CommercialEdge

Managing the Financial Complexities of CRE Brokerage Commissions

How to Optimize Revenue and Commission Operations

INTRODUCTION

KEY TOPICS EXPLORED IN THIS GUIDE

- Overview of Cash vs. Accrual Accounting
  - Specifics for Brokerages
- Commission Split Plans
  - Commission Processing
  - Managing Complexities of Commission Distributions
  - Timing of Distribution Calculations
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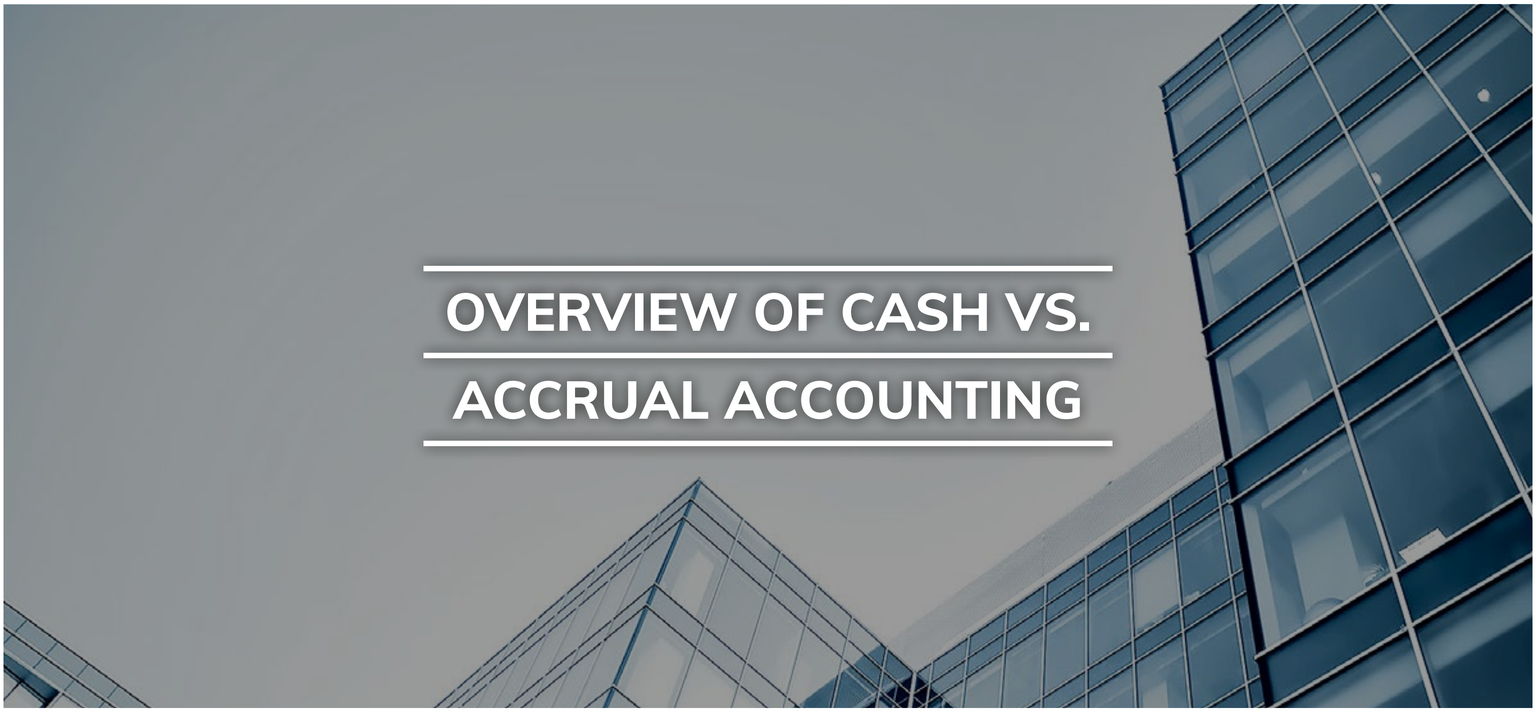
- Navigating Options for Your Business
- How Commission Management Software Helps

Commission management in CRE brokerages is a complex accounting process that typically involves many steps. To manage such a process well, there are several key aspects to consider, such as:

- The accounting method used (cash or accrual)
- The relationships between brokers/agents and the house
- The timing of how commissions are invoiced and received
- The timing of distribution calculations and payments to agents

Managing this process accurately and keeping detailed accounting records is crucial not just for staying compliant with tax regulations and monitoring a company's financial performance, but also for providing transparency to the agents. A critical aspect of the entire commissions process is the accounting method used, as it drives the timing of many steps in the process.

This guide explores all of these commission-related factors in more detail and provides examples and best practices around how to effectively manage the commission process.



OVERVIEW OF CASH VS. ACCRUAL ACCOUNTING

Cash

Cash accounting focuses on a company's cash flow, with revenue recorded when cash is received, and expenses recorded when they are actually paid. Also known as cash receipts and disbursements, this method eliminates the need to track accounts payable or accounts receivable and is a suitable approach for sole proprietors and small businesses.

Cash-basis accounting is a straightforward method that helps determine when and how quickly bills get paid based on the available cash on hand. This approach, however, makes it challenging to accurately assess the current financial health of a business.

Accrual

Accrual accounting is used to track and record revenues that have been earned but not received, or expenses that have been incurred but not paid. This approach follows the matching principle, meaning that revenues and expenses should be recognized in the same period. Accrual accounting provides a real-time and accurate view of a company's financial status by tracking accounts payable and accounts receivable.

This method is often preferred by investors, lenders and financial institutions as it is easier to analyze businesses using standardized GAAP financial statements. All public companies and businesses with an average revenue of $25 million or more over three years are required to use accrual accounting.

SPECIFICS FOR BROKERAGES

Cash basis accounting

In cases where one transaction has multiple receivables/invoices associated with it, the cash accounting method is straightforward because the journal entries are done at the time of payment - when cash is received.

Accrual basis accounting

The accrual accounting method for this scenario is more elaborate. Certain brokerages will record journal entries for income and expenses at the time of the deal being done, while others will record the journal entries when they send out each invoice. This typically happens because there is a certain contingency that must be met before the receivable is due to the broker or brokerage. For example, when the tenant takes possession of the space or the tenant makes the first rent payment.

The accrual method requires the simultaneous recording of the revenue and the related expenses. Specifically, the total commission amount to be received and the commissions owed to the broker or brokers who closed the transaction must be recorded at the same time, as each invoice represents money that the brokerage will receive and retain a share of, while another share will be immediately distributed to agents.

Note

If only income were accrued, the income statement would overstate net revenue because the related commission expense going to agents would be missing.

COMMISSION SPLIT PLANS

Brokers on both sides of the deal split the commission and each broker then splits the commission with any of their agents involved in the transaction. Consequently, agents receive their commissions from the broker or brokerage house rather than their client, as all commissions flow through the house. While there are many different types of split plans, the most common structures are flat rate plans and tiered split plans.

Flat rate plans are commission structures where the house and each agent split a predetermined percentage of the agent's gross. These splits are widely used in the brokerage industry because they are simple to calculate and forecast.

Tiered split plans are commission structures that allow brokers to keep an increasing amount of their gross commission throughout the year, provided their productivity rises during this time.

Commission Processing

There are many intricacies to consider when processing commissions for commercial real estate transactions. There may be variations in commissions due to the type of transaction, such as a lease, sale or fee. Brokers will also have their own way of structuring commissions that may vary from region to region. Ultimately, there are many factors that impact how commissions are structured and processed.

- One scenario is who's responsible for paying whom. On some transactions, the landlord may be responsible for paying both their leasing broker and the tenant rep broker. In other scenarios, the landlord pays the leasing broker and then the leasing broker is responsible for distributions to their agents, managers and tenant reps.
- In calculating commission distributions to agents, any pre-split deductions need to be accounted for and are usually taken off the top before calculating agent commissions. Some examples of pre-split deductions include house fees, bonus pools, admin bonuses or marketing fees.
- Brokers who manage a team of agents may receive a manager override on commissions. When agents on the manager's team make a sale, the manager may receive a percent commission as well. This percentage may come from the house's portion of the commission, "off the top" of the deal or in some other capacity.

MANAGING COMPLEXITIES OF COMMISSION DISTRIBUTIONS

A brokerage house may run into several complexities when processing their commission distributions. Complexities may be due to several factors including crossing split plan tiers, applying agent expenses and entering adjustments.

- Brokerages with tiered agent split plans must pay attention to when agents cross tiers. The order in which deals are executed and then entered can impact how much an agent is paid. This may make the difference between an agent crossing into a new tier and receiving a higher commission payment or remaining in a lower tier.
- A brokerage tracking their agent's draws and expenses will apply the commission distribution against their agent's expenses. When a brokerage processes its distribution, they may elect to apply the total amount of agent expenses against the agent's commission or they may elect to apply a predefined amount, but not all outstanding amounts, against agent expenses.
- If a mistake has been made when processing commissions, it may be challenging to unravel and then enter the appropriate adjusting journal entries. This requires first determining where the mistake was made and the impact on distributions that have been processed. Then the adjusting journal entries must be entered to correct the issue.

Note
For a detailed account of commission split plan types, read our blog post
[5 Effective Commission Split Plans for Commercial Real Estate Brokerages to Consider]

TIMING OF DISTRIBUTION CALCULATIONS

The brokerage house runs distribution calculations of split plans to effectively determine how much the house is going to keep and how much the agent/broker(s) on the deal will receive. Depending on the accounting method the brokerage uses, these calculations occur at predetermined points in the accounting process.

Cash Distributions

- The brokerage runs the distribution calculations to determine the house net and agent(s) net at the time the invoice was paid and the cash was received.
- This works well for organizations that use cash basis accounting because the expense liability (agent net) does not need to be known until the cash is received.

Accrual Distributions

Invoice aligned accrual distributions

The brokerage uses this process to calculate the house net and agent(s) net at the time of sending the invoice and/or accruing income/expense liabilities.

- If the accounting organization uses the accrual method, some brokerages would "accrue" at the time of deal completion or when each invoice is sent. This means that the organization calculates the splits between the house and the agent(s) on the transaction before the deal is completed or each invoice is sent. That way, when the money arrives, the organization already knows what everyone will receive.
- This works well for organizations that use the accrual accounting method, because when they accrue income, they should also accrue the related expenses associated with the portion of the commissions going to the agent(s) who closed the deal.

Cash aligned accrual distributions

This procedure refers to a brokerage that uses accrual accounting and wants to determine commission distributions at the time that cash is received. When performed in the absence of a commission tracking application, this process has by far the most administrative overhead in terms of time and quality assurance.

- If the agents are on tiered plans, the brokerage is required to estimate the commissions that the agents will be due. This is necessary because the organization will need to record the income and the associated agent commission expense before the cash comes in, but the final calculations will be made when the cash is received.
- The calculations must be performed when the money is received, and any discrepancies between the estimated commission and the actual commission calculations will require relevant journal entries.

COMPLYING WITH ASC 606

The primary distinctions between cash and accrual accounting are based on three factors: timing, complexity and responsibility. There is a balance in choosing between cash and accrual accounting for companies that are not required to be on an accrual method.

Cash basis accounting is considerably easier to manage, which is an aspect that may be important for smaller organizations. Although it is simpler to use, the cash basis approach can rarely provide a complete picture of a company's financial health.

The accrual method, on the other hand, requires a more thorough approach. While accrual basis accounting requires more work, it produces a more accurate picture of a company's financial health by recording revenue as it is earned and expenses as they are incurred.

ASC 606 is the revenue recognition standard that applies to all businesses - public, private and non profit - that enter into contracts with customers to transfer goods or services. This standard requires businesses to recognize revenue when promised goods or services are delivered to the customer and the total consideration an entity anticipates receiving in exchange for the goods or services should match the amount of revenue recognized.

NAVIGATING OPTIONS FOR YOUR BUSINESS

Since larger organizations must comply with GAAP, these principles require using the accrual accounting method. Moreover, companies that must observe an accrual method must also adhere to ASC 606 requirements. In order to have an accurate image of their financial status, brokerages must avoid scenarios when only revenue is accrued — and liabilities aren't — as this leads to overstating net income. When net income is overstated, financial budgeting and forecasting is quite a challenge.

For full-service real estate companies, in addition to all the above, having consolidated financials is essential when working with different accounting and commission-tracking systems. If brokerage accounting is being done in a silo, the organization might be able to run open accounts receivables and see property management receivables, but not be able to see brokerage receivables.

While these processes can be time- and resource-intensive, organizations can optimize them by implementing solutions that streamline operations. Such tools can automate accounting and commission workflows, and at the same time, synchronize accounting and property management systems, providing a consolidated financial image integral to operational efficiency.

How Commission Management Software Helps

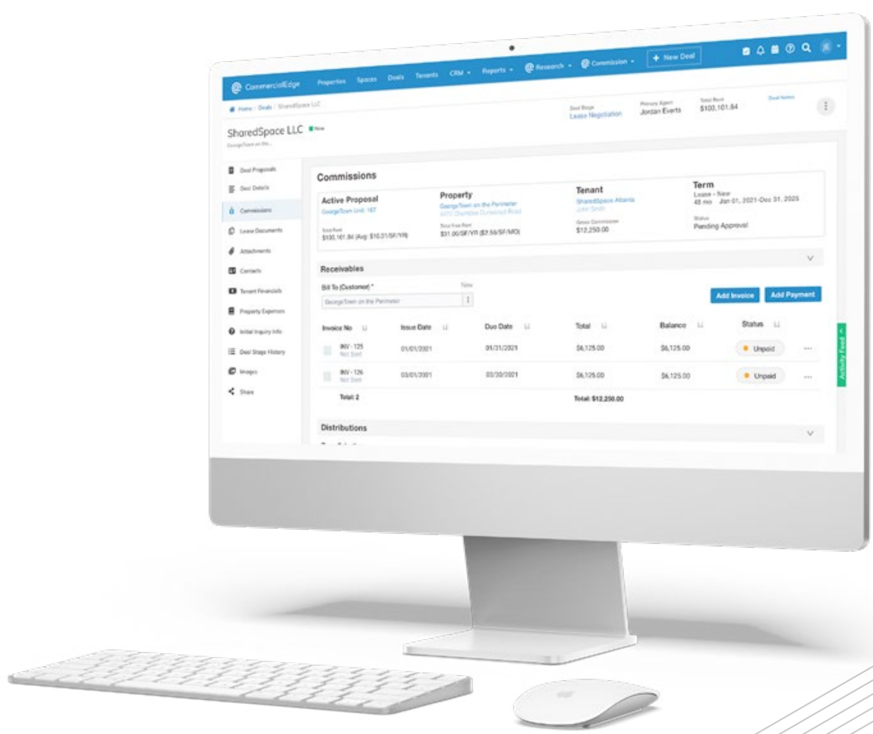
An intuitive commission management platform connects agents, operations, admins and accounting processes by centralizing all deal data, documents, invoice dates and commission splits. What's more, such software tracks invoices, monitors due dates and automates back-office operations, including the most complex commission distributions.

A complete commission and back-office solution for brokerages and leasing teams streamlines operations, enhances collaboration between brokers and back-office teams and boosts revenue with automated workflows powered by real-time business analytics.

CommercialEdge

- COMMISSIONS -

Simplify your commission process, scrap the spreadsheets and increase transparency with a solution that enables secure, automated commission payments and customizable workflows.



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