Real Estate Alert

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Non-GAAP financial measures – a focus on publically registered real estate companies

Why are we talking about non-GAAP financial measures?

There has been a great deal of focus recently on non-GAAP financial measures, primarily through speeches and other public comments made by the SEC staff at conferences and through other forms of media. These comments have not been limited to the typical sources of accounting and reporting commentary (e.g., Division of Corporate Finance or the Office of the Chief Accountant) as even Mary Jo White, Chair of the SEC, has made comments on non-GAAP financial measures over the past year, including at the 2015 AICPA National Conference on Current SEC and PCAOB Developments.

Given their importance among publically-registered real estate companies, non-GAAP financial measures were also one of the featured topics at NAREIT's 2016 REITWise conference, most notably during the Future of Financial Reporting session, which featured Wes Bricker, Deputy Chief Accountant of the SEC, and Russ Golden, Chair of the FASB.

Registrants across the real estate industry continue to receive comments from the SEC's Division of Corporate Finance related to the presentation of non-GAAP financial measures, including inquiries on the adequacy of disclosures around the comparability of non-GAAP financial measures to those used by peers, the prominence with which non-GAAP financial measures presented, and the usefulness of the non-GAAP financial measures presented. On May 17, 2016, the SEC staff issued new Compliance and Disclosure Interpretations (CDI) on non-GAAP financial measures, which provide clarifying guidance and examples in areas of frequent SEC staff comment, including non-GAAP presentations that are misleading or presented with greater prominence than the comparable GAAP measures. As such, the comments received from the SEC's Division of Corporate Finance are not expected to become less frequent in the near future.

What is a non-GAAP financial measure?

To level set, non-GAAP financial measures are numerical measures derived by adjusting the most directly comparable GAAP measure. Publically-listed real estate companies often present non-GAAP financial measures in their MD&A, earnings releases, and other public communications to provide investors and other constituents with insight into its business and performance not otherwise attainable by GAAP measures. From a regulatory perspective, non-GAAP financial measures are governed by SEC regulations, specifically:

- Regulation G governs all public disclosures and communications that contain non-GAAP financial measures by any registrant, including press releases, investor presentations, and conference calls;
- Item 2.02 of Form 8-K governs earnings releases; and
- Item 10(e) of Regulation S-K governs all filings with the SEC under the Securities Act or Exchange Act.

While publically-registered real estate companies use a variety of non-GAAP financial measures, there are a few that are tailored to real estate investments trusts (REITs), most notably:

- Funds from Operations (FFO), as defined by the National Association of Real Estate Investments Trusts (NAREIT) and applicable to all publically registered REITs. FFO is defined by NAREIT as net income (computed in accordance with GAAP), adjusted to exclude gains or losses from sales of real estate properties, impairment charges and depreciation and amortization from real estate assets, and similar adjustments for unconsolidated investees.

- Adjusted FFO (AFFO). AFFO is not a standardized non-GAAP financial measure, but it is commonly presented by publically registered REITs. AFFO is generally comprised of company-specific adjustments to FFO (as defined by NAREIT) to exclude certain non-recurring or non-cash items, such as share-based compensation charges and straight-line rent adjustments. Similar adjustments are typically made for non-recurring or non-cash items of unconsolidated investees.

- Modified FFO (MFFO), as defined by the Investment Program Association (IPA) and applicable to publicly registered, non-listed REITs. MFFO is defined by the IPA as FFO (as defined by NAREIT), adjusted for a number of non-recurring or non-cash items, such as acquisition fees, straight-line rent adjustments, amortization of above or below intangible lease assets and liabilities, and similar adjustments for unconsolidated investees.

In addition to these REIT-specific non-GAAP financial measures, there are other non-GAAP financial measures commonly used by publically-registered real estate companies, including:

- Net Operating Income (NOI)

- Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA)

- Adjusted EBITDA

What's changed with the issuance of the CDI on non-GAAP financial measures?

The CDI does not change the SEC's rules and regulations around non-GAAP financial measures. However, it is important for publically-registered real estate companies to consider the SEC's interpretive guidance.

In the CDI, the SEC staff cautions preparers against certain adjustments in deriving non-GAAP financial measures that could violate Regulation G, including:

- Presenting a performance measure that excludes normal, recurring, cash operating expenses necessary to operate a registrant's business;

- Presenting non-GAAP financial measures inconsistently between periods without disclosing the change and the reasons for it;

- Presenting non-GAAP financial measures that exclude non-recurring charges but do not exclude non-recurring gains; and

- Presenting non-GAAP measures that substitute tailored revenue policies for those that comply with GAAP.

The SEC staff also cautions preparers against certain non-GAAP financial measure presentations that could lead to the non-GAAP financial measure being disclosed more prominently than the comparative GAAP measure, which could violate Item 10(e) of Regulation S-K, including:

- Providing a discussion and analysis of a non-GAAP financial measure without a similar discussion and analysis of the comparable GAAP measure in a location with equal or greater prominence;

- Providing tabular disclosure of non-GAAP financial measures without preceding it with an equally prominent tabular disclosure of the comparable GAAP measures or including the comparable GAAP measures in the same table;

- Omitting comparable GAAP measures from an earnings release headline or caption that includes non-GAAP financial measures;

- Presenting a non-GAAP financial measure using a style of presentation (e.g., bold, larger font) that emphasizes the non-GAAP financial measure over the comparable GAAP measure; and

- Presenting a non-GAAP financial measure that precedes the most directly comparable GAAP measure (including in an earnings release headline or caption).

Finally, the SEC staff provided the following interpretive guidance related to FFO specifically:

- The SEC staff confirmed that FFO, as discussed in Footnote 50 to its *Final Rule on Conditions for Use of Non-GAAP Financial Measures*, is meant to be FFO as defined by NAREIT. Footnote 50 states that companies may use FFO per share in earnings releases and materials that are filed or furnished to the Commission, subject to the requirements of Regulation G, Item 2.02 of Form 8-K, and Item 10(e) of Regulation S-K. Further, the SEC staff confirmed that they continue to accept NAREIT's definition of FFO in effect as of May 17, 2016 as a performance measure and does not object to its presentation on a per share basis.

- The SEC staff confirmed that a registrant may present FFO on a basis other than as defined by NAREIT, provided that any adjustments comply with Item 10(e) of Regulation S-K and the measure does not violate Rule 100(b) of Regulation G. The SEC staff highlighted that certain adjustments might preclude a registrant from presenting the performance measure on a per share basis.

What does this mean for publically registered real estate companies?

The impact of the recent focus on non-GAAP financial measures, including the issuance of the CDI, on publically registered real estate companies depends on the non-GAAP financial measures they choose to present.

What types of adjustments are appropriate when presenting non-GAAP financial measures?

The SEC staff continues to support the presentation of FFO both when it is presented in accordance with NAREIT's definition and when adjustments are in compliance with Item 10(e) of Regulation S-K and the measure does not violate Rule 100(b) of Regulation G. When presenting MFFO or AFFO, or any other non-GAAP financial measure, such as NOI or EBITDA, companies should continue to consider whether the non-GAAP financial measure could be misleading or is provided with undue prominence. Further, companies should carefully evaluate the nature of the adjustments to ensure:

- Charges that represent normal, recurring costs of running their business are not excluded;

- The items being excluded are consistent from period-to-period;

- Non-recurring charges are not excluded without excluding non-recurring income when both existed during the period or in comparable periods; and

- Excluded items are not labelled as "non-recurring" when they have occurred in recent prior periods or are expected to recur in near-term future periods.

Can non-GAAP financial measures be presented on a per share basis?

Non-GAAP financial measures that are used as liquidity measures are prohibited from being presented on a per share basis. The SEC staff continues to support FFO calculated based on NAREIT's definition as a performance measure, in which case the presentation of FFO is permitted. When presenting other non-GAAP financial measures, including MFFO and AFFO, companies should carefully assess the nature of the adjustments to determine if the resulting non-GAAP measure represents a liquidity measure rather than a performance measure. For example, the SEC staff prohibits the presentation of EBITDA on a per share basis as they view it to represent a liquidity measure.

Should companies maintain internal controls over non-GAAP financial measures?

All publically registered real estate companies that present non-GAAP financial measures should ensure they have appropriately designed internal controls over the creation and reporting of non-GAAP financial measures. Existing internal controls should be reassessed to ensure they adequately address the risks of presenting non-GAAP financial measures as highlighted in the CDI.

For additional information, please contact:

Brian Ness
Partner, Real Estate Assurance Practice
(646) 471 8365
brian.ness@pwc.com

Brian Robertson
Senior Manager, Real Estate Assurance Practice
(973) 236 7715
brian.j.robertson@pwc.com

PwC Real Estate Contacts

Byron Carlock
US Real Estate Leader
(214) 754 7580
byron.carlock.jr@pwc.com

Tim Conlon
US Real Estate Clients and Markets Leader
(646) 471 7700
timothy.c.conlon@pwc.com

Richard Fournier
US Real Estate Assurance Leader
(617) 530 7168
richard.e.fournier@pwc.com

Tapan Nagori
US Real Estate Advisory Leader
(312) 298 3574
tapan.nagori@pwc.com

David Voss
US Real Estate Tax Leader
(646) 471 7462
david.m.voss@pwc.com

Tom Wilkin
US REIT Leader
(646) 471 7090
tom.wilkin@pwc.com

www.pwc.com/us/realestate