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# Audit Committee Perspectives

Risk and the 21st Century:  
Real Estate Industry

In late 2006, Ernst & Young conducted a worldwide survey of audit committee chairs, members, and others, from 176 companies across 12 industry sectors, including real estate. The real estate companies represented in Ernst & Young's 2006 Audit Committee Survey are all US-based and publicly traded.

Following is an overview of select survey information about audit committee activities and responsibilities in the real estate sector, particularly those related to risk management. While the sample of real estate companies was limited, the results do raise some interesting issues.

In just the past decade, the real estate industry has become an entirely new, global business sector that is fraught with risk, incredibly complex, and still evolving. The global property market – residential, retail, and office – has become tremendously competitive. Offshoring and co-shoring have many leading real estate companies doing business in foreign markets, or considering such a move in the near future. Meanwhile, merger and acquisition (M&A) activity in the sector is on the rise. Myriad issues weigh on the minds of today's real estate executives from complying with the rigorous demands of Sarbanes-Oxley legislation to addressing the complexities of doing

business internationally, including cross-currency, capital management, and tax issues.

This rapid pace of change throughout the entire sector has brought about a dramatic evolution in the activities of real estate audit committees. Their roles have expanded to include broader oversight of matters relating to financial responsibility and risk management. However, according to findings in *Ernst & Young's 2006 Audit Committee Survey*, the majority of real estate audit committee respondents may not be focusing enough time on risk management beyond financial reporting matters.

Consider the following key findings from *Ernst & Young's 2006 Audit Committee Survey*:

- § No real estate company surveyed reported having a separate risk committee at the board level.
- § Real estate audit committees generally are responsible for managing more risks than audit committees in other industries, including financial risks, such as accounting, tax, and capital structure risk; compliance risks, including legal and regulatory risks; and operational risks, such as information technology (IT) and human resources. Yet the majority of real estate audit committees who responded (43 percent) devote 10 percent or less of their typical meeting agenda to risk issues.
- § “Governance” was ranked by real estate industry respondents as one of the top five risks. For firms that have

- only recently made the transition from private to public, corporate governance is still a fairly new concept. These companies must navigate through today's volatile real estate market, work with various stakeholders, and “bed down” domestic and/or global expansion. Some of them are discovering that their current operations structure is too deal-centric, and does not adequately address other complexities and risks around core business activities.
- § Today's global real estate market demands that companies keep on top of not only what the next important market will be, but also what is happening elsewhere that might have an impact on their target markets. However, survey respondents report that they spend very little time considering emerging markets.

## Making Time For Risk Management

From human capital to leases to construction projects – risk is inherent in the real estate industry. However, no survey respondents reported having a separate board-level risk committee; so, oversight for a wide range of risk falls primarily on the shoulders of audit committee members. Surprisingly, the majority of real estate audit committees devote only a small fraction of their typical meeting agenda to risk topics. Is it possible that, despite the broad areas under their responsibility, the risk focus of real estate audit committees is too narrow? Most respondents said they rely primarily on the CFO, as well as internal and external audit

resources, to inform them about risk. Beyond that, most indicate they receive management reports about risk quarterly, or on an as-needed basis.

The question is whether, given their broad risk responsibilities, real estate audit committees should consider meeting more often, and also, devoting more of their agenda time to risk. At the moment, real estate audit committees hold fewer – and shorter – full agenda meetings than other industries. Or perhaps these risk discussions do occur – just by another name – as real estate audit committees report engaging in more specific-scope and ad

hoc meetings than other industries. This is likely because the current real estate climate requires organizations to be very flexible and responsive. Management must often discuss time-sensitive issues with the audit committee – and risk considerations are surely embedded in the list of critical topics. It is perhaps outside of transaction-related risks that more attention is needed.

Several survey respondents said they feel more meeting time is needed to strengthen the audit committee and improve its effectiveness. One survey respondent said “longer meetings” would be helpful; another suggested that “more dialogue” take place among audit committee members between regular meetings. According to real estate industry respondents, no audit committees in the industry spend more than half of their meeting time engaged in Q&A, and when they do, it is rarely about material not provided prior to the meeting. Instead, the majority of time is spent on presentations about predetermined topics set by management, internal audit, and external audit. Therefore, if broader risk issues are not on the agenda, they are unlikely to be discussed by the audit committee.

### Top-Rated Risks

Even though real estate audit committees may not be discussing risk as much as they should, they are definitely thinking about it. When asked to identify the top risks facing their organizations today, real estate respondents ranked these three areas highest: Market Dynamics, M&A and Divestiture, and Planning & Resource Allocation. Compared to the overall survey where Regulatory and IT issues were among the top three, the rapid evolution of the real estate market is obviously top of mind.

**Market Dynamics, M&A and Divestiture** – The increasing globalization of capital flows in real estate has meant market dynamics have consistently been seen as a key risk in the industry, but real estate companies participating in the survey also identified M&A and Divestiture as a primary – and increasing – area of risk. Because this area has moved up in rank from eighth to second place since the previous Ernst & Young audit committee survey, it is evident that organizations expect recent M&A activity in the industry to continue. Coping with the dynamics of a volatile real estate climate will be a major focus for most real estate companies in the near term.

Not surprisingly, real estate audit committees said they would like to have more education about topics related to M&A activity; no doubt they are looking to gain better understanding of the medium- and long-term trends that will affect market sectors where their companies want to invest. Also, divestiture is high on the agenda of many real estate firms today, most likely due to the tremendous capital appreciation in their portfolios in the past few years. Recent privatizations in the REIT sector have many public companies wondering if they should follow suit; mean-

while, private companies are considering what opportunities the public market may now hold for them.

**Planning & Resource Allocation** – The phenomenal growth in the real estate market and increasingly geographically diverse investment opportunities have meant that real estate organizations must carefully allocate not only their financial resources but also perhaps a scarcer commodity, their human capital. With tightening returns real estate companies need skilled and responsible professionals to develop assets and keep them operating optimally, so it’s no surprise that Resource Allocation was ranked as a key risk. Finding and retaining top talent is particularly challenging for real estate companies operating in today’s tight labor market. And for organizations doing business abroad, finding quality people to manage operations in foreign markets is essential to success.

Following these top three areas of concern, real estate respondents noted Governance, Physical Assets, and IT as other significant considerations. Physical Assets is to be expected given the nature of the industry and the security climate in a post 9/11 world, but is it also possible that an increasing focus on environmental issues is meaning real estate organizations are starting to take a “green” look at their portfolios?

Similarly a focus on IT is not unexpected. As noted earlier it was considered one of the top three risks in the overall survey. For many real estate audit committees today their role includes primary oversight (with board oversight) of IT risk. For most, this is a new responsibility. Technology risk related to security and privacy, business continuity in domestic and foreign markets – and even risk associated with technological investments for improving work productivity, managing assets, and reducing energy costs – is of top concern for many real estate firms today. Plus, for companies that have been expanding rapidly domestically or in markets abroad, there is a need to “backfill” those initiatives with supporting technology. And for real estate companies involved in recent M&A activity, the integration of technological systems has been challenging and quite often, very costly.

Perhaps the most interesting response relates to Governance. The overall survey would suggest the wider business community believes they have the broad aspects of corporate governance well in hand and are focusing on the challenges of an increasingly regulated environment. In real estate, however, the rapid growth and volatile climate – intense competition in some sectors and softening in others – has companies focusing more on strengthening their corporate governance practices, so they can make business decisions quickly and confidently in a rapidly changing market. In the past, most real estate firms operated with a relatively small infrastructure. Today, many companies realize this is not sufficient, and are trying to establish more formalized processes, to address many things around core business activities that go beyond deal-making.

Corporate governance involves effectively managing relationships among many stakeholders. This can be particularly tricky for real estate organizations because transactions can be complex and involve multiple parties. Also, quite often, there are existing relationships among related parties, and therefore, firms must be very careful to negotiate terms fairly so as not to favor one party over another. Corporate governance is also top of mind today for real estate firms that have expanded rapidly into new markets, and must now focus on “bedding down” that recent growth.

## Emerging Markets

*Ernst & Young's 2006 Audit Committee Survey* brought to light one other potential risk area for many real estate companies: the audit committees surveyed spend very little time considering emerging markets. Given the globalization of real estate, now, more than ever, it is imperative for audit committee members to have a deep

understanding of the complexities and risks their organization faces in its markets of choice, no matter what they are or where they are located. Even if a company does not intend to do business in certain markets, there should be awareness of how risks in emerging markets might ultimately affect the firm's target markets.

Audit committees help to set the “tone at the top” for the entire organization; therefore, members must make it a top priority to be proactive about getting the education they need to learn more about emerging markets, and the associated near- and long-term risks. It also is the responsibility of top management, including the board and other board-level committees, to help provide the audit committee with the knowledge and resources its members need to gain deeper perspective into the 21st century real estate industry, and to fully understand their company's role within it.

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