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December 1, 2010

Mr. Russell Golden
Technical Director, Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

File Reference Number 1850-100, *Leases (Topic 840)*

Dear Mr. Golden:

On behalf of the 1.1 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
- Society of Industrial and Office REALTORS® (SIOR)³
- REALTORS® Land Institute (RLI)⁴

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 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.

⁴ Since 1920, the REALTORS® Land Institute (RLI) 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.



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. While we appreciate FASB's efforts, NAR believes implementation of the proposed accounting changes will not achieve these objectives. In fact, NAR believes adoption of the ED will have the unintended consequences of increasing complexity in the financial reporting model, reducing the comparability of issuer financial statements, 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 make loans 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.

Other potential negative consequences of the ED are numerous and include:

- The guidance in the ED treats the leasing of investment real estate⁵ assets as financing transactions, which ignores the true economic characteristics of owning and leasing real estate.
- The significant increase in recorded liabilities for both lessees and lessors of investment real estate will likely result in unexpected 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 from companies that violate debt covenants directly as a result from the adoption of this proposed guidance. These monetary penalties may be deemed consideration for waivers of such violations, curing of defaults or re-negotiation of financial ratio covenants. Overall, we believe these costs will be significant.
- 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.
- With regard to leases of investment real estate, the adoption of the proposed ED will result in financial statements that bear no resemblance, economically or financially, to what happens contractually in a real estate lease.
- Administrative costs will likely 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.
- There will be the potential for tremendous variability in assumptions used in determining the present value of expected lease payments. This variability will further undermine the usefulness and comparability of financial statements, contrary to FASB's intent.

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.

⁵ For purposes of this discussion, we define investment real estate as real estate that is owned for the purposes of generating rental income such as commercial office buildings, retail shopping centers, industrial structures, land assets, multifamily properties and other similar real estate assets.

Background/Summary of the ED

The guidance in the proposed ED would significantly change the way lessees and lessors account for leasing transactions. This model eliminates all lease classifications, including operating and capital leases, and effectively utilizes a fair value accounting type approach for all leases.

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

- (a) 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. The lessee would amortize the right-of-use asset over the expected lease term or the useful life of the underlying asset, if shorter. The lessee would incur interest expense on the liability to make lease payments (e.g. an “obligation to pay” liability) using the effective interest method.
- (b) A lessor would apply either a “performance obligation” approach or a “de-recognition” approach to account for the assets and liabilities arising from a lease, depending on whether the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected term of the lease. In general, most lessors of investment real estate would likely apply the “performance obligation” approach as the business model associated with these real estate assets is to retain the risks and benefits of the underlying real estate asset. The lessor would be required to amortize the “performance obligation” liability (similar to deferred revenue) over the expected lease term. The lessor would record interest income on the “lease receivable” asset using the effective interest method.

The models outlined for lessees and lessors would utilize present value techniques at the inception of the lease to determine the cost of the underlying lease payments. Lessees would discount expected lease payments (including payments occurring during the “most likely” lease term as well as possible contingent rental amounts determined to be the “most likely”) using their own incremental borrowing rates.⁶ Lessors would discount the right to receive rental payments, under the “performance obligation” approach using the rate the lessor charges the lessee. Both lessees and lessor would also be required to update the present value models for changes in the underlying assumptions related to the “most likely” lease payments.

Our Specific 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 and lessors of investment real estate. Our specific concerns with the ED’s proposed guidance are as follows:

- 1) The proposed accounting model treats the leasing of investment real estate assets as a financing transaction, which ignores the true economic characteristics of owning and leasing real estate.

Leases of investment real estate assets are significantly different from the leasing of equipment assets. Real estate leases are not financing transactions (as the ED would treat them) as these leases are generally for a small percentage (on a square footage basis) of the underlying real estate and for lease term lengths well below the useful life of the asset. For example, leases involving a shopping mall or large office complex may include hundreds of underlying leases. These leases usually turn over many times during the 40-year useful life of the real estate asset. Also, there are no residual values to lessees

⁶ Incremental borrowing rate was previously defined in Statement of Financial Accounting Standard 13, *Accounting for Leases*, (SFAS 13) as the rate existing at the inception of the lease that the lessee would have incurred to borrow the funds necessary to purchase the leased asset, over a similar term.

associated with leases of investment real estate. Rather, lessees choose to lease certain investment real estate assets in order to obtain beneficial advantages such as, 1) the location of the property, 2) a tenant mix that will draw desired customers or other lessees, and 3) the overall expertise of the investment real estate owner (the lessor) in marketing and managing the property to maximize these, and other, advantages. For the most part, these tenants do not have the expertise to own and manage real estate and the business model for investment real estate assets is clearly one of property and asset management, rather than financing.

In addition, investment real estate assets, including underlying land, have historically been appreciating assets which is incompatible with the proposed model's focus on depreciating equipment assets. Therefore, we do not believe the proposed model properly reflects the characteristics of investment real estate assets for either lessees or lessors.

2) The proposed ED will result in financial statements that do not reflect the economics of underlying lease transactions.

We believe the proposed accounting model will often distort the income statements of both lessees and lessors of investment real estate. Under the proposed lessee model, expense amounts (including both the amortization and interest components) will be irrationally high early in the lease term and irrationally low late in the lease term. Similarly, under the proposed lessor model, income (including both rental revenue and interest income) will be irrationally high early in the lease term and irrationally low late in the lease term. As a result, contractual rent charges (both those paid by a lessee and those received by a lessor) will bear no resemblance, economically or financially, to what happens contractually in a real estate lease. This distortion will result in less reliable financial statements, contrary to FASB's stated goals.⁷

3) Potential for spontaneous 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) 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. The proposed lease accounting model will result in an increase in debt from both the lessee "right-of-use" model and the lessor "performance-obligation" and "de-recognition" models simply through the adoption of the new accounting rule. Under these models, both lessees and lessors may see drastic increases in reported liabilities on their balance sheets which could trigger violations of debt covenants. 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 and lessors of investment real estate to access the capital and debt markets.

In addition, the proposed approach will require continuous updating of estimated future lease payments. This subsequent updating will be based on changes to the future lease payments that result from changes to estimated lease terms, contingent payments or other expected payments. Not only

⁷ FASB states in the ED that existing models lead to a lack of comparability and undue complexity because of the sharp 'bright-line' distinction between capital leases and operating leases.

will this continual updating of cash flow forecasting be burdensome and difficult, but it may also result in the inability of lessees to effectively monitor debt covenants. This may cause abrupt violations of debt covenants that were not previously identified as being at risk and may increase stock market volatility for both creditors and lenders.

4) Costs associated with renegotiating debt covenants or obtaining waivers of default.

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.

5) Reduced comparability and increased complexity resulting from multiple estimates may provide subjective and possibly unreliable financial statements.

We believe the proposed guidance introduces additional subjectivity into the lease accounting model which will make it more difficult to compare the financial statements of entities entering into similar lease transactions. For example, the guidance in the ED outlines numerous assumptions which will be subject to the judgment of the preparers of financial statements. These assumptions include the use of present value techniques utilizing 1) the incremental borrowing rate of the lessee, 2) the borrowing rate the lessor is charging the lessee, 3) the “most likely” lease terms taking into account the likelihood of renewal options, 4) contingent rental payments utilizing the “most likely” scenario and 5) other estimated payments such as residual value guarantees, termination payments, and lease incentives. For example, as a further demonstration that investment real estate is ill-suited for the model outlined in the ED, lessors of investment real estate do not view their business as a financing business and thus do not have financial metrics that identify the interest rate that they would charge a lessee to occupy a portion of their real estate. As a result, there is a potential for tremendous variability in the assumptions used to determine the present value of expected lease payments receivable. This variability will further undermine the usefulness and comparability of financial statements. The subjectivity inherent in this proposed guidance may even be used to engineer a financial result, which is exactly what FASB is attempting to eliminate.

6) There will likely be additional unintended business consequences, such as shorter lease terms by lessees.

The ED’s proposed on-balance sheet treatment for leases involving investment real estate assets will likely have other unintended business consequences for the commercial real estate industry. For example, it is likely that lessees will enter into shorter lease terms (with no renewal options) to reduce the liability they will be required to record for the lease transaction. The impact of these 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 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.

7) Increased administrative and operating costs necessary to comply with ED.

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 lease administration and accounting systems of most companies are not set up to handle present value techniques for leases as outlined in the exposure draft. The current accounting for operating leases requires only rudimentary data analysis and accounting system support. We 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 of factors such as "most likely" lease terms, contingent rentals and other payments 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.

8) Overall effects on the nation's economy.

Overall, the proposed changes to the lease accounting model may be detrimental to the national economy by reducing the overall borrowing capacity of companies that rely heavily on commercial real estate leases (both from a lessee and lessor perspective). 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 economic transactions and activity 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.

Based on our understanding and analysis of the ED and other relevant information, we believe FASB should pursue an alternative approach. NAR proposes that leases involving investment real estate assets (both from the lessee and lessor perspective) be scoped out of the ED and separate guidance should be developed to address FASB's stated goals. There are many more complexities involving investment real estate leases that have not been discussed here but need to be addressed. Complex issues include termination payments,

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. 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 discussed in the Boards' recent exposure draft "Revenue Recognition in Contracts with Customers." That is, the service model⁸ found therein could more closely reflect the economic characteristics of leases involving investment real estate, as previously outlined.

We believe the above approach will be more closely aligned with the investment real estate business model of property and asset management, rather than the financing business model suggested in the ED. We also believe the above approach will avoid the potential negative economic consequences, including the significant implementation costs, outlined throughout this letter.

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

Sincerely,

A handwritten signature in black ink, appearing to read "Ron Phipps". The signature is fluid and cursive, with a long horizontal flourish extending to the right.

Ron Phipps, ABR, CRS, GRI, GREEN, e-PRO
2011 President, National Association of REALTORS®

⁸ FASB defines the service model in "Revenue Recognition in Contracts with Customers" as an enforceable promise (whether explicit or implicit) in a contract with a customer to transfer a good or service to the customer. Under this model, an entity would recognize revenue when it satisfies its obligation to perform a service or transfer goods.