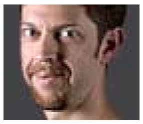
Globe and Mail, Report on Business, Friday, March 10, 2006

INCOME TRUSTS

Trusts overstate payout ability: report

Capital expenses ignored, S&P says



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With files from reporter Dave Ebner

A study of the income trust sector has found a pattern of accounting in which trusts overstate their ability to pay the cash distributions that have made them so wildly popular with investors.

Standard & Poor's, a sober voice of analysis in the investing world, examined 40 trusts and found that a majority had less cash to pay to unitholders than indicated in their financial statements. The study is another negative for a sector that has come under an increasing amount of criticism for not being straightforward in its accounting.

S&P says the problem is that some trusts report the amount of distributable cash they have on hand without first subtracting the dollars they spend to sustain their operations. These capital expenditures cover basics such as the cost of maintaining or replacing factories, machinery and technology.

Kevin Hibbert, the S&P analyst who wrote the report, said capital spending to sustain operations accounts, on average, for 22 per cent of the cash generated by a trust's operations. Yet 57 per cent of the trusts he looked at excluded these costs in stating how much money they had to distribute.

Mr. Hibbert said these trusts won't necessarily have to cut or suspend their distributions, which typically crushes a trust's unit price on the stock market, as experienced by investors in such flameouts as FMF Capital Group, Entertainment One and Associated Brands.

Still, Mr. Hibbert said the study highlights the need for investors to scrutinize the way in which a trust documents its ability to pay out the cash expected by its unitholders.

"Some investors fail to appreciate the financial reporting and disclosure nuances due to a tendency to take at face value the distributable cash and payout ratios that are reported by management," he said. Other critics of trust accounting practices include forensic accountants Al Rosen and Mark Rosen and investor advocate Diane Urquhart, who targeted business trusts in particular. S&P issued an earlier report in January that highlighted the slack and ambiguous way in which trusts report distributable cash.

Independent income trust analyst Harry Levant said investors should be concerned about the lack of accounting rigour in the trust sector, even while noting that there are financially strong income trusts out there. "Investors think trusts are yield-based investment, where there's almost some kind of a guarantee there," he said. "Then there's a big surprise when distributions get adjusted."

In the January report, S&P's Mr. Hibbert said 10 per cent of the trusts examined had distributable cash lower than the amount reported by management and insufficient to cover monthly or quarterly payouts. After factoring in capital expenditures in the latest study, this number rose to 30 per cent.

Business trusts, often maligned for their accounting practices, had the highest level of disclosure of capital spending on existing operations. Energy trusts were off by the highest margin. According to Mr. Hibbert, each of the energy trusts he looked at indicated they were paying distributions that were lower than the amount of cash available. But when capital expenditures were included, he found that only 62 per cent were generating enough cash to cover distributions.

Baytex Energy Trust doesn't subtract capital spending to sustain its business from its distributable cash figure, but says it clearly presents all relevant figures. It had $227-million of cash flow from operations in 2005, of which it paid out half or $114-million. Capital spending was $130-million, not including buying and selling assets. The trust's stated payout ratio was 50 per cent, but would be more than 100 per cent if all capital spending was included.

However, it is difficult to say what capital goes to sustain the business and what goes to grow it, said Derek Aylesworth, Baytex chief financial officer.

"Baytex is comfortable with our disclosures," Mr. Aylesworth said.

The Canadian Securities Administrators, a group comprising provincial securities commissions, is working on a set of rules to standardize the reporting by trusts of their distributable income. Meantime, investors concerned about financially weak trusts have the option of buying a diversified basket of trusts through mutual funds, closed-end funds and exchange-traded funds that hold them in a diversified basket, or using on-line resources like the income trust stability ratings provided by S&P at stabilityratings.com or Dominion Bond Rating Service at dbrs.com.

The Canadian Association of Income Funds also has a committee looking at the accounting issue and it hopes to have ideas to present by mid-year. Baytex's Mr.

Aylesworth said standards would be embraced. "If there is no consistency, I can see that it's confusing for investors."