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International financial reporting standards and financial reporting for the real estate industry

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One of the current hot button accounting issues in the U.S. is the impending conversion from Accounting Principles Generally Accepted in the U.S. (GAAP) to International Financial Reporting Standards (IFRS). For a long time, GAAP was the effective international standard, but in recent years IFRS has been gaining momentum. Over one hundred countries are currently using IFRS, or are moving in that direction. In November 2008, the Securities and Exchange Commission released a proposed road map (i.e., a timeline) for public comment for U.S. public companies to adopt IFRS. That timeline is subject to change as a number of influential financial professionals, including Mary Schapiro the current SEC chairman, have expressed various concerns and reservations about adopting IFRS, as well as the roadmap. However, considering that many U.S. companies, including small and medium size enterprises, do business on a global scale, it is likely that IFRS will be adopted in the U.S., and it will not necessarily be only for public companies. It is likely that IFRS will eventually filter down to private companies. The International Accounting Standards Board (IASB), the organization that writes IFRS, has embarked on a project to develop "Simplified IFRS" for private entities.

There are some significant differences in financial reporting for real estate companies under IFRS as opposed to GAAP. IFRS is primarily a principles based system lending itself more to judgment and interpretation, where GAAP has evolved to become predominantly rules based. Some of the primary areas of difference relate to valuation of investment properties, impairment of long-lived assets and accounting for leases.

Perhaps the most significant difference relates to the valuation of real estate investments. Under GAAP, investment properties are generally carried at historical cost and depreciated over their estimated useful lives. Under IFRS, there is a choice of using the historical cost model or a fair value model. If the fair value model is selected, the real estate is reflected at fair value in the balance sheet and the changes in fair value are reflected in the income statement as unrealized appreciation/depreciation. If the entity chooses to use the historical cost model, the fair values of the investment properties still have to be disclosed in the notes to the financial statements.

Linked to the valuation of real estate investments, is the impairment issue. GAAP requires that whenever events or circumstances indicate that the carrying value of a long-lived asset to be held or used may not be recoverable, the asset must be tested for recoverability. If the carrying amount of the long-lived asset is not recoverable and exceeds its fair value, an impairment loss is recognized. IFRS has a similar standard, although the methodology for impairment testing is different. A major difference is that under IFRS, impairment losses may be reversed if the recoverable amount subsequently increases.

Accounting for lease incentives is another area of potential disparity between GAAP and IFRS. IFRS has a somewhat wider-ranging definition of what constitutes a lease incentive. It is possible that transactions that are classified as tenant improvements under GAAP may be treated as lease incentives under IFRS. Since lease incentives are treated as a reduction of rent income, there may be significant differences in rent income reported under IFRS versus GAAP.

Differences between GAAP and IFRS also have implications that go beyond the financial statements. Contracts and agreements frequently contain provisions such as debt covenants, financial ratios, earn-outs, or calculations of executive bonuses which are linked to amounts reflected in the financial statements. These contracts and agreements will have to be reviewed to see whether the provisions still make sense if the financial statements are prepared under IFRS.

A conversion from GAAP to IFRS will be a major undertaking for most companies. Although IFRS is not currently required for financial reporting in the U.S., it is not too soon to start thinking about what IFRS will mean to you.

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