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A Sarbanes-Oxley road map: Improving real estate data, dialogue and decision making in support of good corporate governance

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ABSTRACT

The pursuit of good corporate governance, as exemplified by compliance with Sarbanes-Oxley (SOX), requires corporate real estate (CRE) departments to gain a better understanding of asset values and lease costs than most companies currently possess. As a result, CRE departments are motivated to centralise control over operations globally, to improve systems for ensuring consistent and accurate accounting worldwide and to scrutinise vendors more thoroughly. These changes will be difficult for many CRE departments, but, done properly, the focus on corporate governance will bring greater understanding of real estate's impact on corporate financial performance, as well as enhancing relationships with the CFO, senior management and business unit leaders.

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Whether or not they know it yet, corporate real estate (CRE) executives of publicly traded companies are facing a major issue. It is an issue that will redefine their relationships with their CFOs and for better or worse (depending on how well the issue is handled), recast the role of the real estate department within the company.

The issue is corporate governance — the set of accounting and financial reporting practices that determines the extent to which a company provides a clear and accurate picture of its financial performance to board members, shareholders, stock analysts and other interested parties. The wave of corporate accounting and financial reporting scandals that crested in 2002 resulted in a surge of government regulation designed to improve corporate governance practices.

The new rules centre on the behaviour of corporate officers, board members and financial advisers such as accountants and auditors. However, other areas of the company are also affected. The initial effect on the responsibilities of CRE teams was mainly limited to re-examining off-balance sheet financing structures, such as synthetic leases, and the impairment of surplus space — two measures mandated by the Financial Accounting Standards Board (FASB). Changes to corporate governance procedures have also been mandated by the Securities Exchange Commission (SEC) and other federal agencies. But the law with the greatest impact on corporate governance was enacted by the US Congress. While its official name is the Public Company Accounting Reform and Investor Protection Act ('the Act'), it is better known by the names of its Congressional co-sponsors — Sarbanes-Oxley, or SOX for short. The Act created the Public Company Accounting Oversight Board (PCAOB), a quasi-governmental agency that oversees the audit of public companies, intending to protect the interest of investors and other users of an 'issuer's' financial statements.

The primary mission of SOX is to restore investor confidence. This includes making improvements in a company's financial disclosures; changing the role and responsibilities of board members; protecting whistle-blowers from retaliation; laying out rules for accountants and lawyers; broadening enforcement; and defining criminal penalties for violators.

A major study was completed in late 2003 about how senior executives across industries perceive the impact of SOX.[1] Figure 1 suggests that seven out of every ten respondents believed that the Act has helped to boost investor confidence. But from the standpoint of the CRE department, the most important aspects of SOX are the requirement for CEOs and CFOs to certify financial reports and the internal controls over financial reporting. This means that both CEO and CFO are now liable for civil and even criminal charges if financial information is found to be false.

In a large company, it is nearly impossible for a CFO to check every detail of each transaction that might affect the company's bottom line. To be in a position to certify financial statements and the internal controls over financial reporting, senior managers need assurances that others whose activities affect financial statements have accurately represented the company's true financial position. As a result, some companies will require CRE to sign a certification that real estate information is presented accurately.

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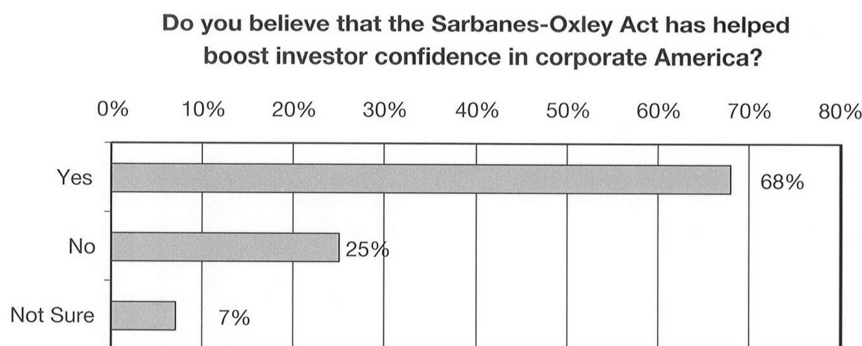

Source: KPMG

Figure 1 Investor confidence and Sarbanes-Oxley — A survey

INTERNAL CONTROLS

Sarbanes-Oxley requires every public company's management first to assess the effectiveness of the company's internal controls over financial reporting and then to report on the assessment at the close of the company's fiscal year. Because real estate activities have a material financial impact on a company's financial position, the real estate department must be a part of the internal control structure and the CFO and CRE must communicate regularly. The CFO's main goal in engaging in a dialogue is to ensure that any real estate data that may impact corporate financial statements have passed the 'definition-to-documentation' process. For example:

- CRE must be able to provide an accurate, up-to-date and consistent summary of the company's real estate, including how much is owned versus leased; where assets are located; what commitments have been made during the year; and how these commitments will affect financial performance in the coming year.
- CRE must show a rigorous, well-documented process to track acquisitions and dispositions across the portfolio.
- Transactions completed in different geographical locations must be subject to the same definitions, assumptions and metrics.
- The company must document its comprehensive real estate expenditures, including costs managed by vendors or business partners.
- Accounting standards for excess space and potential impairment costs must be followed rigorously and consistently.
- Accounting and tax treatment of synthetic leases must be consistent with SOX provisions for these 'special purpose entities'.

Most CRE teams possess at least some familiarity with these requirements, particularly in the areas of impairment and synthetic leases. Compliance in these two areas may require procedural changes within the real estate department, but they normally do not require structural changes. This is an important distinction, because full SOX compliance will lead many companies to reorganise completely the way in which they administer real estate.

As CFOs increasingly rely on CRE to deliver on *all* of the points listed above, and as companies get serious about SOX

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compliance, four key trends are likely to accelerate:

- *Scrutiny of vendor relationships will intensify.* Many companies utilise service organisations, business partners and third-party vendors to process a variety of transactions, including real estate services. Management may need to consider the controls at these organisations in its assessment of the internal controls over financial reporting. As a result, such relationships are likely to become more structured and formal.
- *Outsourcing will become more widespread.* Although the management of CRE is sure to become more complex under SOX, it will still be a non-core activity for most companies. Many may decide to outsource their real estate activities to simplify the process and make it more efficient, while transferring risk to a qualified provider.
- *Best practices will receive increased attention.* Given the potential costs — both economic and legal — of non-compliance, CEOs, CFOs, board members and others who may be called on to attest to the accuracy of financial processes and controls are likely to press for the adoption of company-wide best practices. For example, business-unit leaders who traditionally have made occupancy decisions and driven terms of negotiation for their business units will be under greater pressure to conform to standard company-wide procedures.
- *CRE departments will become more centralised.* The new demands that SOX will place on the organisation may make it difficult for a decentralised CRE function to respond in a timely, consistent and accurate fashion. Developing and managing effective controls and processes consistently is almost always less complicated and less costly with a centralised real estate structure. National companies with regional real estate control will increasingly turn to a centralised national model, while global companies with country-by-country control will increasingly turn to a centralised global model.

All four of these trends share two common characteristics that are important to observe. First, these trends were developing long before SOX became law. The need for SOX compliance has merely increased the rate at which the four trends are rising. Secondly, aside from being vital from a compliance perspective, these trends simply make good business sense. CRE executives across the country have been trying for years to implement structural changes, but most have met with limited success, because business-unit requirements were seen as more important than real estate considerations and because most CFOs have had more pressing priorities than the reorganisation of the real estate department.

But, with the introduction of SOX, CFOs who must attest to the accuracy and completeness of financial data will quickly recognise that their real estate practices must be more closely aligned with accounting and financial processes. In order to accomplish this, real estate procedures must be centralised and organised in ways that will frequently require a significant departure from current practices.

The question for CRE executives is whether their role in the coming transformation will be reactive or proactive. A CRE who is unaware of the ramifications of SOX and other corporate-governance mandates will be forced to react to the transformation, rather than to become an integral part of its design. A CRE executive who understands the importance of corporate governance, and can relate its

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challenges and opportunities to the CFO, will be in a position to drive change in ways that will not only help satisfy compliance with SOX, but also enhance corporate performance.

THE 'THREE DS' OF STRONG CORPORATE GOVERNANCE

Transforming current business processes into a system that will promote strong corporate governance is a complex undertaking, but the foundation for success starts with three general concepts, which can be summed up as the 'Three Ds': data, dialogue and decision making. In other words, success is possible only when a company tracks useful information accurately; communicates clearly and frequently with key decision makers; and ensures that the decision-making process is diligent and includes the appropriate analysis.

Most CRE teams excel at decision making when data and dialogue elements are in place. For example, if the organisation needs to generate cash, the real estate department can contribute by identifying the right real estate assets to monetise and the best financial structures for minimising risk and maximising after-tax cash flows. A successful strategy, however, depends heavily on having accurate and timely property information, as well as an understanding of corporate financial and operational objectives.

THE FIRST D: AVAILABILITY OF ACCURATE DATA

Accounting errors are most often due to inferior data integrity or a failure to engage in a meaningful dialogue with the various stakeholders in the process. For example, the outside auditors for a large publicly traded financial services company several years ago found problems in the notes to the company's financial statements concerning lease commitments: the company's internal accounting for future lease commitments underestimated the figure by 40 per cent. The auditors issued a warning to the board of directors, and when inaccurate data were provided again in the following year, the auditors threatened to withhold certification of the financial statements.

This particular incident took place before the passage of Sarbanes-Oxley. If it had taken place today, such an egregious accounting mistake could have had more serious repercussions for the company. Accounting errors are easy to make when a company does not have a consistent method for gathering and analysing data from properties.

Data integrity is a critical component of effective real estate management, with or without SOX. Developing efficient data structures that span the business enterprise allows real estate executives to identify and respond to potential problems sooner rather than later. Yet many large corporations remain hard pressed to provide an accurate, up-to-date and consistent summary of their real estate: how much of the portfolio is owned, how much is leased, what is the total occupancy cost of the portfolio, and how the portfolio has changed over time.

SOX virtually mandates systems and structures that support the collection, analysis and constant refreshing of property information. For many companies, establishing or improving these systems requires a departmental shift away from a 'project' focus towards an 'operations' focus. This can be a difficult transition for real estate departments that have traditionally focused on project-oriented processes such as planning, architecture, entitlements and development.

The need for better data integrity has

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the likely effect of accelerating the trends of centralising the real estate function and outsourcing functions to service firms with the necessary reporting and administrative infrastructure. The transition of data-oriented tasks to a third party grants the CRE executive more time and energy to focus on maintaining a dialogue with key stakeholders: the CFO's office, the accounting and finance departments, and business-unit leaders.

THE SECOND D: ESTABLISHING A DIALOGUE

An informative, ongoing dialogue between CRE and CFO has the power to integrate the CRE with the company's financial activities. It can also further the CFO's understanding of real estate's impact on the company. Many questions need to be addressed during such a dialogue. For example, does the CFO understand how real estate decisions are currently being made? Does the CRE manager understand the CFO's analysis of SOX implications on the company's real estate function? Do CRE practices comply with current accounting guidance? Do the business units understand how they can reduce real estate costs? Does the CRE manager have knowledge of the company's current tax position?

The first challenge for CRE departments is to create an environment that fosters an effective dialogue. Breaking down communication barriers may seem like a daunting task. But communication will allow CRE continually to educate (and be educated by) those doing the day-to-day transactions; to build a reliable data system for real estate information; to ensure that the CRE group has a working knowledge of all the accounting, finance and tax implications that might relate to real estate; and to implement the processes that will lead to transparency and (ultimately) SOX compliance. To accomplish these tasks, all employees, from entry level to senior management, must collaborate to work toward common goals. Promoting a company-wide understanding of how real estate affects financial and operational performance is perhaps the first step in the journey toward success. But ultimately achieving success will depend on two basic skill sets: communication and financial acumen.

A lack of communication on real estate issues may stem from differing perspectives of the many decision makers involved. Business-unit leaders often regard real estate from a purely operational standpoint. They need space to serve two purposes: to house employees and to support their business. Accounting departments, by contrast, typically consider real estate primarily from a financial perspective. They tend to reduce complex strategies down to simple numbers affecting the financial statements. In the meantime, senior management may focus more on high-level strategy than on either operational or financial considerations of a lease-versus-own decision. Likewise, tax, treasury and finance departments bring their own perspectives to the table.

It is up to real estate executives to turn the din of conflicting voices into one harmonious chorus. Therefore, CRE executives must learn to speak the language of senior management, must learn how different business units operate and change, and must learn how finance and tax departments apply the latest accounting guidelines. Finally, real estate teams must understand how real estate affects the company's goals, financial statements and strategies.

The example in Figure 2 illustrates how a real estate issue can affect financial performance for the enterprise as a whole. Although SOX compliance may be the

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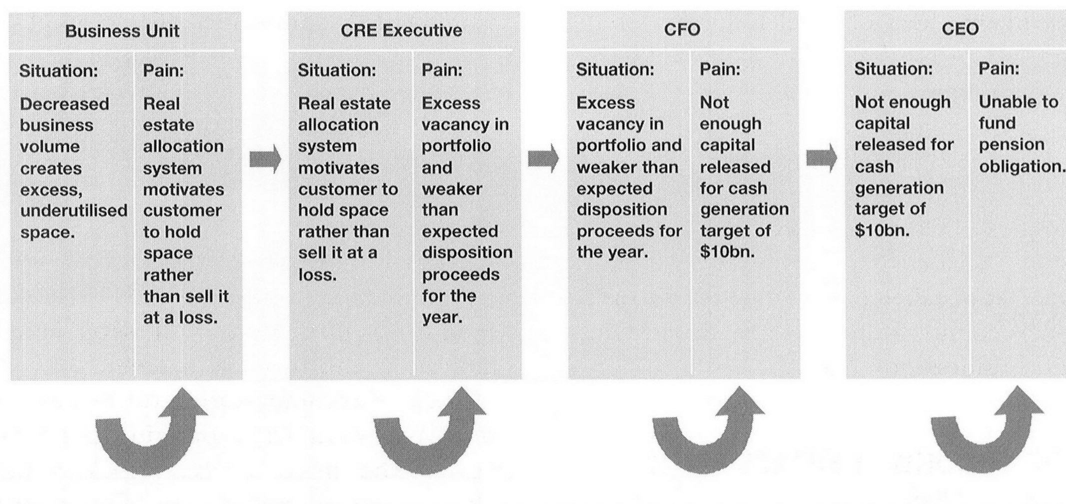

Figure 2 'One thing leads to another' — Real estate and the whole company

rationale for transforming real estate decision-making processes, an equally important reason for undertaking this task is to increase the real estate department's ability to add value in all areas of the company.

Dialogue with the business units

One of the most important relationships that CRE can have is with the business units. Strengthening these relationships leads to results for both parties. Customer relationship managers (CRMs), a standard position within best-in-class real estate departments, are the value creators. In order to link CRE effectively with the business units, CRMs must learn the business of their client, understand its strengths, weaknesses, competitors, opportunities, threats, industry and strategies, and then relate those issues to real estate solutions. The people using the real estate should therefore be the source of feedback for CRE; creating the bond between business units and CRE is a necessary first step to developing an accurate, reliable and constantly refreshed system of real estate information.

Real estate groups should be prepared to provide formal training for CRM positions, because success and effectiveness in this position is key to the successful development of relationships with the CRE's customers. Because business units are not focused on real estate, CRMs have an opportunity to educate the businesses, as well as educating themselves on how the businesses operate.

For example, real estate professionals could explain to business-unit leaders the cost of space 'flexibility', or how various control structures carry different levels of risk and cost. Business-unit leaders often assume that owning property is less expensive over the long run than leasing, and flexibility in the portfolio is rarely the primary goal. The simple relationship between cost and flexibility for owned and leased properties is illustrated in Figure 3. If CRE can articulate the costs and benefits of flexibility techniques such as expansion and contraction options, they may help business-unit leaders to avoid the cost of downsizing that many companies are incurring in today's environment.

New ways to conduct cost-benefit analyses on flexibility issues allow CRE teams to identify the most flexible properties in a portfolio and create

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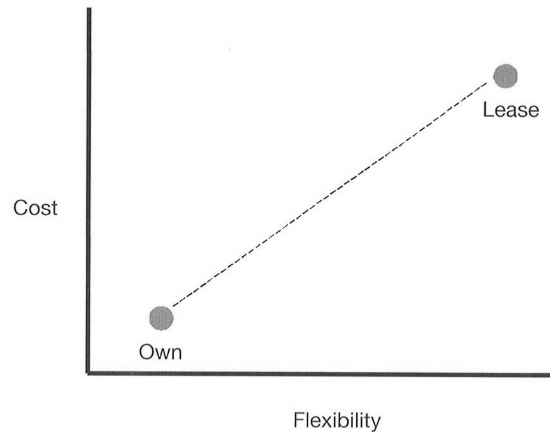

Figure 3 The flexibility matrix: Theory

strategies that leverage this knowledge. The flexibility matrix in Figure 4 — based on a portfolio analysis performed for a worldwide technology corporation — serves as a scorecard of property, market and business factors. This analysis provides a clear comparison of properties from a flexibility standpoint. The properties plotted in the upper right quadrant are the most flexible properties in the portfolio. This information allows for a higher level of strategy and service delivery for CRE's customers and a more agile and flexible real estate portfolio for the enterprise.

CRE can help business leaders to view real estate from a new perspective. A discussion about flexibility might lead to greater understanding of the customer's business cycles and future needs. This dialogue in turn helps CRE to determine which real estate strategies are most appropriate to drive results. Recommendations and results that can be acted upon are a by-product of this dialogue, which — although the topic is not specifically concerned with corporate governance — strengthens relationships and knowledge and often leads to improvements in financial performance.

Dialogue with corporate executives

In addition to business-unit leaders, CRE executives must focus on the true decision makers within senior management as well as in the treasury, accounting and tax departments. Executives in these groups set strategy, determine corporate financial policy and hold the keys to capital deployment. The unique opportunity that SOX provides is one of visibility and impact. While the issues requiring attention are easy to identify — data systems, transparency, working with others to be compliant — communicating those issues in the 'language' of executives is more challenging. After all, these executives traditionally have taken less interest in real estate activities than CRE executives might like.

The key to communicating with executives outside CRE is to 'get into their mindset'. Identify the issues that executives concentrate on in day-to-day business. For example:

- Accounting: how does real estate affect the financial statements of a firm?
- Tax: how does real estate contribute to the tax position and strategies of the company?
- Treasury: what value or cost savings can real estate provide over other capital

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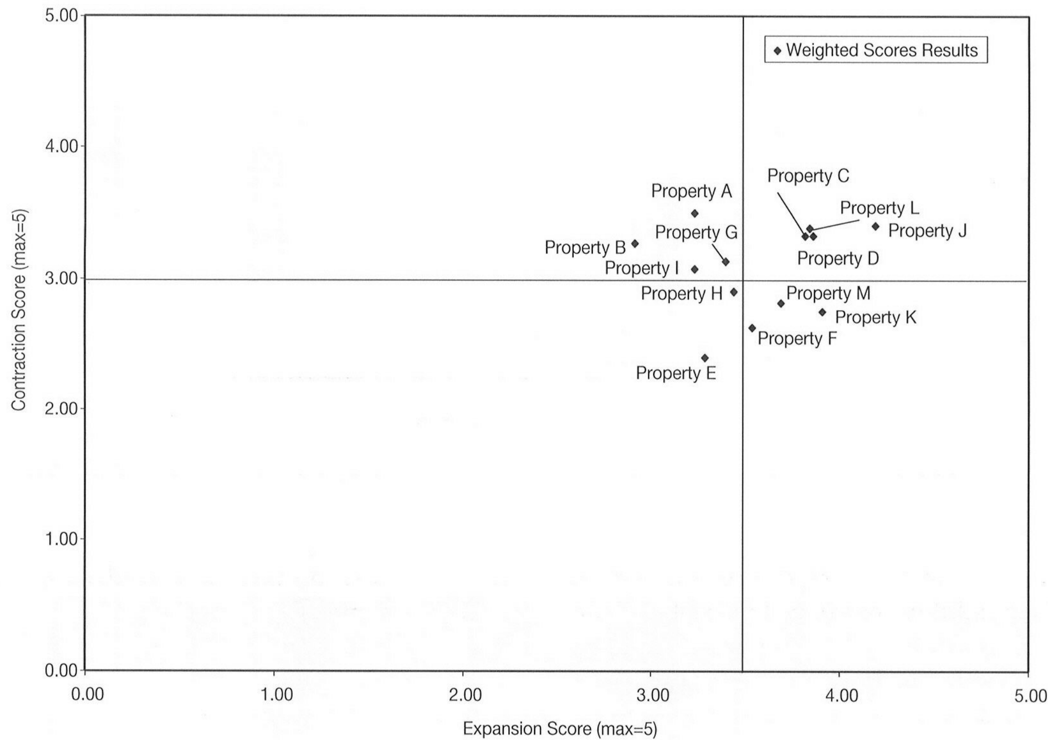

Figure 4 The flexibility matrix: Practice

investment projects vying for Treasury's attention?

- Senior management: how does real estate affect key financial ratios and earnings per share?

Reporting the answers to these questions in the proper language is the challenge facing many CRE executives. Translating real estate results into corporation-wide results is the key. For example, a senior executive might be interested in how owning or leasing real estate affects certain key financial metrics. To illustrate the answer, the charts in Figure 5 report how various control structures affect two different financial metrics: net present value (NPV) and earnings per share (EPS). Specifically, such a graphic can serve as a tool to help explain why there is never one right answer in real estate — to make the appropriate and desired impact, all decisions must align with the strategy of the business units and the company.

Similarly, the treasury and accounting departments may want to know how a specific transaction will affect the corporate financial statements and specific financial targets, as found in the table in Figure 6. This exhibit highlights to corporate executives the major impact a single transaction can have on the company's financial metrics. This particular example was for disposition of an office property worth \$4m. By translating the real estate transaction impact to the financial statements, this graphic reports a one-cent increase in EPS. For a company with an 18 price–earnings ratio and 50 million shares outstanding, this represents an increase in market capitalisation of \$9m. Reporting any measurable increase in earnings or market cap is sure to catch

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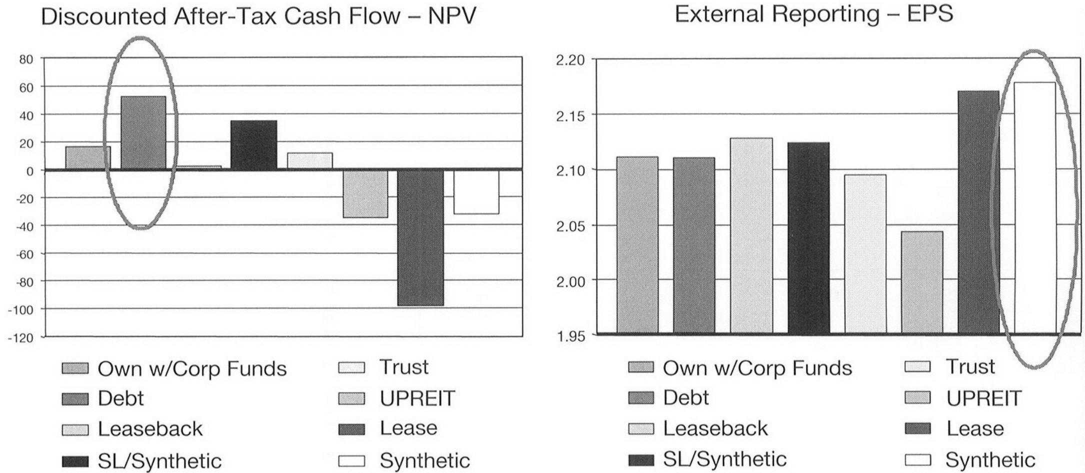

Figure 5 Explaining company proposals: Net present value and earnings per share compared

Figure 6 Explaining company proposals: Financial implications

Measures	Ratio	12/31/03 w/o Trans	12/31/03 w/ Trans	Transaction Impact
Earnings	EPS	$ 1.00	$ 1.01	$ 0.01
Disposal Proceeds	Total Proceeds (Net)	$ -	$ 4,000,000	$ 4,000,000
Profit Margin	Net Income/Revenues	7.00%	7.21%	0.22%
ROA	ROA	12.96%	13.41%	0.45%
Revenue Growth	% Change in Revenue	11.1%	9.3%	–1.8%

the eye of corporate executives outside CRE.

THE THIRD D: EFFECTIVE DECISION MAKING

To report such meaningful information to executives outside CRE, the CRE team itself must be educated and empowered to make the best real estate decisions for the company. Many companies are turning to formal financial acumen training for their CRE teams. This training elevates the team's level of understanding and application of finance, accounting and tax concepts. It can also help to mend the disconnection between corporate goals and how each individual's position affects the company as a whole.

Can your CRE team re-create the graphics shown here with your company's real estate data? Do its members understand how each transaction affects the company? Is CRE working within the framework of corporate tax strategy? On which tax strategies should they focus: donations, 1033 exchanges, ATM taxes, or others? If a CRE team cannot address these issues, then a breakdown in corporate governance, transparency and SOX compliance may soon become a problem. The goal is not to make CRE individuals into tax, accounting or finance experts, but to ensure that they are aware of issues in those arenas and know when, how and whom to contact when issues and opportunities surface in everyday work.

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For example, the recent accounting guidance resulting from FASB's EITF 01-08 relates to embedded leases within a company. It is not unusual for the accounting group to rely upon the real estate department to determine which supplier arrangements might be considered embedded leases, especially since CRE is often heavily involved in the real estate decisions of the suppliers. Problems arise, however, when the accounting group relies on CRE to identify these potentially embedded leases, but CRE has not been educated or empowered to know when to raise a 'red flag' concerning the issue. An open dialogue between the two groups is the basic solution to this problem. Only when an open dialogue exists will CRE be better equipped to identify potential problems and subsequently refer to accounting for guidance on how to handle the issues. Such a dialogue prevents supplier arrangements from falling through the cracks and eventually causing more pain in the future audits.

Smart real estate strategies should not be implemented without a rigorous decision-making process. To execute the best decisions, analysis should be based on more than just the NPV of a project. There must be a solid understanding of how real estate is related to stock prices, debt ratings, tax strategies, accounting guidelines, corporate discount rates and the long-term vision for the company. Only when the CRE team understands how the group contributes to the whole company will each individual feel empowered to make a difference, drive value, and ultimately promote corporate governance from the bottom up.

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(1) KPMG (2004) 'Sarbanes-Oxley Section 404: An Overview of PCAOB's Requirements', April.

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