

Real Estate Accounting: Financing, Development, and Audit Essentials

From financing structures to acquisition costs, this course tackles the more complex accounting challenges in real estate. You'll work through GAAP-based project development cost accounting, revenue recognition for real estate development, and the unique accounting considerations for brokerage operations. The course closes with an overview of real estate audits, making it a strong fit for practitioners who support developers, investors, or firms involved in active real estate transactions.

CREDIT HOURS 2 | FIELD OF STUDY ACCOUNTING | EXAM QUESTIONS 8

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 8 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

- Identify types of real estate financing.
- Recall methods of accounting for real estate investments.
- Recognize the stages of real estate development projects.
- Identify the methods of profit recognition.
- Recognize which costs relate to contracts.
- Recognize types of management assertions.

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Chapter 1: FINANCING OF REAL ESTATE

Chapter Objective

After completing this chapter, you should be able to:

- Identify types of real estate financing.

Investment in real estate requires significant capital. Investors therefore often look outside their own firms to the capital market to raise the funds to invest in these assets. Even investors who have the funds available might not want to put up the whole amount but prefer to use leverage. The two most common ways investors can fund the purchase of real estate are equity and debt financing.

EQUITY

Equity investment includes the investor's own capital and capital from other investors in the purchase of the real estate. The investors could be individual investors, partnerships of individuals or corporations, investments clubs, private equity funds, hedge funds, investment banks, commercial banks, and pension funds, among others. In an equity investment funding structure the investors share the risks and rewards of the real estate investment. The return for these investors would include periodic cash flows from the investment and gains upon disposal of the assets.

DEBT FINANCING

The focus of this chapter is debt financing of real estate. Debt financing can be obtained through numerous sources. Eight of the most common lenders are:

1. Commercial banks
2. Investment banks
3. Mortgage banks
4. Credit unions
5. Pension funds
6. Life insurance firms
7. Savings and loan associations
8. Mortgage real estate investment trusts

Commercial Banks

Commercial banks usually are chartered by the federal or state governments in which the banks operate. Real estate financing is one of many avenues through which commercial banks invest

deposits from their customers. Traditionally, because of the short-term nature of customer deposits, commercial banks offer both short-term and long-term financing. Deposits of bank customers are usually insured up to a limit provided by the Federal Deposit Insurance Corporation (FDIC), which is currently up to \$250,000. Examples of commercial banks in the United States include Citibank, Bank of America, and JP Morgan Chase.

Investment Banks

Investment banks operate mostly in the capital market. These banks help their customers raise significant money in the capital market through debt and equity offerings. They are located mainly in major financial cities and have global networks of offices. They help in the financing of multimillion- and billion-dollar real estate transactions across nations. As a result of the 2008 financial crisis and subsequent bailout of most banks by the U.S. government, many banks that had been investment banks converted to commercial banks. Thus now the delineation between commercial and investment banks is no longer as clear as it used to be. Examples of former investment banks that converted to commercial banks include Goldman Sachs and Morgan Stanley, among others. Some commercial banks also have investment banking divisions that perform similar investment banking transactions.

Mortgage Banks

Unlike other banks that provide real estate and other investment services, mortgage banks focus on real estate financing. These banks originate loans for both themselves and their clients (which include commercial banks, investment banks, life insurance firms, pension funds, and others). When mortgage banks originate loans for themselves, they hold the mortgage until maturity, thereby keeping the mortgages on their own books. They earn fees for originating loans for clients, and they earn service fees if they are the servicing agent on the loan. (Servicing means collecting the periodic mortgage payments from borrowers and remitting them to the lender.) Most mortgage banks are chartered by the state. There are numerous mortgage banks in every state in the United States.

Credit Unions

Credit unions are cooperative organizations that make loans to members. Members make deposits with the credit union and are paid interest on their deposits. Members can also borrow from credit unions for personal use. One of the benefits of credit unions is that the interest they charge members is usually lower than most members can obtain from other sources; thus, most members borrow from the credit union when they purchase real estate.

Life Insurance Firms

Life insurance firms obtain cash through the premiums from policy holders and returns on investments. The cash is then used to cover claims and operating costs. Real estate represents a

major asset class for most life insurance firms due to the fairly predictable nature of real estate cash flow. Most of these insurance firms invest on both the equity and debt sides of real estate. Some of these insurance firms such as American International Group (AIG) invest in real estate-related equity and debt derivatives such as credit default swaps (CDS). These derivatives resulted in the near collapse or total collapse of AIG, ACA Capital, Lehman Brothers, Merrill Lynch, and other similar firms during the 2008 financial crisis.

Savings and Loan Associations

Savings and loan associations are chartered by state or federal laws. They lend only to their members, normally for long-term financing of home purchases. The savings and loans association industry went through a near collapse in the late 1980s and early 1990s due to bad loans until it was rescued by the federal government. Savings and loans associations are currently regulated by the Federal Home Loan Bank (FHLB) system, a federal regulatory agency that sets guidelines and provides depositors with insurance protection for deposits under the Federal Savings and Loan Insurance Corporation.

Mortgage Real Estate Investment Trusts

Real estate investment trusts (REITs) were defined and authorized by the U.S. Congress in the Real Estate Investment Trust Act of 1960. The purpose of the act was to provide individual investors with the opportunity to participate in owning and/or financing a diversified portfolio of real estate.

There are three main types of REITs: mortgage REITs, equity REITs, and hybrid REITs. Mortgage REITs provide and hold loans and other bond-like obligations that are secured by real estate collateral. Equity REITs invest in real estate through the purchase of equity interests. Hybrid REITs invest in both real estate equity and debt interests. The main benefit of REITs as an investment vehicle is that the investors avoid double taxation.

OTHER FINANCING SOURCES

Over the years, many complex financial instruments have been created as sources of financing real estate investments. Three of the most common ones are:

1. Mezzanine debt
2. Preferred equity financing
3. Collateralized mortgage obligations

Mezzanine Debt

Mezzanine debt (also called mezzanine loan or “mezz” for short) is a loan to the equity investor in debt-financed real estate. The mezzanine loan is secured by the borrower’s equity interest in the real estate asset. Mezzanine loans were created to provide additional financing to equity investors.

Preferred Equity Financing

Preferred equity financing is very similar to a mezzanine loan in that it is also provided to the equity investor. However, in a preferred equity financing, the preferred equity investor is entitled to receive all or a portion of the borrower's excess cash flow from the investment until the preferred equity holder's investment is repaid in addition to an agreed-on return. A preferred equity investment is more secure than a common equity investment in the event of dissolution.

Collateralized Mortgage Obligations

Collateralized mortgage obligations (CMOs) were created to help convert the cash flow from real estate mortgages into various investment instruments that fit the needs of particular investors. CMOs are essentially bonds sold to investors that are secured by mortgage cash flows. CMOs are structured, packaged, and sold by some of the major banks to sophisticated investors and firms. In principle, according to Davidson and coauthors, "The mortgage cash flows are distributed to the bond[holders] based on a set of pre-specified rules and the rules determine the order of principal allocation and the coupon level."¹

TYPES OF LOANS

In general, there are two main broad types of loan: conventional and guaranteed loans.

Conventional Loans

In conventional loans, the risk of the lender not being able to recover its investment depends on the borrower's ability to pay its debt obligations and also the availability of sufficient equity in the financed asset in the event of the borrower's default. In conventional loans, there are no guarantees provided by any other third party. Due to the risks involved, lenders tend to require larger down payments in order to reduce the loan to value so that in event of default by the borrower, the lender would be more likely to recover its investment.

Guaranteed Loans

Guaranteed loans are insured or guaranteed by another party other than the borrower. Some of the most common guaranteed loans are those guaranteed by the government or its agencies, such as Federal Housing Authority-insured loans, Veteran's Administration-guaranteed loans, and Small Business Administration-guaranteed loans. Depending on the agency that insured or guaranteed the loan, different percentages of the loan are guaranteed.

DEBT AGREEMENTS

In a debt-financed real estate purchase, buyers usually pledge their ownership interests in the investment as collateral for the debt used in purchasing the real estate asset. In some cases, depending on the risks involved, buyers might be required to personally guarantee the debt,