

FINANCE

Doing Business in Sarbanes-Oxley Era

Real estate experts point to industry's relative transparency in saying the act raises costs and penalties while doing little to stop fraud

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Real estate mavens contend their industry is being unjustly impacted by new accounting requirements designed to suppress corporate malfeasance.

Having already achieved a relatively high degree of transparency to increase public investment, public real estate firms face increased costs and administrative complexities to comply with the new rules intended to reduce accounting ambiguity.

Advocates of the 2002 Sarbanes-Oxley Corporate Reform Act credit it with laying the

foundation for the accounting industry to earn back the investors' trust shattered by the Enron scandal, Arthur Andersen's subsequent collapse and the bankrupt corpses of other once-high profile companies.

They also say it will check latent corruption by auditors and financial advisors by changing how the accounting profession is regulated. The act also holds corporate executives to a higher level of accountability, including fines of up to \$5 million and prison terms up to 20 years for top executives who sign off on improper certifications.

No wonder that chief executive officers have

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a dim view of the law. PricewaterhouseCoopers surveyed 136 chief financial officers of large companies in June and found that just 30 percent had a favorable opinion of the law. That is down from 42 percent in 2002.

Ironically, accounting firms stand to benefit the most from the new legislation with increased client bases as firms look to financial consultants to comply with Sarbanes-Oxley, adding to the cost of doing business.

Larger accounting firms are already benefiting from the new rules with new business, said Michael Ellington, managing director of the Strategic Equity Group, an investment banking firm headquartered in Southern California.

"It's actually increased their overall revenue by slapping them on the wrist," he said.

Problem Solver or Problem Creator?

During a Sept. 23 hearing on the act's implementation, Sen. Richard Shelby, R-Ala., characterized the new requirements as an opportunity for the accounting industry to repair its reputation by reassuring investors that auditors are reviewing corporate books without conflicts.

"These rules were necessary to address conflicts of interest that caused investors to doubt the credibility of auditors and the accuracy of financial reports," he said during the hearing.

Enacting new rules is not the best solution, said Richard Campo, chief executive officer of Camden Property Trust, a Texas-based real estate investment trust. He advocated the vigilant prosecution of existing laws as a better remedy to help solve the problem.

"You cannot legislate morality," Campo said. "To stop the Enrons of the world from happening, they've sort of broadened it to include everything under the sun."

Historically, customers, finding it impossible to regulate ethics, have always relied on the integrity of merchants — whether they're selling flowers or energy — and as a result, from time to time, they have been duped.

Clearly, it is important to protect investors in securities sold in American markets, but industry experts wonder if Sarbanes-Oxley will cut down on the creative accounting witnessed at MCI (formerly WorldCom), Tyco and Enron.

Once the world's largest energy trader, Enron boasted 8,000 contracts in hundreds of businesses at the time of its Chapter 11 bankruptcy filing in December 2001. Its collapse managed to cripple an industry, frighten investors, damage the European market and, in the process, trigger a slew of new regulations designed to prevent this level of corruption from recurring, all while bringing about the demise of a few other corrupt entities.

"I'm not a big fan of Sarbanes-Oxley," Campo said. "It's designed to build confidence in investors that people are doing the right thing. Companies that had good business to start with now have to do a lot of busy work that doesn't add value."

Campo said he has paid some \$500,000 to consultants to comply with the rules. For the money, Campo said he gets, "a little document that says, 'Here's what I did.'"

Unexpected Real Estate Benefit

One unexpected consequence of the corporate scandals was that maligned investors plugged their money into the real estate industry, regarding property as a good investment.

"Typically in a recession, real estate suffers," Campo said. "But real estate is enjoying a pretty good spot ... in spite of the nationally soft apartment market."

With the creation of REITs in the 1960s and modernization in the 1980s, the real estate industry had a vehicle for transforming itself from a relatively opaque industry to a much

Accounting Impacts of New Rules

At the recent George Smith Partners charity luncheon, Stan Ross, former vice-chairman for Ernst & Young and chairman of the board for the University of Southern California Lusk Center for Real Estate, expounded on five new accounting rules impacting the real estate industry: the Financial Accounting Standards Board's Financial Interpretation N0. 46 (FIN46), FASB 141/142, FASB 144, FASB 146 and FASB 150.

"These five rules are extremely costly in interpreting and implementing and have a dramatic impact on balance sheets and financial statements of real estate companies," he said.

FIN 46, which deals with consolidation, is a new set of rules for off-balance sheet financing where the party with the greater downside has to consolidate.

"You are going to find most partnerships are going to wind up on the consolidation with a lot of new liabilities and a lot more assets showing up on the balance sheet," Ross said. "Your banker and rating agency will want to talk to you."

FASB 141 and 142 are principle-based concepts of comparability and relevance that require a single accounting treatment for all business combinations. FASB 141 required that all acquisitions are accounted for on

more transparent one that invited public investors.

Moreover, the relatively straightforward earnings structure of real estate, which is dictated by occupancy and sales, makes the industry easier to track.

But with the impacts of Sarbanes-Oxley hurting smaller real estate firms, many will have to question their place in the industry.

"The cost of compliance seems to be falling disproportionately on the smaller to middle-market companies that have gone public in the last five or six years as part of the robust economy," said Damon Lewis, manager of San Filippo.

The Bay Area accounting firm is active in helping companies achieve compliance with Sarbanes-Oxley.

Whereas such large multinational companies as General Motors have enough resources to make compliance feasible, newer companies have found themselves scrambling to complete just the act's first phase of documenting their policies and procedures, he said.

As a result, a growing number of firms are opting to remain or switch to being private rather than brave the increased red tape that accompanies being public.

At the Real Estate Conference Group's Apartments 2003 multifamily conference in September, Frank McDowell, chief executive officer of BRE Properties Inc., a San Francisco REIT, said the act increased the marginal cost of running a public company between \$5 million and \$10 million a year.

"It's creating additional costs and complexity throughout the organization," McDowell said. "I don't know if it's improving the way companies function, but it has certainly made it more costly to comply."

As the act makes it more expensive to be a public company, McDowell said it will likely either raise the minimum public company size, force some to turn private or others to get bigger to absorb added costs.

McDowell said he speculated that in time people might look back and contend that Sarbanes-Oxley had added costs but did little to improve transparency or corporate governance.

"It's just one of those things that all public companies are going to have to deal with," he said.

company balance sheets as acquisitions and FASB 142 specified how companies must account for intangible assets.

"You have to allocate value to leases as well as to the bricks and mortars, and you have to prove out all the components," Ross said. "Every building now that you guys are looking at, you are going to wind up with an allocation to an intangible for accounting purposes."

FASB 144 deals with write-downs where there's been an impairment of long-term assets.

FASB 146 is intended to deal with restructuring changes in a conceptually sound manner and the expensing of costs in connection with dispositions.

"Remember we now have to account for every single property that's being disposed of," he said.

Ross characterized FASB 150, which changes the classification of certain financial instruments from stockholders' equity to liabilities, as the "sleeper that caught everybody by surprise."

"[The rule] could wind up treating minority partners' equity interest as a liability on the financial statements, and you mark to market," he said. "Make sure you talk to your accountant about it — public or private."

— Laura Coleman

As a consequence, legal and accounting expenses have risen for BRE, McDowell said. Additionally, one of the most difficult aspects about the new legislation is how poorly it is defined.

"The SEC and Congress have mandated a lot of changes, and even mandated timelines, but they're not giving us guidelines," McDowell said. "It's forcing us to respond very quickly and very late to some things that are mandated."

Possibility of Fraud Still Exists

The act, which dramatically changed regulation of the accounting profession, created the Public Company Accounting Oversight Board, which is responsible for registering accounting firms, developing inspection and disciplinary programs, and drafting new auditing and attestation standards. The board is essentially a regulator expected to supervise audit firms in order to ward off future excesses.

"It's more of a pain in the neck than anything else," said corporate attorney Bob Moser, with the downtown Los Angeles law firm of Nossaman, Guthner, Knox and Elliott. "There's always the possibility of fraud in any industry."

In comparison to the corporate world, corruption in the real estate world — perhaps because so many transactions occur in the private sector — is virtually unheard of.

"In general, I would say the real estate industry is in better shape in terms of transparency or board accountability, as opposed to corporate America, because a lot of them went public in the '90s," McDowell said.

The trend toward consolidation emerged in the late 1980s and early 1990s due to new technology, which added to the rapid compartmentalization of the real estate industry.

With the main thrust of the security regulations impacting public companies, it is doubtful that private companies will choose to follow the rules if their own investors don't mind.

"To a certain extent, the requirements under Sarbanes-Oxley had existed all along," said Christopher Kramer, managing director of the Strategic Equity Group. "There's always been an ethical standard to do the right thing."

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