

## COMMENT

# There's hope for income trusts

Proposed rules would improve their reporting

AL ROSEN

Now that the tax disparity and economic productivity issues of income trusts have been addressed by the government, it's time to focus on the last major problem — the weak financial reporting.

I first highlighted the severe drawbacks of income trust financial reporting in this column more than 18 months ago. The large losses then being suffered by some trust investors were largely attributable to virtually non-existent financial reporting requirements.

Fast forward to today and little has changed. The Canadian Securities Administrators have issued limited guidance, but have failed to effectively deal with the most serious issues. Specifically, the critical need for a distinction between earned income and a mere return of investors' own capital has not been addressed.

Likewise, the Accounting Standards Board bowed out early on, based on a self-imposed restriction that widespread manipulation of financial reporting is simply not their concern.

In late May, the Canadian Association of Income Funds (the trade organization for the trusts) promised voluntary improvements in trust reporting by the end of this summer. Of course, summer came and went and nothing happened. Now word comes that CAIF is hung up on the treatment of maintenance capex. Oh, is that all?

In reports we issued to clients 12 and 18 months ago, we identified maintenance capex as representing 70% of the difference be-

## SOME TRUSTS WERE LITTLE MORE THAN PYRAMID SCHEMES

tween net income and distributable cash. So, it seems that CAIF has been at the issue for nine months now, resolved 30% of the problem, but nevertheless claims that a full resolution is just a "few weeks" away.

Confused about who's actually responsible for doing something? I don't blame you. In the meantime, investors have lost billions to date on certain trusts because they were little more than modified pyramid schemes.

Nevertheless, hope for improvement still exists. The Canadian Performance Reporting Board has recently issued proposed guidelines for improving trust reporting. CPRB's primary mandate is to develop and maintain the voluntary MD&A (management discussion and analysis) disclosure guidelines issued by the Canadian Institute of Chartered Accountants (CICA).

The voluntary nature of CPRB's guidelines is both a blessing and a curse for investors. The curse is obvious. Certain abusive trusts will simply continue to mislead investors with their financial reporting. The blessing is that CPRB's mandate is to improve MD&A disclosures, which, unlike financial statements, are not audited.

When the CPRB beefs up MD&A disclosures, there's no additional risk attached to the CICA's auditor members. This eliminates the unpleasant task of auditors having to tell their paying customers (the trusts) that they approved mandatory guidelines that will reduce the ability of the companies to mislead investors.

Given that the auditors remain insulated, CPRB has been allowed to put together some very impressive, investor-friendly proposals.

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# Trust clarity still wanting

ROSEN

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For instance, distributable cash has to be clearly separated into distributable cash obtained from operating, investing and financing activities.

In other words, it should be more apparent when a company is unsustainably funding its cash distributions with borrowed money.

Companies must explain any deviations between their distributable cash figures and their audited financial statements. The guidelines cite the specific example of the difference between depreciation on the income statement and maintenance capex used to compute distributable cash.

It only gets better from there. Companies must disclose the "estimates and assumptions" that they used to justify the differences.

This would help explain, for example, why **Yellow Pages Income Fund** reports depreciation expenses that are more than 10 times the company's estimate of maintenance capex (capital expenditures).

The overall purpose is for companies to adopt the guidelines in their entirety in order to make a statement to that effect in their management discussion and analysis.

This certification will allow investors to immediately identify those trusts that are not following the rules.

A downside is that the rules are written in the hopes that companies will volunteer as much useful information as possible.

The risk is that some companies might make boilerplate statements that skirt the spirit of the guidelines, while still claiming that they comply with the general format.

For instance, a phrase like, "The company used a discounted cash flow approach based on management estimates of future cash flows" is completely worthless on its own.

While it arguably could satisfy a literal interpretation of the guidelines, it is hollow without

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further quantification and description.

In that vein, investors should be especially wary of companies that claim their current disclosures already follow the proposed guidelines.

The CPRB guidelines mark a significant shift in attitude toward satisfying investor needs. We've analyzed scores of trusts and haven't seen any that come close to satisfying the proposed requirements.

Voluntary adoption of the rules by some trusts will mark a vast improvement over the current situation where no useful consensus on distributable cash reporting exists.

The guidelines are prudent proposals that no reasonable company should decline to implement.

Investors would do well to seek out those trusts that choose to apply the new rules.

It's one way to cut through a lot of the misleading financial reporting that still plagues the income trust sector.

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