

Long-term earnings power left out of the equation

ROSEN

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Incidentally, this includes a majority of the largest business trusts.

The Board went on to note that distributable cash was the "culprit" of overvaluation in the business trust market, and that GAAP reporting need not be changed (or presumably expanded to regulate distributable cash). This is where they lost me.

Indeed, it has been a bizarre twist of GAAP that has actually accelerated and promoted the adoption of distributable cash. Back in 2000, long before the trust mania could have been predicted by anyone, a consensus opinion was issued by the Emerging Issues Committee (EIC) of the standards board. Incidentally, the shortcomings of the composition and workings of the EIC were addressed in my articles from March 10 and 28 of last year.

Nevertheless, the standard they passed (called EIC-107) allowed trusts to create some very questionable future income tax liabilities, and then amortize them into income by reducing reported tax expenses.

Of course, the supposed reason for creating trusts in the first place is to avoid tax expenses. Therefore, reducing tax expenses actually produces a net tax credit in many cases.

In other words: it is not unusual to see a trust reporting pre-tax income of, say, \$100-million, tax expense of negative \$20-million, and net income of \$120-million. As such, it is not surprising that investors have openly questioned the utility of GAAP reporting for trusts, with the unfortunate result of turning blindly towards distributable cash reporting.

There's no indication yet that the rule is being considered for an update, even in light of the explosion of interest in the trusts over the past six years. This is despite the fact that a provincial accounting standards task force noted in 2004 that the application of EIC-107 simply "makes no sense."

I've explained the problem in more detail, and how to work around it, in a recent report to clients using **Yellow Pages Income Fund** as an example. In short, the depreciation expenses that many investors seem to be ignoring at Yellow Pages definitely deserve a second look.

Distributable cash at the company

was 161% of reported net income for the first nine months of 2005. By contrast, distributable cash as a percentage of pre-tax income was actually 191% for the same period. This is very strange indeed, as you would more likely expect to see the opposite.

The basic caveat here is that although GAAP has a few problems when it comes to the accounting for trusts, a standardized approach is still miles ahead of the present distributable cash alternative.

Unfortunately some investors have chosen to ignore the income statements of the trusts, in favour of a pick-and-choose approach that mixes some GAAP figures with management's short-term cash budgeting estimates.

Everyone has been in a situation where they've had to tighten their belt for a while, and they also know that they could not have done it forever. In other words, short-term cash budgets have nothing to do with long-term earnings power, the latter of which has traditionally formed the basis for valuing investments.

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COMMENT

It's nice to have company

S&P seems to agree with me on trusts' distributable cash

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Someone asked me the other day how long I've been warning about the downsides of income trusts. The earliest reference I found was back in 2003 when I said that the problems with Atlas Cold Storage were just the tip of the iceberg. Since that time, dozens of income trusts have also cut their distributions because they misjudged their own distributable cash stability.

So it's nice to finally have a little company when it comes to my public views on the manipulative nature in which many incomes trusts are marketed. The only thing more surprising, perhaps, is the source of the apparent camaraderie.

On the one hand, there was Standard & Poor's recently echoing some of the issues I have been hammering away at for years. The report S&P issued essentially stated that distributable cash was easily manipulated because no financial reporting standards exist for its calculation. The obvious problem with this is that distributable cash forms the basis of valuation for many trusts.

The report from S&P seemed a little ironic given the fact that they are also the entity responsible for hoisting a perception of added credibility on to the trusts by recently including them in the S&P/TSX composite index at half their market weight (with full inclusion to follow this March).

S&P promises a sequel to its report, so I hope they address the issue of how they will adjust the reported dividend yield of the index to exclude the portion of trust distributions that represent a return of capital to investors. By my calculation, roughly one-third of cash distributions among the largest business trusts is simply a return of people's original investment principal. An inflated yield calculation for the country's flagship equity index is sure to draw the ire of international regulators — that is, if their concerns over Canadian trusts haven't already been piqued.

The other recent warning about trusts has come rather surprisingly from the Accounting Standards Board of Canada. Just last month, they warned that investors were likely unaware of the dangers inherent in trusts whose "distributions routinely and substantially exceed reported earnings."

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