by Mark Schonberger and Jacqueline M. Bideau

Historically, the Securities and Exchange Commission (SEC) has been wary of allowing public company disclosure of financial measures that are not in accordance with Generally Accepted Accounting Practices (GAAP), citing the risk of misleading investors with information different from that in the company's financial statements. However, public companies – and REITs in particular – have long argued that investors cannot get a meaningful picture of performance when limited to presenting financial information in accordance with GAAP.

The SEC appears to have been listening to REITs. In recent public appearances and comment letters, the SEC staff has not only embraced the use of non-GAAP measures but has also begun insisting on them. In this new era of transparency, the SEC is also asking REITs to present more property-level information that historically has only appeared in "supplemental" financial information voluntarily furnished to the SEC.

So how did we get here and what does the current and future disclosure landscape look like for REITs?

What Are Non-GAAP Measures?

Although uniform GAAP standards allow investors to readily compare investments, GAAP measures may not always adequately capture a company's financial position, particularly in the REIT industry where real estate values move with market conditions rather than depreciate over time (as GAAP assumes). Supplemental non-GAAP measures such as funds from operations (FFO) and net operating income (NOI) more accurately reflect the performance of REITs. FFO assesses the REIT's performance as a whole by adding back, among other things, depreciation and amortization. NOI is an operating performance metric focused on the property level – the property's income less all vacancy and operating expenses. Same-store NOI takes the analysis even further, allowing investors to compare the period-to-period performance of properties owned in multiple periods.

In 2003, the SEC issued rules allowing for non-GAAP financial disclosure, subject to some basic requirements. Regulation G prohibits the use of non-GAAP measures in any public communication unless they are not misleading and are reconciled with the most comparable GAAP measures. Item 10(e) of Regulation S-K more specifically regulates the use of non-GAAP measures in SEC filings, requiring, generally, that the most comparable GAAP measure be equally as prominent and that management disclose why the non-GAAP measure is helpful to investors.

In 2010, the SEC revised its Compliance and Disclosure Interpretations (2010 CDIs) to clarify permitted uses of non-GAAP financial information, hinting at a more friendly approach to non-GAAP measures in the future. Many saw this as a shift in the SEC's position, as did Michael McTiernan, Assistant Director, Office of Real Estate and Commodities of the SEC's Division of Corporation Finance. In a January 2012 Practising Law Institute discussion, McTiernan stated, "I think that with non-GAAP, there was some militancy in the Staff pre-2010 that maybe went beyond what the actual rules called for. I think the 2010 CDI scaled that back a bit." Although this was a shift in the SEC's position, the SEC was clear to note that it was not advocating for the use of non-GAAP disclosure. During a webcast held jointly by the Center for Audit Quality and the SEC's Division of Corporation Finance in June 2011, a deputy chief accountant for the

SEC Non-GAAP and Property-Specific Comments to REITs — December 2010 – June 7, 2012

Comment *Some categorizations were made by the authors to consolidate the data.*	**Agreed to Comply**	**Agreed in Part**	**Did Not Agree**	**Total**
Discuss relationship between market/current asking rents and expiring leases, and relationship between rents on expiring leases and rents on executed renewals or new leases; disclose relationship of rents on expiring leases and market rates.	2	19	1	22
Requests for property-specific information, including: schedule of lease expirations; % gross annual rent represented by expiring leases; occupancy rates; total square feet of expiring leases; rent and occupancy trends; average rent per square foot; effect of tenant concessions, abatements, or reimbursements on average rent; trends in tenant improvement costs.	17	9	2	28
Does management view FFO, Core FFO, NOI, or same store NOI as key performance indicators and, if so, disclose.	15	2	11	28
Include capitalization rates for acquisitions and dispositions, including how capitalization rates and NOI are calculated.	11	16	7	34
Is definition of FFO consistent with NAREIT – quantify any differences; revise FFO to be consistent with NAREIT's definition; requests for clarification of FFO calculation; requests for clarification of NOI definition or inputs to NOI calculation.	19	1	0	20
Explain why FFO/MFFO/Company-Defined FFO/Core FFO is a useful measure to investors.	8	0	0	8

SEC stated the revisions were "not intended to promote the use of non-GAAP measures."

Current REIT Disclosure Landscape

Today, not only has the SEC staff been more open to non-GAAP measures, but they have begun to request that REITs disclose non-GAAP metrics in their public filings if management views those measures as key performance indicators. Common requests include NOI (particularly, same-store NOI) or FFO. Many REITs have been asked to include more property-specific information, such as leasing activities or average effective rent per square foot – items not historically disclosed. These requests seem to suggest the SEC recognizes that these industry-specific metrics are meaningful assessments of a REIT's performance.

Indeed, a review of all SEC 10-K comment letters to REITs from June 2009 to June 2012 shows a significant increase in non-GAAP comments in the 18 months after December 2010 compared to the preceding 18 months. Out of 951 comments from December 2010 to June 7, 2012, 141 were requests to include NOI, FFO, or property-specific information. By contrast, from June 2009 to November 2010, only 31 of 941 SEC comments constituted a request for this type of information and not one requested NOI.

As illustrated in the table, REIT's responses have been mixed. When asked to discuss the relationship between current market trends and expiring leases, the majority of REITs complied, but only when the relevant period had material lease expirations. REITs were more amenable to disclosing property-specific information, such as schedules of lease expirations and average rent per square foot, with almost two-thirds providing this data. REITs were almost evenly split when asked whether management views either NOI or FFO as a key performance measure. Of those that said NOI or FFO was not a key performance measure, reasons included that management did not use these metrics and the lack of an industry benchmark for the calculation. Similarly, when asked to provide capitalization rates, including a disclosure of how NOI is calculated, the response varied widely. Of those that did not disclose this information, reasons included: that the disclosure would be misleading "based on the high degree of judgment/forecasting that goes into its inputs;" that disclosure would be "competitively disadvantageous;" the proprietary nature of this information; and that this information would not be meaningful because peers may calculate capitalization rates differently. REITs will be happy to hear that the SEC staff is no longer pursuing the capitalization rate disclosure.

Future REIT Disclosure Landscape

These comments suggest that disclosure by REITs of non-GAAP measures and more granular property-level information may become the norm – whether REITs like it or not. Although many have championed the value of these metrics, there are some risks. Recognizing that investors may not be comparing "apples to apples," the SEC is beginning to focus more critically on the components of these metrics. Still, with more REITs willingly disclosing non-GAAP information, the SEC is starting to act as if this is the norm and requesting it from the unwilling REITs if management views those measures as key performance indicators. If non-GAAP information is the future for SEC comments, perhaps NAREIT will decide to issue a white paper on calculating NOI (similar to what it did with FFO) to promote consistency, eliminate the risk of misleading investors, and ease the hesitancy of some REITs in providing this information.

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