Vijay Yadlapati, National Association of Realtors®
Associate Commercial Policy Representative

Proposed Lease Accounting Rule Changes Present Challenge to Commercial Real Estate

Just as the frozen commercial real estate credit markets are beginning to thaw, newly proposed accounting rule changes could be the iceberg that sinks any hope for improved commercial real estate lending conditions. Last summer, the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB), which are independent bodies that set accounting standards, proposed lease accounting changes that would bring nearly $1.3 trillion in leased assets back onto companies' balance sheets.

If enacted, the changes would require companies to use a right-of-use accounting model where both lessees and lessors recognize assets and liabilities arising from lease contracts, resulting in the elimination of operating leases. Current accounting rules allow many businesses to classify leases as operating expenses, which do not appear on their balance sheets. While FASB and IASB believe the proposed changes would improve transparency and give investors more consistent and concise financial reporting, NAR is concerned that these changes will hurt the financial stability of many businesses and prolong our nation's economic recovery.

If this proposal is ratified, businesses of all sizes that lease commercial space would see their balance sheets grow, and some companies may see their debt-to-equity ratios increase. Subsequently, they'd find it more difficult to obtain credit, especially those with heavy debt loads or still recovering from the recession. The proposed accounting changes could also complicate compliance with debt covenants or agreements between the bank and borrower, which usually prohibit companies from borrowing more than they are worth. By capitalizing new and existing leases, some businesses could show more debt than allowed in their agreement with the lender, and consequently be in default of their loan. This could force some firms to put up more equity on existing loans or even have their credit lines revoked.

In addition to negatively impacting commercial real estate tenants, the elimination of off-balance-sheet financing would be detrimental to commercial property owners. More frugal lessees would want less space and shorter-term leases without renewal options or contingent rents in order to shrink their balance sheets, which would decrease cash flow for property owners. Also, these smaller contracts would diminish the value of commercial properties and therefore reduce the borrowing capacity of commercial real estate lessors, who rely on leases and the value of the property as collateral in order to obtain financing.

NAR and its commercial affiliates have submitted comments to FASB/IASB regarding their accounting proposal, which were due by December 15, 2010. Both organizations expect to have their joint proposal finalized by mid-2011. The effective date of this proposal will likely be in 2012 or 2013, where virtually all new and outstanding leases would be subject to the new accounting standard. NAR will continue to work with Congress, real estate-related organizations, and other stakeholders – including financial institutions, retailers, and equipment leasing businesses – to ensure that any accounting rule changes will not compromise the overall credit capacity of commercial real estate lessees and lessors.