www.lexisnexis.ca Vol. 23, No. 10 September 2007

Too little, too late, critics say of CICA text

By Jeff Buckstein

The Canadian Institute of Chartered Accountants (CICA) recently issued what it and supporters believe is critical new guidance aimed at obtaining consistent disclosure standards for distributable cash by income trusts and other flow-through entities. Critics charge, however, that it is too little, too late.

Brent Fullard, Canadian Association of Income Trust Investors

"Where was this five, six, seven years ago? Coming out at this point – there are very few of these trusts still being floated," says Al Rosen, founder of Toronto-based Rosen & Associates, a forensic and investigative accounting firm. Rosen also finds "very troublesome" the notion being advanced that CICA's prime interest is protecting investors, particularly seniors. "This is so outrageously not what they are doing," he says.

Kevin Dancey, the CICA president and chief executive officer, defends the CICA initiative, calling it "groundbreaking" and noting that it provides investors with a framework to ask "a couple of key questions: first, where did the cash come from, and second, is the cash flow sustainable?"

It is important to have a common measure of distributable cash so that all investors have a similar understanding of what is meant by the term, agrees Jack Mintz, a professor of business economics at the University of Toronto's Rotman School of Management.

Other key areas the CICA guidance addresses include:
• The entity's strategy for managing its productive capacity, along with disclosure as to whether that capacity has been maintained;
• The entity's strategy for managing debt, and the related impact, if any, on financing distributions; and
• The disclosure of any financial covenants – and the degree to which the entity is complying with such covenants – that might restrict future cash flow distributions.

While some of its critics concede the CICA guidance hits the heart of the issue, they slam the institute for not only waiting so long, but also because they feel any effect the guidance will be muted, since investors have already lost much of the value of the income trusts they were holding.

But contrary to popular belief, the reason those values have dropped is not primarily the surprise October 31, 2006 announcement by Finance Minister Jim Flaherty that distributions from all publicly traded income trusts and limited partnerships would be taxed no later than 2011, alleges Rosen.

"The big issue here" is that many income trusts acted as "Ponzi frauds and pyramid schemes" by virtue of hyping high yields that in reality ended up "giving people back their own money" as part of the advertised returns, he charges.

Kevin Hibbert, the Toronto-based chief accountant at Standard & Poor's Canada, a provider of investment research and data, disagrees with that assessment.

"I'm not sure an irreverent term like Ponzi scheme is fair or accurate to describe what the trusts are doing. A lot of trusts have very good disclosure around the fact that a portion of the distribution is a return of capital, as opposed to a return on capital," says Hibbert, who co-authored a two-part report in 2006 that highlighted various accounting, financial reporting and analytical nuances with respect to the measurement of distributable cash by income trusts.

Diane Urquhart, a Mississauga, Ont.-based investor and consulting analyst who worked in the investment industry for more than 25 years, backs Rosen up. She consulted with him in 2005 to produce a report on income trusts which concluded that many trusts had already declined in value and were a threat to investors, primarily because they were substantially overvalued to begin with – thus leading to significant cuts, or even the elimination of cash distributions.

In a letter to then Finance Minister Ralph Goodale, which is available through the federal Department of Finance website, Urquhart wrote, "We contend that the rush to convert corporations to income trusts has not been due to favourable tax treatment, but more to do with the ability of owners to obtain excessive valuations through permissive distributable cash reporting and improper cash yield valuation methodologies."

The letter goes on to say the research conducted by Rosen and Urquhart found that 75 per cent of the 50 largest business trusts in Canada had cash distributions in excess of income by an average of 58 per cent in the fall of 2005.

Hibbert, however, is not convinced that income is the right standard to measure distributions by. He contends "the more relevant metric" to pay attention to is a distribution relative to cash flow as opposed to accounting earnings, since the latter also includes accruals and non-cash items.

In an interview with The Bottom Line, Urquhart said the cash yield methodology used by the trusts was "inaccurate and unacceptable." She noted, for instance, that many trusts did not "set aside sufficient cash from operations to maintain and replace capital assets that were necessary to stay in business."

Just prior to Flaherty's announcement last fall, Urquhart completed another study on her own and concluded that while trusts had been overvalued by 55 per cent, only 14 per cent of that total was attributable to beneficial tax treatment. The remaining 41 per cent involved other sources of overvaluation, she says.

The idea that trusts are overvalued is "a totally false proposition," charges Brent Fullard, president and chief executive officer of the Canadian Association of Income Trust Investors (CAITI) in Toronto. "Who is somebody to say something is overvalued? Value in a public market is free and open and determined by a willing seller and buyer," he says.

What is clear, however, is that the October 2006 announcement had "an immediate, negative impact on the ongoing value of those trusts (causing) a permanent loss of value," he contends.

Fullard says investors, many of them seniors, have lost $35 billion of their savings in the wake of Flaherty's announcement.

Urquhart doesn't buy that. She believes seniors in particular have been unwitting victims of many false promotions involving trust yields, and thinks it is despicable that this group has been exposed to that at this stage in their lives. She thinks the CICA should have stepped in as early as 2001, when income trusts first began to rise to prominence as investment vehicles. Furthermore, she believes the CICA is acting now only because of public pressure.

Fullard says this issue is being spun in a "spurious" way to "evoke the notion that seniors are being misled," although he agrees the reporting of some trusts likely needed "to be improved." For that he applauds the effort of the CICA and others who are "making belated attempts to correct these problems in an effort to evolve the market and make it better."

Dancey defends the CICA's timing on this issue, noting that the institute responded quickly to the Standard & Poor's 2006 study, which "indicated the need for a framework" to address trust distributions. It took time to formulate and finalize the guidance, he says, because "there were no similar guidances around the world."

Consequently, "it was very important from our perspective to listen to all of the various stakeholders" including the "views of preparers, analysts, investors, regulators, etc., in putting this guidance together."

Moreover, he notes, the guidance extends to various industries, including the oil and gas, real estate and commercial sectors, thus adding to the time required to deal with those diverse elements.

The initial draft guidance was released in the fall of 2006, after being worked on all last summer, and was finalized by the institute in July 2007, following a review of the comments returned to it last spring.

Another criticism of the guidance is that it is only aimed at Management Discussion and Analysis (MD&A), rather than the financial statements, where it would presumably have greater impact. That is the view of Rosen, who says the guidance merely ends up as a "nice to see part of the MD&A section" rather than an "audited portion of an annual report."

Moreover, he claims, "there is nothing in the way of teeth" to enforce this because the CICA "doesn't have the power to do it."

Dancey says this initiative is earmarked for the MD&A because it is a non-GAAP measure, and as such is not subject to a review by the Accounting Standards Board. "This is not an issue of GAAP, but a performance measure that we thought was important to give some guidance to," he emphasizes.

"We would like to think it's going to be adopted by entities as they look at their disclosure responsibilities . . . (and) that this will be an example of best practice to both CFOs and CEOs, and also to audit committees as they make sure that the MD&A has fulsome disclosure. This is just another step in the right direction in terms of coming up with an improved measurement of financial performance," Dancey adds.

Hibbert believes that overall, the CICA standards, in conjunction with the Canadian Securities Administrators (CSA) National Policy 41-201 dealing with Income Trusts and Other Indirect Offerings, "are quite good." Moreover, the CICA and CSA collectively "address most of the reporting distortions that we (S&P) identified in our report," he notes.

But Rosen insists the guidance falls short on several counts, including the information it provides investors. For instance, while the disclosure will say how much cash was spent to replace assets over the course of the year, it doesn't go so far as to say whether trusts are doing all they can to replace and maintain assets, he says.

Mintz doesn’t think that is necessary; in fact he believes that would be overstepping boundaries. “I’m not sure you would want to have rules that force people to replace assets,” he says, noting that it may be appropriate for some companies to wind down by distributing their assets.

For instance, Mintz points out, the key resource of an energy trust involving oil is a depletable asset, which constitutes “a natural part of the yield.”

Consequently, “I don’t think the actual behaviour of the company should be regulated in that way. That would be a mistake.”

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