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CICA proposes standard trust accounting

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Many retail investors were all too casual when buying income trusts, snapping them up as though they were safe, high-paying bonds.

Yet, even those few who carefully scrutinized financial reports and disclosure documents would have had difficulty comparing one income trust to another.

It was hard to tell whether to buy a slice of Pizza Pizza's surplus cash; the Yellow Pages, where the pizza place places ads; or the nursing homes, where artery-clogged customers may eventually reside.

On Monday, the Canadian Institute of Chartered Accountants, a professional association with limited clout, will do a small part to make comparisons between trusts more transparent.

President Kevin Dancy says the association will propose standard rules for revealing the source and sustainability of distributable cash.

A common set of practices will be particularly important now that Ottawa is proposing to slap a 31.5 per cent tax on trust distributions starting in 2011.

Investors will need to be able to assess the impact of those taxes on the flow of income, and management's strategy for maintaining the underlying business, Dancy says.

"Given the importance investors put on the measure of cash flow — the pricing of units tends to be off this measure — it should be a consistent measure," he said in an interview.

"But these trusts are all over the map," he said, pointing to findings from Standard & Poor's Corp., Canadian Securities Administrators and various independent analysts.

Once the accountants' proposed standards are reviewed and adopted, probably after March, investors could look to see whether their income trusts adopted the standards.

To get mass acceptance, however, securities regulators would have to pick up the ball.

Accountants and the Canadian Accounting Standards Board focus on ensuring businesses apply generally accepted accounting principles, better known as GAAP, in financial statements.

Trusts are different from corporations, which may pay a portion of profit, or net, after-tax income to shareholders through dividends.

Income trusts hold conventional businesses, but may pay more cash to investors than the companies would report as earnings under GAAP rules. So far, those distributions have not been taxed, except in the hands of the unit holders.

Management could decide to pay out cash that a rival in a similar business would use to replace aging equipment, retire loans or fund expansion.

In fact, some trusts have borrowed money, sold operations and issued new units just to keep up cash distributions and the price of the units.

Corporations that distribute excess cash typically see their share prices fall afterward. But misconceptions about trusts have allowed them to operate in a netherworld.

When investors are not told just what's what, they get a mistaken impression about the sustainability of the business and its distributions.

Diane Urquhart, an independent consulting analyst in Mississauga, is among those who have been warning for months that trusts are supplementing cash distributions by returning investors' own capital.

For many trusts, the risk of such behaviour has been masked in recent years by rising energy and real estate prices and falling interest rates.

In other business sectors, however, four in 10 trusts that have come to market since the year 2000 were down in price by Oct. 12 from when units were issued, according to a calculation Urquhart made.

Ottawa's proposal to tax new trusts in 2007 and existing trusts in 2011 triggered selling that slashed unit prices of all types of trusts.

An index of 73 large trusts fell 13 per cent over three days.

As of early yesterday afternoon, 75 of the 123 business trusts brought to market since 2000 — or 61 per cent — were trading at a lower price than when they were first issued, Urquhart calculates.

She says she is not optimistic that the accountants' proposals will do much to alter the behaviour of retail investors, many of them seniors.

Urquhart would prefer to see provinces change trust legislation so that income trusts could not distribute more cash than the profit generated by the underlying business, except through occasional special distributions.

That, she says, would bring unit prices closer to reality and expose fewer seniors to a harsh lesson in the financial laws of gravity; i.e., a complete halt of distributions.

CORRECTIONS: Toronto's Firm Capital Mortgage Investment Trust generates income for investors by providing short-term mortgages to businesses and individuals. The name of the income trust was incorrect in my column Oct. 3.

A $1,000 increase in the income-tested age credit, one of the tax changes announced by the federal government this week, will apply for 2006. The date was wrong in yesterday's column.

I regret the errors.

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