



# *White Paper on*

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# *Funds From Operations*

*April 2002*

## TABLE OF CONTENTS

I. Introduction

II. History and Intended Use of FFO Definition

III. Discussion of FFO Definition

A. Amortization and Depreciation

B. Treatment of Non-recurring and Extraordinary items

C. Entities Addressed by the FFO Definition

D. Disclosure of FFO

E. Gains and Losses on Property Sales

IV. Supplemental Disclosure

A. Capital Expenditures

B. Straight-Line Rents

C. Results of Discontinued Operations

V. Implementation

## I. INTRODUCTION

In 1991, NAREIT adopted a definition of Funds From Operations (FFO) in order to promote a supplemental industry-wide standard measure of REIT operating performance that would not have certain drawbacks associated with net income under generally accepted accounting principles (“GAAP”). The definition was clarified in 1995, 1999 and 2002. The current definition 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.

Historical cost accounting for real estate assets implicitly assumes that the value of real estate assets diminishes predictably over time. Since real estate values instead have historically risen or fallen with market conditions, many industry investors have considered presentations of operating results for real estate companies that use historical cost accounting to be insufficient by themselves.

The term Funds From Operations was created to address this problem. It was intended to be a standard supplemental measure of REIT operating performance that excluded historical cost depreciation from — or “added it back” to — GAAP net income.

Since the introduction of the definition, the term has come to be widely used by REITs. In the view of NAREIT, this use (combined with the primary GAAP presentations required by the Securities and Exchange Commission) has been fundamentally beneficial, improving the understanding of operating results of REITs among the investing public and making it easier than before to compare the results of one REIT with another.

Nevertheless, issues have arisen that suggest that greater guidance on its intent and interpretation is useful, both to reporting companies and investors. This White Paper addresses these issues.

## II. HISTORY AND INTENDED USE OF FFO DEFINITION

NAREIT recognizes that the management of each of its member companies has the responsibility and authority to publish financial information that it regards as useful to the financial community, within the limits prescribed by law and regulation. Nevertheless, NAREIT has been and remains convinced that the industry benefits from having a supplement to net income as a 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.

In particular, GAAP historical cost depreciation of real estate assets is generally not correlated with changes in the value of those assets, whose value does not diminish predictably over time,

as historical cost depreciation implies. For this reason, comparisons of the operating results of REITs that rely solely on net income have been less than satisfactory. Some analysts have also concluded that comparing or measuring prices of REIT stocks solely in terms of conventional P/E multiples is not as useful as also using a supplemental metric.

In an effort to overcome this problem, NAREIT adopted the term Funds From Operations in the belief that it would be useful if consolidated after-tax income plus depreciation and amortization were used as a supplemental measure of operating performance. In particular, it was hoped that prices of various REIT stocks could be compared with each other and in terms of the relationship between REIT 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.

However, the underlying premise of the definition of FFO was 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.

Importantly, FFO was also not intended to be used as a measure of the cash generated by a REIT nor of its dividend paying capacity. NAREIT feels that the statements of cash flows provided for by GAAP financial statements are adequate for analysts to assess the cash generated and used by REITs.

Similarly, NAREIT continues to believe that the dividend paying capacity of a REIT 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, much as they are analyzed in comparison to net income in other industries, it was and is not NAREIT's intent to imply that FFO is a measure of the sustainable level of dividends payable by a REIT.

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

### **III. DISCUSSION OF FFO DEFINITION**

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

The 1991 definition of FFO specified that depreciation and amortization were to be added back to consolidated 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" in the calculation.

In addition, some analysts questioned the propriety of adding back any depreciation other than depreciation of real estate, since the original justification for the add back was that historical cost depreciation is inappropriate for real estate assets. 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. It urges all member companies reporting FFO to add back only those items that meet this standard.

Examples of items that should be added back include real property depreciation, amortization of capitalized leasing expenses, tenant allowances or improvements, and the like. Specifically excluded are the add back of items such as the amortization of deferred financing costs, 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 net income.

#### B. Treatment of Non-recurring and Extraordinary Items

NAREIT's intent in the creation of FFO was to try to produce a measure of consolidated operating performance that is recurring in nature. Accordingly, in NAREIT's 1995 White Paper, the definition of FFO excluded items classified by GAAP as extraordinary or unusual, along with significant non-recurring events that materially distort the comparative measurement of company performance over time.

Given the diversity in practice that developed with respect to non-recurring events, in 1999 NAREIT clarified the definition of FFO to include non-recurring events, except for those that are defined as "extraordinary items" under GAAP. This clarification was effective January 1, 2000, and calculation of FFO based on this clarification should be shown for all periods presented in financial statements or tables. NAREIT also reiterated in 1999 that FFO would continue to exclude the earnings impacts of cumulative effects of accounting changes and results of discontinued operations — both 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 should continue to be included in consolidated FFO. This clarification is effective January 1, 2002, and calculation of FFO based on this clarification should be shown for all periods presented in financial statements or tables.

#### C. Entities Addressed by the FFO Definition.

The 1991 definition of FFO addressed the treatment of unconsolidated partnerships and joint ventures. Specifically, REITs were instructed to reflect the contributions of unconsolidated partnerships and joint ventures to the REIT's consolidated FFO on the same basis as the REIT's own operations. It appears that the original drafters intended that the term joint ventures include both unincorporated associations or corporations in which a REIT holds an active interest.

Nevertheless, REITs increasingly use corporations, the operations of which are not reported on a consolidated basis with those of the REITs. NAREIT believes that the use of a corporate

form instead of a partnership should not affect the determination of whether an entity is to be treated as a joint venture for purposes of the definition.

#### D. Disclosure of FFO

Many companies have reported FFO without providing sufficient disclosure to allow analysts to determine how it is being calculated. In turn, this has made it more difficult to evaluate the degree to which reported FFO results are inconsistent with the definition.

NAREIT believes that an important benefit to all REITs has arisen from the increased use of FFO as a supplement to net income in the measurement of REIT operating performance. In order to continue that benefit, NAREIT encourages its member companies to report their FFO on a quarterly basis, and in all SEC filings, including 10-Ks, 10-Qs, and registration statements, along with a statement showing how FFO is calculated.

The format for the statement of FFO should reconcile to net income from the statement of operations 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 net income and FFO.

In addition to depreciation of real estate, examples of important items that should be considered for inclusion in the reconciliation, itemized both for wholly owned entities and partially owned entities, when applicable, include the following:

- separate itemized listing of each of the following: amortization or depreciation of tenant allowances, tenant improvements, or capitalized leasing costs;
- adjustments for extraordinary items, results of discontinued operations and cumulative effects of accounting changes — all as defined by GAAP;
- FFO from discontinued operations;
- gains or losses on asset dispositions, to the extent not included in both net income and FFO; and
- distributions to minority interests, if applicable.

#### E. Gains and Losses on Property Sales

A number of REITs sell undepreciated property incidental to their main business, most often sales of securities or parcels of land peripheral to operating properties. The prohibition against the inclusion of gains or losses on property sales in FFO was not meant to address this kind of activity, but rather the gain or loss on previously depreciated operating properties.

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

#### **IV. SUPPLEMENTAL DISCLOSURE**

##### **A. Capital Expenditures**

Thanks in some measure to a desire to use anticipated rather than historical results of operations in order to explain dividend policies, especially in initial public offerings, companies used their estimates of future FFO to justify anticipated dividend payouts in the descriptions of dividend policy contained in registration statements, and specifically in the so-called “magic page.”

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 by users of these prospectuses that the FFO numbers do not represent an appropriate means for evaluating dividend policy. Some critics 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 result of 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 Funds From Operations 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 Funds (Cash) Available for Distribution or AFFO. Further, NAREIT does not believe that there is a single measure of distributable cash that is consistently applicable to all REITs.

More detailed disclosures regarding capital spending and certain other items would allow REIT financial statement users who wish to estimate Funds (Cash) Available for Distribution or AFFO to make the adjustments to reported FFO that they consider useful to investors for that purpose. When applicable, this disclosure should reflect the pro rata share of such expenditures by consolidated and unconsolidated entities in which the REIT holds a direct or indirect interest.

NAREIT encourages member firms to provide supplemental disclosure that provides useful insights into material capital expenditures. The total of capital expenditures should be broken down between 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 the following information separately for each type of property.

Items that are known to be of particular interest to readers include the following that generally apply to retail, office, and industrial properties:

- separate itemized listing of expenditures on tenant improvements or allowances, both in the aggregate and per square foot, separated into expenditures on new and renewal tenants;
- expenditures on other capitalized leasing costs, including leasing commissions, both in the aggregate and per square foot, and separated by new and renewal tenants; and
- expenditures on expansions and major renovations.

Items generally considered to be of particular interest with respect to apartment properties include the following, to the extent that they are capitalized:

- Expenditures on floor covering, both in the aggregate and per unit owned during the period, and per unit improved;
- expenditures on appliances, both in the aggregate and per unit owned during the period, and per unit improved; and
- expenditures on exterior preparation and painting, both in the aggregate and per unit owned during the period, and per unit improved.

On April 26, 2001, NAREIT issued a National Policy Bulletin that more fully describes these “FFO White Paper Disclosures.”

#### B. Straight-Line Rents

Depending on individual circumstances, GAAP reporting may or may not require “straight lining” of rents in the calculation of net income. In order to provide an opportunity for consistent analysis of operating results among REITs, NAREIT encourages those reporting FFO to make supplemental disclosure of the non-cash effect of straight line rents, if any, affecting their results for each period.

#### C. Results of Discontinued Operations

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. In addition, disclosures should include specific information about discontinued operations that represent sales of significant business segments.





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## V. IMPLEMENTATION

NAREIT believes that implementation of the recommendations contained in this White Paper is up to the business judgment of the management of each company. 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 securities laws or otherwise for any failure to do so.

*Page 8*

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

NAREIT 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 REIT industry as a whole.