

Creating Real Estate Value: Respond Strategically to Financial Reporting Changes

BY ELIZABETH KING FORSTNEGER

"Please stay tuned to see what we come up with." This was the advice of the Securities and Exchange Commission's chief accountant, Conrad Hewitt in June of 2008 (a remark made as a panelist, public accounting forum held by the Financial Accounting Standards Board (FASB) and the Financial Accounting Foundation). This sentiment perpetuates the anxiety that surrounds impending changes in the accounting world stemming from discussions of morphing the US's Generally Accepted Accounting Principles (GAAP) to International Financial Reporting Standards (IFRS).

Currently, the two bodies are working together to tweak existing standards and opine on conflicting rules. Business leaders are already reacting though plans remain undefined, but poised to impact the bottom line. Due to the nature of the changes, real estate executives in particular may find the timing unfortunate during this period of market fluctuation.

While companies cannot predict market conditions in years to come, they can plan for probable change that affects both business decisions and the bottom line. The seemingly inevitable arrival of adjustments to accounting rules is best navigated by companies whose leaders understand and plan for the impact. Some changes described here will take effect at a predetermined date. Others are still under debate. All stem from the merging of US and international standards. This article examines the biggest changes ahead for owners and lessees of real estate; this year's implementation of FASB 157 and the potential reclassification of operating leases as capital leases.

Real Estate Owners

Owners may already be aware of the issuance of FASB 157, effective November 15th of this year. This pronouncement dictates that owned real estate is to be presented at fair market value on an annual basis, and the associated valuation methods be disclosed. The pronouncement emphasizes fair value as a market-based measurement, not an entity-

specific measurement. Many owners currently value their real estate assets every three years, doing so in terms of its contributory value to the company, or based on historical cost and depreciation. Asset managers will need to think critically about highest and best use of land, whether that determination is acted upon or not as described in the following example.

FASB 157 provides examples to describe how the change affects different asset types. Among these is an illustration of actions that follow a land acquisition in a business combination. That land is currently improved with a manufacturing facility. The current use had been presumed to be its highest and best use, but nearby sites have recently been developed as high rise condominiums. Based on surrounding development and recent zoning and other changes to facilitate that development, the reporting entity determines that the manufacturing facility site could be developed as a site for high rise condominiums.

In this instance, the highest and best use of the land would be determined by comparing (a) the fair value of the manufacturing opera-



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tion, which presumes that the land would continue to be used as currently developed for industrial use (in-use) and (b) the value of the land as a vacant site for residential use, considering the demolition and other costs necessary to convert the land to a vacant site (in exchange). The highest and best use of the land would be determined based on the higher of those values. (FASB 157-A10 – This Statement sets out a framework for measuring fair value, which refers to certain valuation concepts and practices.) This could result in a value significantly higher than the earlier number.

Obtaining and managing appraisals will become a much larger part of real estate management. Sweeping changes in value may affect a corporate real estate department's performance and resulting bonus structure for executives. Just as Sarbanes-Oxley made corporations subject to additional costs for guidance on governance issues, companies will need to further rely on accounting and valuation firms to help with valuation methodology with the possibility of conflicting evaluations with greatly differing impacts to the bottom line.

Tenants

Those who lease real estate may also find themselves with a volatile financial statement situation. For several years, discussion has focused on capitalizing leases that are currently treated as operating leases. In 2004, the Securities and Exchange Commission estimated that publicly traded companies in the United States keep \$1.3 trillion in lease-related future cash obligations off of balance sheets through the use of operating leases. Though no firm decision has been made or deadline set, the ongoing effort to increase transparency means that this discussion is gaining momentum.

While capital leases book the present value of minimum lease payments as a liability at the inception of a lease, operating leases recognize expense on the income statement over the entire lease term with

no balance sheet impact. Capitalizing leases currently treated as operating leases could change a company's debt to equity ratio, which could then affect lender agreements. According to Doug McEachern of Deloitte and Touche, a lessee's net income would decrease initially under a capital lease since interest and amortization of the leasehold interest would outweigh the lease payment expense, but EBITDA would increase. (He stated this during a presentation at the Industrial Asset Management Council, IAMC, conference, May, 2008.) He shared two approaches:

↘ **Financial components approach:** Lessee capitalizes value of rights and obligations under the lease, typically the present value of the minimum lease payment. Income statement would reflect depreciation of asset and imputed interest on the lease obligation.

↘ **Whole asset approach:** Lessee capitalizes the leased asset's fair value and books two liabilities: (a) present value of minimum lease payments and (b) obligation to return the asset (reversion.) Income statement would be similar to first approach above.

IASB and FASB appear to be comfortable with overall approach, but many details remain to be resolved. Questions that arose at the IAMC conference included:

- ↘ Will this include synthetic leases?
- ↘ Will it apply to very short leases and/or very small leases?
- ↘ What about subleasing a property to another entity? On whose balance sheet will the lease be shown?
- ↘ Will clients shorten leases to hold down what shows up on the balance sheet?
- ↘ Can a third party logistics provider be used to get your warehouse off the balance sheet?

Additional guidance is anticipated as discussions continue.

Things That Should Be Done Now

Though the timing of the combination of GAAP and IFRS standards and the capital-

ization of all leases is uncertain, the mandate for fair value accounting has arrived via FASB 157. For planning purposes, companies need to be ready 24 months in advance of the effective date for IFRS reporting. For example, if the effective date for companies is for the year ending December 31, 2012, companies need to be ready on January 1, 2011 in order to have a full year comparison.

What steps should be taken for the current and potential changes?

Steps to mitigate risk:

↘ Work with real estate managers and finance departments to improve processes of evaluating affected components of a transaction so that it withstands the scrutiny of regulators, financial analysts and litigators

↘ Discuss the evaluation of transactions and assets and the possible impact to financial statements with senior management and subsequent communication to shareholders, analysts and other stakeholders

↘ Revisit financial covenants written for US GAAP, and test the implications under IFRS. Armed with this information, speak to lenders and major investors about changing borrowing limits. Fair value reporting may require lower leverage models due to market volatility

↘ Revise internal controls and business processes to collect IFRS-friendly data

↘ Monitor property and portfolio insurance coverage as fair values change

While large accounting firms will train professional staff to provide similar guidance and to mitigate risk, real estate-focused services firms can provide expertise in identifying strategies for efficient portfolio planning. Beyond mitigating risk, the following actions can uncover opportunities for value creation within a real estate portfolio.

Steps to creating value:

↘ Perform adjustment projections by examining lease databases line by line and work with lease accounting software to make adjusted projections

↘ Evaluate performance metrics and management reporting

↘ Revisit renegotiation or reconciliation clauses for existing facilities

↘ Reconsider the appropriateness of each asset's use, and identify surplus property

Real estate-focused advisors can evaluate the collected data and identify opportunities in light of this evolving reporting environment. Thinking strategically calls for tools that let you know where you stand. Despite the challenges surrounding mandated financial changes, the best companies will be strategic in their actions. This will lead to better business decisions through more efficient real estate handlings.

Questions such as, "What is this asset worth to me?" will be replaced with, "What is this asset worth to the market?" For example, one financial services client had created a call center in a fully depreciated downtown office building, because its low book value made it appear inexpensive when compared to a new suburban facility. Sales and rents in surrounding buildings showed that the property was worth much more than its depreciation-based book value, so a call center operation there was prohibitively expensive.

When a current valuation was conducted, the company understood that the call center operation made little sense in the downtown location. Selling the building and relocating the call center to a superior labor market would improve the bottom line in both the year of the sale and operationally for foreseeable future.

In another case, a Fortune 200 service provider knew that its portfolio included many surplus properties, but at book values that likely exceeded their market value. The company's real estate leaders held these non-revenue generating properties idle at the book value so as to prevent recognizing a potential loss in event of a sale. There was ample opportunity to increase the value of these properties through development, but the historic book value prevented such decisions from being made. Though opportunity existed, book value kept the company from taking advantage of it.

At another large industrial firm, management took the opposite approach. It was aware of the value of its surplus property and sought to transfer it to a new investment-focused business unit. Business unit leaders were reluctant to surrender low-basis property to the program, since the effect was minimized by low book values. Corporate leaders told business units that identified surplus property, would be removed from capital calculations based on its market value. This created a strong incentive, leading to hundreds of millions in identified property.

Proposed accounting changes may, in fact, spur better business decisions through more efficient real estate handlings, thoughtful placement of property, and incentive to examine underused properties.

History Lessons

Uncovering opportunity may prove to be a key survival strategy as these changes unfold. Unlike the metric system, IAS adoption is not something that the US can successfully delay. Though there is no set deadline currently, most agree that global companies will cease acceptance of US GAAP standards between 2011 and 2015. This would make it difficult for US companies to raise foreign capital. Canada, India, Argentina, and Brazil have all recently announced a mandate to follow International Financial Reporting Standards (IFRS). In 2005, listed companies on the EU Stock Exchange were required to follow IFRS and use fair value accounting.

US companies might have fared better had they changed to fair value several years ago, as the current credit crunch may amplify the volatility of the fair value measurement of real estate assets. Many pose the question, "Is fair value accounting appropriate for illiquid assets such as real estate?" In a bull market, as asset prices increase, balance sheets improve through increased values of the assets, and capital flows more freely.

The opposite is true in the current bear market. Leverage amplifies the impact. As

prices correct amidst the credit crunch, fair value accounting will speed that correction or at times, exaggerate it. Cyclical markets will affect financial statements to a far greater extent. This volatility creates one more unattractive variable for investors in deciphering a company's performance.

As we look across the pond for insight, Denmark may stand testament to the fair value accounting as an overdue correction to a previously flawed way of accounting for real estate. As illustrated by Richard J. Herring, Co-Director of the Wharton Financial Institutions Center, Denmark has been using fair value accounting all along and was the only Scandinavian nation to avoid a banking bust in the wake of commercial real estate pricing changes.

Moving Target

Where are we headed? As the U.S. aims to mirror International Standards, those same International Standards are potentially headed for greater stringency. A recent initial international exposure draft suggests that fair value and capital appreciation must be continuously monitored for investment properties, including rentals. In such an environment, proactive planning would equate to finding and creating value.

The good news is that this change is universal. Many are in the midst of planning for the changes. The SEC's advice remains 'stay tuned for further developments.'

About the Author

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