Article written by ERIN STACKLEY who monitors and analyzes federal legislative developments affecting the field of commercial real estate, and lobbies the U.S. Congress to make sure that their interests are addressed. Prior to joining NAR, she worked for the House of Representatives and had a legal fellowship with the National Federation of Independent Business (NFIB).

LEASE ACCOUNTING UPDATE

In 2006, the Federal Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) commenced a project to develop compatible accounting standards that could be used for both domestic and international financial reporting. This followed a 2005 Securities and Exchange Commission (SEC) report recommending changes be made to lease accounting practices to ensure greater transparency in the system. FASB and IASB's goal for the project was to develop a global rule to bring leases onto corporate balance sheets in both the U.S., Generally Accepted Accounting Principles (GAAP) and the International Financial Reporting Standards (IFRS). Four years later, in August 2010, they released their first exposure draft; after extensive public comments, three years following the release of the first exposure draft, they released the second in May 2013.

Under the current exposure draft, companies would be required to change to a "right-of-use" accounting model. Under the current system, many leases are classified as "operating expenses," which do not appear on balance sheets. The "right-of-use" model being proposed would change to listing leases as assets and liabilities, which are reflected on balance sheets. The FASB and IASB believe this will improve transparency and provide investors with more consistent and concise financial reporting. Leases that are less than twelve-months in length would continue to conform to the current standards and be classified as operating expenses.

WHAT DOES THIS MEAN FOR COMMERCIAL REALTORS®?

The current exposure draft would bring nearly $1.3 trillion in leased assets back onto companies' balance sheets, about 70 percent of which are real estate leases. This "bloating" of balance sheets may have serious effects for commercial real estate practitioners, especially for those who have heavy debt loads or who are still recovering from the recession. Among other potentially detrimental side effects, this balance-sheet bloating could cause companies to see their debt-to-equity ratios increase, making it more difficult to obtain credit. It 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. Finally, it could also have the effect of incentivizing shorter lease-terms, as leases that are less than one-year in length would continue to be considered "operating expenses" under the proposal. Under the new system lessees may prefer shorter leases without renewal options, which could reduce the borrowing capacity of many commercial real estate lessors who rely on leases and the value of the property as collateral when obtaining financing.

WHAT IS NAR DOING?

Since the first exposure draft was released in 2010, NAR has been very involved in the deliberations over the FASB and IASB's lease accounting proposal. Along with sending letters of its own to the agencies asking for a cost-benefit analysis of the proposal and explaining its concerns regarding the detrimental effects it would have on commercial real estate practitioners, NAR has worked in coalition with other industry groups to advocate for real estate's best interests on the issue. NAR has also engaged with Congress on the issue. In 2013 NAR successfully urged thirteen lawmakers to send a "Dear Colleague" letter to the FASB expressing concern once again over the lack of a cost-benefit analysis of the current proposal. Additionally, in September 2013 NAR sent a comment letter to the FASB on their second exposure draft (it sent several comment letters on the first Exposure Draft as well).

NEXT STEPS

It was predicted that the IASB and FASB would finalize their lease accounting proposal in 2014, but as the year comes to a close and they have not done so yet, it seems more likely that it will come out in 2015. If that is the case, it is probable that the proposal will not be put into effect until the year 2018. While the FASB and IASB debate the final rule, NAR will continue to work with both-groups, other industry stakeholders, and key lawmakers to ensure that the final rule does not detrimentally affect commercial real estate practitioners or the economy.