

**WHITE PAPER ON  
FUNDS FROM OPERATIONS  
FOR IFRS**

**REVISED: SEPTEMBER 2010**

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## I. INTRODUCTION AND BACKGROUND

Since the introduction of the REALpac Handbook in 1972, REALpac has promoted Funds from Operations (FFO) as the industry-wide standard measure of a real estate entity's operating performance. The definition, initially labeled as cash flow from operations, has been clarified and amended a number of times to address new issues since that time. The definition historically has been one that was based from generally accepted accounting principles (GAAP). Since the release on November 21, 2003 of the Revised Canadian Securities Administrators' Staff Notice 52-306, *Non-GAAP Financial Measures*, FFO is no longer disclosed in financial statements and is included in other continuous disclosure documents of reporting issuers, both corporations and real estate investment trusts (REITs).

### Definition of FFO based on Canadian GAAP (November 1, 2004 to December 31, 2010)

Prior to the adoption of International Financial Reporting Standards (IFRS) in Canada on January 1, 2011 for publicly accountable enterprises, REALpac's definition of FFO, effective November 1<sup>st</sup>, 2004 was as follows:

*FUNDS FROM OPERATIONS means net income (computed in accordance with generally accepted accounting principles), excluding gains (or losses) from sales of depreciable real estate and extraordinary items, plus depreciation and amortization, plus future income taxes and after adjustments for equity accounted for entities and non-controlling interests. Adjustments for equity accounted for entities and joint ventures and non-controlling interests are calculated to reflect funds from operations on the same basis as the consolidated properties.*

REALpac's previous definition of FFO was based on Canadian GAAP which was an accounting model primarily based on historical cost that included limited concepts of fair value for non-financial items. Historical cost accounting for real estate assets implicitly assumed that the value of real estate assets diminished predictably over time. Historically, real estate values instead have risen or fallen with market conditions. Accordingly, many industry investors considered presentations of operating results for real estate companies that use historical cost accounting to be insufficient. The term FFO was created to address this problem. It was intended to be a standard measure of operating performance that excluded historical cost depreciation from — or “added it back” to — Canadian GAAP net income.

Since the introduction of the definition, the term has come to be widely used by Canadian public companies and REITs. In the view of REALpac, this use combined with the primary measures required by Canadian GAAP, has been fundamentally beneficial, improving the understanding of operating results of reporting issuers among the investing public and making it easier to compare the results of one real estate reporting issuer with another.

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The Impact of IFRS

Effective January 1, 2011, Canadian publicly-accountable entities will be required to prepare and report financial statements in accordance with IFRS. In REALpac's opinion, IFRS introduces greater judgment and interpretation of accounting standards as well as increased options in setting accounting policies. For example, IFRS introduces the option to measure investment property at fair value while maintaining the historical cost option as well. Given this significant change in accounting standards in Canada, it was necessary for REALpac to revise its definition of FFO to reflect the requirements of IFRS and to enhance comparability among reporting entities.

This White Paper has been prepared to provide reporting issuers and investors with greater guidance on the definition of FFO based on financial statements prepared in accordance with IFRS and to help promote more consistent disclosures in reporting issuers' continuous disclosures.

The REALpac definition of FFO for IFRS varies significantly from that adopted by the National Association of Real Estate Investment Trusts (NAREIT) as NAREIT's FFO definition is based on U.S. GAAP. However the concepts and objectives of the White Paper are substantially consistent with that of NAREIT. Differences in the REALpac definition of FFO for IFRS with that of NAREIT's FFO are described in Section VII of this White Paper.

The REALpac definition of FFO for IFRS varies slightly from the FFO-like measure adopted by the European Public Real Estate Association (EPRA), named EPRA Earnings. Differences in the REALpac definition of FFO for IFRS with that of EPRA's are described in Section VII of this White Paper.

This September 2010 revision to the June 2010 FFO White Paper has expanded slightly the treatment in Part IV section "O" to reference a "puttable instrument" as that term is defined in IAS 32, with the effect that certain redeemable and exchangeable units are now included.

## **II. INTENDED USE OF FFO**

REALpac recognizes that the management of each of its public member entities has the responsibility and authority to publish financial information that it regards as useful to the financial community, within the limits prescribed by securities regulation. Nevertheless, REALpac has been and remains convinced that the industry benefits from having a supplement to profit or loss as a measure of operating performance.

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In particular, financial statements prepared in accordance with IFRS do not provide stakeholders with the most relevant information on the performance of the underlying property portfolio under management. Unrealized changes in fair value of real estate property, historical cost depreciation of depreciable real estate properties, gains or losses on disposals of properties and other non-cash items do not necessarily provide an accurate picture of the company's past or recurring performance. For this reason, comparisons of the operating results of reporting issuers that rely solely on profit or loss have been less than satisfactory. Some analysts have also concluded that comparing or measuring prices of reporting issuers' stocks solely in terms of conventional price/earnings (P/E) multiples is not as useful as also using a supplemental metric.

REALpac has adopted the term FFO so it can be used as a supplemental measure of operating performance for the industry. In particular, it was hoped that prices of various reporting issuers' stocks could be compared with each other and in terms of the relationship between stock prices and FFO. Thus, the original intent was that FFO be used for the sake of determining a supplemental capitalization multiple similar to a P/E ratio.

Importantly, FFO was not intended to be used as a measure of the cash generated by a reporting issuer nor of its dividend paying capacity. REALpac feels that the statement of cash flows provided for by IFRS financial statements are adequate for analysts to assess the cash generated and used by reporting issuers. Similarly, REALpac continues to believe that the dividend/distribution paying capacity of a reporting issuer results from the economic characteristics of its assets, the degree of risk in matters of capital structure decided upon by individual companies, and other financial policy matters that are properly the province of management. While dividends can be analyzed in comparison to FFO, as they are analyzed in comparison to earnings in other industries, it was and is not REALpac's intent to imply that FFO is a measure of the sustainable level of dividends/distributions payable by a reporting issuer.

Given that FFO is not intended to be a measure of cash generated or of dividend paying capacity, REALpac realizes that most analysts, in an attempt to evaluate dividend/distribution policy, may make a variety of adjustments to FFO with the desire to adjust it so that it would be a better measure of cash generated or dividend/distribution capacity. These calculations generally are referred to by their authors as Funds Available for Distribution, Cash Available for Distribution or Adjusted FFO ("AFFO"). Although there is some considerable overlap among analysts as to what might be appropriate adjustments to FFO that would make it a better measure of dividend/distribution paying capacity, REALpac believes that there is not adequate consensus among preparers and users of reporting issuers' financial statements to allow agreement on a single definition of AFFO. Further, REALpac does not believe that there is a single measure of distributable cash that is consistently applicable to all reporting issuers. Accordingly,

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REALpac has prepared this White Paper to help reporting issuers provide a consistent starting point for the analysts in their analyses.

The following sections address the definition of FFO and the most important of the interpretive issues under the definition, along with REALpac’s views on them.

**III. FFO DEFINITION**

The format for the statement of FFO should reconcile to IFRS profit or loss (i.e. excluding items within other comprehensive income) from the statement of comprehensive income and include a line-item breakdown of each of the adjustments being used in the calculation of FFO. The reconciliation should be sufficiently detailed to provide readers with a clear understanding of the material differences between IFRS profit or loss and FFO.

REALpac recommends the reconciliation be presented in comparative form to the extent appropriate as follows:

**FFO / IFRS Earnings Reconciliation**

Profit or Loss per IFRS Statement of Comprehensive Income	\$x,xxx,xxx
Adjustments:	
A. Unrealized changes in the fair value of investment properties	xxx,xxx
B. Depreciation of depreciable real estate assets including depreciation for components relating to capitalized leasing costs, capitalized tenant allowances treated as capital improvements and lease-related items ascribed in a business combination	xxx,xxx
C. Amortization of tenant allowances and landlord’s work spent for the fit-out of tenant improvements and amortized as a reduction to revenue in accordance with SIC-15	xxx,xxx
D. Amortization of tenant/customer relationship intangibles or other intangibles arising from a business combination	xxx,xxx
E. Gains / losses from sales of investment properties and owner-occupied properties, including the gain or loss included within discontinued operations (if applicable)	xxx,xxx
F. Tax on profits or losses on disposals of properties	xxx,xxx

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G. Deferred taxes	xxx,xxx
H. Impairment losses or reversals recognized on land and depreciable real estate properties, excluding those relating to properties used exclusively for administrative purposes	xxx,xxx
I. Revaluation gains or losses recognized in profit or loss on owner-occupied properties, excluding those relating to properties used exclusively for administrative purposes	xxx,xxx
J. Transaction costs expensed as a result of the purchase of a property being accounted for as a business combination	xxx,xxx
K. Foreign exchange gains or losses on monetary items not forming part of a net investment in a foreign operation	xxx,xxx
L. Gain or loss on the sale of an investment in a foreign operation	xxx,xxx
M. Changes in the fair value of financial instruments which are economically effective hedges but do not qualify for hedge accounting	xxx,xxx
N. Negative goodwill or goodwill impairment	xxx,xxx
O. Effects of puttable instruments classified as financial liabilities	xxx,xxx
 Other items:	
P. Results of discontinued operations	xxx,xxx
Q. Adjustments for equity accounted entities	xxx,xxx
R. Non-controlling interests in respect of the above	xxx,xxx

**FFO** **\$x,xxx,xxx**

**IV. DISCUSSION OF FFO DEFINITION ADJUSTMENTS**

**A. Unrealized changes in the fair value of investment properties**

Unrealized changes in the fair value of investment property measured under the fair value model per IAS 40 result in unrealized, non-cash, gains or losses that impact profit or loss. To help maintain comparability in operating performance, IFRS profit or loss should be adjusted for the fair value movements to determine FFO.



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**B. Depreciation of depreciable real estate assets including depreciation for components relating to capitalized leasing costs, capitalized tenant allowances treated as capital improvements and lease-related items ascribed in a business combination**

REALpac recommends that all member companies reporting FFO should add back depreciation relating to only those items that are uniquely significant to the real estate industry. Examples of items that should be added back include depreciation on depreciable real estate property (owner-occupied property or investment property measured using the cost model), including the components relating to capitalized leasing costs, capitalized tenant allowances treated as capital improvements, and other lease-related items arising from the recognition of an acquired property in a business combination (i.e. components relating to above/below market rate leases and in-place leases). Specifically excluded are the add back of items such as depreciation of properties used exclusively for administrative purposes, depreciation of computer software, company office improvements, and other items commonly found in other industries and required to be recognized as expenses in the calculation of profit or loss.

**C. Amortization of tenant allowances and landlord's work spent for the fit-out of tenant improvements and amortized as a reduction to revenue in accordance with SIC-15**

This adjustment pertains to the amortization relating to tenant allowances incurred specifically for the fit-out of tenant improvements and fixturing that are accounted for as tenant incentives in accordance with SIC-15 and amortized as a reduction to revenue over the term of the lease. The amortization for these allowances are a non-cash item impacting profit and loss and should be added back to IFRS profit or loss to determine FFO. For added clarity, this adjustment *does not* pertain to the amortization relating to expenditures on tenant incentives that will not be specifically invested in the tenant's leased space such as the reimbursement of tenant non-capital expenses or simple cash payments.

For greater understanding of the rationale for this adjustment, tenant allowances and landlord's work may be accounted for either as tenant incentives or capital improvements. To ensure a comparable FFO number among all entities, the effect of tenant allowances and landlord's work in profit or loss is removed. It is expected that entities or analysts will consider the effect of recurring tenant allowances and landlord's work in other supplemental performance measures, such as AFFO, where a deduction should be made to FFO that reflects tenant allowances and landlord's work based on historical trends.

**D. Amortization of tenant/customer relationship intangibles or other intangibles arising from a business combination**

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The amortization relating to values assigned to tenant/customer relationship intangibles or other intangibles arising from a business combination is a non-cash item impacting profit and loss and should be added back to IFRS profit or loss to determine FFO.

E. Gains/losses from the sales of investment properties and owner-occupied properties, including the gain or loss included within discontinued operations (if applicable)

To help maintain comparability of on-going operating performance, IFRS profit or loss should be adjusted for the gain or loss on sales of real properties in the calculation of FFO.

F. Tax on gains or losses on disposals of property

Consistent with adjustment E. above, the tax charge or credit relating to gains or losses from the sales of investment properties and owner-occupied properties should also be eliminated from IFRS profit or loss.

G. Deferred taxes

Deferred taxes should be added back to IFRS profit or loss to help ensure consistency between reporting issuers that are corporations and all REITs. In addition, since deferred taxes are often impacted by substantively enacted changes in income tax rates, the add back removes any distortion arising from this factor.

H. Impairment losses or reversals recognized on land and depreciable real estate properties, excluding those relating to properties used exclusively for administrative purposes

Impairment write-downs or reversals of land and depreciable real estate properties are often early recognition of losses or gains on prospective sales of land or depreciable real estate property. Since such gains or losses are excluded from FFO, it is consistent and appropriate that increases or decreases in the carrying amount of these properties in advance of the realization of such gains or losses should also be excluded.

I. Revaluation gains or losses recognized in profit or loss on owner-occupied properties, excluding those relating to properties used exclusively for administrative purposes

Revaluation gains or losses on owner-occupied properties measured under the revaluation model per IAS 16 may, in part, or fully be recognized in profit or loss. To help maintain comparability in operating performance, IFRS profit or loss should be adjusted for the revaluation gains or losses included in profit or loss to determine FFO. Specifically excluded from this adjustment are the revaluation gains or losses pertaining to properties used exclusively for administrative purposes.

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J. Transaction costs expensed as a result of the purchase of a property being accounted for as a business combination

The purchase of a property may be accounted for as an asset acquisition or business combination. In the case of an asset acquisition, transaction costs are capitalized as part of the total initial cost of the property. In the case of a business combination, transaction costs are expensed as incurred. To ensure FFO reflects consistent treatment of transaction costs for all purchases of property, the transaction costs expensed as a result of the purchase of a property being accounted for as a business combination should be added back to profit or loss to determine FFO.

K. Foreign exchange gains or losses on monetary items not forming part of a net investment in a foreign operation

Foreign exchange gains or losses arise when monetary items are translated from their functional currency to an entity's reporting currency. If the monetary items are not considered part of a net investment in a foreign operation (for example any intercompany loans to a foreign interest (subsidiary, joint venture, equity investment) with a fixed repayment term), the translation of these monetary items flow through profit and loss. These foreign exchange gains or losses represent capital transactions impacting profit and loss and should be added back to IFRS profit or loss to determine FFO.

For greater clarity, this adjustment is meant to be restricted to those loans or receivables that arise due to an entity's interest in a foreign operation. This adjustment should not include any other foreign exchange gains or losses (realized or unrealized).

L. Gain or loss on the sale of an investment in a foreign operation

Where an investment in a foreign operation relates to the ownership and operation of investment property or owner-occupied property, consistent with the gains or losses recognized on the sale of domestic properties (adjustment E. above), to help maintain comparability of on-going operating performance, IFRS profit or loss should be adjusted for the gain or loss on the sale of an investment in a foreign operation.

M. Changes in the fair value of financial instruments which are economically effective hedges but do not qualify for hedge accounting

The changes in the fair value of financial instruments which are economically effective hedges but do not qualify for hedge accounting under IFRS are non-cash items impacting profit and loss and should be added back to IFRS profit or loss to determine FFO. Such changes include any related foreign exchange differences, if applicable. For greater

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clarity, this adjustment *should not* include changes in the fair value of all other financial instruments (except those described in item O. below), nor any changes in the fair value of financial instruments pertaining to the ineffective portion of a hedge.

N. Negative goodwill or goodwill impairment

The excess of the fair value of assets acquired over the fair value of the consideration paid in a business combination, which IFRS requires to be recognized immediately in profit or loss as a gain, together with any impairment charges in respect of positive goodwill are non-cash items impacting profit or loss and should be adjusted for in arriving at FFO.

O. Effects of puttable instruments classified as financial liabilities

In certain cases, IAS 32 requires that puttable instruments be classified as financial liabilities. As a result, this impacts both interest expense and unrealized fair value changes relating to those financial liabilities. To ensure comparability in the FFO of all entities, the accounting effects of classifying certain puttable instruments as financial liabilities is eliminated from profit or loss to arrive at FFO. Specifically:

- Where puttable instruments are classified as financial liabilities and distributions are therefore treated as interest expense impacting profit or loss, the amount of distributions accounted for as interest expense should be added back to profit or loss to arrive at FFO;
- Where the puttable instruments are classified as financial liabilities and are required to be measured at fair value each reporting period, the unrealized fair value changes in re-measuring the financial liability should be added back to profit or loss to arrive at FFO; and
- Where the conversion feature of a convertible debt is required to be accounted for as a derivative because the debt will be converted into redeemable or exchangeable units that are classified as financial liabilities, the unrealized fair value changes in re-measuring the derivative should be added back to profit or loss to arrive at FFO.

P. Results of discontinued operations

FFO related to non-current assets held for sale, sold or otherwise transferred and included in results of discontinued operations should continue to be included in consolidated FFO.

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To the extent the results of discontinued operations contain items discussed above, FFO should be adjusted for these items.

Q. Adjustments for equity accounted entities

An entity's share of profit or loss of equity accounted entities should be adjusted for adjustments to convert the entity's share of IFRS profit or loss to FFO.

R. Non-controlling interests in respect of the above

An entity's FFO should reflect the FFO attributable to the parent. Therefore, FFO should be adjusted for the non-controlling interest included in each of the adjustments made to profit or loss to arrive at FFO.

S. Items not adjusted for in determining FFO

REALpac urges all member companies reporting FFO to adjust for items relating to only those items that are uniquely significant to the real estate industry and that are not operating in nature. As a result there would be no adjustment to IFRS profit or loss in determining FFO for the following:

- Unusual items including gains or losses from debt extinguishments;
- Depreciation, impairment losses or reversals of losses, and revaluation changes recognized in profit or loss of property used exclusively for administrative purposes (property, plant & equipment);
- Depreciation of computer software, company office improvements and other property, plant and equipment items commonly found in other industries;
- Expenditures on long-term replacement items recoverable from tenants that are deemed repairs and expensed;
- Amortization relating to expenditures for tenant allowances that will not be specifically invested in the tenant's leased space (e.g. reimbursement of tenant's non-capital expenses or simple cash payments), accounted for as tenant incentives and amortized as a reduction to revenue;
- Amortization of financing costs including those related to imputed interest rate adjustments;
- Accreted interest expense recognized on convertible debentures;
- Loss on trade receivables;
- Expense arising from stock options, the unrealized fair value changes due to the re-measurement of a stock option liability (arising from the fact that the stock-based compensation is to be settled by redeemable units), or the unrealized fair value changes due to the re-measurement of other stock-based compensation liabilities (e.g. restricted share units);

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- Non-cash effect of straight-line rents; and
- Unrealized changes in the fair value of financial instruments that are not specifically financial instruments which are economically effective hedges but do not qualify for hedge accounting.

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## **V. DISCLOSURE OF FFO**

REALpac encourages its members that are reporting issuers to report their FFO in all continuous disclosure filings. In accordance with the Revised Canadian Securities Administrators' Staff Notice 52-306, *Non-GAAP Financial Measures*, issuers should:

- state explicitly that the non-IFRS financial measure does not have any standardized meaning prescribed by IFRS and is therefore unlikely to be comparable to similar measures presented by other issuers;
- present with equal or greater prominence than the non-IFRS financial measure, the most directly comparable measure calculated in accordance with IFRS;
- explain why the non-IFRS financial measure provides useful information to investors and how management uses the non-IFRS financial measure;
- provide a clear quantitative reconciliation from the non-IFRS financial measure to the most directly comparable measure calculated in accordance with IFRS, referencing to the reconciliation when the non-IFRS financial measure first appears in the disclosure document; and
- explain any changes in the composition of the non-IFRS financial measure when compared to previously disclosed measures.

## **VI. IMPLEMENTATION**

REALpac believes that implementation of the recommendations contained in this White Paper is subject to the business judgment of the management of each reporting issuer. The recommendations are intended to be guidelines for management, rather than a mandatory set of inflexible rules; they are not an indication that REALpac or any of its members or advisors believe that any of the information is material to investors in reporting issuers. Nothing contained herein is intended or shall be construed to impose any legal obligation to follow these guidelines or any liability under the securities laws or otherwise for any failure to do so.

REALpac recognizes that in some situations it may be difficult to reconstruct comparable information for prior periods. Nevertheless, REALpac encourages all companies to calculate and present FFO consistently for all periods presented in financial statements or tables.

REALpac believes that public confidence in the quality of reported results, and the adequacy of disclosures as to the method of calculation of those results, is of paramount importance to the public real estate development industry as a whole.

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Disclosures in accordance with this White Paper are expected to be implemented by REALpac members for fiscal years commencing on or after January 1<sup>st</sup>, 2011 (or earlier if IFRS is adopted prior to this date) with prior period amounts restated to conform to the new definition.

REALpac encourages its members, that when reporting FFO, to make an explicit statement that it calculates its FFO in accordance with the REALpac definition for FFO. Where a member does not determine FFO based on the REALpac definition, it should state this fact and disclose how its FFO differs from that prescribed by REALpac.

## **VII. DIFFERENCES WITH NAREIT AND EPRA**

### **A. NAREIT FFO**

NAREIT's definition for FFO differs significantly from that of REALpac. NAREIT's FFO is based on U.S. GAAP and includes only a limited number of adjustments. NAREIT's definition for FFO is as follows:

*Funds From Operations means net income (computed in accordance with generally accepted accounting principles), excluding gains (or losses) from sales of property, plus depreciation and amortization, and after adjustments for unconsolidated partnerships and joint ventures. Adjustments for unconsolidated partnerships and joint ventures will be calculated to reflect funds from operations on the same basis.*

The NAREIT FFO definition is detailed in NAREIT's "White Paper on Funds From Operations" dated April 2002 and can be found on NAREIT's website at [www.reit.com](http://www.reit.com).

### **B. EPRA Earnings**

EPRA's definition of EPRA Earnings is based on a fair value model and therefore does not consider any impacts from accounting for investment property at cost. As a result, differences between REALpac's FFO for IFRS and EPRA Earnings are largely based on the fact that REALpac's definition considers the impact of depreciation, amortization, and impairments or the reversal of impairments. REALpac's definition of FFO for IFRS includes additional adjustments not made by EPRA, for issues arising from the classification of certain puttable instruments as liabilities, the effect from specific foreign exchange gains or losses and adjustments to remove the effect of tenant allowances included in profit or loss. EPRA Earnings reflects the full impact of tenant incentives. The EPRA Earnings definition is as follows:

*EPRA Earnings means earnings (per the IFRS income statement) adjusted for: i) revaluation movement on investment properties, development properties held for*



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*investment and other interests, ii) profits or losses on disposal of investment properties, development properties held for investment and other interests, iii) tax on profits or losses on disposals, iv) negative goodwill/goodwill impairment, v) movement in fair value of financial instruments, vi) acquisition costs on share deals and non-controlling joint venture interests, vii) deferred tax, and viii) minority interests in respect of the above.*

The EPRA Earnings definition is detailed in its Best Practices Recommendations document (updated annually) and can be found on EPRA's website at [www.epra.com](http://www.epra.com).

REALpac Financial Best Practices Committee  
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