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UNITED STATES CONGRESS

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Via E-Mail (director@fasb.com)

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Financial Accounting Standards Board
File Reference No. 1850-100
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Re: Comments on Proposed Accounting Standards Revision (Leases, Topic 842)
FASB File Reference No. 2013-270

Dear Board Members and Staff,

For 17 years, I've been the loudest voice on the relevant House Committee (The Committee on Financial Services) in favor of independence for the Financial Accounting Standards Board (FASB). A few years ago I also co-founded the CPA Caucus in Congress. To some extent, my credibility with my colleagues on that Committee is dependent on the FASB making reasonable decisions.

My arguments in favor of FASB independence will seem impractical, even delusional, if the FASB adopts the current Exposure Draft on leases. The harm to the economy, and particularly to small and medium-sized businesses, is far greater than you can imagine.

Congress has urged you not to adopt the Exposure Draft at different times, including:

- Letter dated May 14, 2013 signed by myself and a bipartisan group of 12 others:

John Campbell, Peter King, Jim Matheson, Gary Miller, Eliot Engel, Steve Stivers, Bill Owens, Dennis Ross, Mike Quigley, David Schweikert, Dana Rohrabacher, Ken Calvert

- Letter dated May 17, 2012 signed by myself and a bipartisan group of 60 others:

Jim Matheson, Pedro Pierluisi, Wm. Lacy Clay, Joe Baca, Bill Owens, Collin Peterson, Dennis Kucinich, Grace Napolitano, Ed Pastor, Russ Carnahan, Robert Brady, Sam Farr, Marcy Kaptur, Gwen Moore, Janice Hahn, Dan Boren, Ed Perlmutter, Jim Moran, John



Carney, Zoe Lofgren, Mike Ross, Maxine Waters, Suzanne Bonamici, Judy Chu, Mike Thompson, Gerald Connolly, Peter DeFazio, Albio Sires, Carolyn Maloney, Ted Deutch, Leonard Boswell, Shelley Berkley, Jerry McNerney, Ron Kind, Eliot Engel, Charlie Gonzalez, John Campbell, David Schweikert, Paul Broun, Jim Gerlach, Rob Bishop, Tom Petri, Lynn Westmoreland, Peter King, Nan Hayworth, Robert Dold, Peter Roskam, Ed Royce, Scott Garrett, Bill Posey, Ken Calvert, Dana Rohrabacher, Bill Johnson, Walter Jones, Charles Dent, Bill Flores, Michael Grimm, Steve Stivers, Donald Manzullo

To my knowledge, virtually all the members of Congress aware of your Exposure Draft have urged you not to adopt it. The only reason you haven't received a letter signed by hundreds of members is that not many of my colleagues have yet focused on it.

To adopt the Exposure Draft when the FASB's own Investor Advisory Committee (IAC) has determined that the proposed change is not needed by the users of financial statements would be mystifying.

Economic Harm

I particularly urge you to carefully review the comment letters from people in the real estate industry, which repeatedly make the factually accurate point that all real estate leases are not financings, and should not be treated as if they were. Current GAAP correctly draw a distinction between a capital lease on the one hand and an ordinary lease on the other. American law, including bankruptcy law, treats leases as dramatically different from financed ownership of an interest in real estate. Under virtually every lease which is not regarded as a "capital lease" under current accounting principles, the lessee does not substantially obtain all of the economic rights of ownership of the lease property.

As detailed in the comment letters, a study by the Equipment Leasing and Finance Foundation indicated that capitalizing operating leases would add \$2 trillion of debt to the balance sheets of U.S.-based corporations, dramatically increasing the cost of capital, and perhaps stalling our fragile economic recovery. Accounting rules should not have such dramatic effects on economic activity; they are meant to be neutral means of scorekeeping.

Another study highlighted in several comment letters, commissioned in 2012 by the National Association of Realtors, the Real Estate Roundtable, the Business Owners and Managers Association International, and others, shows as follows:

- In its "best case scenario" the Exposure Draft would destroy 190,000 U.S. jobs and reduce U.S. GDP by \$27.5 billion annually.
- In the worst case scenario the cost would be 3.3 million jobs and a reduction of U.S. GDP of \$478.6 billion annually.

This study bases its conclusions on the effect that the Exposure Draft would have in reducing spending by companies necessitated by de-leveraging in order to deal with the apparent increase in liabilities; increased borrowing costs for lessees because they have higher debt ratios; and the

reduced value of real estate resulting from contraction in the economy. The study did not include all of the following which would further exacerbate the harm done to the American economy, all of which are predicted in the comment letters you have already received: higher rents; shortened lease terms; downward pressure on real estate values from shortened lease terms; and increased administrative costs.

As noted by many commenters, there will be a shift to shorter lease terms, which will raise the cost of (or possibly make unavailable) the construction and permanent financing that lessors must obtain in order to successfully build and lease commercial and industrial real estate. Tenants will have strong incentives to opt for shorter-term real estate leases in order to both reduce their reported liabilities, and to avoid the complexity of constantly estimating and re-estimating whether and when future real estate lease options will be exercised. They will also be incented to avoid real estate renewal options and to compensate lessors with contingent rather than fixed payments.

Social Effects

In addition to these egregious problems identified by numerous commenters, Congress has a substantial national interest in community continuity. Distorting the economic behavior of lessees and lessors is not only bad for both parties to the transaction, it is bad for the communities we represent. Closed down factories, even if they are relocated to some other location in the U.S., creates a social cost. Our tax policy favors continuity in community, homeownership, and continuity of ownership of real estate, which is subject to capital gains tax only upon a change of ownership. My state and many others have adopted property tax laws designed to assure community continuity. I doubt that this is an issue that the Board has even considered. Penalizing the long-term lease will do great social harm.

Adherence to the Role of Accounting Principle Authorities

The proposed exposure draft violates a number of the principles for creating new accounting standards. First, it will not merely measure financial behavior, it will distort financial behavior. It will certainly push toward short term leases. It will disincentivize lease renewal options. It will encourage lessees to compensate lessors using those forms of contingent lease payments that are not required to be capitalized.

Financial statements should be comparable over time. Individual investors have made mental notes as to what balance sheet ratios they would like to see. Will these investors mentally recalculate their rules of thumb? I have not reviewed to what extent lessees will be required to restate all their prior balance sheets. If they do so, this will be at substantial cost. If they do not, then comparing a company over time will be difficult. Even if they do restate their balance sheet, comparing the company over time will be difficult because many investors have already analyzed the balance sheets when originally issued.

Under the Exposure Draft it will be almost impossible to compare two businesses in the same industry, if one tends to sign fixed-rate leases and the other tends to sign contingent-rate leases. A tenant that decided to compensate the lessor by providing valuable contingent rent, together

with a lower fixed rent, could capitalize far less. This might distort economic behavior and will certainly make it impossible to compare one retailer with another.

Process

No Member of Congress can devote even 1% of their time to following the FASB. Few are able to allocate even close to that. Most of my colleagues will be shocked when they see the economic impact of this exposure draft if it is adopted, and how the process failed to listen to the real estate industry and how it excluded small business from participation.

Fighting for FASB independence will be much tougher in the decade to come than it has been in the decade just completed. This is because the behavior of Fannie Mae and Freddie Mac have created a strong ideological abhorrence for organizations that are part governmental (whether they choose to admit it or not) and partly private. The FASB is funded by fees which most would regard as taxes, in the sense that they are not voluntary and are paid by those who do not want the service provided. The FASB promulgates “principles” affecting our economy and every bit as significant as regulations issued by a host of government agencies. While most of the ideological abhorrence of entities that are part-governmental is focused on Fannie Mae and Freddie Mac, over the coming years a host of other entities that have both governmental and non-governmental characteristics will face increasing scrutiny. Accordingly, it is necessary that FASB issue reasonable principles after a fair process.

It is important that FASB show that it is focused on the potential harms of the Exposure Draft, as detailed by the studies mentioned above. In addition, the IAC has determined that this exposure draft does not improve financial statements from the standpoint of users. **The failure of FASB to do full-blown field testing of this proposed change in accounting for leases dramatically undermines its credibility in Congress and elsewhere.** It’s almost as if the Board wishes to remain oblivious to the implementation cost, practicality, consistency of results, negative impacts and unintended consequences of this ill-conceived change.

The FASB believes it has done a reasonable job of reaching out to the public. This is because the FASB and 99% of lessees are oblivious to the impacts this rule will have. As noted below, this rule will put hundreds of thousands of small businesses in violation of their loan agreements. These hundreds of thousands of businesses don’t have the money to pay lawyers and accountants to speak for them. They have not been heard. While you are having two meetings in the U.S., only persons specifically invited are allowed to speak. Less than a tenth of a percent of the hundreds of thousands of businesses that will be affected are even aware of the hearing. This is less due process than is afforded even the most inconsequential actions taken under the Administrative Procedure Act, which affects federal agencies whose rules are far less consequential than yours. Likewise, those who will lose construction jobs, those whose communities will lose continuity, and many others who will be adversely affected are shut out of the process both because of your limited outreach to ordinary America, and by your restricted approach to who may address even the minority of board members who are hearing public testimony.

The FASB is aware of its own process, and judged by that standard, believes that its efforts to seek input have been more than adequate. My colleagues, however, are not so much aware of the FASB history, and are more familiar with the process that city councils, administrative agencies, the Securities and Exchange Commission, and state and federal legislative bodies follow before making an important decision. Measured by these standards, your outreach has been woefully inadequate and your refusal to field-test your proposal conflicts with the due process expectations of my colleagues in Congress. Under such circumstances defending FASB independence will become increasingly difficult.

Violations of Loan Covenants

As you well know, the Exposure Draft standard would, when it takes effect, immediately trigger the violation of many loan covenants.

I've discussed this matter on several occasions with FASB staff. They've assured me that there really is not much to worry about because loan covenants contain provisions such that the balance sheet ratios are to be calculated according to the accounting principles in force when the loan is extended. Even for the largest companies, however, this will not always be true.

My concern, however, is for the rest of American business. The FASB staff has shown a phenomenal disconnect with the world outside of the Fortune 1,000 companies. The Fortune 1,000 companies play a very substantial role in drafting their loan documents. When they issue bonds in the public market, the issuer (borrower) drafts the documents. When these large companies negotiate major loan agreements, they're represented by an experienced legal counsel. When the borrower drafts the loan document, care is often taken so that a change in accounting principles does not trigger a loan default.

What about the rest of American business? These businesses borrow from banks and other lenders pursuant to loan documents drafted by the lenders. They may on occasion be able to change a paragraph or two here or there, but all the standard provisions are drafted by, and for, the lender. In virtually all of these cases, the borrower does not have the acumen to suggest that loan covenants are calculated according to then-existing accounting principles, nor does the borrower have the bargaining strength to insist that changes in such technical provisions of the loan documents be effectuated.

Thus, the adoption of this exposure draft would cause a large percentage of American businesses to be in violation of their loan covenants. Your staff has also put forward the idea that the banks will simply waive the violation of the loan covenants, or negotiate new provisions calling for different balance sheet ratios. This also shows an absurd lack of connection with the business reality faced by most small and medium sized businesses.

Some banks will want to be generous, kind and reasonable to their borrowers. They may want to voluntarily waive or modify the loan covenants, even if the value of the security pledged for the loan has declined (as is true for virtually all pre-2009 loans). In those cases, they face federal and/or state bank examiners who will penalize them for their generosity. Even performing loans that are modified are subject to new banking-examiner analysis. A bank that decided to be

reasonable and waive loan covenants might find itself disadvantaged by bank examiners. This is particularly true if the value of the security for the loan has declined.

In the majority of cases affecting perhaps millions of small businesses, lenders will demand any of the following: immediate payment of the loan; higher interest rate; or a personal guarantee from the business owners.

You could of course provide that the new accounting principle is not applicable to businesses with pre-existing loan covenants. Then you would have two identical businesses reporting according to two different accounting principles based only on whether or not their loan documents contain requirements that they maintain certain balance sheet ratios.

Transition Rules Can't Solve Loan Covenants Problem

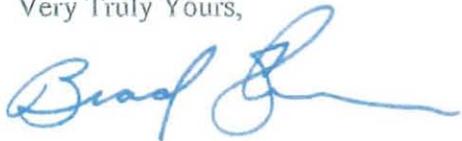
This problem cannot be solved by a transition rule of less than thirty years, and of course a translation period of that length would make the accounting principle nonviable. Many of the bond indentures provide for terms of thirty years or even longer in length. While some of the bond agreements applicable to publicly-traded debt contain a provision stating that the balance sheet ratios are to be calculated according to accounting principles in existence when the bonds are issued, some do not. Virtually none of the loan agreements signed by non public and especially smaller companies contain such an "out" for the borrower, and many long-term lease agreements, the very object of your concern, may be voided at the lessors' option if the lessee (often a small business with little bargaining power) fails to maintain certain balance sheet ratios.

Conclusion

The fact that there will not be 500 business owners and their employees marching in front of your Los Angeles-area hearing is not because you will destroy fewer jobs and fewer businesses than you imagine. It is only because the owners of these businesses and their employees do not have the time, resources, or inclination to study FASB exposure drafts—and your outreach efforts have been so inadequate that they remain unaware of the tsunami that is about to hit them.

The change in accounting rules that are proposed by the Exposure Draft is simply too important to be left to those very few Americans who regularly read FASB exposure drafts. It is time to field test. It is time to have real public outreach.

Very Truly Yours,



Brad Sherman, CPA