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September 13, 2013

Mr. Russell Golden
Chairman
Financial Accounting Standards Board
401 Merrit 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Leases (FASB Project 2013-270, Accounting Standards Update Topic 842)

Dear Chairman Golden:

On behalf of the one million members of the National Association of REALTORS® (NAR), I am writing to provide comments on the Financial Accounting Standards Board's Exposure Draft: *Leases* (the "ED"). The National Association of REALTORS® is America's largest trade association and includes the following four commercial real estate institutes and societies: CCIM Institute¹, Institute of Real Estate Management (IREM®)², REALTORS® Land Institute (RLI)³, and Society of Industrial and Office REALTORS® (SIOR)⁴.

REALTORS® are involved in all aspects of the residential and commercial real estate industries and belong to one or more of some 1,400 local associations or boards and 54 state and territory associations of REALTORS®.

NAR appreciates the opportunity to comment on the ED and commends the Financial Accounting Standards Board (FASB) for pursuing the objectives of improving financial reporting and reducing complexity in existing accounting requirements. We appreciate the improvements to the ED regarding the definition of the lease term and lease payments and the decision that most real estate leases will be Type B leases with a straight line rent expense for lessees and with operating lease accounting for lessors. But as we have said in previous comment letters as the project has progressed, while we

¹ The CCIM Institute confers the Certified Commercial Investment Member (CCIM) designation through an extensive curriculum of 200 classroom hours, as well as experiential requirements. The designation was established in 1969 and is recognized as the mark of professionalism and knowledge in the commercial real estate industry. More than 9,000 professionals currently hold the CCIM designation, with another 6,000 practitioners pursuing it. The mean value of commercial real estate transactions completed by a CCIM member in a 12-month period is \$44.6 million.

² The Institute of Real Estate Management (IREM®)—has been the source for education, resources, information, and membership for real estate management professionals for more than 77 years. Membership in this international organization includes more than 18,000 individual members and over 525 corporate members. IREM® promotes ethical real estate management practices through its credentialed membership programs, including the CERTIFIED PROPERTY MANAGER® (CPM®) designation, the ACCREDITED RESIDENTIAL MANAGER® (ARM®) certification, the ACCREDITED COMMERCIAL MANAGER (ACOM) certification, and the ACCREDITED MANAGEMENT ORGANIZATION® (AMO®) accreditation. Collectively, IREM® Members in the United States manage over \$1.5 trillion in real estate assets, including 9.37 million residential units and 8.4 billion net square feet of commercial space.

³ Since 1920, the REALTORS® Land Institute has served a unique constituency in the real estate industry – those who broker, lease, sell, develop, and manage land assets, including vacant, transitional land for development; agricultural and pastureland; timberland; and ranch and recreational properties. As an affiliate organization of the National Association of REALTORS®, the Institute confers its Accredited Land Consultant (ALC) designation to only those real estate practitioners who complete a rigorous land education program through its Land University and who achieve the highest level of experience and professionalism.

⁴ The Society of Industrial and Office REALTORS® provides the prestigious SIOR designation to industrial and office real estate brokers who meet SIOR's stringent pre-requisites for experience, education, and annual transactional volume. In addition, SIOR has members engaged in developing and investing in industrial and office properties. SIOR's 3,000 members are located in 580 cities in 28 countries. They conclude more than 78,000 transactions each year.



appreciate FASB's efforts, NAR believes implementation of the proposed accounting changes will not achieve these objectives and will result in many negative unintended economic consequences.

Moreover, we believe the Boards should re-evaluate the project as a result of two recent events:

- First, the American Accounting Association (AAA) released a study in July 2013 that presents empirical evidence that the current GAAP lessee operating lease footnote disclosures are processed effectively by users as evidenced by market pricing of debt and equity securities of companies with operating lease obligations. This raises an important question – why capitalize operating leases and completely change lease accounting when evidence shows current lease accounting is effective as-is?
- Second, on August 27, 2013, the Investors Technical Advisory Committee (ITAC), for the second time, explained that the ED is not an improvement over current GAAP and is too complex, recommending improved disclosures as opposed to the re-working of all lease accounting. This raises another rational question – wouldn't the approval of a cost benefit analysis be justified if users of financial statements indicate current GAAP accounting is less complex and provides them with better information than the proposed ED?

In fact, NAR believes adoption of the ED will have the unintended consequences of increasing complexity and costs in the financial reporting model, and decreasing the overall usefulness of the information contained in the financial statements. In addition, we are concerned that the proposal will cause lenders to be more reluctant to issue loans to both lessees and real estate lessors and, as a result, reduce the availability of credit to businesses and individuals and further weaken the commercial and residential real estate markets and the economy as a whole. NAR believes that new real estate lease terms will shorten as a result of the ED, reducing the collateral value of commercial real estate and reducing the availability of financing. Other potential negative consequences of the ED are numerous and include:

- The significant increase in recorded lessee liabilities regarding the former operating leases, that are not properly classified according to their substance by the ED (they are not debt in bankruptcy) will likely result in unexpected technical violations of financial debt covenants, or even debt defaults, and give lenders the opportunity to restrict credit availability.
- Similarly, lenders will likely require monetary penalties/fees from companies that violate debt covenants directly as a result from the adoption of this proposed guidance. These monetary penalties/fees may be deemed consideration for waivers of such violations, curing of defaults or re-negotiation of financial ratio/debt limit covenants. Overall, we believe these costs will be significant and could be avoided if minor modifications are made to the ED to reflect the substance of lease contracts (capital leases versus executory contract/operating leases).
- The higher cost of lending and reduced availability of credit, discussed above, will hurt the U.S. real estate market and be an ongoing constraint on real estate prices and the broader economy.
- Administrative costs will be substantial as companies will need to assess the impact of the ED on IT systems, human capital, financial reporting and accounting functions and internal controls and significantly change processes to comply with the proposed ED. The failure to classify leases according to their substance under US legal and tax regimes means lessees will have to maintain duplicate records to comply with tax rules and provide information needs of users of their financial statements. There will be a high cost of complying with the Type B lessee accounting that imputes interest that does not exist and is so complex especially when dealing with reassessment adjustments which are common in real estate leases that an IT system is needed to do the accounting. While we do not support on balance sheet accounting for leases, Type B straight line lease expense accounting could be accomplished by keeping current operating lease accounting where the average rent is the accrued expense and simply recording the current value of operating lease assets and liabilities on the balance sheet, while removing the previously reported values. The Boards decided that the contract is the unit of account and the value of any rights and obligations should be accounted for. We strongly believe that, over time, the value of assets and liabilities arising from an executory operating lease contract **are always equal**, except for initial direct costs and impairment.

Given these potential negative economic effects, NAR urges FASB to reconsider this proposal. Our concerns and suggested approach for moving forward are discussed in more detail in the remainder of this letter.

Background/Summary of the ED

The guidance in the proposed ED would significantly change the way lessees account for real estate leasing transactions, while lessor accounting for most real estate leases remains virtually the same as current GAAP. This model changes lessee lease classification criteria in a way that is at odds with the risks and rewards based legal and tax view of leases, mixing operating and capital leases, such that the reported results are not as useful to lenders and credit analysts as under current GAAP. In addition, analysts will not have the information to adjust the results to meet their analytical needs.

The exposure draft proposes a new accounting model for leases in which:

- (a) For all real estate leases a lessee would recognize an asset (the “right-of-use” asset) representing its right to use an underlying asset during the lease term, and a liability to make lease payments. For Type B leases, the vast majority of real estate leases, the lessee would impute interest expense on the liability to make lease payments (e.g. an “obligation to pay” liability) using the effective interest method even though the Boards conclude there is no financing element in a Type B lease. The lessee would amortize the right-of-use asset over the expected lease term by “backing into” an amount that will create a level “single lease expense.” The lessee will re-assess the lease payments for changes in variable payments and changes in the assumed lease term and make complex accounting adjustments. For Type A leases, which are not as common in real estate, the lessee will impute interest on the liability and amortize the ROU asset straight line over the lease term.
- (b) A real estate lessor would apply the operating lease method for Type B leases, the majority of real estate leases, based on the decision to maintain lessee/lessor symmetry in lease classification. Only real estate leases that are financings would have the Type A Receivable and Residual accounting method applied. Commercial real estate lessors are in the “operating” leasing business and accounting rules should reflect this appropriately. While we agree with the outcome that allows real estate lessors to use the operating lease method for most real estate leases, we think the classification process should be based on a lessor business model and that lessee/lessor symmetry is not a given.

Concerns with the Proposed Accounting Model

While the proposed rules will impact all companies and organizations with current operating leases, we believe the most significant impact will be to lessees of investment real estate. Our specific concerns with the ED’s proposed guidance are as follows:

- 1) The proposed accounting model bases lease classification on the lessee view and requires symmetry for lessor accounting. Lenders and investors want to see an “operating” financial statement, not a “finance” based financial statement when analyzing a real estate investment property lessor. Forcing symmetry in lease classification could, in rare circumstances, have the unintended consequence of forcing a financial model on “operating” lessors of real estate. We think the principles behind lessee classification should be different than the principles that support lessor accounting. How one recognizes revenue should not be automatically linked to how a counterparty recognizes costs.
- 2) The proposed ED will result in financial statements that do not reflect the economics of underlying lease transactions for lessees. We believe the proposed accounting model will distort the balance sheet of lessees. Former operating leases of real estate will be classified as Type B leases while former operating leases of most equipment leases will be classified as Type A leases. Lenders to our lessee customers will ask them to recast the reported asset and liability amounts based on existing GAAP risks and rewards classification tests so that they can make informed credit/loan granting decisions. This cost has to be included in the cost/benefit analysis of the ED.
- 3) There is the potential for spontaneous technical debt covenant violations and a decrease in overall borrowing capacity for many companies. Most corporate debt agreements include financial ratio covenants (such as the debt-to-equity ratio) and debt limit covenants to analyze a company’s risk profile and to ensure that a company does not exceed a pre-determined risk threshold. The debt-to-equity ratio is a measure frequently used by lenders in the real estate market to determine a company’s leverage and subsequent risk. Under the ED model, lessees will see drastic increases in reported liabilities on their balance sheets from the “right-of-use” model which could trigger violations of debt covenants, even though the ROU lease liabilities are not debt in bankruptcy under US commercial law. This will be particularly evident with national retailers and large corporations that lease office space from owners of investment real estate, as well as for the owners of investment real estate themselves. We also believe the immediate increase in liabilities resulting from the proposed guidance may trigger credit rating downgrades, further impacting the ability of lessees of investment real estate to access the capital and debt markets. This has to be included in the cost/benefit analysis of the ED.

- 4) With respect to the potential trigger of debt covenant violations upon implementation of the ED, we would like to believe that lenders will recognize that the proposed guidance is simply a matter of accounting preference and not driven by cash flow or economics. However, we also recognize that this proposed guidance gives lenders the opportunity to restrict credit terms or the availability of credit under revolving credit lines or to negotiate monetary penalties for “paper” violations of debt covenants that result simply from the application of this new guidance. Lenders could potentially even take the opportunity to declare an event of default. We believe these costs, both monetarily and in the form of lower credit availability, will be significant. These costs have to be included in the cost/benefit analysis of the ED.
- 5) There will likely be additional unintended business consequences, such as shorter lease terms by lessees and the reluctance of lessees to agree to renewal options, variable rents. The impact of shorter term leases may result in reduced borrowing capacity for investment real estate owners that rely on the contractual revenue stream as collateral to obtain financing. Shorter contractual revenue streams for lessors will likely result in reduced borrowing capacity. In addition, investment real estate owners may attempt to offset these shorter lease terms and elimination of renewal options and variable rents with higher rental rates, putting pressure on the already fragile commercial real estate markets. In fact, we believe that lessees and lessors of investment real estate are already anticipating the approval of the ED and are beginning to take such actions.
- 6) The costs associated with the administrative and operating burden of implementing the ED’s proposed guidance will likely be significant. Lessees and lessors of investment real estate will be particularly impacted due to their high volume of lease transactions. These companies will be required to assess the impact on human capital, information technology systems, financial reporting and accounting processes and internal controls. For example, the lessee lease administration and accounting systems of most companies are not set up to handle the Type B present value techniques, accounting for assets and liabilities and extremely complex re-assessment adjustments for leases as outlined in the exposure draft. The current lessee accounting for operating leases requires only rudimentary data analysis and accounting system support that is often accomplished by using a simple Excel file. We also expect significant costs associated with the modification of lease administration and accounting systems as leases involving investment real estate are not standard and include a great deal of unique structured terms. We also believe there will be ongoing human capital costs associated with the continual monitoring and updating of cash flow scenarios required by the ED. This periodic monitoring and updating “significant economic incentive” assessments of lease options will involve senior management’s judgment. As such, companies will need to alter accounting policies and procedures and internal controls. Likewise, we anticipate that these costs will be significant and burdensome. These costs have to be included in the cost/benefit analysis of the ED.
- 7) Overall, the proposed changes to the lease accounting model may be detrimental to the national economy by reducing the overall borrowing capacity of lessee companies that rely heavily on commercial real estate leases. We believe that corporate lines of credit, which are now difficult to obtain, will become almost impossible to obtain due to the immediate increase in corporate liabilities that will result from adoption of this ED. This proposed guidance also has the ability to create volatility in the equity and debt markets of our country. If enacted, this proposal could have a significant negative impact on the financial stability of many businesses. We believe accounting standards should reflect the economic reality of transactions and not drive them.

Suggested Way Forward

While we generally understand FASB’s objective to provide an accounting model that 1) provides a complete and understandable picture of an entity’s leasing activities, 2) improves comparability, and 3) reduces the complexity of the existing lease guidance, we do not believe that the proposed guidance accomplishes these goals for leases involving investment real estate. In addition, NAR believes the proposed guidance places an undue burden on lessees and lessors of investment real estate and misunderstands the investment real estate business model. In light of the evidence from the AAA study and the ITAC rejection of the ED we strongly believe that the off balance sheet treatment of operating leases and risks and rewards lessee lease classification are not significant deficiencies in financial reporting.

Based on our understanding and analysis of the ED and other relevant information, we believe FASB should pursue an alternative approach. NAR proposes targeted improvements to current lease accounting GAAP rather than the major changes required by the ED. We believe that lessee operating leases should remain off balance sheet but disclosures should be improved to include a calculation of the value of operating leases and the weighted average incremental borrowing rate (discount rate used to present value the lease obligations). We believe that disclosures should be developed that meet the needs of specific user groups rather than trying to change the basic accounting for leases to suit their unique needs. We also believe that lessor accounting should be based on the business model of the lessee so that commercial real estate lessors will use the operating lease method.

There are many more complexities involving investment real estate leases that have not been discussed in this comment letter, but need to be addressed. Complex issues include termination payments, gross billed versus net billed costs in leases, percentages rents, break-point rents, ground leases, lease incentive payments, tenant improvements, common area maintenance reimbursements, key money, leases that are only a small portion of the underlying investment real estate (such as malls or office complexes), and sub-leases and sale-leaseback transactions involving investment real estate, among others. Many of these issues would be moot if the lessee accounting remained the same as current GAAP and real estate lessors used the operating lease method. Although we support the current operating lease model for leases involving investment real estate, NAR would also generally support an accounting model for investment real estate leases (from both a lessee and lessor perspective) as contracts for services, as that is the US commercial law view of operating leases. This approach more closely reflects the economic characteristics of leases involving investment real estate, as previously outlined.

NAR believes the above approach will be more closely aligned with the investment real estate business model of property and asset management. We also believe the above approach will avoid the potential negative economic consequences, including the significant implementation costs, outlined throughout this letter. We further believe leasing is pervasive and lessees and users in the US business, legal and tax environment are well served by current lease accounting GAAP. However, this may not be true for other countries served by the IASB. Furthermore, this project may be best accomplished if the FASB breaks from the IASB and focuses on targeted changes to US GAAP. Convergence may not be appropriate or workable for every accounting issue.

If you would like to discuss our comments and concerns, please contact Vijay Yadlapati, NAR's Senior Legislative Policy Representative – Financial Services, at 202.383.1090 or vyadlapati@realtors.org.

Sincerely,



Gary Thomas
2013 President, National Association of REALTORS®