RE102C17: The New Era of Accounting for Real Estate Commercial Leases and Financial Statements

I. HOW DOES REAL ESTATE AFFECT A TENANT'S FINANCIAL STATEMENT?

The accounting treatment of a commercial lease has been drastically altered by a recent agreement between the US and Europe's accounting system. In short, commercial leases might be treated as an operating lease or capital lease on a tenant's financial statement that can affect lease negotiations and subletting. So what is an operating lease, a capital lease and what are the changes that a real estate broker be discussing with a tenant's financial personnel?

II. DIVISIONS OF A COMMERCIAL TENANT FINANCIAL STATEMENT

- **There are 3 components to a financial statement:**
    - Income Statement (Profit and Loss)
    - Cash Flow Statement
    - Balance Sheet
- **GAAP Method**
    - Generally Accepted Accounting Principles
    - It is a body of opinions, principles and practices used by FASB and SEC
- **FASB**
    - Financial Accounting Standards Board
    - It is an independent committee that develops accounting standards for organizations
    - In 1972 FASB drafted rules on accounting that were accepted by GAAP
- **FASB 13: Deals with accounting for leases**
    - Any kind of lease: equipment, car, real estate and the rules have to be followed
    - Covers straight lining of rents and accounting for rents and possession of rent liability

III. COMPONENTS OF FINANCIAL STATEMENTS

- Financial reports are different than tax statements
- A Financial Statement will incorporate FASB and GAAP
- IRS and SEC set laws while FASB and GAAP deal with codes and are not laws

- **Income Statement or Sources of Income**

- An Income Statement is often known as the “Profit and Loss Statement” for a company. It is not beyond one year.
- The purpose is to show earnings measured in a specific period of time
- Basic components: Income and Expenses
- Rents will be noted on the Income Statement but not the Balance Sheet
- Income Statement = Profit
- Balance Sheet = Assets and Liabilities
- <u>Components:</u>
  - Revenues: Gross Sales – Cost of Goods = Gross Profit
  - Gross Income
  - Other Income:
    - Cost of Goods sold
    - Cost of Labor
    - Cost of raw materials
    - <u>Manufacturing or assembly costs</u>
    - = **Gross Profit**
- Operating Expenses:
  - Salaries
  - Insurance
  - Research and development
  - Rent
  - Occupancy costs
  - Insurance
  - Utilities
  - Transportation
  - Administrative
  - Professional fees
- Depreciation:
  - Allowance for wear and tear
- Profit:
  - Actual and earned during the year
  - Rent will be listed on an operating sheet and Income Statement
  - Generally short-term leases are considered “off-balance” sheet
  - Long term leases are considered “on-balance” sheet
  - Sample of an Income Statement

- **Cash Flow Statement**
  - The Cash Flow Statement describes the changes that have occurred in the Balance Sheet during the fiscal period in terms of cash
  - The CF Statement is a “bridge” between the balance sheet at the end of the previous period and the balance sheet at the end of the current period.
  - There are 3 components of a Cash Flow Statement:
    - Operating Activity
    - Investing Activity
    - Financing Activity

- Operating Activity
  - Describes the cash flow effects of the activities represented in the operating portion of the Income Statement
- Investing Activity
  - Describes cash flow inflows and outflows that result from investments in assets such as real estate
- Financing Activity
  - Describes cash flows from debt and equity financing transactions
  - Inflows would come from sale of stock or the proceeds of a mortgage
  - Sample Cash Flow Statement

IV. BALANCE SHEET

- There are 3 primary sources of a balance sheet: Assets, Liabilities and Equity
- A balance sheet is a picture in time of the financial health of a company or individual
- Balance Sheet is only accurate for the day it was printed: only 1 day in time
- Formula:
  - Assets = Liabilities + Equity
- Assets: These assets are divided into 3 categories.
  - Current Assets
  - Fixed Assets
  - Intangible Assets
- Current Assets:
  - Cash and other assets that can be converted to cash within a year
  - CDs, Treasuries, money market accounts
  - Marketable securities
  - Accounts receivables
  - Stocks
  - Bonds
  - Non-marketable securities
  - Securities held by a broker in margin accounts
  - Restricted or controlled stocks
  - Partial interest in real estate equities
  - Loans receivable
  - Cash value of life insurance
  - Selling Inventory
  - Other itemized assets
- Fixed Assets:
  - Property, real estate
  - Machinery, equipment
- Automobiles and personal property

    - Transportation
    - Land
    - Less: Depreciation to give “net fixed assets”
- Intangibles
- Current Liabilities
- Long Term Liabilities

V. THE ACCOUNTING CHANGES

Introduction

- GAAP states the real estate leases and rent expenses are ordinary and are paid each month. A lease is categorized as an “Operating Lease”. It is to be designated on an Income Statement or Profit/Loss Statement.
- An operating lease is short-term, shorter than the economic life of the asset and there is no transfer of ownership. Could be 1-10 years.
- A mortgage is a long-term expense and long-term financial commitment. A real estate mortgage is required to be designated on a Balance Sheet as a Liability.
- Owned real estate is listed as an Asset on a Balance Sheet.
- A mortgage is designated under GAAP as a “capital expense.” There is ownership in the building.
- In a long-term lease with options, GAAP recognizes that the tenant has controlling the building. The tenant has economic characteristics of asset ownership.
- A long-term lease is categorized as a “capital lease” and listed on a balance sheet.
- Europe accounting is different. It recognizes both real estate commercial leases and mortgages as capital leases and required to be listed on the Balance Sheet.
- Mortgages and leases are treated the same.
- In the late 2000s, the US Accounting Board and the International Accounting Standards Board (IASB) recognized the differences between N. America and Europe. Meetings were held to create one accounting standardized system.
- Under new proposed guidance, a commercial tenant will be required to recognize assets and liabilities for leases with lease terms of more than 12 months.
- Leases with options extended the term of the lease obligation.
- If the tenant had a termination language, it may not be considered.
- Unlike current GAAP, new rules will require both types of leases to be recognized on a balance sheet.

Compromise

- An agreement was made in 2015-6 that will dramatically impact real estate, its accounting and how commercial real estate is leased or owned.
- The IFRS: International Financial Reporting Standards announced that these changes would go into effect during 2018 and 2019.

- FASB issued a compromise with IASB on Feb. 25, 2016. There would be 2 types of leases. One type (finance lease) would be treated as a capital lease. The other type of lease would be accounted in the Income Statement and Cash Flow Statement in a manner consistent with operating leases. The lease liability will be recognized as a lease liability based upon the present value of remaining lease payments and corresponding lease assets for operating leases.
- In short, there is a Type A and Type B lease. Europe has decided to continue to treat all leases the same (Type A).
- All leases will be required to be capitalized on the balance sheet except short term leases (12 months or less). The lease is recognized as both an asset and liability.
- Type A lease will be those considered capital or finance leases and will have front-end loaded expense pattern consisting of amortization and interest expense. It will be classified as Other Debt on the balance sheet.
- Type B leases will be those considered operating leases under current accounting guidelines and will be account as rent expense on a straight-line basis over the term of the lease. It is not debt and will be classified as "Other Liabilities" on the balance sheet. It will be straight-line rent expense.
- Both leases, Type A and B will be capitalized, meaning placed on the balance sheet. There will be no grandfathering.
- A lease term of less than 12 months also is to be listed on the Balance Sheet if there is an option that is more likely than not to be exercised
- Type A is a financing lease with a right-to-use; Type B is an operating lease with a right to use asset and liability
- Other details

Impact

- Every lease in a company now needs to be identified as Type A or B.
- Could harm businesses of all sizes.
- Debt to equity ratios could increase.
- May be more difficult to obtain credit and real estate financing.
- Could complicate compliance with debt covenants or agreements with bank and borrower.
- Company may be showing more debt than allowed in lender agreements and fall into loan default.
- Tenants may negotiate shorter term leases impacting landlords, no renewal options or contingent rents which could all affect a landlord's cash flow.
- Commercial property owners could be forced to increase rental rates due to market uncertainty and reduce tenant improvements.
- No one knows for sure until the rules are in effect.
- Publicly traded companies must be compliant by 2019.
- Discussion of other issues