



Financial Accounting Standards Board
Technical Director - File Reference No. 2013-270
Financial Accounting Standards Board
401 Merritt 7 - PO Box 5116
Norwalk, CT 06856-5116

August 23, 2013

Re: Proposed Accounting Standards Update (Revised), Topic 842: *Leases*; issued May 16, 2013.

Dear Board Members:

This letter represents the Real Estate Information Standards (“REIS”) Board’s comments on behalf of the members of the National Council of Real Estate Investment Fiduciaries (“NCREIF”) and the Pension Real Estate Association (“PREA”) to the Financial Accounting Standards Board (the “FASB”) regarding the exposure draft, *Leases*. We appreciate the opportunity provided by the FASB to comment on the exposure draft. We applaud the development of principles which result in comparable and consistent reporting. We as an industry are most concerned with comparable and consistent net asset value reported on a fair-value basis (FVNAV). We also support the development of principles which allows for a presentation that provides investors with the most useful financial information. A summary of our thoughts and concerns regarding the anticipated impact on our industry and a detailed explanation of our opinion regarding the impact of the exposure draft on lessors and lessees within our industry is discussed below.

REIS Overview:

The REIS initiative is sponsored by NCREIF and PREA to develop, refine and integrate each of the standards with the Foundational Standards¹ and to provide guidance concerning their application in the institutional real estate investment industry. NCREIF is an association of institutional real estate professionals which includes investment managers, plan sponsors, academicians, consultants, and other service providers who share a common interest in the industry of private institutional real estate investment. NCREIF serves the institutional real estate community as an unbiased collector and disseminator of real estate performance information, most notably the NCREIF Property Index (NPI). PREA is a non-profit organization whose members are engaged in the investment of tax-exempt pension and endowment funds into real estate assets. PREA’s mission is to serve its members engaged in institutional real estate investment through the sponsorship of objective forums for education, research initiatives,

¹ Within REIS, Foundational Standards include U.S. Generally Accepted Accounting Principles, the Global Investment Performance Standards and the Uniform Standards of Professional Appraisal Practice.

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membership interaction and the exchange of information. Collectively the organizations represent the institutional real estate community consisting of over 7,000 investment properties with a fair value of approximately \$336 billion.

Our Opinion on the Proposed Lease Accounting:

REIS recognizes and appreciates the overall objectives of the FASB which include the improvement of financial statement transparency, provision of a principles-based set of standards, and alignment of lease accounting across all industries. We are however concerned that under the proposed exposure draft, the comparable and consistent fund net asset value and its corresponding net income and appreciation components calculated on a fair-value basis, which is of paramount importance to our industry and the users of its financial statements and resulting performance measures, may not be achieved. We applaud the FASB for recognizing that lessor accounting for real estate is achieving its stated objective and for having modified the revised exposure draft to allow for lessor accounting as it relates to real estate to be measured consistently with current practice-with the exception of one critical element-straight lining the lease receivable.

We request, that the FASB eliminate the requirement to straight-line the lease receivable in situations when the real estate assets are reported on a fair-value basis. This concept was recognized in the original Lease exposure draft and subsequently omitted for reasons we are unable to identify. Our industry has never recorded a straight line lease receivable as it runs contrary to current appraisal methodology used in fair value accounting practices. In addition, our industry calculates measures of performance based on fair value statement information. One such measure is component (i.e. income and appreciation) time weighted returns. Although total return would not be impacted as fair value methodology would ensure the same net asset value, a GAAP requirement to straight line the rent receivable would cause a shift in these component returns. Investors use these component and total returns for current and prospective investment decision making. The industry's indexes and benchmarks, including the NCREIF Property Index, NCREIF Open-end Diversified Core Equity Index, PREA/IPD Open-end Diversified Index all report component returns which do not recognize the straight-line rent concept. Accordingly, to preserve 30 + years of consistent calculation and analysis our industry would have to consider whether non-GAAP based measures of performance were more meaningful to investors if the straight line lease receivable concept became GAAP. The value associated with in place leases is already embedded in the asset's fair-value and no additional value is derived from reporting it separately on the balance sheet or income statement. If you strip out the in-place leases you are left with the discounted worth of the future value attributable to the property once the current lease expires. Providing a meaningful picture of the fair value of the real estate asset can be accomplished without creating the extra step and/or effort needed to account for the leases separately from the asset. The true economic value of the asset is derived from a combination of the in- place leases and of the reversionary value of the property (once the current lease(s) expire(s)). Applying the concept of straight- line rent in a fair value model would distort the presentation and potentially misleads an investor in determining the asset's true value. Straight-line depreciation is an unnecessary abstraction from the realistic treatments of contract lease value, often providing less information not more, to the user of the financial statements. Typical commercial real estate leases incorporate contract terms that include far

more than the simple conveyance of the right to use, many of which can affect value from a discounted cash flow standpoint.

As stated above, our industry reports investment property at fair value, which includes recording rental income on an accrual basis. Reporting a straight-line rent receivable asset under the proposed model on a lessor's balance sheet in addition to reporting the related investment property at fair value would, without adjustment, result in the double-counting of future expected cash flows from leases, a dominant valuation input when valuing real estate under a discounted cash flow method. A reconciliation would require reporting a residual value (or discount) for each property (the difference between fair value and the sum of the lease valuations), adding unnecessary complexity to the balance sheet. Under the *Uniform Standards of Professional Appraisal Practice*, the application of a discounted cash flow analysis when valuing real estate under the income approach has prevailed for many years, whether for determining fair value for mark-to-market accounting or when recording an other-than-temporary-impairment under Topic 360, *Property, Plant and Equipment* (i.e. depreciated cost model). As our financial statements, including any leases, are already presented at fair value, the accounting/reporting creation of any additional asset or liability associated with the leases of a lessor recorded and reassessed as proposed in the exposure draft would introduce an additional asset or liability entry that must otherwise be offset elsewhere in the financial statements. Additionally, recording an asset such as straight-line rent would have implications for existing industry performance measures that investors rely on.

We would also encourage the FASB at a minimum to adopt a similar approach for lessee accounting for real estate. We do not see how the right-to use model satisfies the needs of the financial statement user. We do not see why the FASB would want an inconsistency in reporting for lessor and lessee accounting for the same asset/industry. By not adopting a similar principle for lessees it would distort the financial statements within our industry, rather than increase comparability and transparency. While the FASB has chosen to effectively leave the accounting by lessors the same we believe that the existing disclosure requirements related to minimum lease payments for lessees in the notes to the financial statements provides adequate and useful information to real estate investors. Real estate property assets are unique compared to other leased assets such as machinery and equipment as each asset typically has multiple lessees, values may appreciate over time, rather than only depreciate and are actively managed. The FASB appears to have recognized that fact with regard to lessor accounting but not lessee accounting.

Further, the accounting proposed for lessees may have significant unintended negative consequences to the business fundamentals of investing in real estate. We are concerned with the overall potential impact to real estate leasing activity (i.e. lessees and lessors), as well as the industry as a whole as outlined below. The propensity on the part of lessees to enter into shorter term leases in order to minimize the effects of the right-to-use lease model will have a profound effect on how real estate is typically viewed as a long-term investment. For example, insurance companies tend to allocate a portion of their General Account assets to equity and debt (i.e. mortgage loans) investments in real estate in order to sustain consistent returns to their policyholders and also as a hedge against inflation. If the long-term investment perception of

real estate were to dissipate over time, the industry could begin to suffer a mass liquidation by investors who no longer view the returns on real estate aligning with the associated risks of short term leases. Additionally, shorter lease terms would negatively affect the availability and cost of financing for property acquisitions as lenders would not have the security of long term rental streams to secure debt. The following issues summarize our concerns:

1. The FASB seeks to achieve financial statement transparency through the issuance of the proposed lease accounting rules. However, as these proposed rules are applied within the real estate industry the transparency objective would be compromised by the inconsistent practice for lessee accounting, which should be symmetrical with lessor accounting applicable to properties. The proposed lease accounting rules will result in a financial statement presentation that is inconsistent with the economics of a real estate lease transaction. Furthermore, financial statement metrics (i.e. financial ratios) will be inappropriately impacted by the additional assets and liabilities recorded by lessees, as well as corresponding changes to the reporting of capital appreciation and income returns. In some instances, the resulting breach of debt covenants due to an increase in reported liabilities can cause borrowers and lenders to enter into costly negotiations in order to cure such breaches.
2. Lessees will likely begin to negotiate lease terms in such a way that additional assets and liabilities required under the right-to-use lease model would be minimized. Potentially, such strategies could result in shorter lease terms than currently witnessed in today's leasing market and a reduction in future variable rent components, which may not always be in the best interest of the company and/or shareholders. Furthermore, lessors and lessees are less likely to invest substantially in tenant improvements given the shorter lease terms, and the pending increase to annual amortization expense given an accelerated amortization period. We are concerned that in certain instances an accounting driven change in leasing strategies could have a negative economic effect under the proposed rules. The desire to invest in real estate is founded on the long-term contractual cash flows provided by the lessee. Dramatic changes in lessee behavior could occur from this proposal and reduce contractual cash flows which would then change the desired economic profile for real estate investments. The domino effect of such occurrences will negatively affect other industries related to real estate such as the mortgage lending and construction industries. We caution the FASB in issuing accounting rules that will strongly encourage businesses to structure transactions to accommodate preferable accounting which will have an overall negative economic outcome.
3. With the potential for an increase in the use of short-term leases, the valuation estimation will become more uncertain. Real estate investors and appraisers may be faced with assessing the fair value of a property (i.e. income approach) based on shorter lease terms (e.g. 3-5 years) in comparison to today's customary lease terms which on average range 7-15 years depending on several factors such as the size of the leased space. The valuation process may be forced to rely less on reliable valuation inputs such as in-place long-term leases and rely more on short-term leases and unobservable future estimates of

potential leasing activity. This could result in more volatility in real estate valuations further impacting investors and lenders negatively.

4. The likely result of lessors and lessees not investing substantially in tenant improvements because of shorter lease terms will be a reduction in the levels of rent that landlords will be able to receive for the unimproved space. The reduced contractual cash flows that result from short-term leases can impact the underwriting of an investment property from a lender's perspective and decrease the amount of financing proceeds. Additionally, short-term leases could lead to more frequent lessee turnover and therefore result in additional leasing costs incurred by property owners. The combination of these effects may lead to destabilizing property values, creating unwarranted volatility in the real estate market.
5. Under the right-to-use model for lessees will incur significant incremental costs to acquire, implement and maintain software that can accommodate the new accounting and reporting requirements under the proposed update, without any corresponding benefit. Additional staffing will be necessary for the on-going assessment and control over leasing activity to ensure compliance with the proposed update and appropriateness of adjusting entries. Retrospective accounting requirements for in-place leases will magnify these costs and resource issues beyond a reasonable level. An institutional real estate fund could own many properties and a single property alone can be occupied by over one-hundred tenants, resulting in thousands of leases that must be reviewed each reporting period to assess renewal options and variable rent components.

We welcome the FASB's significant outreach activities relating to this exposure draft, but believe they should be further extended to explore the lessor and lessee model as it relates to real estate and fair value reporting. We would ask for reconsideration of a requirement to straight-line the lease receivable in a fair value model and to align real estate lessee with lessor accounting. We would be pleased to discuss our comments above with you at your convenience. Please feel free to contact the undersigned at 978-887-3750 should you wish to discuss the contents of this letter.

Very truly yours,

A handwritten signature in blue ink that reads "John J. Baczewski". The signature is written in a cursive, flowing style.

John J. Baczewski
Chair, Real Estate Information Standards Board