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# IFRS in Real Estate

*More Than Just Accounting & Reporting*



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# IFRS in Real Estate

## More Than Just Accounting & Reporting

As the acronym IFRS (international financial reporting standards) appears with increasing frequency in print, on the Web, and in conversation, real estate (RE) executives have begun to take notice. RE executives have particular reason to pay attention, as characteristics of their industry make it a prime candidate for early IFRS conversion:

- **RE is global.** Major REITs, RE private equity firms, RE owners and operators, and corporate real estate divisions often have operations and assets that span countries and continents.
- **RE is capital intensive.** Major initiatives require significant capital. Accounting and financial reporting provide a vital link between real estate companies and their capital providers.
- **RE is competitive.** In a challenging economy and a highly competitive market, RE companies are continually looking for ways to stay ahead of their rivals.

If your company fits the description above, chances are you or someone in your organization is already thinking about IFRS. That's a positive sign, because developments over the last year have shifted the discussion from the abstract and distant to the concrete and near-term. "If" is no longer part of the conversation; "when" is now the relevant term.

Recent events suggest that reporting under IFRS will be allowed or required for most public companies in the U.S. and around the globe within the next few years. On November 14, 2008, the SEC issued its long-awaited proposed IFRS "roadmap" outlining milestones that, if achieved, could lead to mandatory transition to IFRS 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. The SEC believes that "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 roadmap also notes that IFRS has the potential "to best provide the common platform on which companies can report and investors can compare financial information." The SEC is seeking comments on numerous questions raised in the proposed roadmap. The comment period is expected to run until mid-to-late February 2009.

The proposed roadmap outlines seven milestones. Milestones 1–4 discuss issues that need to be addressed before mandatory adoption of IFRS:

1. Improvements in accounting standards.
2. Accountability and funding of the International Accounting Standards Committee Foundation.
3. Improvement in the ability to use interactive data for IFRS reporting.
4. Education and training on IFRS in the United States.

Milestones 5–7 discuss the transition plan for the mandatory use of IFRS:

5. Limited early use by eligible entities: This milestone would give certain U.S. issuers the option of using IFRS for fiscal years ending on or after December 15, 2009.
6. Anticipated timing of future rule making by the SEC: On the basis of the progress made on milestones 1–4 and experience gained from milestone 5, the SEC will determine in 2011 whether to require mandatory adoption of IFRS for all U.S. issuers. Potentially, the option to use IFRS could also be expanded to other issuers before 2014.
7. Implementation of mandatory use: The roadmap raises many questions, including whether the transition to IFRS should be phased in. According to the roadmap, large accelerated filers would be required to file IFRS financial statements for fiscal years ending on or after December 15, 2014, then accelerated filers in 2015, and nonaccelerated filers in 2016.

Under the proposed roadmap, U.S. issuers that meet both of the following criteria would be eligible to use IFRS earlier in financial statements for fiscal years ending on or after December 15, 2009:

- The U.S. issuer is globally among the 20 largest listed companies worldwide in its industry, as measured by market capitalization.
- IFRS, as issued by the IASB, is 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.

An issuer that meets these criteria and chooses to use IFRS (an "IFRS issuer") must prepare its financial statements in accordance with IFRS as issued by the IASB. 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.

Investment companies; employee stock purchase, savings, and similar plans; and smaller reporting companies, as defined by the SEC, are excluded from the definition of an "IFRS issuer" in the proposed roadmap and therefore would not be eligible to early adopt IFRS. For more information on the SEC's action, visit [www.deloitte.com/us/ifrs](http://www.deloitte.com/us/ifrs).

If you think the year 2014 gives you plenty of breathing room, think again. A conversion effort that is both sane (in the sense of avoiding the fire-drill type atmosphere that characterized compliance with Sarbanes-Oxley and the Y2K problem) and successful (one that can stand up to the scrutiny of regulators, analysts, and your independent auditor) will require a lengthy runway. In mid-2008, the American Institute of Certified Public Accountants announced that it considered a 3–5 year timeline to be reasonable for transition to IFRS. Other organizations have made similar determinations.

## Challenges and Opportunities in Real Estate

Conventional wisdom notwithstanding, 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, your company is likely to spend significant amounts of time addressing concerns around tax, valuation, treasury, legal, people, technology, and communications.

Clearly, a great deal of work lies ahead. Yet, despite these challenges, you may find that the benefits of reporting under IFRS 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 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.

Consider these factors:

**Conversion provides a fresh look at current practices.** If your close process includes reconciling multiple GAAPs and dealing with a variety of sub-ledgers, manual adjustments, data hand-offs, and accounting overrides, you may want to consider a fresh look at your policies and procedures. IFRS provides this opportunity.

**Conversion can be a catalyst for streamlining and consolidation.** As your company expands through growth and acquisitions, your information technology systems may become increasingly convoluted. Many companies operate a patchwork of legacy accounting and ERP systems — machines that can't talk directly, 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. GAAP and its voluminous rules for dealing with accounting issues. For a decade or more, CFOs and other finance executives have openly pinned for principles-based accounting to help standardize and improve the reliability of financial reporting. IFRS answers that wish.

### Three Actions for Real Estate Executives

1. Determine how your standing in the industry will be impacted by a conversion to IFRS. Would reporting under IFRS enhance the presentation of your financial performance and balance sheet to your investors and capital providers?
2. Conduct a competitive analysis. Which of your first- and second-tier competitors are, or are going to be, reporting under IFRS? Would it be advantageous to be a leader into this new world of financial reporting? Do you need to adopt IFRS to facilitate comparisons to and benchmarking with your peers?
3. Decide whether early adoption of IFRS aligns with and could be leveraged to support the strategy of your company. Do you have global operations, or do you want to expand your international presence?

**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 improved ability to benchmark with peers and competitors.

## The Roadmap

Whether you plan to charge ahead full steam or take small, measured steps, development of an IFRS implementation roadmap is an important first step. Through this effort, you'll be able to chart your optimal course, determine the pace of your conversion journey, and possibly skirt some detours and potholes.

To start, consider gathering answers to a few preliminary questions:

- Have we inventoried our current IFRS reporting requirements, if any?
- How many local generally accepted accounting principles (GAAPs) do we currently report under?
- How many of our business units already prepare IFRS financial statements?
- How might our access to capital be impacted by an IFRS conversion?
- How many of our competitors have converted? Is there an expectation that they would switch to IFRS, if given the choice in the U.S.?
- Do we have a major ERP or finance transformation project in the works?
- Are we 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 impacts on our company of a possible IFRS requirement in the U.S.?
- Have we assessed the costs and benefits of adopting IFRS?

Of course, your IFRS implementation roadmap will likely contain significantly more detail than shown above. Given the far-reaching scope of IFRS, your map-making process may assess the potential impact on each department in your 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 your external auditor.

### Four Actions for Real Estate Controllers

1. Assess the potential costs and benefits of uniform reporting across your organization.
2. Create a timeline for IFRS conversion. Highlight the key milestones.
3. Determine your resource requirements — internal and external — for a conversion project. Consider the impact of redeploying internal resources.
4. Collaborate with your CIO to assess system requirements for reporting under IFRS.

By estimating your costs, benefits, and timing up front, you can avoid the rushed approach (and unnecessary expense) that characterized some initiatives such as the Sarbanes-Oxley Act and the Year 2000 issues. A carefully designed roadmap will likely empower your company to convert on its own terms. By taking a measured and informed approach, you improve 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 time frame and extensive reach of the directive had many companies scrambling to comply. Anecdotal reports from the field suggest that the conversion placed significant resource pressure – human and financial – on finance teams and their companies at large.

A more 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 disclosure 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.

Among the lessons learned from the European experience were the following:

- **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.
- **Projects often lacked a holistic approach.** Because of the limited view cited above, companies frequently did not take the collateral effects into consideration, such as the impacts on IT, HR, 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 "business as usual" state for IFRS reporting.** The highest quality financial data is obtained when a company fully integrates IFRS into its systems and processes. The compressed time frames precluded this possibility; instead, first-year financials were often produced using extraordinary, labor-intensive, and unsustainable measures.

Several European companies are only now starting to explore 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.

## Two Conversion Approaches

Generally speaking, two approaches to IFRS conversion predominate: all-in and tiered. The former is characterized by a relatively short time frame; 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. (See sidebar, "The European Experience")

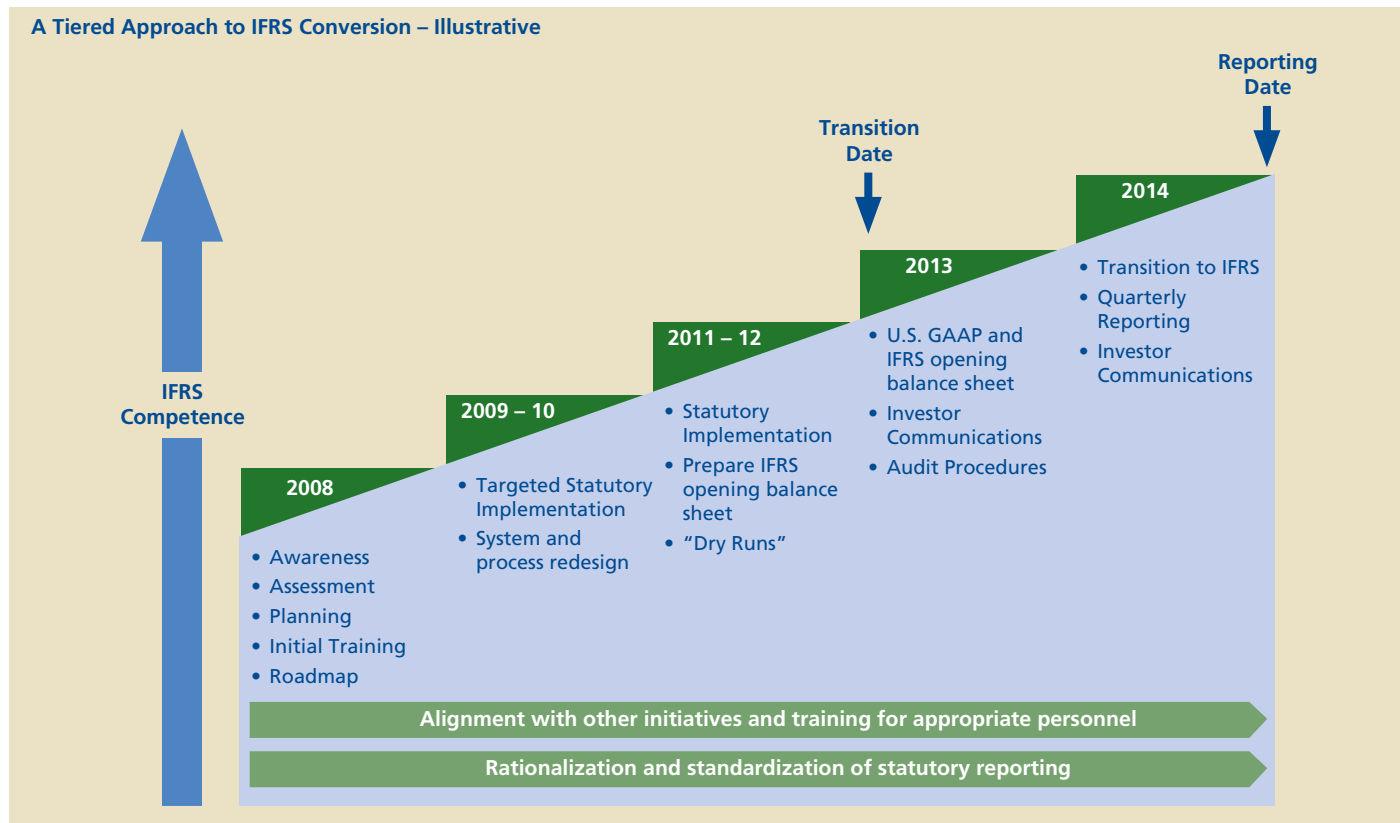
A tiered approach – staged, rational, and measured – to IFRS conversion will likely provide better results. This comes with a seemingly self-contradictory caveat: You'll have to act fast if you want to go slow. That is, if you want to reap the potential benefits of phasing in your conversion, you may need to start almost immediately.

Companies that choose a tiered strategy should consider staggering their conversions on a country-by-country or region-by-region basis. As each group moves through the stages (see graphic, "A Tiered Approach to IFRS Conversion," on page 4), the processes developed and lessons learned are applied to the next group. Some real estate companies will choose Canada for the first conversion, given its 2011 mandate for conversion. Others may opt for their European entities, since they are already 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.

## Three Actions for Real Estate CFOs

1. Assess the potential benefits of presenting your company's financial data on an IFRS basis.
2. Assess the impact of reporting under IFRS. Consider factors such as volatility of earnings, appropriate IFRS-based performance measures, and access to global capital markets. Examine the potential impact on financing, particularly covenant tests and measures, as well as remuneration and other KPIs in the business and accounts.
3. Create a project management office (PMO) for planning, coordination, and oversight.

## A Tiered Approach to IFRS Conversion – Illustrative



## The Investors' Perspective

Naturally, the impact of IFRS extends well beyond the finance department. One group that can expect a significant impact is investors.

IFRS is more principles-based and is less prescriptive than U.S. GAAP, and thus requires additional judgment. Accordingly, the disclosures accompanying financial statements become even more important to investors, as they provide information about the decisions made regarding various accounting alternatives and the judgments made by management in preparing the financial statements.

When considering the impact of IFRS, investors may want to consider these questions:

- What are the differences between the GAAP standard I am familiar with and IFRS?
- How do these differences impact my evaluation of the financial performance and position of my investments?
- How do I assess the impact of recording real estate investments at fair value, and the resulting income statement volatility?

## More Than Accounting and Financial Reporting

Without question, the impact of IFRS on the general ledger and the financials will be substantial. But in a relative sense, the accounting may be the easy part. How you handle the nonfinancial aspects of the conversion may be a more accurate indicator of your success. Among the areas warranting your attention are human resources, legal, M&A, valuation, tax, treasury, and information technology.

**Human Resources:** IFRS will likely influence your hiring, training, compensation, and termination practices.

Consider hiring: How many of your finance staff are currently versed in IFRS? (If you don't know, consider adding a personnel inventory to your IFRS work plan.) Assuming a talent shortfall, how will you make up the difference? Most U.S. college-level accounting programs are only just now getting their IFRS curriculum established. If you can't recruit in sufficient numbers, can you train existing staff? You'll need a budget and a plan to do so.

What about compensation? Some real estate companies pay commissions 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. In many cases, reporting under IFRS will change that bottom line. Executive compensation plan revisions may be required to smooth out the differences.

## Four Actions for Boards of Directors and Audit Committees of Real Estate Entities

1. Become informed about IFRS. Gain a general overview of the topic through research and/or presentations from external or internal auditors or other resources.
2. Understand management's assessment of the impact of IFRS on the company, including the benefits and costs of adopting, alignment with strategy and other activities/initiatives, and their plans and proposals related to IFRS.
3. Develop and share with management your perspective on IFRS.
4. Understand how management will deal with financial reporting and control risks associated with IFRS.

**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 your company's consolidated financial reporting system. Also, the transparency resulting from fair value reporting of investment properties may impact your strategic business decisions around acquisitions and dispositions based on their likely impact to your financial statements under IFRS.

**Tax:** 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.

Adoption of IFRS may also result in changes in profit recognition and ultimately pre-tax income. These changes will likely result in the need to evaluate 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.

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.



**Valuation:** Measurements of fair value weave their way through many sections of IFRS, transcending many functional areas of a real estate firm, including M&A via purchase accounting or the reporting of investment property at fair value. Fair value also potentially has a direct impact on tax through asset impairment testing, as well as on treasury functions through disclosure and transparency effects. In addition, legal areas may be affected through debt covenants, partnership or joint venture agreements, or even compensation arrangements with employees or management. 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 (cost of capital, discount rates, capitalization rates, rental and expense growth rates, etc.), qualification of the valuation specialist, and explanations of fair value conclusions.

**Treasury:** 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 your 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 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.-headquartered real estate companies.

Additional impacts of IFRS on the treasury function may include the following:

- Companies that choose to present fair value may consider the need to lower their leverage models to ensure that market fluctuations can be adequately absorbed by equity.
- Companies may need to consider and revise existing debt terms for covenants based on U.S. GAAP metrics or financial results which don't make sense or are no longer attainable under IFRS.
- Transparent presentation of the fair value of collateral (whether presented on the balance sheet or disclosed in the footnotes) may alter lenders' evaluation of creditworthiness and may impact the terms of new debt instruments related to collateral values and covenants.

**Information Technology:** Expansive real estate holdings equal extensive 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, standalone 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. And, as noted, reporting under IFRS will be an inevitable future need.

The latest versions of many enterprise resource planning (ERP) systems have IFRS capabilities, but adopting them is not akin to flipping a switch. If you don't plan for an IFRS conversion at the earliest stages of your upgrade, you will likely find yourself 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 your 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.

## Technical Accounting Issues for Real Estate Companies

U.S. GAAP and IFRS differ in key ways, including their fundamental premise. Overall, U.S. GAAP is more of a rules-based system, whereas IFRS is more principles-based. Under U.S. GAAP, voluminous guidance attempts to address nearly every conceivable accounting problem that might arise. And if that guidance doesn't exist, it generally is created. Although IFRS is not without its rules, it is clear that 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 sets of 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 convergence, significant differences remain in areas such as investment properties, PP&E, 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 advisable to assist in the comparability and transparency of the financial reporting.

## The Business Case for IFRS

Not everyone is sold on the merits of IFRS. If you find yourself needing to convince others, consider some of these talking points:

- **Global positioning:** We do business globally; our brand is international; we are expanding into new markets. Our financial reporting should be a reflection of this operational reality.
- **Cost savings:** We are currently reporting under multiple standards —U.S. GAAP, local GAAPs, and IFRS. Consolidating to a single reporting standard and eliminating the large number of accounting reconciliations will yield potentially significant savings.
- **Inevitability:** IFRS is coming. If we start soon, we can implement a phased, efficient, and orderly process and likely avoid the chaos that has typified other major projects.
- **Access to global capital markets:** Aligning with the global reporting standard may bring the company to the attention of international investors and open up new sources of capital.
- **Alignment:** We are already undergoing a major [ERP/finance transformation/IT system/fill in the blank] project. If we integrate our IFRS conversion effort with this project, we can make better use of our resources while ensuring that the two work harmoniously together.
- **Internal control:** Accounting policies and procedures will be refreshed during an IFRS conversion project; the number of financial reporting standards used and reconciliations required will drop dramatically. Net result: improved accuracy and timeliness of financial reporting.

The table on page 7 highlights a number of accounting issues. A more detailed discussion of a select few U.S. GAAP/IFRS differences follows.

**Investment Properties:** When real estate companies evaluate a potential IFRS adoption, the most significant consideration generally relates 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 more closely align 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).

Furthermore, while U.S. GAAP does not allow properties under operating leases to be recorded on the books of lessees, under IFRS a property interest held under an operating lease that would otherwise meet the criteria of an investment property may be classified and accounted for as investment property, if the lessee uses the fair value model for the asset recognized. This classification alternative is available on a property-by-property basis, but if selected, all property classified as investment property shall be accounted for using the fair value model.

## Technical Accounting Issues

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 covenant 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.	Potentially 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 consider 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 transaction 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 JVs domestic undistributed earnings.	Tax accounts and processes for deferred taxes and uncertain tax liabilities may change	Foreign taxes in some foreign jurisdiction based on reported earnings may change.

**Property, Plant & Equipment (PP&E):** The main difference between U.S. GAAP and IFRS in accounting for PP&E used in the business (as opposed to held for investment, which would be considered investment property) is the requirement under IFRS to componentize 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 PP&E 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 PP&E 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.

**Impairment:** Two major differences exist between U.S. GAAP and IFRS relating to impairment of long-lived assets held and used:

1. When assessing for impairment of long-lived assets held and used under U.S. GAAP, a two-step approach is applied to determine whether an impairment loss should be recognized. First the carrying value of the asset or asset group is compared with the undiscounted value of the future cash flows. If the carrying value is higher, then the asset or asset group is written down to fair value. Under IFRS, a one-step test is applied such that the carrying value is compared with the asset's recoverable amount (defined as the higher of the asset's value in use, which is based on discounted future cash flows and fair value less costs to sell), and if higher, the asset is written down to the recoverable amount. The ultimate effect is often that impairment losses are recognized sooner and possibly more frequently under IFRS.

2. Under U.S. GAAP, reversals of previous impairment losses are not permitted. However, under IFRS, where evidence of the event that led to the impairment charge no longer exists or where the impairment has decreased, and there has been a change in the estimates used to determine the asset's recoverable amount, a previously-recognized impairment loss is reversed by increasing the asset to its newly determined recoverable amount. (Goodwill impairment is an exception and may not be reversed.)

**Leases:** There are several key differences between IFRS and U.S. GAAP in the area of lease accounting, including:

1. 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.
2. 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 as found in U.S. GAAP lease standards. Rather, IFRS focuses on the transfer of risks and rewards concept for lease classification, with only limited indicators and examples provided. 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.
3. In leases of land and building, IFRS requires that the land and buildings elements of a lease be considered separately for purposes of lease classification, unless the land element is immaterial. Whereas, in addition to the significance of the land element, U.S. GAAP considers the land and building elements a single unit unless certain specific criteria are met. During the European conversion, this proved to be a particularly time-consuming process; many companies needed expert advice to assist with the value split.

**Sale of real estate:** Unlike U.S. GAAP, IFRS does not contain detailed rules or strict provisions around continuing involvement in accounting for sales of real estate. In fact, IFRS does not draw a significant difference between a sale of real estate and a sale of other assets – both follow the concept of transfer of risks and rewards for sale recognition. IFRS provides only limited guidance relating to the sale of real estate.



For sales of condominium units and other construction-type sales accounted for under the percentage of completion method in U.S. GAAP, IFRS may require gains from such construction-type sales be deferred until completion of construction, depending on the ability of the buyer to provide input in the construction design and the continuous transfer of risks and rewards of the real estate during construction.

**Sale-leaseback transactions:** IFRS applies the same principles to all sale-leaseback transactions; that is, it does not draw a distinction between sale-leaseback of equipment and that of real estate. U.S. GAAP makes a significant distinction between equipment and real estate sale-leaseback transactions and provides very detailed and restrictive guidance with respect to sale-leaseback of real estate. Therefore, more sale-leaseback transactions may qualify for derecognition of the asset from the balance sheet under IFRS.

Further, the profit recognition on sale-leaseback transactions is also different. Under IFRS, the profit recognition on a sale-leaseback transaction is based on the classification of the leaseback and whether the sale transaction was entered at fair value. If the leaseback is an operating lease and the sale is at fair value, the profit is generally recognized immediately. If the leaseback is a finance lease, the profit is deferred and amortized over the lease term. The profit might also be required to be deferred and amortized based on the relationship between the sale price, fair value, and the carrying amount of the asset sold and leaseback.

U.S. GAAP generally requires profit on sale-leaseback transactions to be deferred and amortized in proportion to the amortization of the leased asset or gross rental charged to expense, unless the leaseback is considered minor or other specific criteria are met for partial gain recognition.

**Joint Ventures:** IFRS requires venturers to record their share of jointly controlled assets and jointly controlled operations, which do not have a legal entity structure, and requires venturers to record their interests in jointly controlled entities. Unlike U.S. GAAP, IFRS includes an option to present a venturer's interest in jointly controlled entities under either the equity method or proportionate consolidation. However, the accounting treatment for jointly controlled assets and jointly controlled operations under IFRS is similar to that required for undivided interests in U.S. GAAP.

Keep in mind that the IASB has proposed a standard currently in exposure draft to revise the joint venture standard to remove the proportionate consolidation option for jointly controlled entities and change how transactions are evaluated as joint assets and joint operations.

**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 U.S. Securities and Exchange Commission (SEC) requirement to provide three comparative years of statements of income, cash flows, and equity. However, it is worth noting that in 2005, when foreign private issuers from the European Union initially adopted IFRS, the SEC provided an accommodation on the first year that allowed companies to include only one year of comparative information. Thus, the SEC may consider a similar accommodation for domestic registrants.

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 (i.e. no more bright line tests).
- PP&E 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 PP&E 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.

## Smoothing the Transition

If you decide an accelerated IFRS conversion is desirable, here are a few considerations for smoothing implementation:

**Leverage existing projects:** If you are already going through — or recently completed — an enterprise resource planning (ERP) or finance transformation project, now may be the time to consider IFRS adoption. Recent versions of major ERP systems are designed to accommodate IFRS, which can be mapped in, usually with significant cost savings.

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



**Consider shared services centers:** IFRS provides a compelling reason to establish shared services centers to potentially consolidate dozens of local GAAPs 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.

**Strengthen controls:** 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 control environment.

**Refresh your policies:** Conversion to IFRS drives a need to revisit revenue recognition, impairment, share-based payments, cost capitalization, and other accounting policies. In other words, IFRS provides a refresh exercise for accounting policy implementation, with the aim of more accurate and timely financial reporting.

**Improve your access to capital:** Capital is migrating away from the U.S. for a number of reasons, including the weakness of the dollar, the credit crisis, and the growth of foreign financial centers in Europe and Asia. Regardless of the cause, when it comes to raising capital, trends are clearly global. IFRS can potentially improve liquidity and access to capital by offering greater transparency, in the form of full and better disclosure, to investors.

Access to capital may also be enhanced by virtue of aligning with a common standard. Markets and investors have been demanding a common standard for years, and IFRS has increasingly served that need. As such, companies reporting under IFRS may have an improved ability to access other capital markets that have adopted the standard.

## Time for Leadership

You are in an enviable position because you possess knowledge that many others in your organization may not: the movement toward IFRS is inexorable, and the initiative involves multiple corporate functions, not solely finance.

So you have a choice: either sit back and wait for it to happen (with all the attendant uncertainty and risk), or mobilize your company to attempt to extract every possible benefit and dodge every avoidable obstacle.

In other words, it's time for leadership.

By starting now, you will likely spread out your costs, get the jump on your competition, and reel in scarce talent before it vanishes. You can avoid the fire-drill atmosphere that characterizes most last-minute projects. You can improve your processes and systems. You can integrate with other initiatives, such as an ERP upgrade or a merger or acquisition. Most important, you can do it on your own terms, at a pace that suits your company and its circumstances.

Real estate companies are characterized by intensive activity that places major demands on financial and human resources. An IFRS project cannot be a distraction from the primary activities of your business. It must be integrated, coordinated, and aligned. It starts now with some preliminary questions and a carefully drawn roadmap. And it ends somewhere in the twenty-teens when you report for the first time under a single unified standard. Whether the journey from here to there is rocky or smooth may be entirely up to you.

## Resources

With over 900 professionals, the Real Estate practice has a solid track record for helping companies make smart real estate business decisions. Our professionals provide assurance, reporting advisory, enterprise risk, tax, consulting, and financial advisory services to companies in most segments of the real estate industry. We craft creative solutions to help clients structure transactions, develop opportunities, monitor performance, and improve processes with information technology, including assisting real estate clients as they plan and implement International Financial Reporting Standards.

### **Deloitte offers companies assistance with:**

- evaluating the potential impacts of IFRS
- assessing readiness for IFRS conversions
- implementing IFRS conversions, providing support with technical research, project management, and training
- addressing the implications of IFRS in such areas as tax, finance operations, technology, and valuation.

### **Deloitte's Online Resources**

For a wealth of online resources related to IFRS, visit [www.deloitte.com/us/ifrs](http://www.deloitte.com/us/ifrs). Available materials include newsletters, whitepapers, pocket guides, timelines, webcasts, podcasts, and more.

### **International Accounting Resources**

The International Accounting Standards Board (IASB) develops international financial reporting standards for general purpose financial statements. Visit the IFRS section of [www.iasb.org](http://www.iasb.org) for additional details and copies of the standards.

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