International Financial Reporting Standards in Real Estate

Explaining the intricacies of IFRS.

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ON NOVEMBER 14, 2008, the SEC issued its long-awaited proposed International Financial Reporting Standards (IFRS) "roadmap" outlining milestones that, if achieved, could lead to mandatory transition to IFRS by U.S. issuers starting in fiscal years ending on or after December 15, 2014. The roadmap also contains proposed rule changes that would give certain U.S. issuers the early option to use IFRS in financial statements for fiscal years ending on or after December 15, 2009.

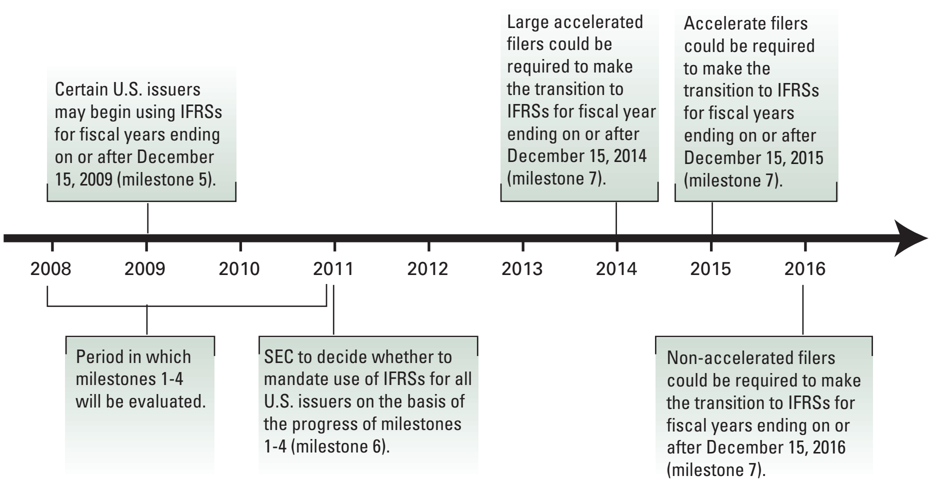
According to the SEC, "the use of a single, widely accepted set of high-quality accounting standards would benefit both the global capital markets and U.S.

investors by providing a common basis for investors, issuers and others to evaluate investment opportunities and prospects in different jurisdictions." The SEC also notes that IFRS has the potential "to best provide the common platform on which companies can report and investors can compare financial information."

A number of characteristics of the real estate industry make it a prime candidate for early conversion to IFRS. Major REITs, real estate private equity firms, owners and operators, and corporate real estate divisions often have operations and assets that span several countries and continents. Accounting and financial reporting provides a vital link between real estate companies and their capital providers. In the United States, some real estate entities, such as public REITs, report on a historical cost model under U.S. generally accepted accounting principles (GAAP), while other real estate entities, such as investment companies, and real estate funds owned primarily by institutional investors, such as pension plans, report on a fair value model, also under U.S. GAAP. Real estate investors are looking for more consistency and comparable information in financial reporting from real estate companies, which IFRS can provide.

Recent events suggest that reporting under IFRS will be allowed or required for most public companies in the United States and around the globe within the next few years. The proposed roadmap highlights seven milestones. Milestones 1 through 4 discuss issues that need to be addressed before mandatory adoption of IFRS and Milestones 5 through 7 discuss the transition plan for the mandatory use of IFRS.

Figure 1: SEC's proposed roadmap—Timeline for adoption of IFRS by U.S. issuers



Under the proposed roadmap (Figure 1), U.S. issuers that meet both of the following criteria would be eligible to use IFRS in financial statements for fiscal years ending on or after December 15, 2009. First, the U.S. issuer must be globally among the 20 largest listed companies worldwide in its industry, as measured by market capitalization. Second, IFRS, as issued by the International Accounting Standards Board (IASB), must be used as the basis for financial reporting more often than any other basis of accounting by the 20 largest listed companies worldwide in the U.S. issuer's industry, as measured by market capitalization.

U.S. issuers electing to file IFRS financial statements with the SEC would be required first to do so in an annual report and would not be able to file IFRS financial statements with the SEC for the first time in a quarterly report, registration statement, or proxy or information statement. The American Institute of Certified Public Accountants (AICPA) has not yet provided its roadmap or guidance for IFRS adoption for non-public companies, but has expressed its support for the SEC's proposed roadmap and timeline.

The SEC's proposed timeline does not provide a lot of breathing room. A conversion effort that is both sane and successful will require a lengthy runway. In mid-2008, the AICPA announced that it considered a three-to-five-year timeline to be reasonable for transition to IFRS.

CHALLENGES AND OPPORTUNITIES

An IFRS conversion is not primarily an exercise in reshuffling the chart of accounts, nor is it principally a technical accounting and financial reporting matter. In fact, companies are likely to spend significant amounts of time addressing concerns regarding tax, valuation, treasury, legal, people, technology, and communications. Clearly, a great deal of work lies ahead. Yet, despite these challenges, the benefits of reporting under IFRS may outweigh the costs.

Companies with global operations or properties usually grapple with numerous statutory reporting requirements under different accounting standards in each country. In such cases, there are significant benefits that can be gained from transitioning the financial reporting of all global subsidiaries and affiliates to IFRS—including potential for reduced lead time in preparing consolidated financial statements, reduced consolidation issues, improved internal controls, reduced personnel costs, and a centralized approach to addressing statutory reporting issues. Transitioning to a uniform set of standards carries the possibility of enhancing shareholder value.

Conversion provides a fresh look at current practices. If the financial close process includes reconciling multiple accounting standards and dealing with a variety of sub-ledgers, manual adjustments, data hand-offs, and accounting overrides, IFRS adoption provides an opportunity for a fresh look at these processes and elimination of steps required to close the books.

Conversion can be a catalyst for streamlining and consolidation. As a company expands through growth and acquisitions, information technology systems may become increasingly convoluted. Many companies operate a patchwork of legacy accounting and enterprise resource planning systems across geographies and business units, leading to error-prone adjustments and reconciliations. Moving to IFRS provides a chance to streamline and consolidate these disparate systems.

IFRS offers an opportunity to use principles-based accounting. Many finance professionals have become increasingly frustrated with U.S. GAAPs and its voluminous rules for dealing with accounting issues. For a decade or more, many CFOs and other finance executives have openly pined for principles-based accounting to help clarify and improve the reliability of financial reporting. IFRS answers that wish.

IFRS helps open the doors of the global marketplace. Adopting IFRS may improve access to foreign capital markets by giving foreign investors greater insight into a company's financial performance. Such investors may be more comfortable with, or have more confidence in, a globally accepted set of accounting standards. Companies themselves can also benefit from an improved ability to benchmark with peers and competitors.

THE IMPLEMENTATION PLAN

Development of an IFRS implementation plan is an important first step. Through this effort, companies can chart an optimal course, determine the pace of the conversion process, and possibly skirt some detours and potholes.

To start, consider gathering answers to a few preliminary questions: Have current IFRS reporting requirements, if any, been inventoried? How many local generally accepted accounting principles does the company currently report under? How many business units already prepare IFRS financial statements? How might access to capital be affected by an IFRS conversion? How many competitors have converted? Is there an expectation that they would switch to IFRS, if given the choice, in the United States? Is there a major enterprise resource planning or finance transformation project in the works? Is the company involved in, or considering, a major acquisition? What is the level of IFRS knowledge within the company, both domestically and globally? What would be the effect of a possible IFRS requirement in the United States on the company? What are the costs and benefits of adopting IFRS?

Given the far-reaching scope of IFRS, the process may assess the potential impact on each department in the organization, including finance, human resources, tax, legal, information technology, and investor relations. Other stakeholders may also be involved, including the board, audit committee, shareholders, and external auditor.

By estimating costs, benefits, and timing up front, management can avoid the rushed approach, and unnecessary expense, that sometimes characterized initiatives such as the Sarbanes-Oxley Act and the Year 2000 efforts. A carefully designed roadmap will likely empower a company to convert on its own terms. By taking a measured and informed approach, management improves the likelihood of identifying value in an exercise that otherwise may be reactive and solely compliance-driven. The value may show itself in the form of reduced costs of implementation, standardization and centralization of statutory reporting activities, enhanced controls over recording of operations of foreign subsidiaries and affiliates, greater standardization of accounting policy application, faster close processes, and possibly core finance transformation.

THE EUROPEAN EXPERIENCE

In July 2002, the European Parliament passed legislation requiring listed companies to convert to IFRS by 2005. The short timeframe and extensive reach of the directive had many companies scrambling to comply and placed significant resource pressure—human and financial—on finance teams and their companies.

A tangible measurement of the effort can be found by comparing European companies' 2004 local GAAP and 2005 IFRS financial statements. The latter averaged more than 50 percent more voluminous than the former; in some instances, reports doubled in length. Much of the increase can be attributed to an increased level of IFRS disclosure requirements in the financial statements in areas such as judgments made and assumptions used. Certain accounting issues proved especially vexing during the transition, including asset impairments, financial instruments, lease accounting, and componentization.

There are many lessons learned from the European experience. First, the effort was often underestimated. The original perception that conversion was solely an accounting issue was replaced with a growing realization that the initiative was much broader, larger, and more complex. And conversion projects often lacked a holistic approach because companies took such a limited view of the conversion process. Companies frequently did not take the collateral effects into consideration, such as the impacts on information technology, human resources, and tax.

A late start often resulted in an escalation of costs. Those few companies that anticipated conversion and took steps to prepare for it were in much better shape than those that did not. Companies that delayed their response paid a price for it, in terms of higher costs and greater diversion of resources.

Many companies did not achieve a "business as usual" state for IFRS reporting. The highest quality financial data and most efficient processes are obtained when a company fully integrates IFRS into its systems and processes. The compressed timeframes precluded this possibility; instead, first-year financials, and in some cases ongoing financial reporting, were often produced using extraordinary, labor-intensive, and unsustainable measures.

Several European companies are only now starting to attain benefits from IFRS implementation. Due to multiple constraints, the first-year effort in the EU was focused more on "getting it done." Potential benefits in terms of reducing complexity, increasing efficiency, decreasing costs, and improving transparency had to be deferred.

MORE THAN ACCOUNTING AND FINANCIAL REPORTING

The impact of IFRS on the general ledger and the financials can be substantial, but in a relative sense, the accounting may be the easy part. How the non-financial aspects of the conversion are handled may be a more accurate indicator of success. Among the areas warranting attention are human resources, legal, mergers and acquisitions, valuation, tax, treasury, and information technology.

With respect to human resources, IFRS will likely influence hiring, training, compensation, and termination practices. Consider hiring. How many finance staff are currently versed in IFRS? If that information isn't available, consider adding a personnel inventory to the IFRS work plan. Assuming a talent shortfall, the gap will need to be closed. Most U.S. college-level accounting programs are only now getting their IFRS curriculum established. If a company cannot recruit in sufficient numbers, it should consider training existing staff.

Compensation is another area for review. Some real estate companies pay commissions or bonuses based on sales or rental revenue. But revenue recognition rules differ between IFRS and U.S. GAAP, meaning that sales or rental revenues under one standard might be treated differently under the other. Also, some incentive-driven compensation may be based on net asset value, which may differ between U.S. GAAP and IFRS. Additionally, many real estate companies calculate bonuses for top executives based on profits or metrics relevant under U.S. GAAP, such as funds from operations. In many cases, reporting under IFRS will change that bottom line. Funds from operations is a measurement that lacks relevance under IFRS. Executive compensation plan revisions may be required to smooth out the differences.

For mergers and acquisitions, implementation of a single set of accounting standards for all properties, subsidiaries, and joint ventures around the world will allow for streamlined integration of new acquisitions into a company's consolidated financial reporting system. Also, the transparency resulting from fair value reporting of investment properties may affect strategic business decisions around acquisitions and dispositions based on their likely impact on financial statements under IFRS.

From a tax perspective, adoption of IFRS may also result in changes in profit recognition and ultimately pre-tax income. These changes will likely require evaluating their impact on the deferred taxes recorded, the timing of reversals of deferred items, and valuation allowances. It is important to acknowledge these changes and understand that the book revenue/expense recognition policies may all need to be reviewed to get them right. As certain foreign jurisdictions require taxes to be paid based on earnings reported in the financial statements, the changes to net earnings due to an IFRS adoption may result in significant fluctuations—increases or decreases—in the foreign taxes owed. This is an area that management would be expected to carefully evaluate as an IFRS adoption is considered. Additionally, the many changes to the financial reporting of assets, liabilities, profits, and losses may result in significant impacts on compliance with regulatory requirements—particularly for REITs.

Measurements of fair value weave their way through IFRS, including accounting for acquisitions, investment property reporting, and accounting for financial instruments. Estimating, supporting, documenting, and reporting fair-value requires a thoughtful process and the allocation of appropriate resources to manage this important aspect of IFRS. Several areas related to fair value estimates may be considered, including the use of qualified specialists; the determination of proper extent and frequency; careful scoping of the analysis and report; and the development of a detailed policy or standard. Fair-value disclosures in financial statements will likely vary in detail; however, they should include information on valuation methods, assumptions, qualification of the valuation specialist, and explanations of fair-value conclusions.

Moving to a global financial reporting model may open up access to new sources of capital. Many global lenders, global private-equity firms, and international exchanges require or prefer IFRS reporting due, in part, to its increased transparency into fair values and comparability to other investments or companies. Thus, these sources potentially become new avenues for capital funding, particularly in the current U.S. capital markets environment. Note, however, that greater use of fair value of underlying investment properties may create more volatility in a company's access to capital. That is, not only can reporting under IFRS potentially open up access to additional capital in a favorable fair-value environment, but it can also serve to limit the availability of additional capital in an unfavorable fair-value environment. Furthermore, with reporting or disclosure of the fair values of investment properties, management will likely need to understand, evaluate, and manage the expected market reactions to reported volatility in property values. This will represent new territory for most U.S. real estate companies.

Expansive real estate holdings equal extensive information technology (IT) needs. From leasing data to depreciation schedules to tax recordkeeping to recording the fair value of investment properties, there's plenty of financial information for real estate companies to track. The merits of a single consolidated system to do this are well known but, unfortunately, not widely practiced. Rather, a patchwork of legacy systems, homegrown programs, stand-alone machines, and inherited equipment often predominates. Constantly changing portfolios complicate an already far-from-simple picture. In sum, it's a situation calling out for remedy. Fortunately, real estate companies have heard the call. Many of the industry's largest players are currently planning or engaged in major IT initiatives, consolidating disparate systems down to a single platform. The benefits in terms of efficiency, productivity, security, and compliance are potentially enormous to companies within the industry. However, much of the work may be for naught if IFRS is not factored into the upgrade. Any initiative of such magnitude should not only accommodate present needs, but must be able to seamlessly handle future needs.

The latest versions of many enterprise resource planning systems have IFRS capabilities, but adopting them is not akin to flipping a switch. If IFRS conversion isn't planned for at the earliest stages of the upgrade, companies may end up engaged in a lengthy and expensive reconfiguration effort a few years down the road. Even if a major IT overhaul is not in the works, a change in accounting standards will likely require modifications to financial reporting systems to accommodate information not currently required under U.S. GAAP. It may also be necessary to modify or rework certain business process IT systems, particularly those that are relied upon to accumulate data and feed into the accounting and financial systems.

GAAP AND IFRS

U.S. GAAP and IFRS differ in key ways, including their fundamental premise. Overall, U.S. GAAP is rules-based, whereas IFRS is principles-based. Under U.S. GAAP, voluminous guidance attempts to address every conceivable accounting problem that might arise. And if that guidance doesn't exist, it is created. Although IFRS is not without its rules, American accountants will have less interpretive guidance to use under IFRS and consequently will be required to use more professional judgment than they are accustomed to.

However, it is not simply the dissimilarity between a rules-based approach and a principles-based approach that accounts for the differences between the two sets of standards. The standards differ on a number of points and can significantly affect a company's financial results. Although the extent of these differences is dwindling as a result of ongoing convergence projects by U.S. and international standards-setting bodies, significant differences remain in areas such as investment properties, property, plant and equipment, leasing, impairment, income taxes, and revenue recognition. Also, as IFRS generally allows for more choices than U.S. GAAP, differences in accounting for similar transactions under IFRS may result. This is particularly evident in the accounting for investment properties under IFRS, which allows the choice of accounting using historical cost or fair value. Given that the principles-based approach and more choices may result in differences in accounting for what appear to be similar transactions, robust disclosures are required to assist in the comparability and transparency of the financial reporting. Table I details some of the more significant accounting and financial reporting differences between IFRS and U.S GAAP impacting real estate companies, and the implications on processes and information technology, as well as some broader considerations and issues related to the differences.

Investment Properties: When real estate companies evaluate a potential IFRS adop-

Table I: Appropriation of divestment proceeds

POTENTIAL DIFFERENCES	POTENTIAL IMPLICATIONS		
	Financial Statements	**Process/IT**	**Other Issues**
Investment Properties	IFRS gives an option to report at either fair value or historical cost with disclosure of fair values.	Increased need for qualified independent or internal valuations; systems modifications to track fair values necessary.	May need to manage external stakeholder reactions to volatility in fair values and debt convenant compliance may be at risk.
Property, Plant and Equipment	IFRS requires componentization approach for significant parts of PP&E; revaluation model optional.	Systems modifications may be necessary to track components and separate depreciation amounts.	Potential difficulty in transition of existing assets to componentization depending on age of assets and detail information available.
Impairment	IFRS has only one-step impairment test based on recoverable amount; IFRS impairment losses may be reversed if recovery occurs.	Changes in impairment analysis and system modifications to track impairments for future reversal.	Increased focus on periodic assessments and possibly increased volatility from more frequent write-downs and reversals.
Leases	IFRS classification criteria contains no bright lines; broader than just land and PP&E	Changes to classification analysis including new data considered.	Pre-EITF 01-8 contracts (not previously evaluated as containing leases under U.S. GAAP) will require evaluation as potential leases under IFRS.
Sale of Real Estate	IFRS considers transfer of risks and rewards model, but without bright lines and little guidance on continuing involvement.	Changes to sale recognition and/or gain recognition evaluation, including increase in professional judgment.	IFRS changes revenue recognition for condominium unit sales and similar transactions.
Sale-leasebacks	Potential for immediate gain recognition for sale-leasebacks that are classified as operating leases.	Changes to evaluation of sale-leaseback transactions and gain recognition.	More sale-leaseback transactions may qualify for removal of the asset from the balance sheet under IFRS.
Joint Ventures	IFRS recording differs for jointly controlled assets and operations vs. jointly controlled entities/ventures.	Systems modifications to manage differing consolidation processes.	Proposed IFRS standard likely to remove proportionate consolidation option; potentially change evaluation of joint assets and operations.
Taxes	No specific guidance related to uncertain tax positions in IFRS; IFRS deferred taxes not required on certain JV's domestic undistributed earnings.	Tax accounts and processes for deferred taxes and uncertain tax liabilities may change.	Foreign taxes in some foreign jurisdictions based on reported earnings may change.

tion, the most significant consideration generally will relate to the accounting policy choice regarding recognition of investment properties, which under IFRS may be reported at either fair value with unrealized gains and losses reported in earnings or at historical cost. The choice to move from the historical cost model under U.S. GAAP to a fair-value model under IFRS may significantly alter the fundamental look and feel of a real estate company's financial statements. Balance sheets will likely align more closely with the true economics of the company's holdings, while income statements will include increased volatility as a result. Even if the fair-value reporting option is not elected under IFRS, the fair values of investment properties must still be disclosed in the footnotes to the financial statements, unless not determinable. The vast majority of European real estate companies chose to report investment properties at fair value.

Property, Plant and Equipment: The main difference between U.S. GAAP and IFRS in accounting for property, plant and equipment used in the business, as opposed to being held for investment and therefore considered investment property, is the requirement under IFRS to separate into components significant parts of real estate and equipment that have different estimated useful lives. That is, each significant part of an asset with a different useful life or depreciation pattern is accounted for and depreciated separately. For example, a newly acquired building would likely not be recorded as a single asset, but rather as several component assets such as a building shell, heating system, and roof. The depreciation of the cost of the building is based on the separate estimated lives for each component, rather than based on a weighted average of the components' lives, which is currently the practice under U.S. GAAP.

Furthermore, IFRS provides companies a choice of accounting for property, plant and equipment under either the historical cost model, which is the required model under U.S. GAAP, or a revaluation model. Although the revaluation model is not widely used under IFRS, it does require companies to re-measure property, plant and equipment at fair value and record the change in value directly to equity. However, under this model, depreciation is recorded from the revalued amount, typically resulting in a higher depreciable basis and higher depreciation expense.

Leases: There are several key differences between IFRS and U.S. GAAP in the area of lease accounting. IFRS lease accounting standards cover a wider range of transactions than under U.S. GAAP. While only property, plant and equipment (land and/or depreciable assets) can be subject to a lease under U.S. GAAP, IFRS covers lease arrangements for all assets, with the exception of certain intangibles. Although many of the lease classification criteria are similar under IFRS and U.S. GAAP, IFRS does not have the bright lines and specific criteria found in U.S. GAAP lease standards. Additionally, the nomenclature of leases under IFRS and U.S. GAAP differs: IFRS has only operating and finance leases, whereas U.S. GAAP has operating, capital, sales-type, direct financing, and leveraged leases.

Initial adoption: IFRS requires one year of comparative financial information to be reported under IFRS based upon the rules in effect at the reporting date. This requirement differs from the SEC requirement to provide three comparative years of statements of income, cash flows, and equity. Generally, companies must apply initial adoption rules retrospectively—with some limited exceptions. Any differences resulting from the change in accounting policies upon the initial adoption date of IFRS are recorded directly through retained earnings. Key adoption differences or exceptions specific to real estate companies include:

—Fair value estimates of investment properties at initial adoption date need to be consistent with estimates made at the same date under U.S. GAAP, after adjustment to reflect any difference in accounting policies, unless there is objective evidence that those estimates were in error. Contracts, including leases, existing at the date of adoption will require review to determine if they contain a lease on the basis of facts and circumstances existing at either inception of the agreement or the adoption date, and judgment will be required to determine the appropriate classification of leases under IFRS (no more bright line tests).

—Property, plant and equipment that previously did not require impairment losses if the undiscounted cash flows exceeded carrying value may require write-down at adoption date if recoverable value is less than carrying value. At initial adoption, a company may elect to measure property, plant and equipment or investment property at the date of transition to IFRS at its fair value and use that fair value as its deemed cost at that date, if the historical cost model is used for investment property instead of fair value. Acquisitions and business combinations prior to the date of initial adoption do not require retrospective application of IFRS related to the assets and liabilities acquired.

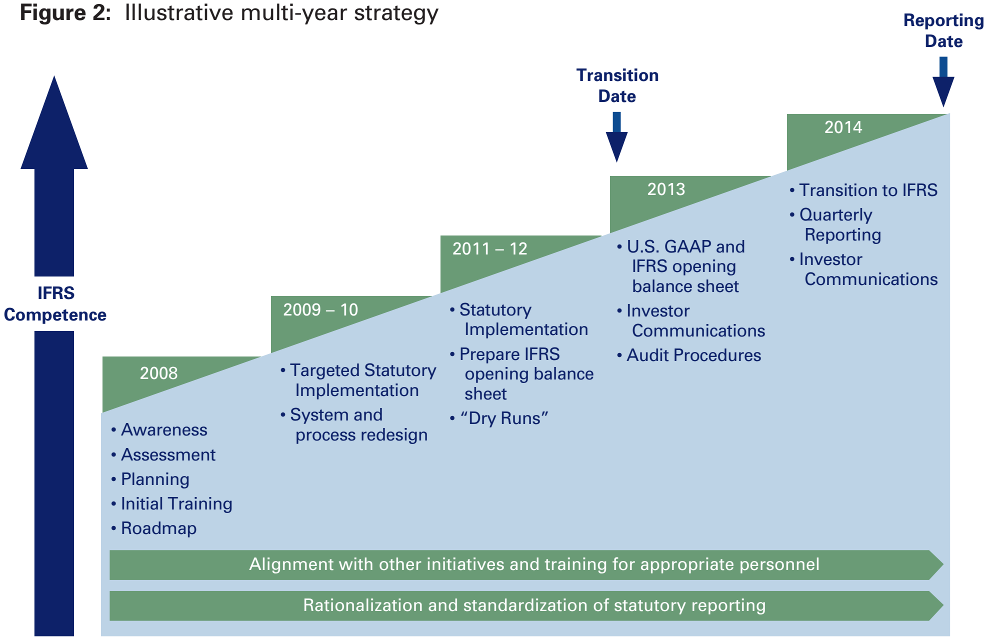
THE CONVERSION PROCESS

Generally speaking, two approaches to IFRS conversion predominate: all-in and tiered. The former is characterized by a relatively short timeframe, simultaneous conversion of all reporting entities, dedicated project teams, and devotion of significant resources. The latter is conducted over a more extended period, with phased conversion of reporting entities, with at least some personnel retaining their "day job" duties, and with a spreading out of project costs.

When the European Union converted to IFRS in 2005, it was, for most companies, an all-in effort driven by the tight timelines imposed by the European regulators. Without the luxury of time to convert on a staggered basis, most companies were forced to rush through the process, leading to inevitable inefficiencies and ineffectiveness. A tiered approach—staged, rational, and measured—to IFRS conversion will likely provide better results. This comes with a seemingly self-contradictory caveat: companies have to act fast if they want to go slowly. That is, if they want to reap the potential benefits of phasing in conversion, companies may need to start almost immediately.

Companies that choose a tiered strategy (Figure 2) should consider staggering their conversions on a country-by-country or region-by-region basis. As each group moves through the stages, the processes developed and lessons learned are applied to the next group. Some real estate companies will choose their Canadian subsidiaries for the first conversion, given Canada's 2011 mandate for conversion. Others may opt for their European entities, since they are already

Figure 2: Illustrative multi-year strategy



using IFRS for statutory accounting and their employees have more IFRS experience. To the extent they are maintaining dual sets of books to support U.S. GAAP reporting of the parent, this may yield immediate cost reductions.

Here are a few considerations for smoothing implementation of IFRS conversion. It's a good idea to leverage existing projects. If the company is already going through—or recently completed—an enterprise resource planning or finance transformation project, now may be the time to consider IFRS adoption. Recent versions of major enterprise resource planning systems are designed to accommodate IFRS, which can be mapped in, usually with significant cost savings.

Implementation might be easier if a bite-sized approach is taken, starting with a single country or reporting entity. Use existing reporting requirements and local country IFRS requirements to their advantage. For example, subsidiaries in countries adopting IFRS over the next three years may be good candidates for a trial run. Learn from this initial conversion exercise, and apply the lessons learned to the global rollout down the road.

IFRS provides a compelling reason to establish shared services centers to potentially consolidate dozens of local accounting standards down to a single reporting standard. Geographically dispersed finance offices could be drastically reduced or even eliminated in favor of a central finance function, strategically located to take advantage of tax incentives, payroll savings, and facilities cost reductions. In many cases, this concept is already aligned with the strategic direction real estate companies have taken or are currently considering relative to their finance function. Since many real estate companies have operations located across the globe, a decentralized structure can sometimes lead to reduced oversight and weakened controls. IFRS offers the opportunity to implement standardized frameworks and processes to enhance the overall internal control environment.