WHITE PAPER ON SUPPLEMENTAL DISCLOSURES FOR REAL ESTATE INVESTMENT AND DEVELOPMENT ENTITIES

REALpac
Real Property Association of Canada
Association des biens immobiliers du Canada

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White Paper on Supplemental Disclosures for REIDEs
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I. INTRODUCTION

In November 2004, REALpac issued its White Paper on Funds From Operation (FFO) which includes a discussion on *Other Supplemental Disclosure in Management's Discussion and Analysis*. With the revisions to policies and recommendations issued by the Canadian Securities Administrators in 2006 and 2007[1], REALpac determined it was time to revisit the recommended supplemental disclosures, in addition to FFO, that are reported by real estate entities in the Management's Disclosure and Analysis (MD&A) report. The Maintenance Capex Sub-Committee of the REIT Committee (the "Sub-Committee") was established to develop a "best practices" disclosure model for supplemental disclosures.

This best practice disclosure model (the "White Paper") is not intended to repeat the requirements prescribed by the CICA Handbook, nor any of the rules and policies issued by the Canadian Securities Administrators or provincial regulators. REALpac and the Sub-Committee believe that consistency in financial reporting among member companies could be advanced by providing best practice disclosure models, especially related to certain items of particular importance to real estate investment and development entities. Although the recommended disclosure models presented are designed to be applicable to the majority of companies/sectors in the industry, they should not be considered exhaustive. REALpac believes that the specific content and manner in which the disclosure models presented are utilized should be based on materiality and on the business judgment of the management of each company.

II. ADJUSTED FUND FROM OPERATIONS

FFO, as defined by REALpac, is not a measure of cash generated or of dividend or distribution paying capacity. REALpac's White Paper on FFO clearly states that the statement of cash flows provided by GAAP financial statements are adequate for investors to assess the cash generated and used by reporting entities. Nevertheless, the analyst community and certain reporting entities make adjustments to FFO so that they may better evaluate recurring economic performance. The net result of these adjustments is commonly referred to as 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 economic performance, REALpac believes that there is not adequate consensus among members and users of real estate entity financial statements to allow agreement on a single

[1] CSA Staff Notice 52-306 (Revised) Non-GAAP Financial Measures, issued August 4, 2006, CSA Staff Notice 51-319 Report on Staff's Second Continuous Disclosure Review of Income Trust Issuers, issued August 4, 2006, and National Policy 41-201 Income Trusts and Other Indirect Offerings, issued July 6, 2007.

definition of AFFO. Similarly, with respect to REITs, REALpac does not believe that there is a single measure of distributable cash ("DC") or distributable income ("DI") that is consistently applicable to all REITs.

More detailed disclosures regarding capital spending and certain other items discussed in this White Paper would allow real estate entity financial statement users who wish to estimate AFFO, to make the adjustments to reported FFO that they consider useful to investors for that purpose.

III. CAPITAL EXPENDITURES

This White Paper describes certain capital expenditures that are known to be of particular interest with respect to certain property types. These include, but are not limited to, tenant improvements and leasing commissions for office, retail, and industrial properties, and maintenance capital such as floor coverings and appliances for apartment properties and seniors housing. Other capital expenditures may be of particular interest regardless of the property type. These include, but are not limited to, corporate/administrative items, expansions, major renovations, and acquisitions.

Some capital expenditures of particular interest may be similarly grouped regardless of the property type. For example, the industry utilizes the nomenclature revenue enhancing vs. non-revenue enhancing capital expenditures, or recurring vs. non-recurring capital expenditures, or recoverable vs. non-recoverable capital expenditures. The Sub-Committee recommends that, if these terms are used, each company disclose how they are defined and how they fit within the entity's overall capital expenditure philosophy and policies.

The nature of the expenditures should be characterized as thoroughly as is practical. Aggregate, rather than property-by-property totals should be provided, but entities owning more than one property type should disclose information separately for each property type.

The following outlines the information that may be included in the disclosure of capital expenditures:

A. <u>Capital Expenditure Philosophy and Policies</u>
Each entity should include a discussion in the MD&A of the entity's overall philosophy and approach towards capital expenditures, identifying capital expenditure policies and definition of productive capacity. Productive capacity may be defined by statistical measures such as total leasable square feet or rentable units/suites or may be defined by financial terms such as revenue dollars or net profit. The entity should include discussions of how certain capital expenditures may or may not impact or are expected to impact the productive capacity of the entity's

operations. In its discussion of capital expenditure policies, entities should also disclose how it determines those expenditures that are expensed versus those that are capitalized. Where categories of capital expenditures are identified, adequate disclosure should be provided of how these categories are defined and measured.

B. Periods of Presentation

Capital expenditures disclosures recommended in this section should be presented for the following periods:

- Current period
- YTD
- Prior Year

To provide a better perspective of trends and to minimize the impact of "lumpy" capital expenditures in any given period, entities are encouraged to provide capital expenditure data on rolling longer term averages of 24, 36 or 72 months.

C. Reconciliation to GAAP Financial Statements

Capital expenditures reported in the MD&A, by different categories, should always be easily reconciled to the capital expenditure amounts reported in the Cash Flow Statement determined on a GAAP basis.

D. Units of measurement

In addition to disclosing capital expenditures in financial terms, an entity should disclose capital expenditures based on units of measurement when such information is helpful in understanding and interpreting historical expenditure levels. The level at which information on leasing and capital expenditures is disaggregated into units of measurement is discretionary and should reflect the entity's unique operations.

Examples include, but are not limited to:

1. rentable square feet
2. units
3. rooms
4. suites
5. beds

E. General Categories

Capital expenditures should be presented in the aggregate and/or on a per unit of measurement in the following broad categories, when applicable, and in accordance with its disclosed capital expenditure policies, as discussed in Section A above:

Examples of general categories include, but are not limited to:

1. Portfolio type:
   1.1 Corporate/administrative items, such as:
      - Company office renovations

- Company furniture, fixtures & equipment
- Company computers, etc.

1.2 Existing properties
1.3 Development properties
1.4 Acquisitions

2. Revenue-based:
   2.1 Revenue enhancing
   2.2 Non-revenue enhancing

3. Frequency:
   3.1 Recurring
   3.2 Non-recurring
      3.2.1 non-recurring capital improvements
      3.2.2 non-recurring development/redevelopment costs

4. Recoverability:
   4.1 Recoverable
   4.2 Non-recoverable

F. <u>Office and Industrial Properties</u>
The following types of expenditures should be provided for office and industrial properties when applicable, and in accordance with its disclosed capital expenditure policies, as discussed in Section A above:

1. Tenant improvements
2. Leasing commissions and other capitalized leasing costs
3. Tenant allowances amortized to revenue

The expenditure data of the two items above should be disclosed:

- in the aggregate, and
- on a per unit of measurement,

further separated by:

- New tenants
- Renewal tenants

G. <u>Retail Properties</u>
The following types of expenditures should be provided for retail properties when applicable, and in accordance with its disclosed capital expenditure policies, as discussed in Section A above:

1. Tenant improvements

2. Leasing commissions and other capitalized leasing costs
3. Tenant allowances amortized to revenue

Expenditure data should be disclosed:

- in the aggregate, and
- on a per unit of measurement,

further separated by:

- New tenants
- Renewal tenants

H. Apartments/Hotels/Seniors Housing

Capital expenditures for apartment, hotels or seniors housing properties should be presented in accordance with its disclosed capital expenditure policies, as discussed in Section A above. Examples of capital expenditure categories used in this sector include the following, but are not limited to:

1. Furniture, fixtures and equipment
2. Appliances
3. Floor coverings
4. Kitchens and baths
5. Operating capital
6. Roof replacements
7. Parking structures
8. Windows
9. Boilers
10. Elevators
11. Building improvements
12 .Common areas/lobbies
13. Suite renovations

Expenditure data should be disclosed:

- in the aggregate, and
- on a per unit of measurement basis (where applicable)

IV. OTHER DISCLOSURE ITEMS

For each period presented, the following would be useful to assist users in determining stabilized cash flow/valuation metrics:

A. Straight-line rents
B. Amortization of a above and below market rate leases arising from a building acquisition
C. Unrealized changes in the fair value of financial instruments recognized in the income statement
D. Gains/(losses) on sales of securities or property included in FFO
E. REIT Tax Implications
F. General & administrative expenses
G. Other significant unusual and/or non-cash items

A. Straight-Line Rents

The REALpac White Paper On FFO specifically states that the non-cash effect of recognizing rent on a straight-line basis should not be adjusted from net income to arrive at FFO. However, some investors want to understand this amount in order to develop stabilized cash flow/valuation metrics, and therefore this amount should be disclosed. Canadian GAAP requires that the rental revenue from an operating lease be recognized as income over the term of the leases on a straight-line basis. As a result, rental revenues recognized in a reporting period may vary from the actual contracted rent received. Disclosure of the difference between the rental revenues recognized and actual contracted rent received will provide information on the non-cash credit or charge included in the determination of cash flows from operating activities, usually reported within the change in accounts receivable.

B. Amortization of Above and Below Market Rate Leases Arising From a Building Acquisition

Additional disclosures should be provided on the amounts of amortization of above or below market rate leases included in revenue. The revenue line may be viewed by investors as a recurring revenue amount. However, if embedded in the revenue number, there is an amortization of above or below market rate lease amortization, that component is not an on-going recurring number as it is amortized over the term of the respective leases. The amortization relating to below market rate leases is clearly more sensitive since it increases the revenue amount. Recommended disclosures may include:

a. disclosure of accounting policy regarding the amortization of above or below market rate leases,

b. separately quantify the amount of amortization of both the above market rate leases and below market rate leases, included in revenue,
c. quantify the average term in which these intangible assets are being amortized

C. <u>Unrealized Changes In The Fair Value Of Financial Instruments Recognized In The Income Statement</u>

In accordance with CICA Handbook Section 3855 *Financial Instruments – Recognition and Measurement and 3865 Hedges*, certain financial instruments may be classified as held for trading and measured at fair value each reporting period, with changes in fair value flowing through the income statement. Where the fair value changes have not yet been realized, the charge or credit recognized in the income statement is a non-cash item. The fair value changes of financial instruments recognized in the income statement should be added back to net income to arrive at cash flow from operating activities. The unrealized changes in the fair value of financial instruments recognized in the income statement should be disclosed if not separately identified within cash flow from operating activities.

D. <u>Gains/(Losses) on Sales of Securities or Property Included in FFO</u>

Entities that include gains or losses on sales of marketable securities or land in their FFO should disclose the amount of such gains or losses for each applicable reporting period. Those entities that do not should address the amount of such gains or losses in their reconciliation of net income to FFO.

E. <u>REIT Tax Implications</u>

REIT entities should provide disclosure about the tax attributes of distributions. Significant differences between the tax bases of significant classes of assets and the carrying values of those assets that may affect the taxable nature of future distributions should be disclosed, quantified and discussed.

<u>F. General & administrative expenses</u>

Additional disclosure should be provided on the amount of general & administrative (G&A) expenses that are recognized in a reporting period, including both G&A that is expensed or capitalized. G&A expenses may be reported in various sections of the income statement, included with other expenses or labeled differently among entities, making it difficult to adequately compare entities. G&A expenses may be included in property expenses, trust expenses, corporate overhead or sometimes separately identified as a line item on the income statement. In addition, G&A expense directly related to a development project may be eligible for capitalization during the development period, thus some G&A expenses may also be included in capitalized amounts on the balance sheet. It is therefore difficult to determine total G&A expenses realized by an entity without supplemental disclosure. Most analysts or users need to understand G&A expenses in order to prepare net asset valuation calculations. It is recommended that entities report total G&A expenses incurred in the period, separately identifying G&A expenses that are expensed and G&A expenses that are capitalized. Disclosed amounts of G&A expenses that are expensed to the income statement should be categorized in accordance with the section of the income statement it relates to. Lastly, entities should disclose the types of costs included in G&A expenses as determined by their respective accounting policies.

G. Other Significant Unusual And/Or Non-Cash Items

In limited circumstances, certain revenue and expense items may not be clearly identified as non-recurring or non-cash in nature within the face of the financial statements. Disclosure is recommended on any significant unusual, non-recurring or non-cash items that may be useful to assist users in determining stabilized cash flow/valuation metrics.

REALpac Financial Best Practices Committee
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