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Kahr Notes

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"Kahr Notes" is an electronic newsletter from Kahr Real Estate Services LLC that carries interviews, news, and original research. This month's issue is going to 613 readers.

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1. Opening Shot

Welcome to another issue of Kahr Notes.

I just spent a few days in San Francisco on business, and I'm amazed at the real estate disaster that "South of Market" has become.

During the dot.com years, the South of Market ("SoMa") district was considered the prime location for the "New Economy" companies. With that desire came new construction and inflated rents. Now that the bubble has burst, the district looks like the set of an apocalyptic horror movie; the people are all gone and have left behind only hip architecture and empty storefronts.

Hunter S. Thompson, in his book "Fear and Loathing in Las Vegas", also talks about a similar experience - that of the feel-good times of the 1960's coming to an end.

"We had all the momentum; we were riding the crest of a high and beautiful wave. So now, less than five years later, you can go up on a steep hill in Las Vegas and look West, and with the right kind of eyes you can almost see the high-water mark - the place where the wave finally broke and rolled back."

Perhaps in thirty years, tour guides will offer the SoMa district as an alternative to walking through Haight-Ashbury.

That's it for my ramblings. Enjoy this month's interview and you'll hear from me

again soon.

Regards,

Joshua Kahr
Editor/Publisher, Kahr Notes

2. Interview with Dale Goldstein, Managing Director of Chatham Square Associates

KN: This is Joshua Kahr, publisher of Kahr Notes, and I'm sitting here with Dale Goldstein, Managing Director of Chatham Square Associates. Dale, let's start off with a little about your professional career.

DG: I have over 15 years of "Big 4" management consulting experience, most recently as a Director in the Merger and Acquisition Risk Services practice of PricewaterhouseCoopers. In addition to my merger and acquisition experience, I have led large multi-disciplinary teams responsible for providing business process transformation, performance improvement, and systems integration expertise to support organizations undergoing change through the implementation of ERP systems, e-Marketplaces, and web-based applications, such as e-Procurement.

I began my career with Deloitte & Touche in the Enterprise Risk Services practice, where I provided technology audit services for our clients, as well as counsel to audit teams, and provision of audit services in support financial statement audit engagements. This also included coordinating technology risk assessments and providing technology related consulting services in such areas as: business continuity management and recovery planning, pre and post- implementation reviews of systems initiatives including application controls integrity, project risk management, information security, and internal controls reviews.

After leaving PricewaterhouseCoopers, I formed Chatham Square Associates, a consultancy focused solely on Business Risk Advisory Services. Originally focused on the risks related to a Merger and Acquisition scenario, we have expanded our service offering to provide internal controls consulting services to provide guidance for compliance with the Sarbanes Oxley Act of 2002.

KN: What is Sarbanes Oxley?

DG: Sarbanes Oxley is legislation that was enacted in 2002 to help bring back investor confidence in the financial markets. It requires organizations to implement disclosure procedures as well as document, test, and monitor internal control policies and procedures.

The overall intention is, given the issues of Enron, Worldcom, and other public companies, to show that there is accountability in terms of controls. The biggest issue that has come out of the new legislation is Section 302. Section 302 requires the CEO and CFO on a quarterly and annual basis to certify their financial statements as well as internal controls and disclosure reporting. Section 404 describes the specific requirements related to internal controls.

KN: What happens if the CEO and CFO certify the financial statements and something comes up?

DG: It's different than it used to be in the past. Now, they are personally liable for the issues that come up, both financially and potentially criminal. The certification is a requirement of all public companies

KN: It seems to me that a lot of the investing public is not aware of Sarbanes Oxley.

DG: They are not aware to the same extent as the financial community has. For any CFO of a publicly traded organization, this is on the top of their agenda. In terms of the investing public, the public companies are making their investors aware that they are in compliance in a number of ways, such as the internet, annual reports, etc.

KN: And then leaving it to the investors to figure it out?

DG: Correct.

KN: Let's talk about how your consulting work has exposed you to real estate.

DG: My clients have been organizations that have real estate portfolios, such as large financial institutions, a REIT, being solely in the business of real estate, and public companies that have significant real estate interests. I even had a project with the Department of Defense, which also has a large real estate portfolio.

KN: In your opinion, would you agree that real estate is an industry that has not worked with consultants very much?

DG: I think that if you look at many real estate focused organizations that are out there, they are organizations which are entrepreneurial, deal centric, and not as focused on infrastructure, policies, procedures, and controls.

In terms of consulting, the most that they have used consultants for would be legal, accounting, and some technology, but not historically more than that.

Where Sarbanes is an issue is with organizations such as REITs is that these are fairly new companies without a lot of infrastructure, internal controls, or documented procedures. Since they are publicly traded, they required to file financial statements on an annual and quarterly basis, and they are as required as anyone else to address these issues. They have limited expertise in house to assist them with this. They might have a strong CFO and acquisitions person, but in many cases they don't have an internal audit function or a deep knowledge of internal controls.

The other area that I have been working with is with public companies that have large real estate portfolios. Internal controls are still an issue. Although they are not in the business of real estate, when you look at the cost and financial impact that real estate might have on those organizations, it also makes it very material and relevant.

KN: For many companies, real estate is the second largest expense after labor. Most people are surprised when they hear that.

DG: That's exactly right.

KN: When you say internal controls, what do you mean?

DG: Internal controls are the policies, procedures, and related infrastructure that is in place to ensure that financial statements accurately reflect the financial position of an organization. What you want to implement is a controls framework to support each account on the financial statements. An example being the COSO framework, developed by the Treadway Commission. This now is an industry standard.

KN: What's a typical consulting assignment for you right now?

DG: The biggest projects that I've been involved in are what would be called are

"404 readiness assessments".

A project would go from six to twelve months. We would start with project organization such as understanding the scope and what entities are required under Sarbanes.

Essentially, we develop an internal controls framework. Within this framework, you want to make sure that these processes are creating financial information that is accurate and from a business perspective that all your business objectives are being satisfied. Then we would identify control activities, and the mechanism to ensure that they are tested, and all weaknesses are corrected.

In the case of a REIT, what you would do is look at your financial statement, and develop your testing around that. You would choose to test your portfolio either by property or by geography. You'd want to figure out a strategy where you could test your internal controls. What's centralized in terms of property management, accounts payable, and your major financial components? A REIT is no different from any publicly traded business. It's just in the business of buying and selling real estate. It has a sales cycle, expense cycle, fixed assets, payroll, human resources, and general ledger. It is not different than any other organization.

KN: What must be challenging with REITs is that the management is often very thin. There are so few people at the top that there is no one that this task can be delegated to.

DG: That's why many of the REITs are turning to their accountants, typically the "Big Four", for help in that area. Where the issue comes these days is in terms of cost. Many organizations feel the cost is high for a project which is perceived as compliance in nature.

The other big issue is with many of the publicly traded companies is that under Sarbanes Oxley any non-audit consulting services that is provided by the auditors must be approved by the board. A lot of publicly traded companies are not using their auditors for this kind of work. They are either using another audit firm or a smaller firm from a cost perspective.

We have been successful in partnering with a number of "Big Four" to provide a service that they may be precluded from performing. We provide a lower cost alternative to an organization which may use their auditors to provide an opinion on internal controls, while we perform all other aspects of 404 readiness.

KN: If you were to identify one key issue of the impact of Sarbanes Oxley, what would it be?

DG: The biggest issue and the takeaway from this discussion is that this legislation is not going away. Public organizations have to address it. The biggest decision a company will make is whether or not this is just a compliance project or are you going to make more out of it? What we have been doing with our projects is instead of looking at only controls, we are looking at business processes. It's an opportunity to optimize processes and identify cost reduction opportunities. That's where we're seeing our greatest value.

Forward thinking organizations are taking the time to look at each key process and look for ways that they can streamline and improve. That's the biggest advantage of this.

KN: I'd imagine that since many REITs have rarely used consultants, they probably find significant cost savings when they undertake this process.

DG: One thing in particular, if you look at a REIT, when you look at the purchasing cycle, the big question that comes up is whether it is centralized? Are we taking advantage of national vendor contracts? This applies across everything including utilities, facilities management, professional services, and labor. This is an add-on to this kind of project.

KN: That fits in with statements that some REIT CEO's have made, like Sam Zell of Equity Office, that the larger real estate companies will enjoy significant economies of scale.

DG: Well, you're still in the business of real estate and that's where you're going to see your greatest profits. That said, on the infrastructure side, there are smarter ways of doing things. You can keep greater control over quality. What has historically happened in real estate is that many of the organizations have related companies or parties. In many ways, it is incestuous in terms of who is doing your construction, and who is doing your financing? Often, it is someone within the organization or someone that is related to you. With Sarbanes, that has to be disclosed. Some of the old guard of real estate operators will be disappointed and have to change their operations.

KN: Thanks for your time.

DG: Thank you.

If you're interested in finding out more, you can visit Chatham Square Associates' web site at <http://www.chathamglobal.com>

Also, I posted on my web site a link to a short PowerPoint presentation outlining a "Readiness Assessment". The link is <http://www.kahrrealestate.com/404%20Readiness%20Project%20Sequence%202000-3.ppt>