Guest Column: George Salden (10)

SERIES: The German Real Estate Market: if you want good returns, you must understand financial statements

In past articles we have mostly taken an in-depth look at the three major phases of investing in Germany and cases of individual properties in terms of making an investment, raising an investment's value and exiting an investment. These three steps in the Dynamic Method will now be combined on one level: financial statements as prescribed by law in Germany. Why? Because this is an excellent basis for checking investments in properties or companies that do business on the property market. A glimpse at the German characteristics of annual financial statements is also worth while for anyone who works on the international property investment market and views Germany as very attractive for good business.

The most important parts of the financial statements for an individual company in Germany are the balance sheet, the income statement and the description of the methodological procedure applied in the preparation of the annual financial statements. At corporations, the cash flow statement, the statement of shareholders' equity and, possibly, segment reporting are also required.

Since financial statements in Germany must be prepared for financial regulators and shareholders anyway, it is very sensible to use them to determine the current and future success of a company and to recognise the opportunities for an improvement in returns. In order to do this, we will examine the structure of the balance sheet, the income statement and the cash flow statement here. In the following article we will discuss the analytical tools that are available for an analysis of balance sheets since they play a critical role in determining the investment strategies and the risk-reward profile of an investment.

The German government, creditors and potential shareholders have an interest in the key performance indicators on the financial statements. The size of the company in Germany determines the parts of financial statements that are required and the extent to which they have to be published – the larger the company, the stricter the requirements. However, the bookkeeping may comply with different accounting norms. The German Commercial Code [Handelsgesetzbuch] and the International Financial Reporting Standards [IFRS] are very popular in Germany. We want to concentrate on the German Commercial Code here. In this regard it is important to know that Germany has not only statutory provisions that the annual financial statements must comply with, but also customary standard accounting principles that need to be followed. The standard accounting principles are in part unwritten principles that are derived from practise in case law and recommendations made by economic associations. The most important principles of proper accounting are:

- the principle of clarity and transparency,
- the principle of balance sheet identity,
- the cost accounting principle,
- the going concern principle,
- the principle of individual valuation and
- the principle of caution.

Every businessman – also in the property investment market – is required to prepare financial statements in Germany. The most important documents prepared to satisfy this requirement are, as described above, the balance sheet and the income statement. Similar to double-entry accounting, they show the economic position of a company from two perspectives. In contrast to the balance sheet, which determines the value at a certain point in time, the income statement gives insight into the expenses and income in a financial year. The balance of these two has a direct impact on the company's equity. The German Commercial Code requires the report form [Staffelform] as the structure for the income statement, which is advantageous as it shows the individual components of the company's profits and losses.

In the report form [Staffelform], companies have the option of choosing between the cost of sales method and the total cost type of expenditure method. The total cost type of expenditure method juxtaposes all income from a period to all expenses by types of expense such as cost of materials, personnel expenses or depreciation and amortisation. By contrast, the cost of sales method shows the expenses divided by functional areas, for example, expenses for production, administration or sales, in relation to sales revenue. Here we will limit ourselves to the total cost type of expenditure method, which is more complete and popular in Germany. The eight positions in this method are defined by law in Germany:

• total output
• operating expenses
• operating profit/loss
• income and expenses in finance
• profit/loss from ordinary operating activities
• extraordinary income and expenses
• tax expenses
• net profit/loss for the year

Sales revenue is a major part of the total output of property funds, real estate investment trusts and other actors in the property market, and is generated primarily by income from:

• property investments
• direct investments
• net rental proceeds
• the sale of properties
• the investment of liquidity

The company's total output must then be reduced by the operating expenses so that the operating profit/loss can be determined. In Germany, changes in market value that are caused by cyclical fluctuations in the value of property are also included in the income statement here. However, this only applies if they have been recognised in a sale or, if the property has not been sold, in light of the lower of cost or market principle under the German Commercial Code, which provides the guidelines for the subsequent measurement of property on the balance sheet. Positive changes in value for properties that are in the company's portfolio may not be reported. If the income is netted with expenses, the operating profit is calculated. In order to calculate the gain/loss on financial investments, the income from equity investments, securities, currency transactions or interest income, extraordinary income and expenses as well as tax expenses must be taken into account. The net profit/loss for the year is then determined.

Besides the income statement, the balance sheet is the most important part of the financial statements prepared in accordance with the German Commercial Code. In Germany, it must be prepared in account form since it is divided in two: assets on one side, and liabilities and equity on the other. We will address the most important key performance indicators on the balance sheet of companies that make property investments in the next article.

In Germany, the third and very important part of the annual financial statements consists of the so-called "Notes to the financial statements". The notes explain the methodological procedure for the preparation of the balance sheet and the income statements and make both more understandable. The notes to the financial statements also contain information about the use of debt, the conversion factors in currency transactions as well as information about the applied accounting and valuation principles. In addition to the obligatory information from the German Commercial Code, voluntary information can also be provided. Notes to the financial statements are also only required by law for corporations. In consolidated financial statements, the preparation of a cash flow statement is also required in addition to the income statement and the balance sheet. Since the cash flow statement is also of interest for the investor, we will take a brief look at this part of the consolidated financial statements in the following.

In the consolidated financial statements, a cash flow statement is obligatory. The cash flow statement shows the company's use of the cash and cash equivalents. Cash flows that are listed in the cash flow statement are broken down into three areas:

• cash flows from ongoing operating activity,
• cash flows from ongoing investment activity,
• cash flows from ongoing financing activity,

In the preparation of a cash flow statement, it is important to know that transactions are only included if they are actually connected with payments. Therefore, for example, depreciation and amortisation are not included in the calculation of the cash flows. Although there is no prescribed template for the preparation of a cash flow statement in accordance with the German Commercial Code, there is a minimum breakdown for the cash flow statement that has been issued by the German Standardisation Council in standard "DRS 2" [German Accounting Standard 2].

George Salden is the author of the book "Die Dynamische Methode" [The Dynamic Method] based on his 19 years of experience as an expert and manager in property and transaction management which highlights the way towards a whole new method of determining the profitability of properties. He was previously a director at alt+kelber Immobilienmanagement, a subsidiary of conwert Immobilien Invest SE, where he was responsible for major international transactions. He then took over as International Head of M&A at AK Holding GmbH & Co. KG. He is now Head of Transaction/ Executive Board Member at Dr. Lübke & Kelber / Arbireo.