

# CFO ROUNDTABLE BRIEFING



## THE TRANSITION TO IFRS

A NEW BALL GAME FOR COMMERCIAL REAL ESTATE IN THE UNITED STATES

SEPTEMBER 2008

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### EXECUTIVE SUMMARY

In anticipation of a formal conversion from US GAAP to International Financial Reporting Standards (IFRS), the United States is beginning to prepare for change. The transition promises to challenge public companies and investors in many ways, as the new financial reporting standards focus more on the balance sheet (and fair value measurement) and less on the income statement. Additionally, a level of economic risk will be introduced as a result of the replacement of a tightly defined, rule-based system with a more interpretive, principle-based approach under IFRS.

Cushman & Wakefield is uniquely positioned to offer a worldwide team of talented professionals ready to help our clients assess their commercial real estate portfolios under the new regulations and develop successful transaction and valuation techniques through the transition and beyond.

### INTRODUCTION

Reminiscent of Sarbanes Oxley, the adoption of IFRS promises to impact management across all industries. CFOs should be aware of one common insight shared by the European Union (EU) during their IFRS implementation: the transition requires a huge amount of work, much more than originally anticipated – now is the time to get started.

Based on FASB's June session, it is likely US issuers will have the choice of using either IFRS or US GAAP for public reporting purposes in the United States as early as 2009, with potential mandatory application by public companies between 2011 and 2013. A transition by 2013 is no easy task considering numerous projects addressing significant IFRS weaknesses must be completed by 2011. IASB and FASB agree – “the issues are many and controversial, and completing them in two years represents a significant challenge.”



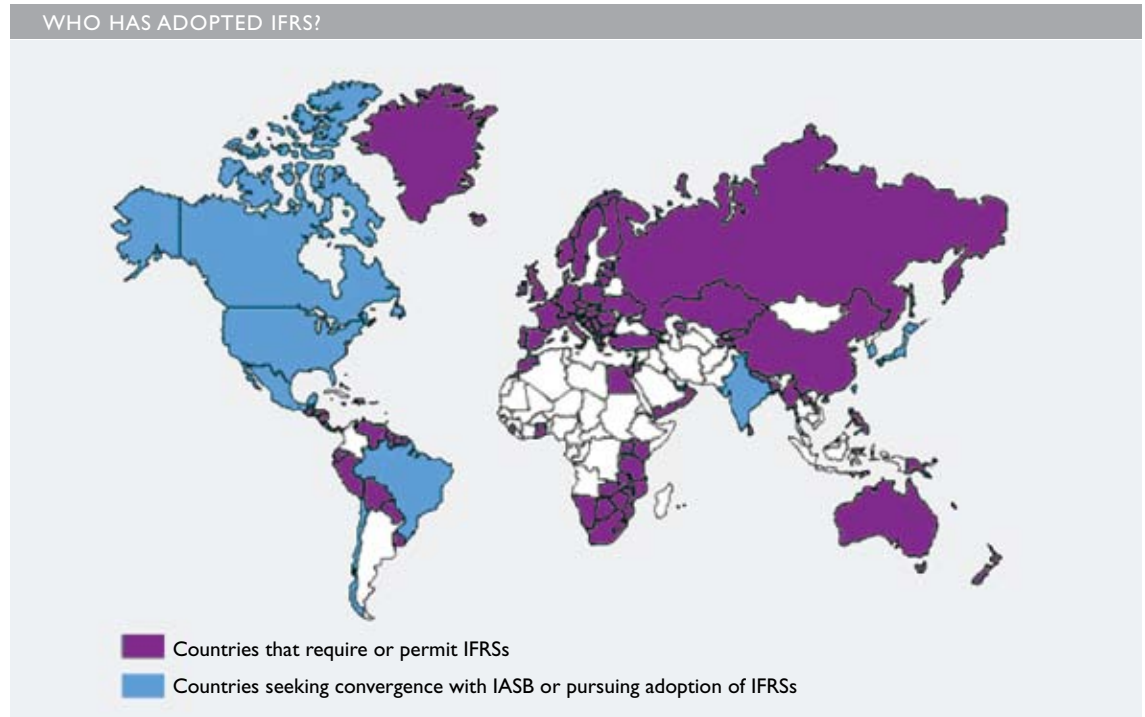
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“What one is talking about [on the transition to IFRS] is the replacement of the language in which the companies, the auditors, the analysts, the banks and the interested parties are talking.”<sup>1</sup>

Itamar Levin, Editor,  
*The Accountant*

To reiterate, the time to get involved is now. Not just to implement the agreed upon standards, but to participate in shaping the final standards to be adopted in critical areas.

For real estate owners and occupiers, the proposed shift to fair value, adoption of new measurement processes and transfer of operating leases to the balance sheet will radically transform strategic planning for real estate assets and obligations.



Source: IASB Website: [www.iasb.org](http://www.iasb.org), accessed March 1, 2008

KEY AREAS OF IMPACT

CFOs not experienced with IFRS are seeking more information on the technical standards and transition process ahead. US companies should heed the lessons learned from IFRS introduction in the EU and on current legislative changes in the United States.

Events to date suggest the following:

1. IFRS seems to be happening faster than anticipated. Support from regulatory bodies continues to promote a shift to IFRS. Current momentum suggests the US transition is likely to occur in the next three to five years.
2. IFRS will affect organizations in many ways. It is not just a reporting change. Remuneration and bonus systems, metrics and benchmarking, and relationships with analysts and investors will be impacted.
3. Significant training efforts will be required to educate the business community: board members, executives, management and financial staff. In a sense, every individual with financial responsibilities will be made at least partially obsolete by the move to IFRS.



Jon Symonds, CFO of AstraZeneca, the first large UK company to restate its accounts under IFRS in 2003 suggests, "This has been viewed as an exercise in accounting, whereas, more significantly, it's a serious exercise in communications."<sup>2</sup>

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4. Because IFRS is principle-based in contrast to the more rule-based GAAP, exposure to litigation will increase. A principle-based system allows for a broader use of judgment, which almost guarantees disagreement. Initially there will be limited ability to benchmark, which will increase the need to justify and document all assumptions and estimates. It will be critical, in all cases, to preemptively "buy" the best available expertise to minimize litigation risk. Advisors, such as valuation professionals, will be in short supply.
5. The first wave of IFRS introduction in the EU covers listed (publicly traded) companies only. The timetable for rollout to private companies is still under discussion. The United States will likely set expectations for public and private companies in the near term.
6. IFRS is already here. New SEC rules, instated December 2007, allow foreign companies to file financial results in the United States under IFRS – without comparative GAAP reconciliation in the reporting. This creates an uneven trading field which may put US REITs at a disadvantage in their own backyard. Differences in reporting under GAAP versus fair value under IFRS can create distortion in the perceived value of US companies relative to the foreign entities and interfere with their access to global capital investment funds.

## THE IMPACT OF IFRS ON REAL ESTATE

Proposed changes to Fair Value (FV) and Lease Accounting under IFRS portend significant changes for real estate owners and occupiers.

## First Wave of IFRS: Fair Value Trends

The adoption of fair value as it currently stands under IFRS will increase the volatility of financial reporting and asset measurement. Given that the United States dominates commercial property markets and accounts for one third of the world value (or roughly \$10 trillion of non-government assets according to the Q1 2008 Federal Reserve Flow of Funds Report), the change due to revaluation during the first wave of implementation could be sweeping, and perhaps destabilizing, in some markets.

Under IAS 40, IFRS permits real estate held for investment to be reported at fair value with the gain or loss reported in that period. Once initiated, fair value reporting must continue and cannot revert to historical cost basis. As a result, questions about what to measure, how to measure, and when to measure have introduced vigorous debate in developing long-range strategic plans in the EU.

1. **Global move to fair value reporting for real estate held as investments:** *The positive:* All real estate investments are marked to fair value each reporting period – gains from this treatment are recognized in profit and loss. The optional practice of disclosing gains in the notes section does not appear to have the same impact for companies looking to secure global capital. EU experience is that 80 percent of companies holding real estate for investment chose the fair value method.
2. **Increased volatility in financial reporting for real estate:** *The negative:* Fair value reporting introduces earnings volatility as economic trends will trigger financial events regardless of the *actual* long term gain or loss. FV can be misleading if it is applied too consistently across the board, particularly in markets which are inactive or dysfunctional.



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FINANCIAL STATEMENT AND RATIO COMPARISON –  
ADOPTION OF FAIR VALUE COMMERCIAL REAL ESTATE  
HELD AS INVESTMENT

ABC Investment Company  
BALANCE SHEET

	Current GAAP	IFRS – Fair Value <sup>2</sup>
Cash	455,000	455,000
Investment Properties	2,400,000	3,800,000
<b>Total Assets</b>	<b>\$2,855,000</b>	<b>\$4,255,000</b>
Debt	1,800,000	1,800,000
Deferred Income Taxes	65,000	597,000
Equity and Retained Earnings		
Open	920,560	920,560
Change	69,440	937,440
Close	990,000	1,858,000
<b>Total Liabilities and Equity</b>	<b>\$2,855,000</b>	<b>\$4,255,000</b>

STATEMENT OF PROFIT AND LOSS

Unrealized Valuation Changes		
during period	–	1,400,00
Realized Valuation Changes	220,000	220,000
Interest on Debt	(108,000)	(108,000)
Income Taxes	(42,560)	(547,560)
<b>Net Earnings</b>	<b>\$69,440</b>	<b>\$937,440</b>

LIQUIDITY AND LEVERAGE RATIOS

Debt/Equity Ratio	1.82	0.97
Debt/Total Assets (DCR)	0.63	0.42
Times Interest Earned	0.64	8.68

Ratios used for liquidity and leverage metrics will fluctuate as a result of fair value changes and recording of unrealized gains and/or losses. Loan covenants should be reviewed for fair value considerations.

Sample assumes IFRS fair value measurements would be representative of fair value as adopted under GAAP

3. **Benchmarking challenges:** Measurement standards and methodologies differ across markets, which creates comparison difficulty. Currently IFRS does not align with the much stricter FAS 157 (the new standard for fair value measurement in the United States).
4. **External valuation explosion:** Investors and sources of capital prefer objectivity in the measurement process.
5. **Historical cost preference for owner-occupied buildings:** Most companies will stick to historical cost of owner-occupied real estate (84 percent in the EU remained at historical cost) as gains from fair value increases to PP&E go directly to equity. The lack of impact on earnings makes this fair value exercise less desirable than the fair value options for investment property.

Second Wave of Standards: Lease Overhaul

Of equal significance to real estate owners and occupiers will be anticipated changes in accounting for leases. A FASB/IASB joint project on leases is leading to a radically different standard that brings all operating leases to the balance sheet as *financed assets (per right-of-use methodology)*. As operating leases represent about \$1.3 trillion of liabilities in the US market alone, this will be a considerable and complicated change with the potential for changing the way that investors look at both companies and real estate markets.

1. **Long-term leases lose favor:** Occupiers may attempt to minimize the size of leased assets and liabilities by contracting for shorter leases. This would reduce the quality of the underlying income stream of commercial real estate, introduce more risk into the valuation of the asset and make properties more difficult to finance.
2. **Enhanced EBITDA:** Capital lease treatment effectively substitutes rent expense accounting for a mortgage payment; i.e., interest recognition and principal repayment, which serves to enhance EBITDA. Loan covenants based on EBITDA improve while covenants based on debt/equity ratios tighten.
3. **Occupiers become owners:** Capitalization treatment would put leases on par with ownership. More corporations may entertain ownership than before since the decision to lease versus own has become balance sheet neutral. As in the EU, many of these new owners may, in turn, decide to lease or sublease surplus space on an interim basis.



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4. **Advent of a robust office condo market:** With ownership now on par with leases, occupiers may seek ownership strategies within multi-occupant type properties as well as single occupant facilities.
5. **Sale leaseback market impact:** Sale leaseback transactions will have pros and cons. On the pro side – this may be the best alternative to get gain recognition for an owner-occupied building into P&L; the con is that it will still require the recognition of the asset and liability for the lease transaction on the balance sheet.
6. **Fair value accounting provides more transparency for leasing transactions:** Valuations of properties will be based on two discrete components. The first is the portion of the building valuation tied to rental income. The second, residual value, will provide new transparency previously unavailable to investors, lenders and tenants. A large positive residual may suggest to tenants that they are obtaining a good deal on rent. A negative residual may imply that tenants are overpaying for rent.

## Industry Rebuttal

Both of the proposed changes are being heavily debated as industry and investment representatives offer alternatives and opposition. The National Association of REITS (NAREIT) and its global commercial real estate alliance have met with FASB publicly to discuss their position on FV and Lease Accounting changes. While they accept a global move towards fair value, they oppose fair value changes being recognized in Net Operating Income. This potentially creates more volatility in REIT performance.

With regard to lease accounting, NAREIT “vigorously opposes changes to lease accounting that would re-characterize what has long been understood and accepted to be a rental transaction for real property into a financing transaction.” The proposed lease accounting change is being criticized for its treatment of replacing real estate asset disclosures in notes to the financial statements with lease receivables and a residual value account.

## SUMMARY

The stakes are high. Be prepared for last-minute changes. There is general agreement that global convergence to a shared set of IFRS will happen in the near future. But the standards themselves are still a work-in-progress. A consensus on final standards for fair value measurement, revenue recognition, financial statement presentation, lease accounting and consolidation (SPEs) has not been reached. However, the trend is clear: fair value and principle-based accounting are on the way.

The transition will be difficult in the short term. If there is one lesson from the 2007 introduction of FAS 157 (the new fair value measurement standard under GAAP), it is that major reporting changes confuse the market, trigger economic consequences, increase workload, drive organizational changes and boost the need for skilled resources.



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The long term view is more optimistic. Most certainly, IFRS will alter the economic gauges used in measuring and managing businesses around the globe. The well-managed organization will engage professional advice, train and staff to prepare and execute an IFRS transition – one that is likely to be complicated by last minute negotiated changes.

At the end of this process lies the promise of an improved and more transparent reporting framework that will help businesses raise money more easily across global markets. This flexibility is likely to be particularly important for organizations in countries such as the United States that are financing government and trade deficits externally. It will enable organizations to finance growth with a lower cost of capital and retain a competitive advantage both nationally and internationally.

#### REFERENCES:

1. "Interview with Itamar Levin, Editor, The Accountant", *Journal of Accountancy*, May 2008
2. "Ready Reckoner", *Financial Management*, Feb. 2005, p. 12



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**ABOUT THE CFO ROUNDTABLE PROGRAM**

The CFO Roundtable is a thought-leadership initiative created by Cushman & Wakefield professionals, John O'Neill and Chris White, in partnership with The University of Georgia's Terry College of Business. It's an invitation-only series of quarterly events designed by and for CFOs and senior finance executives on topics relevant to the CFO community. The program and its events facilitate regionally driven, peer-to-peer discussions that deliver practical value. The interactive format engages attendees and provides new ideas to drive business performance. In addition, the program builds meaningful relationships within the CFO community and participating sponsors.

Following the initial launch in Atlanta in June 2005, the initiative is expanding nationwide. In association with top-tier business schools, the CFO Roundtable is currently active in seven markets and continues to grow. It will be established in 14 markets within the next 18 months, reaching an estimated 15,000 CFOs and senior finance executives.

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