

Dec 12, 2006

TO: Participants in Canada's Financial Markets

FROM: The Canadian Advocacy Council of Canada's CFA Institute Member Societies

Re: Income Trust Disclosures, Analysis and Market Integrity

During the past several years, Income Trusts (defined as including royalty trusts, REITs and business based income trusts) have emerged as prominent participants in the Canadian capital market. Although these Income Trusts have a legal structure that is distinctly different from share capital corporate issuers (since, for tax purposes, they are generally organized as mutual fund trusts) for purposes of accounting, disclosure, governance standards and financial analysis, they are just an alternative form of business entity and should be held to the same standards as corporate issuers.

As the Income Trust market has evolved, market participants and regulators have periodically reviewed the quantity and quality of disclosure by Income Trust issuers and have found that a significant number of these issuers under-comply with a variety of either securities regulations or accounting standards. In particular, while distributable cash has become the key performance and valuation parameter for Income Trusts, disclosure regarding distributable cash and the related MD&A leaves much to be desired. Distributable cash is not calculated in a consistent manner, and in practice, distributable cash calculations are non-standardized and involve a high degree of management discretion. The members of the Canadian Advocacy Council¹ are of the view that thoughtful dialogue on these matters should occur as they impact the integrity of Canada's capital markets.

From a financial analysis perspective, difficulties arise from the fact that Income Trust performance and value is benchmarked by reference to distributable cash, a non-GAAP and non-standardized metric. As a result, without full disclosure about how it is derived, distributable cash is rendered meaningless for comparative analysis and as a reasonable basis for making or recommending investment decisions.

¹ The Canadian Advocacy Council ("CAC") represents the 12 Canadian member societies of the CFA Institute comprising more than 11,000 professional members who are active in Canada's capital markets. The members of the CAC consist of portfolio managers, investment analysts, corporate finance professionals and other capital market participants. The CAC has been charged by Canada's CFA Institute member societies to review Canadian regulatory, legislative and standard setting activities.

Background on the Income Trust Market

Income Trusts have grown from their modest origins to account for a considerable portion of the Canadian capital markets. At present, there are more than 275 listed Income Trusts in Canada, with a market capitalization of more than \$180 billion.

The Income Trust structure has developed because of two perceived advantages over the traditional corporate capital share structure:

- **Tax Benefits** – Income Trust distributions are paid from predominantly pre-tax income, whereas dividends are paid from after-tax income. Despite recent announcements (which will in time eliminate the tax advantage) this tax benefit is still an important economic incentive for existing business to convert to an Income Trust.
- **Market Demand for Fixed Income product** - Income Trusts are perceived by some investors as a higher-yielding “fixed” income investment, and are therefore still used by retail and professional investors anxious to increase income in a historically low-yield environment. From the point of view of the seller of a business, premium pricing can be achieved by converting a share capital structured business to an Income Trust.

Disclosures and Their Interpretation in This Market

As noted above, distributable cash has evolved as a key valuation metric for Income Trusts. We applaud the CICA’s recent guidance for MD&A disclosure on distributable cash, but we feel that to be meaningful, reported “distributable cash” must represent a genuine calculation of “cash generated” and “available for distributions”. Its calculation must begin with, and should be reconciled to an income or cash flow statement item (usually reported consolidated cash from operations). Adjustments must then be made for distortions arising from accounting conventions and for discretionary adjustments including reserves for maintenance capital, future debt service payments, and distributions for “rainy days.” Each adjustment should be fully disclosed and its rationale fully explained in the MD&A.

Current disclosure practises are inconsistent and offer insufficient comparability. For example, in a proper analysis, the reasonableness of management’s estimate of current and future sustaining capital expenditure requirements should be disclosed and benchmarked against book depreciation/depletion, industry rules of thumb, capital expending commitments, asset retirement obligations or other relevant measures.

Many participants in the Income Trust sector would have investors believe that since amortization and depreciation are non-cash expenses from the past they have no

relevance. From an accounting perspective, amortization is the allocation of the cost of acquiring assets over their estimated useful life. For example, as an energy trust extracts oil from the ground, its assets slowly reach the end of their useful life, thus reducing the future potential earning power of the entity. Depreciation is an estimate of that amount of decrease in the value of an asset². Therefore, if management estimates that, in the future, production capacity can be maintained with less capital expenditure, then management should reconcile historical depreciation to their long-term estimate of the replacement cost of depleting assets.

From a review of financial literature, issuer marketing material, and various analyst reports, participants in the Income Trust sector place an extremely high emphasis on “distributable cash” and “payout ratios.” Both calculations are determined at the discretion of the entity’s management. We are of the view that, under current circumstances, these metrics are of little value in comparative analysis, or as a reasonable basis for investment decisions. Distributable cash can and, in many cases, does include borrowed funds that, all other things being equal, will reduce future cash payments to investors or result in a return of capital. Often, the maintenance capital expenditure estimate is insufficient to replace assets that are being depleted. Moreover, many Income Trusts return a portion of an investor’s initial investment with each cash distribution. **For investors, it is vital to understand the mix of distributions between return on capital and return of capital.**

Our View on Disclosure and the Market

The assertion that income from an Income Trust is fundamentally different from that of a traditional corporate entity, and thus should be analyzed differently, is erroneous. In our view, the accounting, disclosure and financial analysis methods developed by standard setters and securities regulators for traditional corporate issuers are completely applicable to Income Trusts.

Moreover, we are of the view that the correct starting point for the analysis of Income Trust performance is the same as for any business entity, namely its net income. Each item that is deducted from revenue to reach the net income metric has been carefully considered by accounting standard setters. Thus, each adjustment made to net income is either an expense in the current year or an allocation or estimation of expenses that by the nature of the enterprise’s operations are spread out over several years (such as depreciation or amortization). By definition, GAAP means “generally accepted accounting principles”. Where an Income Trust disseminates distributable cash figures, it is the responsibility of management, as outlined under CSA rule 52-306 (Revised), to explain and disclose the rationale behind its use of non-GAAP metrics. If management cannot or does not provide sufficient disclosure for non-GAAP metrics then analysts and investors should be wary of using these metrics as a basis for analysis or investing.

² From a technical point of view, depreciation is the historical cost allocation of costs. Currently, the CFA Institute would like to see historical depreciation replaced with a “reduction of fair value of the asset.”

Our membership believes that the Accounting Standard Board (AcSB) has the power and technical ability to prescribe standards specifically for Income Trusts by defining the use of terms such as distributable income, sustaining capital, distributable cash, etc. Nonetheless, we accept the AcSB assertion that many terms used by participants in the Income Trust sector are in fact non-GAAP measures and are often presented by management to display financial results in a more favourable manner than would be allowable under GAAP. The AcSB has for some time discouraged the use of non-GAAP measures and if non-GAAP numbers are incorporated into the financial statements, then such statements require reconciliation to the corresponding GAAP numbers.

A Call to Action

Our goal is to promote a dialogue within the capital markets community aimed at developing a more robust framework for distributable cash calculations and disclosures. We believe that the following actions should be taken by various participants in the Income Trust marketplace:

1. The Canadian financial community should be encouraged to report **net income per unit** as well as **cash distribution per unit**. Usage of the term “yield” can be erroneous and misleading as cash distribution divided by current unit price (the “Cash Yield”) is not the same as that of a fixed income security.
2. Auditors of Income Trust entities are reminded that Cash flow or Income calculated on a non-GAAP basis “must not be held out as being prepared in accordance with generally accepted accounting principles” (*Background Information and Basis for Conclusions Section 1100 – para. 38*). Non-GAAP measures incorporated into the audited financial statements should be reconciled to an appropriate GAAP metric. These reconciliations should not be superficial.
3. Intervention by the Canadian Securities Administrators is also needed. In our view, disclosure by Income Trust entities has not improved significantly during the last several years, notwithstanding the growing importance of the sector. The use of any non-GAAP numbers either in the financial statements (which is the responsibility of the AcSB and the auditors) or, equally important, the MD&A must be reconciled to a GAAP number in a clear manner as outlined in CSA Notices 52-306 and 41-304. Only the regulators have enforcement capabilities, and current MD&A disclosures often do not communicate many key risk factors, including under funding of maintenance capital expenditures and the likelihood of debt covenants impeding cash distributions.
4. We encourage the CICA to continue its efforts to improve guidance on appropriate MD&A disclosure. We recognize that the most recent draft is a step in the right direction.

5. CFA Institute members and other capital market participants are reminded that there are no short cuts to good financial analysis. Analysts must ask management the difficult questions and not accept the published version of the facts without careful consideration, corroboration, and verification. As outlined in Standard V of the CFA Institute's Standards of Professional Conduct, the investment process must be built on exercising diligence, independence, and thoroughness when providing a reasonable basis and representation of the facts and opinions in all investment analysis, recommendations, or action.

Therefore, as this letter represents our first attempt to begin the collective dialogue between these market participants, we pose the following questions:

1. Do you agree that publicly owned Income Trusts are merely another form of business structure and should be treated in the same manner as share capital corporate issuers for disclosure, analytical and valuation purposes? If not, why not?
2. Do you believe that regulators have provided sufficient guidance to managers of Income Trusts on disclosure, including the reconciliation of distributable cash and GAAP measures such as cash from operations? If not, why not, and what other measures would you recommend?
3. Do you believe that the current quantity and quality of financial disclosures by public Income Trust issuers is sufficient? If so, why? If not, what additional material should be disclosed?
4. Do you believe that the enforcement of current accounting and securities rules and regulations is sufficient? If so, why? If not, how can it be improved?
5. What processes should be utilized by capital market professionals and financial analysts to ensure that their terminology and analysis provides investors in Income Trusts with a reasonable basis for making investment recommendations and decisions and ensure to provide integrity to the Canadian capital market.

We appreciate your comments on the above matter and welcome them to be submitted to us at chair@cfaadvocacy.ca by Jan 30, 2007. Commentaire en français sont bienvenue.

Sincerely,

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