

# Nareit Funds From Operations White Paper - 2018 Restatement

This 2018 Nareit FFO White Paper Restatement is intended to serve as a useful distillation and consolidation of previous Nareit guidance and is not meant to alter the fundamental definition of FFO.

## I. Introduction

In 1991, Nareit, following extensive consultation with its REIT members, REIT financial statement users, representatives from accounting firms and others, created a supplemental measure of REIT operating performance named Nareit “Funds From Operations” (FFO) in order to promote a uniform widely-accepted supplemental industry-wide standard measure of equity REIT operating performance. Nareit’s intention was not to replace U.S. Generally Accepted Accounting Principles (GAAP), or to diminish its prominence in REIT financial statements. Rather, Nareit’s intention was to establish a standard supplemental REIT industry-wide metric that would address certain limitations associated with the measurement of net income in accordance with GAAP for real estate operating companies such as equity REITs.

FFO has gained wide acceptance by REITs and investors. Nareit believes—and investors have confirmed—that FFO prepared in accordance with Nareit’s definition, presented in conjunction with the financial statements prepared in accordance with GAAP required by the Securities and Exchange Commission (SEC), has been fundamentally beneficial, improving the understanding of operating results of REITs as real estate companies among the investing public and enhancing the

ability to compare the operating results of one REIT with another.

The primary reason Nareit developed FFO as a supplemental measure of operating performance of a REIT is to address the artificial nature of historical cost depreciation and amortization of real estate and real estate-related assets mandated by GAAP.

To provide a supplemental operating performance measure that is comparable period to period, Nareit FFO also excludes gains and losses on the sale of certain real estate assets, as well as impairment write-downs of certain real estate assets.

Consistent with GAAP as it relates to the calculation of net income, FFO of a REIT includes the FFO of all consolidated properties, including consolidated, partially owned affiliates. Additionally, FFO includes the REIT’s share of FFO generated by unconsolidated affiliates. FFO of these affiliates is measured based on the Nareit definition.

Since the introduction of FFO, REIT market conditions have evolved, and new issues have arisen. Accordingly, Nareit clarified the definition of FFO in 1995, 1999, and 2002 and since then has issued interpretive guidance for reporting FFO in the form of Financial Standards Alerts and Nareit Policy Bulletins.

In 2017, Nareit's Best Financial Practices Council (the council) recommended that Nareit's Funds From Operations (FFO) White Paper dated April 2002 should be restated and that the restatement should incorporate interpretive guidance and clarification of issues made by Nareit after 2002.

The purpose of the restatement was not to change the fundamental definition of FFO, but simply to clarify, when necessary, existing guidance and consolidate alerts and policy bulletins into a single document for ease of use by Nareit members.

On Nov. 7, 2018, Nareit's Executive Board approved the White Paper restatement, effective Dec. 15, 2018.

## II. Definition of FFO

The Nareit definition of FFO is as follows:

Net income (calculated in accordance with GAAP), excluding:

- Depreciation and amortization related to real estate.
- Gains and losses from the 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.

These reconciling items are more fully addressed below.

The reconciling items include amounts to adjust earnings from consolidated partially-owned entities and equity in earnings of unconsolidated affiliates to FFO. Alternatively, these adjustments could be presented as a single line item. To be clear, the FFO of partially-

owned entities should be calculated in accordance with this White Paper.

Although rare, reconciling items may also include adjustments to report cumulative effects of accounting changes, which are excluded from FFO.

While the great majority of equity REITs measure FFO in accordance with Nareit's definition, there are variations in the securities to which the reported Nareit-defined FFO applies (e.g., all equity securities, all common shares, all common shares less shares held by non-controlling interests). While each of these metrics may represent FFO as defined by Nareit, accurate labeling with respect to applicable securities is important. Therefore, care should be taken in labeling the FFO metric, as well as the GAAP earnings metric in all FFO reporting. This is particularly so in the GAAP earnings to Nareit FFO reconciliation required by the SEC.

## III. The SEC's View of FFO Reporting

Although it has reviewed FFO reporting since the metric was first contemplated in 1991, the SEC issued its first proposed general rule on reporting non-GAAP financial measures for public issuers in 2002 with its proposed *Rule on the Conditions for Use of Non-GAAP Financial Measures* (the rule).<sup>1</sup> The rule, which became effective in 2003, set forth a new non-GAAP disclosure regime, Regulation G, requiring all public companies that disclose non-GAAP measures to present, with equal or greater prominence, the most directly comparable GAAP measure and to reconcile the two. Importantly, the SEC's subsequent June 13, 2003 release, *Frequently Asked Questions Regarding the Use of Non-GAAP Financial Measures*<sup>2</sup> specifically recognized FFO, citing it together with earnings before interest, taxes, depreciation and amortization (EBITDA), as an example of a "Non-GAAP Financial Measure" under Regulation G and ushered in the wide-spread use of the term, "Nareit FFO," referring to Nareit-defined FFO, by real estate companies includ-

The primary reason Nareit developed FFO as a supplemental non-GAAP measure of operating performance of a REIT is to address the artificial nature of historical cost depreciation and amortization of real estate and real estate-related assets mandated by GAAP.

ing equity REITs.

On May 17, 2016, SEC staff released its updated *Compliance and Disclosure Interpretations* (2016 Non-GAAP C&DIs)<sup>3</sup> to clarify its existing rules and regulations applicable to non-GAAP financial measures and to address certain problematic practices across industries that it was then observing. At that time, SEC staff affirmed that it would continue to accept Nareit's definition of FFO as in effect on May 17, 2016 (the adoption of the Updated C&DIs) as a performance measure and, importantly, *that it would continue to not object to its presentation on a per share basis*.

FFO has been widely adopted by the REIT sector and has gained acceptance—and endorsements—by REIT investors. However, some REITs report an adjusted FFO calculation. The SEC's 2016 Non-GAAP C&DIs clarify that a company may use an adjusted FFO calculation provided that "any adjustments made to FFO must comply with the requirements of Item 10(e) of Regulation S-K for a performance measure or a liquidity measure, depending on the nature of the adjustments, some of which may trigger the prohibition of presenting this measure on a per share basis" (Question 102.02).

Nareit's definition of FFO does not specify whether FFO should be attributed to the company or to common shareholders. In 2015, in a series of *Comment Letters* issued to REITs<sup>4</sup>, the staff of the Division of Corporation Finance of the SEC raised concerns that, while the great majority of REITs measured FFO in accordance with Nareit's definition, REIT filings reflected

some variations in the securities to which the reported FFO was applicable (e.g., all equity securities, all common shares.) Noting that while each of these metrics may represent FFO as defined by Nareit, the SEC cautioned that accurate labeling with respect to applicable securities is very important.

#### IV. Intended Use of FFO

Nareit recognizes the legal obligation of each of its member REITs to prepare and disclose financial statements prepared in accordance with GAAP and the value to the investor community of doing so. But, as is true for all U.S. issuers, the management of a REIT has the responsibility and authority to publish any *additional* financial information that it regards as useful to the investor community, within the limits prescribed by securities law and regulation. Nevertheless, Nareit believes that the industry benefits from having a *uniform* supplement to GAAP net income as a standard measure of operating performance and is aware that the SEC's Accounting Series Release (ASR) No. 142 encourages the development of such "industry standard" accounting terms.

It is important to emphasize, however, that the underlying premise of the definition of FFO is not to sanction deviations from GAAP in the name of calculating Funds From Operations. In fact, the definition specifically refers to GAAP net income as the starting point in the calculation of FFO. Moreover, FFO is not intended to be used as a measure of the cash generated by a REIT nor of its dividend-paying capacity. Nareit believes that the statements of cash

**FFO has gained wide acceptance by REITs and investors. Nareit believes—and investors have confirmed—that FFO prepared in accordance with Nareit’s definition, presented in conjunction with the financial statements prepared in accordance with GAAP, has been fundamentally beneficial, improving the understanding of operating results of REITs as real estate companies among the investing public and enhancing the ability to compare the operating results of one REIT with another.**

flows prepared in accordance with GAAP are the appropriate basis for analysts to assess the cash generated and used by REITs.

Similarly, Nareit continues to believe that the dividend-paying capacity of a REIT is best explained by a range of factors, including 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, much as they are analyzed in comparison to net income in other industries, it is not Nareit's intent to imply that FFO is a measure of the sustainable level of dividends payable by a REIT.

## **V. Certain Items in FFO Definition**

This section addresses frequently asked questions regarding the definition of FFO, including Nareit’s basis for its conclusion with respect to each issue. This White Paper reaffirms and, when appropriate, refines Nareit’s prior determinations concerning FFO, as discussed below.

### **A. Depreciation and Amortization**

The original definition of FFO specified that depreciation and amortization were to be added back to consolidated GAAP net income, without specifying what amortized items are to be included. As a result, different capitalization policies among reporting REITs led to widely varying lists of items being added back to GAAP net income in the calculation of FFO.

In addition, some analysts questioned the propriety of adding back any depreciation and amortization other than depreciation and amortization of certain real estate assets addressed by this White Paper. Their argument has been that depreciation of assets other than real estate is no less real when they are owned by a REIT than when they are owned by a company in another industry, and that there is therefore no reason to add back their depreciation in measuring the operating performance of a REIT.

Nareit agrees that the logic underlying the concept of FFO is inconsistent with the add back of depreciation or amortization of assets other than those uniquely significant to the real estate industry. Therefore, Nareit urges all member companies reporting FFO to add back only those items that meet this principle.

Examples of items that should be added back to GAAP net income in calculating FFO include depreciation of real estate, amortization of capitalized leasing expenses, and tenant allowances or improvements. Additionally, amortization of intangible real estate-related assets that are recognized pursuant to a business combination or asset acquisition (*i.e.*, an in-place lease intangible) should be excluded from FFO. To be clear, depreciation on operating properties that are located on land held under a ground lease should be excluded from FFO. The aforementioned items are all commonly included in depreciation and amortization in the statement of operations. Other “amortization” not included in depreciation and amortization should not be excluded from the calculation of FFO. This includes the amortization of above

The SEC staff has accepted Nareit's definition of FFO as a performance measure and does not object to its presentation on a per share basis.

and below market leases (which are included in revenue and/or expenses) and amortization of deferred financing costs and premiums and discounts on debt (which are included in interest expense). Further, non-real estate depreciation and amortization such as computer software, company office improvements, furniture and fixtures, and other items commonly found in other industries are required to be recognized as expenses by GAAP in the calculation of net income and, similarly, should be included in FFO.

### **B. Amortization of the Lessee's Right-Of-Use Asset**

In February 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2016-02; *Leases (Topic 842)*.<sup>5</sup> The standard requires that a lessee recognize a liability for obligations under a lease contract and a right-of-use asset (the ROU asset). The carrying amount of the ROU asset will be amortized over the term of the lease. Because the lessee has no ownership rights (current or residual) in the underlying asset, Nareit concluded that the amortization of the ROU asset should not be added back to GAAP net income in calculating FFO – this amortization expense should be included in FFO.

### **C. Gains and Losses Recognized on the Sale of Assets**

From time to time, REITs may sell assets. Gains and losses from the sale of depreciable real estate and land when connected to the main business of a REIT are excluded from the computation of FFO. For purposes of sections V(C) and (D), the main business of a REIT is acquiring, own-

ing, operating, developing, and redeveloping real estate in conjunction with the company's rental of real estate. On occasion, REITs may sell assets incidental to the main business of a REIT. These assets may include, but are not limited to, land peripheral to operating properties, property developed for sale, and securities. To the extent a REIT recognizes a gain or loss with respect to these types of incidental assets, the REIT has the option to include or exclude such gains and losses in the calculation of FFO. Consistent with this approach, a REIT has the option to include or exclude mark-to-market changes in value recognized on equity securities in each reporting period in calculating FFO.

Treatment of gains and losses of assets incidental to the main business of a REIT should be consistent with the treatment of impairment write-downs on similar assets that are incidental to the main business of a REIT.

REITs should provide narrative disclosure surrounding the option it chooses for the treatment of gains and losses from sales of assets incidental to the main business of a REIT.

REITs that choose to include gains and losses incidental to their main business in FFO should disclose the amount of such gains and losses for each applicable reporting period. Those that do not should address the amount of such gains and losses in their reconciliation of net income to FFO.

### **D. Treatment of Impairment Write-Downs**

To the extent there is an impairment write-down of depreciable real estate or land

**FFO is not intended to be used as a measure of the cash generated by a REIT nor of its dividend paying capacity. Nareit believes that the statements of cash flows prepared in accordance with GAAP are the appropriate basis for analysts to assess the cash generated and used by REITs.**

related to a REIT's main business, the write-down is excluded from FFO (*i.e.*, adjusted from net income in calculating FFO). For purposes of Sections V(C) and (D), the main business of a REIT is acquiring, owning, operating, developing, and redeveloping real estate in conjunction with the company's rental of the real estate. As a corollary, to the extent that a REIT recognizes an impairment write-down of depreciable real estate or other assets that are *incidental* to its main business, the REIT has an option to include or exclude such impairment write-downs in the calculation of FFO. The option to include or exclude impairment write-downs on assets that are incidental to the main business of a REIT is consistent with the option to include or exclude gains or losses on the sale of similar assets that are incidental to the main business of a REIT.

In addition, impairment write-downs of land held for the development of property for the REIT's own operating portfolio are excluded from FFO. This treatment is consistent with the treatment of gains and losses on sale of land initially held for development.

Further, with respect to the treatment of impairment write-downs, in January 2012 Nareit issued FFO guidance that FFO excludes impairment write-downs of investments in in-substance real estate<sup>6</sup> investees under certain circumstances. Nareit concluded that the only impairment write-downs of investments in affiliates that are excluded from FFO are impairment write-downs of investments in affiliates when there is clear evidence that the write-downs of the investor's investment have been driven by a measurable decrease in

the fair value of depreciable real estate held by the affiliate. The SEC staff has generally taken the view that a REIT excluding these write-downs from FFO must include clear and detailed narrative disclosure of how it determined that the write-down was driven by a measurable decrease in the fair value of depreciable real estate held by the affiliate.

This discussion and conclusion do not refer to property abandonments. The write-off of costs associated with property abandonments are included in calculating FFO.

### **E. Treatment of Unusual and Non-Recurring Items**

In 1999, Nareit clarified that the definition of FFO included non-recurring events. Nareit also reiterated in 1999 that FFO continued to exclude the earnings impacts of cumulative effects of accounting changes as defined by GAAP. In 2002, Nareit clarified that FFO related to assets held for sale, sold or otherwise transferred and included in results of discontinued operations are included in consolidated FFO.

### **F. Gains and Losses from Change in Control**

ASU No. 2017-05 *Other Income - Gains and Losses from the Derecognition of Non-Financial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets*<sup>7</sup> issued by the FASB, requires a seller to recognize the full gain on the sale of a partial interest in an asset when the seller loses control of the asset. The retained interest is recognized at fair value. Nareit members have questioned whether the full gain should be eliminated in calculating FFO or only that

part of the gain related to the interest transferred. Nareit concluded that the full gain is eliminated from net income in calculating FFO when the asset transferred is depreciable real estate or an interest in depreciable real estate.

Similarly, the resulting gain or loss upon consolidation of a previously held equity interest in in-substance real estate also is eliminated from net income in calculating FFO when the underlying asset is depreciable real estate (or an interest in depreciable real estate).

### G. FFO Per Share

In July 1999, Nareit issued guidance for presenting FFO on a per share basis. This guidance indicated that FFO per share is consistent with GAAP by using the methodology under Accounting Standards Codification 260 *Earnings per Share* (formerly [Statement of Financial Accounting Standards No. 128 Earnings per Share](#)). This standard provides a methodology for computing basic and diluted net income per share. As noted above, the SEC's C&DI from May 2016 specifically indicated that the SEC accepted Nareit's definition of FFO as a performance metric and did not object to its presentation on a per share basis. However, it is important to note that other adjustments to arrive at metrics such as adjusted funds from operations (AFFO) or cash available for distribution (CAD) or funds available for distribution (FAD), depending on their nature, may trigger a prohibition of presenting those measures on a per share basis (*e.g.*, as analogous to cash flow per share).

### H. Taxes

In February 2004, Nareit concluded that any taxes, current or deferred, directly associated with a gain or loss on a sale of property not included in FFO also is not included in FFO. All other taxes, current or deferred, are included in the calculation of FFO (*i.e.*, not adjusted from net income in the calculation of FFO).

## VI. Supplemental Disclosure

### A. Adjustments to FFO

Many REITs adjust FFO to achieve comparable results among periods presented and/or to report an FFO metric that better explains dividend policies.

Given that FFO is not intended to be a measure of cash generated or of dividend paying capacity, this practice has led to understandable confusion and criticism. For this reason, some market participants have gone further and suggested 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 capacity. The results of these calculations generally are referred to by their authors as FAD, CAD or AFFO.

Although there is some overlap among analysts as to what might be appropriate adjustments to FFO that would make it a better measure of dividend paying capacity, Nareit believes that there is not adequate consensus among preparers and users of the REIT financial statements to allow agreement on a single definition of FAD, CAD, or AFFO for this purpose.

Further, Nareit does not believe that there is a single measure of distributable cash that is consistently applicable to all REITs. Nevertheless, issuers that do adjust Nareit-defined FFO should reconcile its adjusted measure with the Nareit definition and the most closely associated GAAP measure.

### B. Capital Expenditures

More detailed disclosures regarding capital spending would allow REIT financial statement users who wish to estimate FAD, CAD, or AFFO to make the adjustments to reported FFO that they consider useful to investors for that purpose. When applicable, this disclosure should reflect such expenditures by consolidated and unconsolidated entities in which the REIT holds a direct or indirect interest.

Nareit encourages member companies to provide supplemental disclosures that provide useful insights into material capital expenditures. The total of capital

Nareit believes that public confidence in the quality of GAAP-reported results are of paramount importance to the REIT industry. Nareit also believes that certain non-GAAP supplemental information relating to operating performance can be valuable in explaining and clarifying GAAP financial results for REIT investors. Non-GAAP measures, including FFO, should be considered only in addition to, not as a substitute for, the information prepared in accordance with U.S. GAAP and should never be used to obscure or diminish the prominence of GAAP-reported results.

expenditures should be separately presented for amounts being spent on corporate items, existing properties, development of new properties, and acquisitions. The nature of the expenditures should be characterized as thoroughly as is practical. Aggregate, rather than property-by-property, totals should be provided, but REITs owning more than one property type should disclose capital expenditure information separately for each property type.

### **C. Non-Cash Revenues and Expenses (e.g., Straight-Line Rents)**

GAAP reporting may require recognition of non-cash revenues and expenses in the calculation of net income (e.g., "straight lining" of rents.) To provide an opportunity for consistent analysis of operating results among REITs, Nareit encourages those reporting FFO to make supplemental disclosure of all material non-cash revenues and expenses affecting their results for each period.

### **D. Results of Discontinued Operations**

Although rare under current GAAP, when a discontinued operation is reported, Nareit encourages full disclosure of amounts reported in "results of discontinued operations." These disclosures should identify FFO, gains/losses and other items included in discontinued operations.

## **VII. Implementation**

Nareit believes that public confidence in the quality of GAAP-reported results are of paramount importance to the REIT industry. Nareit also believes that certain non-

GAAP supplemental information relating to operating performance can be valuable in explaining and clarifying GAAP financial results for REIT investors. Non-GAAP measures, including FFO, should be considered only in addition to, not as a substitute for, the information prepared in accordance with U.S. GAAP and should never be used to obscure or diminish the prominence of GAAP-reported results.

The advice set forth in this White Paper is intended for REITs generally and is not intended as specific advice for any individual REIT or category of REITs. Nareit believes that implementation of the recommendations contained in this White Paper is up to the business judgment of the management of each company, taking account of the financial results and specific circumstances. The recommendations are intended to be guidelines for management, rather than a mandatory set of inflexible rules; they are not an indication that Nareit or any of its members or advisors believe that any of the information is material to REIT investors. Nothing contained herein is intended or shall be construed to impose any legal obligation to follow these guidelines or any liability under the federal securities laws or otherwise for any failure to do so.

## **VIII. Effective Date**

The Nareit FFO White Paper – 2018 Restatement is effective for annual periods beginning after Dec. 15, 2018 and interim periods reported within those periods. Early application is permitted in any interim or annual period after issuance of the Nareit FFO White Paper – 2018 Restatement.



<sup>1</sup> SEC Release No. 33-8145; 34-46768, Proposed Rule: Conditions for Use of Non- GAAP Financial Measures (Nov. 4, 2002) available at: <https://www.sec.gov/rules/proposed/33-8145.htm>

<sup>2</sup> Note this release has been superseded, but is cited for its history of the SEC's recognition of Nareit-defined FFO, available at: <https://www.sec.gov/divisions/corpfin/faqs/nongaapfaq.htm>

<sup>3</sup> U.S. Securities and Exchange Commission, Non-GAAP Financial Measures, Compliance & Disclosure Interpretations (May 17, 2016), available at: <https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm>

<sup>4</sup> See, e.g., <http://www.auditanalytics.com/blog/reits-non-gaap-measurements-face-sec-scrutiny/>

<sup>5</sup> [http://www.fasb.org/jsp/FASB/Document\\_C/DocumentPage?cid=1176167901010&acceptedDisclaimer=true](http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176167901010&acceptedDisclaimer=true)

<sup>6</sup> Accounting Standards Update (ASU) No. 2017-05, *Other Income—Gains and Losses From the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets* – amends Subtopic 610-20, which was originally issued in May 2014 as part of [ASU No. 2014-09](#), *Revenue from Contracts with Customers (Topic 606)*.

<sup>7</sup> [http://www.fasb.org/jsp/FASB/Document\\_C/DocumentPage?cid=1176168837607&acceptedDisclaimer=true](http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176168837607&acceptedDisclaimer=true)