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REALPAC Adjusted Cashflow From Operations (ACFO) for IFRS

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REALPAC Adjusted Cashflow from Operations (ACFO)

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. (Please refer to REALPAC Funds from Operations and Adjusted Funds from Operations (AFFO)).

Since the introduction of the definition, the term has come to be widely used by Canadian public companies and REITs.

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 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 expand the guidance on FFO to include a definition of Adjusted Funds from Operations for IFRS in February 2017, as well as issue guidance on a new metric referred to as Adjusted Cashflow from Operations (ACFO). For more information on FFO and AFFO, please refer to REALPAC FFO and AFFO.

The February 2018 revision on the February 2017 ACFO edition added an adjustment for distributions on puttable instruments that are classified as financial liabilities and therefore treated as interest expense.

The February 2019 revision (updated) on the February 2018 ACFO edition adjusted for revenue and expenses from Right of Use Assets that are part of the entity's ongoing business operations (and includes wording edits).

This January 2023 revision expands the adjustment for non-controlling interest (NCI)

to include an adjustment to deduct NCI for consolidated investments in entities that have puttable units classified as financial liabilities under IAS 32, where the NCI has not been deducted as a result of being treated as a liability rather than equity.

II. Intended Use of ACFO

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 believes that the industry benefits from having FFO, AFFO and ACFO as supplements to IFRS financial statements.

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.

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 Cashflow from Operations (ACFO). ACFO is intended to be used as a sustainable, economic cash flow metric.

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.

III. ACFO Definition

The format for the statement of ACFO should reconcile to IFRS cash flow from operations and include a line-item breakdown of each of the adjustments being used in the calculation of ACFO. The reconciliation should be sufficiently detailed to provide readers with a clear understanding of the material differences between IFRS cash flow from operations and ACFO.

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

ACFO / IFRS Cash Flow Reconciliation	
Cashflow from operations per IFRS Statement of Cash flows	\$x,xxx,xxx
Adjustments:	
1. Change in Working capital	xxx,xxx
2. Interest expense included in cash flow from financing	xxx,xxx
3. Amounts from joint ventures not included in cash flow from operations	xxx,xxx
4. Capital expenditures (CAPEX)	xxx,xxx
5. Leasing costs	xxx,xxx
6. Tenant improvements	xxx,xxx
7. Realized gains/losses on marketable securities not included in cash flow from operations	xxx,xxx
8. Taxes related to non-operating activities	xxx,xxx
9. Transaction costs associated with acquiring Investment Properties	xxx,xxx
10. Transaction costs associated with disposing of Investment Properties	xxx,xxx
11. Deferred financing fees	xxx,xxx
12. Debt termination costs	xxx,xxx
13. Off market debt (either favourable or unfavourable)	xxx,xxx
14. Interest income/expense	xxx,xxx
15. Effects of puttable instruments classified as financial liabilities	xxx,xxx
16. Operational revenue and expenses from Right of Use Assets	xxx,xxx

17. Non-controlling interest in respect of the above	xxx,xxx
ACFO	\$x,xxx,xxx

Items not adjusted in determining ACFO:

Items not listed above, including, for example, compensation expense (including any portions relating to stock options or other equity instruments), should not be included in adjustments from cashflow from operations to ACFO.

IV. Discussion of ACFO Definition Adjustments

1. Change in Working Capital

The intent of this adjustment is to only eliminate fluctuations due to changes in A/R, A/P and other working capital items that are not indicative of sustainable cash available for distribution. For example, significant build-ups of accounts payable amounts on condo developments in inventory, or pre-payments of real estate taxes, may not be representative of sustainable cash flows. Adjustments should be made for all material amounts that are not consistent with sustainable, economic cash flows.

2. Interest Expense Included in Cash Flow from Financing

The Ontario Securities Commission (OSC) viewpoint is that, while there is an accounting policy choice under IFRS, the principal intent of National Policy 41-201 was the inclusion of interest within cash flow from operations for the purposes of reconciling cash flow from operations to distributions (OSC Staff Notice 51-724, January 26, 2015). Interest paid represents cash paid out that decreases sustainable cash available for distribution.

The calculation of ACFO should have interest expense as a deduction. It is a matter of choice whether that deduction is included in deriving cash from operating activities, or as a deduction from cash from operating activities in reconciling to ACFO.

For clarity, this excludes interest capitalized in compliance with IFRS (i.e. on development).

3. Amounts from joint ventures not included in cash flow from operations

The option is provided to include either ACFO from joint ventures (calculated in accordance with this guidance) or distributions from joint ventures, whichever best reflects business operations. Amounts may also include notional interest that would have been capitalized, with the intent that interest expense that funds development should impact ACFO in the same manner regardless of whether that development is done on fully owned property or property held through a joint venture.

These amounts contribute to sustainable cash available for distribution but are not reflected in cash flow from operations under IFRS due to equity accounting.

4. Capital expenditures ("CAPEX")

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. However, the amount in this reconciliation 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.

CAPEX reduces sustainable cash available for distribution and is not reflected in cash flow from operations under IFRS.

For consistency, if AFFO is disclosed (in accordance with the REALPAC FFO and AFFO), "CAPEX" amounts deducted for AFFO should be the same as for ACFO.

5. 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 ACFO purposes, external leasing costs should be deducted, except to the extent that leasing costs relate to development projects. For clarity, internal leasing costs would already be expensed through net income in arriving at cash flow from operations, so the adjustment would only be for the remaining external costs.

Overall, ACFO should be “net” of either the actual leasing costs incurred (both external and internal), or a reserve amount as discussed in CAPEX adjustment above.

6. Tenant Improvements

Amounts paid for tenant improvements reduce sustainable cash available for distribution and are not reflected in cash flow from operations under IFRS. For consistency, if AFFO is disclosed (in accordance with the REALPAC FFO and AFFO), “tenant improvements” amounts deducted for AFFO should be the same as for ACFO.

7. Realized gains/losses on marketable securities not included in cash flow from operations

Realized gains add to cash available for distribution and realized losses reduce cash available for distribution and should be reflected in ACFO.

8. Taxes related to non-operating activities

This adjustment is limited to adding back tax amounts that were deducted from cash flow from operations in the IFRS financial statements (for example, taxes on disposition of investment properties).

9. Transaction costs associated with acquiring Investment Properties

Under IFRS, transaction costs related to asset purchases are capitalized, while those related to a business combination are expensed.

For consistency purposes, transaction costs that are deducted from net income (i.e. expensed) under IFRS for the acquisition of Investment Properties should be added back in calculating ACFO.

10. Transaction costs associated with disposing of Investment Properties

When a business is disposed of, the gain or loss on disposal is not included in cash flow from operations.

For consistency purposes, transaction costs that are deducted from net income (i.e. expensed) under IFRS for the disposition of Investment Properties (that have not been added back to cash from operations under IFRS) should be added back in calculating ACFO.

11. Deferred financing fees

Amounts that have been booked for net income purposes under IFRS should be reflected in ACFO on the same basis. (i.e., amounts deducted for net income should flow through as a deduction for ACFO).

For example, where deferred financing fees (including amortization thereof) have been added back to arrive at cash flow from operations, amounts should be subtracted in arriving at ACFO.

Debt financing costs are a cost of doing business and represent a reduction in cash available for distribution.

12. Debt termination costs

Amounts that have been booked for net income purposes under IFRS should be reflected in ACFO on the same basis. (i.e., amounts deducted for net income should flow through as a deduction for ACFO).

Debt termination costs are a cost of doing business and represent a reduction in cash available for distribution.

13. Off market debt (either favourable or unfavourable)

Amounts that have been booked for net income purposes under IFRS should be reflected in ACFO on the same basis. (i.e., amounts deducted for net income should flow through as a deduction for ACFO and conversely, amounts added to net income should flow through as an increase for ACFO).

14. Interest income/expense

Amounts that have been booked for net income purposes under IFRS should be reflected in ACFO on the same basis (i.e., amounts deducted for net income should flow through as a deduction for ACFO), with the exception of point 15. below where applicable.

For example, where the timing of the recognition of interest income/expense differs

from the collection/payment date and have been adjusted to arrive at cash flow from operations, these amounts should be added/subtracted in arriving at ACFO.

15. Effects of puttable instruments classified as financial liabilities

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 arrive at ACFO.

16. 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 financing cash flows rather than operating cash flows, and therefore no longer included in cash flow from operations. 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. Where an entity treats interest income as investing activities, instead of operating activities, ACFO should also add interest income relating to such finance lease payment earned relating only to subleases in cases where such subleases are under head/ground lease(s) for both the underlying land and building.
- The purpose of this adjustment is to include rental revenue from these subleases in ACFO as this cash flow 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 right of use asset (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.

17. Non-controlling interests in respect of the above

An entity's ACFO should reflect the ACFO attributable to the parent. Therefore, ACFO should be adjusted for the non-controlling interest included in each of the above

adjustments made to profit or loss or cash flow from operations to arrive at ACFO. ACFO should also include an adjustment to deduct NCI for consolidated investments in entities that have puttable units classified as financial liabilities under IAS 32, where the NCI has not been deducted as a result of being treated as a liability rather than equity.

V. Suggested Additional Best Practices for ACFO

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 ACFO

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.

VI. Disclosure of ACFO

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.

VII. Implementation

REALPAC believes that implementation of the recommendations contained in this 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 ACFO 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 edition are expected to be implemented by REALPAC members for fiscal years commencing on or after January 1st, 2023 or thereafter with prior period amounts restated to conform to the new definition(s). Early adoption is permitted.

REALPAC Financial Best Practices Committee
January 2023

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

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