NAR Issue Summaries

Commercial / Lease Accounting

NAR Committee:

Commercial Federal Policy Committee

What is the fundamental issue?

In February 2016, the Financial Accounting Standards Board (FASB) released its long awaited updated lease accounting standards. The Accounting Standards Update (ASU)on leases will take effect for public companies for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For all other organizations, the ASU on leases was effective for fiscal years beginning after December 15, 2019, and for interim periods within fiscal years beginning after December 15, 2020.

Under the new standard, companies are required to use a “right-of-use” accounting model where both lessees (renters) and lessors (property owners) recognize assets and liabilities arising from lease contracts. The FASB believes these changes will improve transparency as well as provide investors with more consistent and concise financial reporting.

In addition, FASB and the U.S. Securities and Exchange Commission (SEC) implemented the Current Expected Credit Losses (CECL) accounting standard, which focuses on estimating expected losses over the life of a loan, using historical data, current conditions, and reasonable forecasts. The CECL standard went into effect in January 2020 for some lending institutions, and after December 15, 2022 for all others.

I am a real estate professional. What does this mean for my business?

The updated lease accounting standard may impact some businesses, especially lessees and lessors of commercial real estate. With leases included on balance sheets, some companies saw their debt-to-equity ratios increase and found it more difficult to obtain credit. The new standard can also complicate compliance with debt covenants or agreements between the bank and borrower. By capitalizing new and/or existing leases, some businesses show more debt than allowed in their agreement with the lender, and therefore be in default of their loan. This could force some firms to put up more capital for existing loans or even have their credit lines revoked.

Additionally, the elimination of off-balance-sheet financing could be detrimental to commercial property owners. More frugal lessees will want less space and shorter-term leases without renewal options or contingent rents, which will decrease cash flow for property owners. Shorter-term rents will likely reduce the borrowing capacity of many commercial real estate lessors, who rely on leases and the value of the property as collateral in order to obtain financing. Ultimately, property owners would be forced to increase rent rates due to market uncertainty and reduce tenant improvements due to shorter recovery periods. Conversely, this change could encourage some firms to consider buying instead of leasing commercial real estate.

The CECL standards can have the effect of requiring that banks hold more capital as "countercyclical reserves," which may impact their ability to lend - especially smaller lending institutions.

NAR Policy:

NAR believes the new lease accounting standard will be detrimental to our nation's economy. Also, NAR is opposed to lease accounting standards changes that would treat the income producing real estate business as a financing business on company balance sheets. NAR supported proposals that would have exempted privately held companies from complying with the new standard.

The new lease accounting proposal reduces the overall borrowing capacity of many commercial real estate lessees and lessors, by requiring them to recognize leases on their balance sheets as liabilities and assets, as opposed to their current treatment as operating expenses, which are not reflected on balance sheets. Including leases on balance sheets may have the effect of "bloating" them, and some companies may see their debt-to-equity ratios increase as a result, making it more difficult for them to get credit. Treating income producing real estate business as a financing business on company balance sheets will not accurately depict the unique characteristics of the investment real estate sector and in turn discounts the usefulness of the industry's financial statements.

Opposition Arguments:

Opponents of NAR policy believe that real estate should not get special treatment over other asset types: all assets, including real estate, should be reflected on company balance sheets.

Legislative/Regulatory Status/Outlook

The FASB lease accounting standards went into effect incrementally between 2018 and 2020. The CECL standards have been in effect for some lending institutions since January 2020 and December 2022 for others.

Current Legislation/Regulation (bill number or regulation)

No actions at this time.

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