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May 31, 2013

Ms. Susan Cosper  
Technical Director  
File Reference No. 2012-260  
Financial Accounting Standards Board  
401 Merritt 7  
PO Box 5116  
Norwalk, Connecticut 06856-5116  
[director@fasb.org](mailto:director@fasb.org)

**Delivered Electronically**

**Re: File Reference No. 2012-260, *Financial Instruments – Credit Losses*  
(*Subtopic 825-15*)**

Dear Ms. Cosper:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) in response to the Proposed Accounting Standards Update from the Financial Accounting Standards Board (FASB or the Board) on *Financial Instruments – Credit Losses (Subtopic 825-15)* (the Proposal).

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate, and finance income-producing real estate, as well as those firms and individuals who advise, study, and service those businesses.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease, and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT U.S. Real Estate Index, which covers both Equity REITs and Mortgage REITs. This Index contained 172 companies representing an equity market capitalization of \$603.4 billion at 2012 year end. Of these companies, 139 were Equity REITs representing 90.2% of total U.S. listed



REIT equity market capitalization (amounting to \$544.4 billion)<sup>1</sup>. The remainder, as of December 31, 2012, was 33 publicly traded Mortgage REITs with a combined equity market capitalization of \$59 billion.

### **NAREIT's Recommendation**

NAREIT concurs with the FASB's goal of developing a financial reporting model that more accurately reflects the timing and degree to which companies sustain credit losses on financial assets. However, with respect to the FASB's proposed current expected credit loss model (CECL), we believe that there are a number of areas that need improvement for the model to become operational for preparers and understandable for users, regulators, and auditors alike. Therefore, NAREIT proposes the following enhancements with regard to the CECL model:

- **Allow the credit loss allowance to be based on management's "best estimate" of expected credit losses – so, for example, an investor in an AA-rated bond or U.S. Treasury bond or Agency security would expect a best estimate of zero**
- **Clarify that the time horizon for the CECL model is based on the expected life (as opposed to the contractual life) of the financial asset**
- **Allow preparers to reverse previously recorded credit losses and require preparers to adjust the effective yield over the remaining life of the financial instrument to the extent that the expected cash flows exceeds the originally anticipated amount**
- **Exclude trade receivables and lease receivables from the scope of the Proposal**
- **Ensure that interim disclosures are not a mere repeat of the annual disclosures unless there is a material change**

*Allow the credit loss allowance to be based on management's "best estimate" of expected credit losses – so, for example, an investor in an AA-rated bond or U.S. Treasury bond or Agency security would expect a best estimate of zero*

NAREIT understands that the Proposal would require companies to book a credit loss upon execution of the transaction based on multiple possible outcomes. The estimate would be neither a worst-case scenario nor a best-case scenario, but rather would be based on an entity's assessment of current conditions and reasonable and supportable forecasts about the future. As such, the Proposal would expressly prohibit companies from utilizing a "best estimate" or "most likely outcome" approach that may result in recognizing zero credit losses.

NAREIT does not believe that the Proposal, as written, would faithfully present the underlying economics of certain transactions. NAREIT questions the Proposal's outcome when the model is applied to securities that are measured at fair value with changes in value recognized in other comprehensive income. For example, preparers would be required to record an allowance for credit losses immediately upon purchasing an AA-rated bond, a U.S. Treasury bond, or an Agency

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<sup>1</sup> <http://returns.reit.com/reitwatch/rw1301.pdf> at page 20.



mortgage-backed security and thus “expect” credit losses of something other than zero. The vast majority of companies have never incurred a credit loss with respect to these particular investments. Therefore, NAREIT questions why the Board would require management to book an allowance for credit losses for these types of financial instruments, regardless of how small, when management’s long-standing history indicates that there has never been a credit loss incurred historically. Further, the purchase price already inherently reflects what little credit risk exists.

The results of the CECL model become further perplexing when considering the fact that a company would record *no allowance for credit losses* at the date of purchase if these financial instruments are measured at fair value, with changes in value recognized in net income.

In NAREIT’s view, the Board could easily address this accounting anomaly in the Proposal by permitting management to utilize a “best estimate” of expected credit losses. The concept of “best estimates” has conceptual merits in current U.S. GAAP. For example, FASB Concepts Statement No.7, *Using Cash Flow Information and Present Value in Accounting Measures*, defines the term *best estimate* as follows:

The single most-likely amount in a range of possible estimated amounts; in statistics, the estimated mode. In the past, accounting pronouncements have used the term *best estimate* in a variety of contexts that range in meaning from “unbiased” to “most likely<sup>2</sup>.”

NAREIT believes that providing management with the ability to use a “best estimate” approach within the CECL model would more accurately report management’s view of the financial position of a company to users of financial statements.

***Clarify that the time horizon for the CECL model is based on the expected life (as opposed to the contractual life) of the financial asset***

A literal reading of the Proposal suggests that the allowance for credit losses estimate would be based on the cash flows that management does not expect to collect over the *contractual* life of the financial instrument. NAREIT questions whether it was the Board’s intention for management to use the entire contractual life in all instances. For example, based on information obtained from the Federal Housing Finance Agency, the historical assumption for the average life of a 30-year residential mortgage loan is approximately 10 years<sup>3</sup>. The shorter life is due to prepayments that result when homeowners either sell their homes to move, decide to refinance due to decreasing interest rates, or default on the mortgage loan. NAREIT does not believe that an allowance for credit losses that is based on the entire 30-year life of the mortgage loan would be an accurate estimate.

NAREIT recommends that the Board discontinue use of the phrase “contractual cash flows” and utilize the term “expected cash flows” in its place. This would permit management to take

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<sup>2</sup> <http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175820900214&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs> at page CON7-5.

<sup>3</sup> [http://www.fhfa.gov/webfiles/25006/MIRS\\_Feb\\_2013\\_final.pdf](http://www.fhfa.gov/webfiles/25006/MIRS_Feb_2013_final.pdf) at page 2.



prepayments into consideration when estimating the expected life of a loan. NAREIT believes that making this change would dispel the confusion regarding whether the Board's intention was for preparers to estimate credit losses over the life-time contractual term of financial instruments that surfaced after the Proposal was issued. Subsequently, the Board attempted to address its intention in question 8 of the Proposed Accounting Standards Update, *Financial Instruments—Credit Losses (Subtopic 825-15)* Frequently Asked Questions document.

***Allow preparers to reverse previously recorded credit losses and require preparers to adjust the effective yield over the remaining life of the financial instrument to the extent that the expected cash flows exceeds the originally anticipated amount***

While we understand the impetus for the development of an expected credit loss model, we are concerned about any model that would only allow preparers to record downward adjustments and not reverse those credit losses in situations where the fair value of investments (*e.g.*, estimates of future cash flows) subsequently increases. With the benefit of hindsight, a preparer could observe whether market downturns later reverse. To the extent that market conditions stabilize, we believe that an accounting model that allows for reversals of previously recorded credit losses would more accurately reflect the financial position of a company. Thus, in that regard, we agree with the Proposal as an improvement over current practices for debt securities.

However, NAREIT believes that preparers should be able to adjust the effective yield over the remaining life of the financial instrument to the extent that the expected cash flows exceed the *originally* anticipated amount, unlike the Proposal that would record an immediate gain. In our view, the accounting model that we recommend would provide the best information to users of financial statements as well as address the uncertainty of estimates in a prudent manner.

***Exclude trade receivables and lease receivables from the scope of the Proposal***

NAREIT fails to see the benefit of including trade receivable and lease receivables within the scope of the Proposal. NAREIT observes that the Board is inconsistent when it comes to defining whether a lease is a financial asset. For example, lease receivables are excluded from the scope of the project that deals with financial assets (*e.g.*, the Proposed Accounting Standards Update on *Financial Instruments: Recognition and Measurement*), while in projects such as this, the FASB includes lease receivables as financial assets within the scope of the Proposal. Further, we note that trade receivables are generally short term and present few accounting issues under current U.S. GAAP.

To avoid confusion and complexity, NAREIT recommends that the Board exclude these assets from the scope of the Proposal. NAREIT believes that the accounting treatment for credit losses with respect to these asset types is best suited for the chapters in the codification that address these asset types. For example, credit losses for leases should be included within the codification section that is dedicated to leases. In order to ensure that convergence is achieved, the FASB and IASB should include the accounting for credit losses for leases within the scope of the *Leases* Project.

In the event that the Board does not decide to follow our recommendation, NAREIT requests that the Board clearly articulate the types of leases that would be in scope of the Proposal (*e.g.*, both operating and finance lease receivables?). Depending on the Board's anticipated timing for the



effective date, this scoping decision should contemplate both leases under current U.S. GAAP and leases that would exist under the proposed *Leases* standard.

***Ensure that interim disclosures are not a mere repeat of the annual disclosures unless there is a material change***

As NAREIT indicated in its November 30, 2012 submission<sup>4</sup> on the FASB's *Disclosure Framework* discussion paper and in its May 15, 2013 submission<sup>5</sup> on the FASB's *Financial Instruments: Recognition and Measurement* Proposal, NAREIT has observed a growing trend in accounting pronouncements that requires companies to prepare the same types of disclosures at both interim and annual reporting dates. NAREIT questions whether detailed information can continue to be disclosed at interim periods given shorter quarterly SEC financial reporting deadlines (*i.e.*, 40 days for both large accelerated filers and accelerated filers, and 45 days for non-accelerated filers<sup>6</sup>) when compared with annual SEC financial reporting deadlines (*i.e.*, 60 days for large accelerated filers, 75 days for accelerated filers, and 90 days for non-accelerated filers<sup>7</sup>). According to APB 28: *Interim Financial Reporting* (Accounting Standards Codification Topic 270), each interim period is an integral part (as opposed to a discrete part) of the annual reporting period.

NAREIT suggests that the Board consider the approach that the SEC utilizes for changes in financial condition and quantitative and qualitative disclosures of market risks. The SEC requires these disclosures in annual reports. To the extent that there has been a material change since the date of the most recent annual report, the SEC requires disclosures in quarterly filings as well. By taking this approach, the SEC has effectively reduced unnecessary disclosure duplication. NAREIT believes that the FASB would achieve its objective by taking a similar approach.

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We urge the FASB and the IASB to work toward a converged solution. As the Boards near the completion of the convergence projects, we implore the FASB and IASB to work together to reduce differences in their respective Financial Instruments models. This will benefit preparers, users, auditors, and regulators alike.

We thank the FASB for the opportunity to comment on the Proposal. If you would like to discuss our views in greater detail, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at [gyungmann@nareit.com](mailto:gyungmann@nareit.com) or 1-202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at [cdrula@nareit.com](mailto:cdrula@nareit.com) or 1-202-739-9442.

Respectfully submitted,

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<sup>4</sup> <http://www.reit.com/~media/Files/Policy/Letter-to-FASB-on-Disclosure-Framework-11-30-12.ashx>

<sup>5</sup> <http://www.reit.com/~media/2013/NAREIT%20Comment%20Letter%20on%20FASB%20Recognition%20and%20Measurement%20Proposal.ashx>

<sup>6</sup> <http://www.sec.gov/answers/form10q.htm>

<sup>7</sup> <http://www.sec.gov/answers/form10k.htm>



Ms. Susan Cospier  
May 31, 2013  
Page 6



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