

Real Estate Accounting: Expenses, Budgeting, and Valuation

Dig into the operational side of real estate accounting with coverage of expense recognition, reconciliation, and cost recoveries. You'll also explore lease incentives, tenant improvements, and the budgeting process for operating properties. The course rounds out with variance analysis, market research techniques, and real estate valuation methods—giving you a well-rounded toolkit for advising clients who own or manage income-producing properties.

CREDIT HOURS 2 | FIELD OF STUDY ACCOUNTING | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recognize proper accounting treatment for operating expenses.
- Identify recoverable and nonrecoverable operating expenses.
- Recognize how to account for tenant improvements and lease incentives.
- Identify the components of a budget.
- Identify bases for variance analysis.
- Recognize sources for market research and market analysis.
- Identify approaches to real estate valuation.

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Chapter 1: ACCOUNTING FOR OPERATING PROPERTY EXPENSES

Chapter Objective

After completing this chapter, you should be able to:

- Recognize proper accounting treatment for operating expenses.

As was noted in the previous chapter, on February 25, 2016, the FASB issued Accounting Standards Update No. 2016-02, *Leases* (ASC or Topic 842), which significantly changed the way in which leases are recorded by lessees. The previous lease standard, ASC 840, *Leases*, was criticized by industry participants for failing to provide good representation of operating lease transactions. Prior to the issuance of ASC 842, assets and liabilities inherent in operating leases were kept off-balance sheet of lessees. The new standard effectively brings the assets and liabilities related to operating leases into the balance sheet of lessees and does not fundamentally change lessor lease accounting of operating leases.

The new standard was effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, for any of the following:¹

1. A public business entity, as defined in U.S. GAAP.
2. A not-for-profit entity that has issued, or is a conduct bond obligor for securities that are traded, listed, or quoted on an exchange or an over-the-counter market.
3. An employee benefit plan that files financial statements with the U.S. Securities and Exchange Commission (SEC).

Hence for most calendar year public companies the new standard was effective January 1, 2019. For all other entities, the new guidance was effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.

Even though Topic 842 requires lessees to recognize assets and liabilities related to operating leases on the balance sheet, the standard still retains a distinction between operating and finance leases. These distinctions have been discussed in the previous chapter of this course.

Under Topic 842, lessees are required to recognize on their balance sheet a lease liability representing future lease payments and a right-of-use asset representing its right to use the underlying asset over the lease term. The standard requires that when measuring the right-of-use assets and lease liabilities, a lessee should include payments to be made during renewal option periods only if the lessee is reasonably certain it will exercise such option to extend the lease. In

addition, in measuring the right-of-use assets and lease liabilities, the lessee should exclude variable lease payments except those that depend on an index, a rate, or are in substance fixed payments.

It is important to note, however, that the lease standard allows lessees to make an accounting policy election not to recognize right-of-use assets and lease liabilities for short-term leases. A short-term lease is defined as a lease that has a lease term of 12 months or less and does not include a purchase option that the lessee is reasonably certain to exercise. If a lessee were to make this election, then it should recognize lease expense on a straight-line basis over the lease term.

LESSEE MEASUREMENT AND RECORDING OF OPERATING AND FINANCE LEASES

From the perspective of a lessee, a lease is classified as either an operating or finance lease. The difference between the two has already been discussed in the previous chapter, but in this chapter we discuss how these two leases are recorded by a lessee.

For operating leases, a lessee is required to:²

1. Recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in the statement of financial position.
2. Recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term on a straight-line basis.
3. Classify all cash payments within operating activities in the statement of cash flows.

For finance leases, a lessee is required to:³

1. Recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in the statement of financial position.
2. Recognize interest on the lease liability separately from amortization of the right-of-use asset in the statement of comprehensive income.
3. Classify repayments of the principal portion of the lease liability within financing activities and payments of interest on the lease liability and variable lease payments within operating activities in the statement of cash flows.

CONTRACTS WITH MULTIPLE COMPONENTS

Before discussing further, let's define a lease and what constitutes a lease. ASC 842 defines a lease as a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration. It describes control over the use of the identified asset as when the lessee has both (i) the right to obtain substantially all of the economic benefits from the use of the assets and (ii) the right to direct the use of the asset.

In real estate leases, it is relatively easy to identify the assets, i.e. the premises being leased, and also relatively easy to determine when control is passed from lessor to lessee as these are important aspects of a valid lease agreement.

ASC 842 also requires the lessee to separate the lease components from the non-lease components of a contract. A contract can contain multiple lease components. The right to use an underlying asset is considered a separate lease component if both of the following criteria are met:⁴

- a. The lessee can benefit from the right of use either on its own or together with other resources that are readily available to the lessee. Readily available resources are goods or services that are sold or leased separately (by the lessor or other suppliers) or resources that the lessee already has obtained (from the lessor or from other transactions or events).
- b. The right of use is neither highly dependent on nor highly interrelated with the other right(s) to use underlying assets in the contract. A lessee's right to use an underlying asset is highly dependent on, or highly interrelated with, another right to use an underlying asset if each right of use significantly affects the other.

Only the lease components of contracts are required to be accounted for in accordance with Topic 842. When assessing whether an activity in a lease should be considered a separate non-lease component, the lessee should consider whether the activity transfers a separate good or service to the lessee. Activities that do not transfer goods or services to the lessee or amounts paid solely to reimburse costs of the lessor are not separate components in a contract.

The consideration paid by the lessee to the lessor is allocated to the lease and non-lease components on a relative standalone price basis. It is therefore important to note that the consideration attributable to the non-lease component is not a lease payment and therefore is not included in the measurement of lease liability or right-of-use asset.

In a typical real estate lease, the contract may contain more than one component, such as:

- a. Lease Component: only these must be accounted for in accordance with ASC 842.
- b. Non-lease Component: these are items in a contract that convey another good or service. Example includes common area maintenance.
- c. Not a Component: if an item in a contract does not provide a separate good or service, it does not represent a separate component. Examples include reimbursement from the lessee to the lessor for property taxes and insurance since these do not convey a good or service.

As was previously noted, components include only those items or activities that transfer a good or service to the lessee. Hence common area maintenance and utilities consumed by the lessee and reimbursed to the lessor are non-lease components because the lessee would have otherwise obtained these services on their own. However, property taxes and insurance would likely be

considered part of the lease component because they do not transfer separate goods or services to the lessee. However, from a practical standpoint, property taxes and insurance frequently vary over time and therefore would not be included in the determination of lease liability, as is noted in the next section.

Also notwithstanding the requirement for separating the components, the standard provides a practical expedient for lessees as it relates to separating lease from non-lease components. It allows lessees to make an accounting policy election not to separate lease components from non-lease components. Hence if a lessee makes that election, it is allowed to account for the non-lease component together with the lease component as a single lease component.

LEASE LIABILITIES AND RIGHT-OF-USE ASSETS

The lease standard requires the lessee to recognize lease liability and the right-of-use asset at lease commencement. Lease liability is defined as the present value of lease payments not yet paid over the lease term.

Lease payments are calculated as the sum of:

- a. Fixed payments, including in substance fixed payments, less any lease incentives paid or payable to the lessee (lease incentives include both payments made to or on behalf of the lessee and losses incurred by the lessor as a result of assuming a lessee's preexisting lease with a third party).
- b. Variable lease payments that depend on an index or rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate at the commencement date.
- c. The exercise price of an option to purchase the underlying asset if the lessee is reasonably certain to exercise that option.
- d. Payments for penalties for terminating the lease if the lease term reflects the lessee exercising an option to terminate the lease.
- e. Fee paid by the lessee to the owners of a special-purpose entity for structuring the transaction.
- f. For a lessee only, amounts probable of being owed by the lessee under residual value guarantees.

Lease payments do not include any of the following:

- a. Variable lease payments other than those in (b) above.
- b. Any guarantee by the lessee of the lessor's debt.
- c. Amounts allocated to non-lease components.