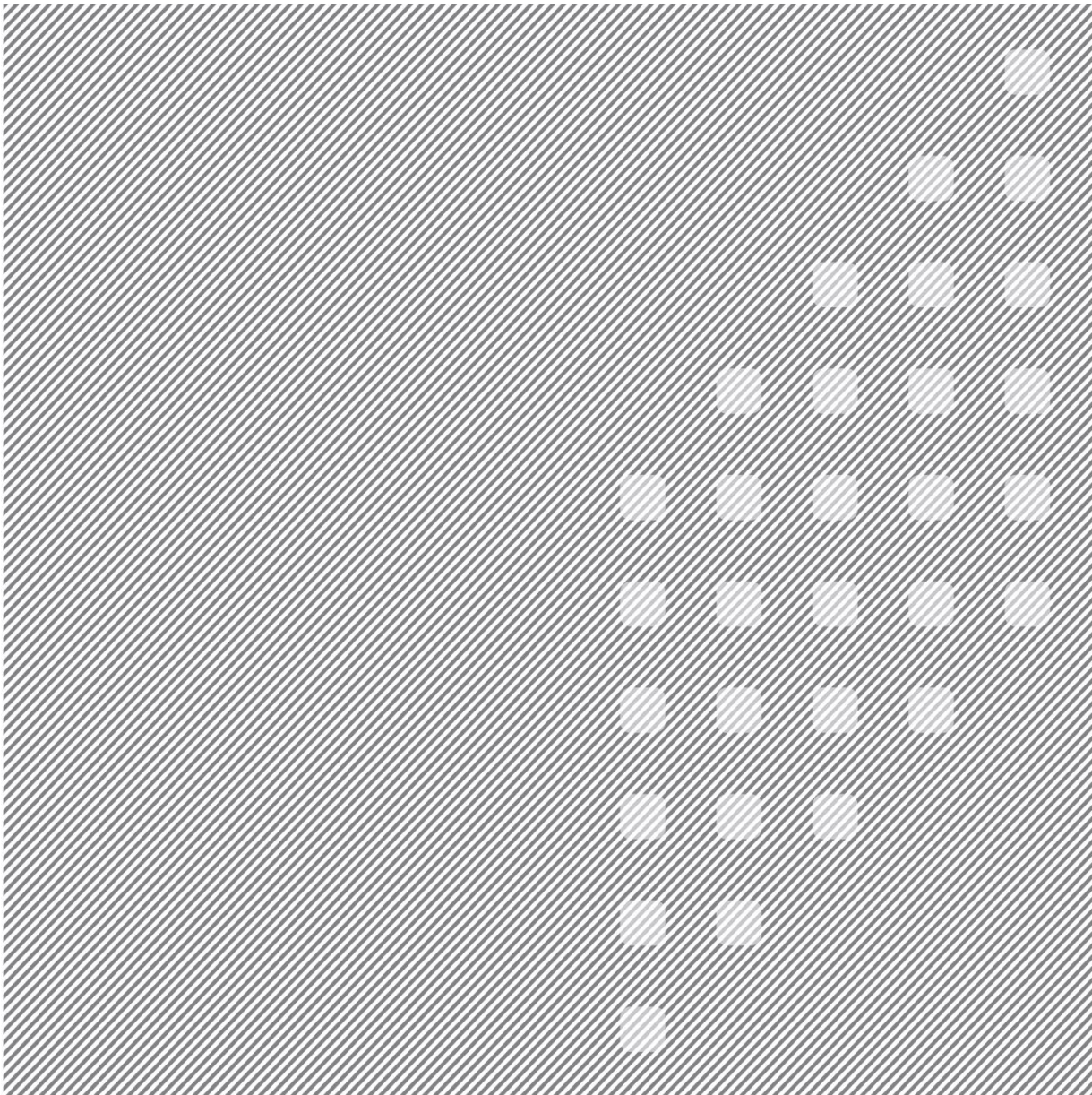


# White Paper on Funds From Operations & Adjusted Funds From Operations for IFRS

*February, 2019*



## **Copyright**

REALPAC is the owner of all copyright in this publication. All rights reserved. No part of this document may be reproduced, transmitted or otherwise used in whole or in part in any form or by any means, without permission from the publisher. Further, no person shall use this publication, in whole or in part, in any form or by any means, to create any precedent for resale or license for remuneration.

**DISCLAIMER:** The information contained in this document is for general guidance only. The application and impact on an entity's financial reporting can vary widely based on specific facts involved. The guidance in this document is provided with the understanding that the authors and publishers are not herein engaged in rendering legal, accounting, tax, or other professional advice and services. While we have made every attempt to ensure that the information and guidance herein is developed from reliable sources, no representation or warranty, express or implied, is made by REALPAC, its directors, officers, and staff or any other person for whom REALPAC is legally responsible, as to its accuracy, completeness, or correctness. Information and guidance expressed or contained herein constitute the author's judgment as of the publication date, are subject to change without notice and are provided in good faith but without representation or warranty as aforesaid. REALPAC, its directors, officers, and staff or any other person for whom REALPAC is legally responsible assumes no responsibility for the use of, effect of, or appropriateness of the language, wording, or information contained in this publication or any typographical or printing errors or omissions. REALPAC, its directors, officers, and staff or any other person for whom REALPAC is legally responsible assumes no liability for damage or loss arising from the use of information contained herein. Readers are urged to consult their own professional advisors for further confirmation, information, and advice.

## Table of Contents

I.	Introduction and Background
II.	Intended use of FFO
III.	FFO Definition
IV.	Discussion of FFO Definition Adjustments
	A. Unrealized changes in fair value of investment properties
	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
	C. Amortization of tenant allowances and landlord's work spent for the fit-out of tenant improvements and amortized as a reduction to revenue
	D. Amortization of tenant/customer relationship intangibles or other intangibles arising from a business combination
	E. Gains/losses from the sales of investment properties and owner-occupied properties, including the gain or loss included within discontinued operations (if applicable)
	F. Tax on gains or losses on disposals of properties
	G. Deferred taxes
	H. Impairment losses or reversals recognized on land and depreciable real estate properties, excluding those relating to properties used exclusively for administrative purposes
	I. Revaluation gains or losses recognized in profit or loss on owner-occupied properties, excluding those relating to properties used exclusively for administrative purposes
	J. Transaction costs expensed as a result of the purchase of a property being accounted for as a business combination
	K. Foreign exchange gains or losses on monetary items not forming part of a net investment in a foreign operation
	L. 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
	N. Negative goodwill or goodwill impairment
	O. Effects of puttable instruments classified as financial liabilities
	P. Results of discontinued operations
	Q. Adjustments for equity accounted entities
	R. Incremental leasing costs
	S. Property taxes accounted for under IFRIC 21
	T. Operational revenue and expenses from Right of Use Assets
	U. Non-controlling interests
	Items not adjusted for in determining FFO
V.	AFFO Definition
VI.	Discussion of AFFO Definition Adjustments
VII.	Suggested Additional Best Practices for AFFO

- VIII. Disclosure of FFO and AFFO
- IX. Implementation
- X. Differences with NAREIT and EPRA

## 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.

### The Impact of IFRS and Reporting FFO

Effective January 1, 2011, Canadian publicly-accountable entities were required to

prepare and report financial statements in accordance with IFRS. In REALPAC's opinion, IFRS introduced greater judgment and interpretation of accounting standards as well as increased options in setting accounting policies. For example, IFRS introduced 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 definitions of FFO and AFFO 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 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 X of this White Paper. NAREIT does not provide a definition of AFFO.

The REALPAC definition of FFO for IFRS varies 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 X of this White Paper. EPRA does not provide a definition of adjusted EPRA Earnings.

A September 2010 revision to the June 2010 FFO White Paper 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.

A November 2012 revision to the September 2010 FFO White Paper added an adjustment related to hedge accounting, a clarification on stock-based compensation related to redeemable units classified as financial liabilities, and adjustments for equity accounted entities.

An April 2014 revision on the November 2012 FFO Whitepaper added an adjustment on incremental leasing costs of full-time or salaried staff, and an adjustment for property taxes accounted for under IFRIC 21.

A February 2017 revision on the April 2014 FFO Whitepaper expanded the section "O" adjustment on puttable instruments to include an adjustment to transaction costs for convertible debt to allow for consistent treatment amongst opened-end REITs, closed-ended REITs and REOCs. In addition, REALPAC added a definition for AFFO and renamed the Whitepaper to include AFFO.

The February 2018 revision on the February 2017 FFO and AFFO Whitepaper clarified the treatment of stock-based compensation for puttable units to allow for consistent treatment between equity-based and cash-based compensation.

This February 2019 revision on the February 2018 FFO and AFFO Whitepaper adjusts for revenue and expenses from Right of Use Assets that are part of the

entity's ongoing business operations.

## II. Intended Use of FFO and AFFO

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.

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' stock 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.

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. 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 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").

While 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, divergence in calculations of Adjusted Funds From Operations (AFFO) among reporting issuers led REALPAC to develop a definition for AFFO.

In consultation amongst preparers and users of reporting issuers' financial statements, it was determined there was diversity in how AFFO should be utilized – some viewing it as an earnings metric, some viewing it as a cash flow measure, and others considering it a hybrid between the two. In order to develop greater

consistency within the industry, it was determined that AFFO should be defined as a recurring economic earnings measure. For those using AFFO as more of a cash flow metric, REALPAC concurrently developed a new metric, Adjusted Cash Flow from Operations (ACFO). ACFO is intended to be used as a sustainable, economic cash flow metric. For more information on ACFO, please refer to REALPAC’s Whitepaper on ACFO.

REALPAC encourages its members to determine which metrics are most appropriate for reporting quarterly results, and present the appropriate combination of FFO, AFFO and/or ACFO. REALPAC also encourages its members that, when reporting FFO, AFFO and/or ACFO, to make an explicit statement that it calculates its FFO, AFFO and/or ACFO in accordance with the REALPAC definition for FFO, AFFO and/or ACFO. Where a member does not determine FFO, AFFO and/or ACFO based on the REALPAC definition, it should state this fact and disclose how its FFO, AFFO and/or ACFO differs from that prescribed by REALPAC.

The following sections address the definition of FFO and AFFO and the most important of the interpretive issues under the definitions, 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 of 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	\$ 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
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
P.	Results of discontinued operations	\$ xxx,xxx
Q.	Adjustments for equity accounted entities	\$ xxx,xxx
R.	Incremental leasing costs	\$ xxx,xxx
S.	Property taxes accounted for under IFRIC 21	\$ xxx,xxx
T.	Operational revenue and expenses from Right of Use Assets	\$ xxx,xxx
U.	Non-controlling interests in respect of the above	\$ xxx,xxx
<b>FFO</b>		<b>\$x,xxx,xxx</b>

## 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.

### 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

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 and amortized as a reduction to revenue over the term of the lease. The amortization for these allowances is 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

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.

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

There are situations under IFRS where an economically effective hedge may not qualify for hedge accounting; for example, when an entity chooses not to fulfill the rigorous documentation requirements of hedge accounting under IFRS for efficiency or logistical reasons. In such situations, IFRS profit and loss would be subject to fluctuations due to the resulting fair value adjustments, despite it being readily apparent that the hedging relationship is effective from an economic point-of-view.

In these circumstances, an entity should adjust FFO to reflect the accounting treatment that would have arisen had the entity obtained hedge accounting, including the reversal of the related fair value adjustments and any ongoing effects arising from the accounting for the hedged item after the hedging relationship ceases. For greater certainty, this adjustment to FFO should only take place when it is self-evident (or easily proven) that the hedge is economically effective, and in no case should an adjustment be made with respect to any derivative that is speculative in nature.

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;
- 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;
- Where convertible debt is classified and measured as a financial liability by the fair value through profit and loss method, due to the ability of the debt to be converted into trust units that are deemed puttable financial instruments, all transaction costs expensed to profit and loss upon initial recognition of the convertible debenture may be added back to arrive at FFO. In future periods, the transaction costs allocated to the debt component of the convertible debenture should be recognized as a deduction to FFO, on a straight-line basis, over the remaining term of the convertible debenture. This ensures equal treatment to those entities with trust units that are deemed and recognized as equity and are able to net transaction costs to the debt component of the convertible debenture; and
- Where stock-based compensation is classified as a liability (arising from the fact that the stock-based compensation is to be settled by puttable units) and is required to be remeasured at each reporting period, the remeasurement component should be added back to profit or loss to arrive at FFO. The attribution of grant-date fair value should remain in profit or loss, similar to the amortization of grant date fair value for equity-based compensation, and not removed for FFO purposes if market-based conditions are ultimately not met.

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. To the extent, the results of discontinued operations contain items discussed above and below, 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. This should include an adjustment to add general or indirect interest incurred by the entity in respect of its properties under development (each of which are qualifying assets as defined in International Accounting Standard 23, Borrowing Costs) held in and through equity-accounted joint ventures.

R. Incremental Leasing Costs:

Leasing costs of full-time or salaried staff, and related internal costs, that can be reasonably and directly attributed to signed leases, and that would otherwise be capitalized if incurred from external sources should be added back to profit or loss in determining FFO. The purpose of this adjustment is to achieve consistency between entities that use internal leasing personnel and those that use external leasing personnel.

S. Adjustments for Property Taxes accounted for under IFRIC 21:

As a result of the requirements of IFRIC 21 wherein the obligating event that gives rise to the property tax liability (where such property taxes meet the definition of a levy in IFRIC 21) does not occur over a period of time, an adjustment should be made to FFO to reflect a pro-rata expense over the period of ownership.

T. Operational revenue and expenses from Right of Use Assets:

Revenue from Right of Use (ROU) Assets:

- With the implementation of IFRS 16, some ground leases for land and building that were classified as operating leases under IAS 17 were reclassified to finance leases, and as such, rental income from these leases is now accounted for as finance income rather than operating income, and therefore no longer included in operating income. In the situation where the real estate company, as lessee of a ground lease of land and building and an intermediate lessor of tenant subleases, continues to be responsible for leasing, operating and maintaining the property (actively managing the property), an adjustment should be made by adding the principal portion of the finance lease payment earned by a sublease lessor. The adjustment should be the amount relating only to subleases in cases where such subleases are under ground/head lease(s) for both the underlying land and building.
- The purpose of this adjustment is to include rental revenue from these subleases in FFO as this income is part of a real estate entity's operating business.

Expenses from Right of Use (ROU) Assets:

- Where the entity is the lessee under a land/ground lease that was accounted for as an operating lease under IAS 17, and where a ROU must be set up under IFRS 16, an entity should deduct the lease principal payments on the ROU asset for those leases. This deduction reflects that, as a lessee, the entity is required to make these lease payments, and that this expense is part a real estate entity's operating

business. Where a ROU asset is being measured at cost and depreciated/amortized, then any depreciation/amortization should also be added back.

#### U. 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.

#### 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;
- Remeasurement of stock-based compensation resulting from a change in the compensation plan.
- 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.

## V. AFFO Definition

The format for the statement of AFFO should reconcile to REALPAC FFO, as reconciled from 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 AFFO. The reconciliation should be sufficiently detailed to provide readers with a clear understanding of the material differences between IFRS profit or loss, FFO and AFFO. For clarity, where AFFO is presented, the reconciliation from IFRS profit or loss to REALPAC FFO to REALPAC AFFO should be presented in one table.

**Where AFFO is not presented, REALPAC recommends that reporting issuers include supplemental disclosures on capital expenditures, leasing costs, tenant improvement and straight-line rent that are sufficient for analysts and users to calculate AFFO.**

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

<b>FFO and AFFO / IFRS Earnings Reconciliation</b>	
Profit or Loss per IFRS Statement of Comprehensive Income	\$x,xxx,xxx
Adjustments as per <b>III. FFO Definition</b> above	
<b>FFO</b>	<b>\$x,xxx,xxx</b>
V. Capital expenditures (CAPEX)	xxx,xxx
W. Leasing costs	xxx,xxx
X. Tenant improvements	xxx,xxx
Y. Straight line rent	xxx,xxx
Z. Non-controlling interests in respect of the above	xxx,xxx
<b>AFFO</b>	<b>\$x,xxx,xxx</b>

**No other adjustments are recommended in determining AFFO.**

## VI. Discussion of AFFO Definition Adjustments

### V. Capital Expenditures (CAPEX):

The thought process in deriving AFFO includes a deduction for the portion of depreciation that is “economic”. To this, we look to the sustaining capital reinvestment needs of owning real estate and these typically include recoverable and non-recoverable capital expenditures, tenant inducements and leasing costs (broker commissions etc.)

For CAPEX, expenditures related to sustaining and maintaining existing space are subtracted. Expenditures related to development and those that are revenue enhancing (i.e. related to new gross leasable area) are excluded from this calculation. The intent is to only subtract costs related to sustaining/maintaining existing space.

There are differing viewpoints on whether this should be the actual amount for the period or a reserve amount; therefore, additional best practices on CAPEX (noted below) should also be followed.

The amount deducted should be based on actual amounts. If a management’s estimate (reserve) is used, then to the extent that actual historical amounts are materially different from management’s reserve amount, a reconciliation between



the reserve and actual historical amounts should be disclosed. A discussion would be expected as to why the actual historical amount differs from management's reserve amount, and why management's reserve amount is more relevant.

W. Leasing Costs:

Under IFRS, internal leasing costs are expensed while external leasing costs can be capitalized to investment properties. For REALPAC FFO purposes, internal leasing costs are added back to FFO to afford the same treatment for external and internal leasing costs.

For AFFO purposes, both internal and external leasing costs should be deducted, except to the extent that leasing costs relate to development projects.

Overall, AFFO should be reduced by either the actual leasing costs incurred (both external and internal), or a reserve amount as discussed in CAPEX adjustment above).

X. Tenant Improvements:

See CAPEX adjustment U. above

Y. Straight Line Rent:

Straight line rent is deducted to better represent rent on a contractual and receivable basis.

Z. Non-controlling Interests in Respect of the Above:

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

## VII. Suggested Additional Best Practices for AFFO

CAPEX: The following disclosures should also be included:

- If a reserve amount is used, disclosures on how the reserve amount is calculated (i.e. rolling 3-year average of actual capital expenditures)
- Total amount of capex, subsequently broken out; and for example, where a reserve is used, an explanation as to why any portions are not included in the reserve amount
- Break-out of actuals and/or reserve amounts related to
  - Development and Re-development
  - Ongoing/existing properties
  - Joint ventures (proportionate consolidation)
- Actual spend; and, where a reserve is used, why management's reserve is more relevant in determining AFFO

DRIP non-cash distributions: As noted in OSC Staff Notice 51-724, January 26, 2015, “(n)on-cash distributions (including distributions paid in connection with a Distribution Reinvestment Plan, or “DRIP”) have the effect of increasing the number of units outstanding and therefore increase the aggregate dollar amount of distributions over time, assuming a stable cash component of distributions on a per unit basis.” As a result, in calculating whether or not distributions were in excess of cash flow from operations, total distributions (including non-cash) should be used. Payout ratios should not be calculated using a numerator that is net of DRIP amounts.

## VIII. Disclosure of FFO and AFFO

REALPAC encourages its members that are reporting issuers to report their FFO, AFFO and/or ACFO in all continuous disclosure filings in accordance with applicable securities law.

## IX. 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, and if applicable, AFFO 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.

Disclosures in accordance with this revised White Paper are expected to be implemented by REALPAC members for fiscal years commencing on or after January 1<sup>st</sup>, 2019 or thereafter with prior period amounts restated to conform to the new definition(s).

## X. Differences with Nareit and EPRA

### 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 (calculated in accordance with generally accepted accounting principles), excluding:*

- *Depreciation and amortization related to real estate.*
- *Gains and losses from sale of certain real estate assets.*
- *Gains and losses from change in control.*
- *Impairment write-downs of certain real estate assets and investments in entities when the impairment is directly attributable to decreases in the value of depreciable real estate held by the entity.*

The Nareit FFO definition is detailed in "Nareit Funds From Operations White Paper – 2018 Restatement" and can be found on Nareit's website at [www.reit.com](http://www.reit.com).

## 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) changes in value of investment properties, development properties held for investment and other interests, ii) profits or losses on disposal of investment properties, development properties held for investment and other interests, iii) profits or losses on sales of trading properties including impairment charges in respect of trading properties, iv) tax on profits or losses on disposals, v) negative goodwill/goodwill impairment, vi) changes in fair value of financial instruments and associated close-out costs, vii) acquisition costs on share deals and non-controlling joint venture interests, viii) deferred tax in respect of EPRA adjustments, ix) adjustments to the above in respect of joint ventures (unless already include under proportional consolidation), and x) non-controlling 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  
February 2019

## **About REALPAC**

REALPAC (the Real Property Association of Canada) is the national leadership association dedicated to advancing the long-term vitality of Canada's real property sector. Its membership includes chief executives and the vanguard of real estate investment.

REALPAC delivers value through:

- Acting as a powerful collective champion for policy decisions
- Research-based intelligence and insights
- Best-in-class professional practice
- Exclusive connections and leadership development opportunities

For more information on this White Paper, contact:

*Nancy Anderson*  
*VP, Financial Reporting & CFO*  
*t. 416.642.2700 x 226*  
*e. [nanderson@realpac.ca](mailto:nanderson@realpac.ca)*

*REALPAC*  
*77 King St W*  
*TD North Tower*  
*Suite 4030 PO Box 147*  
*Toronto ON M5K 1H1*  
*Canada*