Watch Your Real Estate Language!

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"I meant what I said and I said what I meant." Dr. Seuss' elephant character Horton provides speakers with a worthy goal. The same applies to writers.

In the English language, the same word can have many different meanings. The word *run* reportedly has 100 different definitions, from a score in baseball to a tear in a knitted fabric. The word *strike* means one thing in baseball, another in bowling, still another in a fight, and something entirely different in a labor union activity. When an entrepreneur strikes out into a new venture, we wish him luck, but a salesman who strikes out has failed in a sales call. In the latter case, the baseball meaning of "strike out" is used figuratively.

It should be no surprise that many words have special meanings in real estate activities. This can cause misunderstanding between parties, whether intentional or not. For example, a real estate appraiser may provide a report with the word *value* in it. When modified by *investment* to become "investment value," it is related to but quite different from "market value." Investment bankers may not understand the difference in these terms when packaging a real estate offering for sale.

An appraiser of a regulated public utility explains that the term *cost* is important because *historical cost* is the amount that determines regulated utility rates charged to customers and returns to capital providers. The same appraiser then determines *replacement cost new* for the property, which is an entirely different, much higher amount that is not warranted while the property is within its regulatory shackles.

The misunderstandings often result from reports prepared by appraisers and accountants. Terms that the two professions share take on entirely different definitions, sometimes without either profession recognizing the validity of the other's use.

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The gap increases with education, as each group feels more strongly about its own lexicon and refuses to recognize any other. Anyone with a college degree in business administration has taken Accounting 101 (literally), where the accounting definition of terms such as *depreciation, amortization, capitalization*, and *lower of cost or market* are drilled in. Nearly all business majors get through their degree program *without* a course in real estate, and at least 99 percent without a course in real estate appraisal or finance. When the college graduate hears one of these terms, he/she may not recognize the different vernacular used by the real estate professional and may view the other party with misunderstanding or distrust, assuming that the real estate professional is ignorant of the proper (accounting) usage.

Here we explore a few of the commonly encountered terms in real estate and explain how the real estate definitions differ from other well-known uses. The list will be considered in alphabetical order.

AMORTIZATION

The most common use of *amortization* in real estate is the systematic reduction of a debt through payments toward the principal. Whenever a periodic debt payment exceeds the interest requirement, the excess reduces (or *amortizes*) the principal balance.

In accounting, amortization is the periodic write-down of an intangible asset over time, which may be its estimated useful life or another period, based on tax or accounting regulation.

AUDIT

To an accountant, *audit* means a test of the fairness of presentation (validity and accuracy) of financial statements. Taxpayers, however, may dread the audit that is an investigation to validate their compliance with tax laws, frequently concerning reported taxable income.

For real estate owners, an audit may be a test to determine the validity of the rent rolls or of tenant lease terms. It could be an effort to determine the accuracy of expense pass-throughs to commercial tenants or whether sales reports comply with overage rent requirements.

CAPITALIZATION

In real estate and economics, capitalization is a process of valuation of an income stream whereby the expected future income is converted into one lump-sum capital value.

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In accounting, capitalization is establishing an asset on a balance sheet. To qualify as capital rather than an expense, an acquisition must cost over a certain threshold amount set by corporate policy at, say, $1,000 to avoid cluttering the balance sheet with trivial amounts, and the asset must have a useful life of more than one year.

The cost of repair to a roof or a parking lot may be expensed or capitalized in financial accounting statements depending on the amount and whether the repair will extend the useful life of the asset.

CASH EQUIVALENT

The financing of real estate, whether good or bad, is likely to influence the price paid. The *cash equivalent* is the result of converting the amount paid for real estate that comes with debt to an amount equal to what would be paid for the same property in cash. Land bought with below-market-rate seller financing may have a higher selling price associated with the sale than if it had been bought with cash. The process of cash equivalence then reduces the face value of the debt and the face selling price of the real estate to what it would have been in an all-cash transaction.

In financial statements, cash equivalents include corporate investments that are virtually the same as cash in value and liquidity. Treasury bills (which mature in a year or sooner) may be shown as an asset in an account called "Cash or Cash Equivalents."

COST

Generally, *cost* is the amount historically paid for an asset that was acquired.

Original cost in real estate is the amount the very first purchaser paid. *Historical cost* is the amount paid by the current owner. *Trended cost* is original or historical cost increased (or decreased) by changes in the price over time for that type of property. *Reproduction cost new* is the

current cost of a replica, while *replacement cost new* is the current cost to acquire an asset with equivalent function, built to modern standards.

For accounting purposes, *cost* is the initial amount paid, including freight and installation. *Replacement cost* is the amount required to purchase the same asset, in its current age and condition, in the market.

DEPRECIATION

In economics, *depreciation* is a loss in market value from all sources. In most real estate situations, depreciation is a reduction from reproduction or replacement cost new in appraisal, having three possible sources: physical, functional and external (also called environmental or economic).

Depreciation expense for accounting purposes is generally original cost spread over useful life. The method applied may be straight-line (equal each period) or accelerated (more in early years). This is a method of allocation, not valuation. Should depreciation accounting approximate the economic loss in value over time, it is likely to be due largely to a knowledgeable selection of life and method from experience, or to coincidence.

For regulated utilities, the historical cost of prudent investments is accepted in the rate base, and depreciation is generally applied based on that amount, spread over its estimated useful life allowed by regulation.

Depreciation allowed for income tax purposes is based on tables with lives for different types of assets, as stated in tax law. Tax lives allowed for buildings have ranged widely, from as little as 15 years for assets acquired in 1981–1984 to the current 27.5 years for apartments and 39 or 40 years for commercial property.

EXTRAORDINARY ASSUMPTION

In real estate appraisal, an *extraordinary assumption* is an assumption directly related to a specific assignment, as of the effective date of the assignment results, which, if found to be false, could alter the appraiser's opinions or conclusions. It is a term of art describing an appraiser's presumption as fact otherwise uncertain information about physical, legal, or economic characteristics of the subject property; or about conditions external to the property, such as market conditions or trends; or about the integrity of data used in an analysis.

Since the dictionary definition of *extraordinary* will be something like "going beyond what is usual, regular or customary," it may appear that an extraordinary assumption is one that is unwarranted or indefensible, and the appraiser's explanation may fall on deaf ears when provided to an attorney who wishes to discredit the appraisal in litigation.

FAIR VALUE

After numerous modifications, the Financial Accounting Standards Board (FASB) developed Accounting Standards Codification Topic 820 (ASC 820), previously FAS 157, to explain the accounting application of concepts related to value.

ASC 820 embraces many of the same concepts of market value that real estate appraisers use for financial institution appraisals. However, there are many nuances of ASC 820 that distinguish *fair value* measurement from the *market value* used by real estate appraisers.

LOWER OF COST OR MARKET

This is an accounting concept applied by CPAs to assets, carefully applied to inventory, but the term also has been embraced by business appraisers, with different meanings.

In accounting, "cost" is the amount in the company's records based on the cost paid plus freight-in and installation. For inventory, costs of purchases may be kept as first-in-first-out (FIFO), last-in-first-out (LIFO), average cost, moving average cost, and retail method. "Market" is the amount required to currently acquire the same products from suppliers.

In one appraisal meaning of "lower of cost or market," "cost" is the amount that must be paid to replace or reproduce the product. "Market" is the amount a willing buyer and willing seller (presuming the current owner would sell) would agree upon for the sale of that product.

DR. SEUSS CONCLUDES

Horton said, "I meant what I said, and I said what I meant." But do listeners hear what Horton said, or understand it as it was intended? Or do they hear something different, based on their different understanding of the words?

When the definition of a term is crucial to the execution of a transaction, it is often important to determine the writer's or speaker's understanding of a term, to be assured that the listener or reader is on the same page. It is particularly important when real estate appraisers or consultants are dealing with other professionals having their own technical vocabularies that use the same words with different meanings. ■