

COMMENT

*Don't trust the numbers*Regulators, auditors
blind to income
trust shenanigans

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Pinpointing some of the causes of the continued hype in the business income trust market is easy, including a tax policy decision based solely on election timing, and unabated greed by corporate underwriters.

The less obvious, but more disturbing roles, however, have been played by the securities regulators and corporate auditors. Instead of safeguarding the market, they appear to be either woefully over-matched or willfully ignorant.

For several years now, I have highlighted the lack of income present in income trusts, noting that you eventually have to pay the piper. Perhaps not this year or the next, but at some point, you have to earn the cash you're handing out to investors — you can only borrow for so long. In effect, net income holds great insight into what distributable cash doesn't tell you. Thus, while I cringe whenever I see analysts or the media confusing the two, I practically fell off my chair when I saw the Ontario Securities Commission commit the same gaffe.

On the Commission's Web site is an Investor Alert from January, 2005, which states, "Distributable cash' is the term that is used to describe the income that flows from the business to investors."

And there you have it, the country's top securities cop practically blessing the notion that reported net income and management's short-term cash budgeting guesstimates are one and the same.

So, let me set the record straight: borrowing \$20 from your friend is not the same as earning \$20 at your job. One is sustainable and the other is not.

A more accurate assessment for investors would have been that: "Distributable cash is all of the income earned by the business, plus roughly 50% more that they hope to earn in the future, but are paying to investors now in order to juice the stock price so they can either: (a) acquire more companies

to eventually earn that money, or (b) secure additional investment capital in order to pay the de facto obligations to current investors.

"Option (b) is more commonly called a Ponzi scheme (please see OSC Investor Alerts dated September and December, 2003)." By the way, you can view these alerts yourself at www.investored.ca.

While some business trusts are simply paying out unsustainable levels of borrowed money over the short-term in order to let original shareholders cash out, others are more legitimately trying to expand their business by playing the valuation spread. In other words, they are trying to acquire other businesses by using their own over-valued units as the currency. This isn't a game that is new to income trusts. The extra valuation given to trusts has simply increased the spread.

There is, of course, nothing wrong with this in principle. But in reality, the financial reporting problems related to acquisitions, combined with the additional haze of distributable cash figures, means that valuations can easily get ahead of fundamentals.

A significant change in financial reporting that has never fully sunk in for investors is the way in which acquired intangible assets are expensed. Or, not expensed, is a better way of putting it.

Acquiring a company opens the door to numerous financial reporting choices, which are left up to management to decide. Perhaps the most significant is determining what proportion of the purchase price should be allocated to intangible assets that do not need to be regularly expensed. The higher the number that is chosen, the greater reported net income can be. Essen-

tially, expenses that are crucial to earning the current level of revenue are being deferred in order to show a more positive profit picture today.

As this relates to income trusts, investors will quickly seize the higher revenue figure as being "cash" even though it hasn't been fully earned because some of the expenses have not been recognized. I cannot overstate how faulty a presumption this is when it comes to valuing a business from a fundamental viewpoint. In terms of the current overblown valuations of some business income trusts, perhaps a lack of fundamental valuation is indeed the explanation.

The management leeway provided by acquisition accounting rules is just one area where the figures can be fudged. Similar management prerogative has been granted in the areas of pension accounting, foreign currency translation, hedging, asset valuations, and income tax reporting.

This extreme degree of choice is no accident, but rather a deliberate design of the accounting standard setters to offload potential liability from corporate auditors onto company management. Since it's naive to expect our self-regulating auditors to take responsibility for more than they have to, it begs the question why our securities regulators don't step in to correct the financial reporting imbalance. Why not let the OSC overrule the accounting standards board in Canada the way that the SEC can do in the United States?

I've asked senior officials at the OSC this question, and the response was basically: "You don't expect us to start setting accounting rules, do you?"

Well yes, because it's obvious that nobody else will.

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