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Accounting For Property Lease Incentives

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Lease incentives are negotiated into many commercial property leases as an incentive for the tenant to sign a long-term lease.

Free rent, cash for moving expenses, renovations, video conferencing equipment, and elaborate conference rooms help close deals.

Such incentives require specific accounting treatment under Accounting Principles Generally Accepted in the United States (U.S.GAAP).

They generally include a rent-free period, a reduced rent period, or cash payments from the landlord to cover specific costs.

Lease agreements with a rent-free period or a reduced rent period are required to have the rent expense to a tenant or rental income to a landlord be recognized on a straight-line basis over the lease term based on the total rental payments. Therefore, even in rent-free months, rent expense and income would still be recorded. Deferred asset or liability accounts would be adjusted to achieve the straight-line rent expense or rental income.

Lease incentive payments are usually provided in one of two ways:

The landlord directly pays for various improvements to the property (or for equipment, fixtures or whatever the tenant is demanding) for an agreed upon amount or The landlord pays the tenant an agreed upon amount and the tenant purchases the improvements (or equipment, fixtures and similar).

For both payment methods discussed above, U.S. GAAP requires the tenant to record the incentives at gross value on their balance sheet. Thus, the cost of the improvements will be recorded in fixed assets and be depreciated over the shorter of the estimated useful life of the improvements or the life of the lease.

The other side of the entry is to record a liability for the deferred rent benefit that will decrease rent expense over the life of the lease.

The landlord records the cost of these incentives as an asset for the deferred lease cost that will be expensed over the life of the lease as a reduction of rental income.

Many times these incentives evade the required accounting treatment by getting lost in the books and records.

The tenant may receive incentive money that gets offset against the payments for improvements. If the landlord makes all the payments, the tenant won't have a transaction to show for this.

The landlord may just book a tenant fit-up for the costs and forget what is required. Having these lease incentives buried towards the back of a 60 page lease agreement also doesn't help make them obvious for accounting purposes.

The authors of U.S. GAAP believe this accounting treatment better reflects the true economic reality of property lease incentives. To prepare financial statements in accordance with U.S. GAAP, we have to abide by these rules.

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