adopt the fair value option under IAS 40, providing more accurate and timely information about the value of a parcel of real estate than does the cost model.

   Because the method of reporting rental income for Type B leases under the proposed leases standards would be virtually the same as it is currently under IAS 40 and IAS 17, there will no longer be any incentive for lessors of investment property to adopt fair value reporting for real estate investments. Under the provisions of the 2013 IASB Exposure Draft, an entity can continue to carry real estate assets on their balance sheet at acquisition cost (and disclose the fair value), while reporting lease obligations in accordance with the new lease accounting standards We do not necessarily disagree with the method of lessor accounting included in either entity's proposed leases standard (continued recognition of the asset and straight-line rental income over the term of the lease), as it does not represent a significant

change from current standards. However, we strongly believe that there should be some type of incentive, such as a scope exception from the lease accounting standards, for those issuers that adopt the fair value model for investment property under IAS 40, or a under a similar ASC.

8. Further, we recommend that FASB and IASB highlight to both lessors and lessees the importance of seeking out opinions from third-party subject matter experts when examining real estate leases, including lease renewal options, determining future rent projections, and analyzing contract rents versus current market rents. We do not believe that seeking out the services of a third-party real estate valuation experts will add significantly to the cost of preparing financial statements for lessees of real estate.

9. We also recommend that both FASB and IASB provide some guidance to the audit standards setting bodies regarding the importance of appropriate testing of the information and assumptions utilized by the preparers of financial statements when determining the value of right-of-use assets and associated liabilities. As it relates to real estate valuation generally, there is currently a significant amount of inconsistency within the audit community regarding these issues. The adoption of lease accounting standards will further exacerbate this problem, with different auditors requiring different information from issuers and preparers, and third-party real estate valuation experts, to support their conclusions.

Comments on Relevant "Questions for Respondents"

Question 2: Lessee Accounting

Yes, we agree that the recognition, measurement, and presentation of expenses and cash flows arising from a lease, specifically a lease of real property which often includes a land element, should be different than for other types of property. Most leases of real property are for an insignificant portion of the life of the asset, and few, if any, of the benefits embedded in the "ownership" of the asset are transferred to the leasee. As such, leases of real estate bear a closer resemblance to operating leases, rather than to finance leases and should be treated differently. We generally agree with the creation of right-of-use assets and liabilities for rent payments by lessees, but believe that both the IASB and FASB should require the periodic revaluation of the right-of-use asset and liability by the lessee to reflect changes in market realities since the time the lease was initiated. Other than the creation of the right-of-use asset and liability on the balance sheet, the accounting for and reporting of rent expenses associated with real property held under an operating lease is not significantly different than what is contained in FAS 13 and IAS 17.

Question 3: Lessor Accounting

Yes, we agree that lessors of real estate should account for those leases differently than if they were lessors of equipment, vehicles or machinery. A lessor of real estate

typically retains most, if not all, of the economic benefits that are embedded in the underlying asset. This is particularly true with office buildings, shopping centers, self-storage facilities, apartment buildings, etc. where the owner of the underlying real estate maintains all of the rights and responsibilities associated with the parcel, including the ability to use the parcel as collateral for financing and the responsibility to pay real estate taxes. The lessee only obtains the right to use the portion of the real estate contained in the lease agreement. Lessees of equipment, vehicles, and machinery obtain the right to use the entire asset for a period of time. At the conclusion of the lease term, the lessor will have an asset with residual value. On the other hand, a lessor of real estate will likely receive the leased property back in virtually the same form as when it was originally leased. Again the methods for the accounting and reporting of the value of real estate assets that are subject to operating leases, and the rent income from those assets, is not significantly different than what is contained in FAS 13, IAS 17, and IAS 40.

Question 4: Classification of Leases

Yes, a lessee of real property will consume an insignificant portion of the underlying real estate asset during the term of a lease. On the other hand, a lessee of vehicles, equipment or machinery will consume a definable portion of the underlying asset with a residual remaining at the end of the lease term. These two different expectations as to the consumption of the economic benefits warrant different treatment within the proposed lease accounting standards. Most leases of real estate assets will be classified as operating leases by lessors and lessees.

Question 8: Disclosure

Yes, we agree with these disclosure requirements. A real estate valuer would be in the unique position of being both a producer of the information contained in these disclosures, as well as a consumer of the same information when preparing real estate valuations. Professional real estate valuers are prepared to assist financial statement preparers in complying with the new lease accounting standards, specifically as it relates to lease analysis. In addition, the information that will be included within these disclosures will be extremely valuable to real estate appraisers as they perform valuations on subject properties that are subject to leases.

Question 12: Consequential Amendments to IAS 40 (IASB Only)

We wholeheartedly support the proposed amendments to the scope of IAS 40 that would require, rather than permit, a lessee that holds real property under an operating lease that subsequently meets the definition of investment property to account for the right-of-use asset created by the lease using the fair value model contained in IAS 40. There is functionally no difference between the owner of a parcel of property that leases all, or portion, of the property under an operating lease to realize rental income, and the holder of a right-of-use asset that subleases all, or a portion, of the property held under an operating lease, and realizes rental income from that sublease. The only

difference between an investment property that is owned by a lessor, and an investment property that is held under an operating lease by a lessee and further subleased, is that the owner of the property will realize capital appreciation and the lessee of the property will realize appreciation in the value of their leasehold interest vis-à-vis current market rents for the same parcel. As such, subleases of real estate held under an operating lease that meet the definition of investment property should be accounted for in the same way as other investment properties.

We appreciate the opportunity to provide comments on the FASB and IASB lease accounting Exposure Drafts. If you should have any questions, please do not hesitate to contact Bill Garber, Director of Government and External Relations at (202) 298-5586 or bgarber@appraisalinstitute.org, or Scott DiBiasio, Manager of State and Industry Affairs at (202) 298-5593, or sdibiasio@appraisalinstitute.org.

Sincerely,

Appraisal Institute