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May 30, 2006

Paul Cherry  
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Dear Paul Cherry:

**In this letter, I am providing recommendations for changes in income trust accounting standards that the CASB should adopt on behalf of seniors and other income seeking investors.** These investors buy income trusts for retirement income and they need to preserve their retirement capital. **I have cc'd this letter to the associations in Canada that have taken an active interest in income trust abuses and in accounting and securities oversight and enforcement, in general.**

My husband and I met with the Canadian Accounting Standards Board ("CASB") on May 23, 2006. Unfortunately, you were unable to attend the meeting due to an emergency. We met with Mark Walsh, Chairman of the CASB Emerging Issues Committee, Peter Martin, Director of Accounting Standards and Greg Edwards, Principal of Accounting Standards. The subject of this meeting was: What can the CASB do in the circle of accounting and securities authorities to mitigate the billions of dollars of losses being borne by seniors, who are buying income trusts at excessive prices due to deceptive cash distributions and cash yield valuation methodology? Mark Walsh agreed to prepare a report on our specific recommendations for changes in income trust accounting standards for consideration of approval by the Canadian Accounting Standards Board at its next meeting. Subsequent to our meeting with the CASB, I have had a thorough discussion of the problem of income trust losses and our specific recommendations for changes in accounting standards with Tom Scott, member of the CASB and Professor of Accounting at the University of Alberta.

I am requesting that the Canadian Accounting Standards Board take the following actions:

- 1. If not adopting our specific recommendations for any technical reasons, adopt alternative changes in accounting standards**

- governing income trusts, so as to present audited financial information where recurring income and one time income and income and return of capital are clearly distinguished. Then, the buyers can more easily determine the value of income trusts using appropriate multiples on recurring income, one time income and return of capital.**
2. Revise CASB Emerging Issues Committee EIC-107 and EIC-145, so as to treat the corporation subsidiaries of income trusts differently than those of corporations to reflect the special nature of income trusts, which are targeted to seniors and other investors seeking income. These EIC decisions permit the assets in subsidiary corporations to be marked up to current replacement value and permit a future income tax liability for future taxes payable on the possible future sale of the marked up assets.
  3. **Add to the Handbook of the Canadian Institute of Chartered Accountants a requirement that income trusts report both income distributions and return of capital distribution. Both of these terms should be defined in the Handbook and the Handbook should contain a prohibition on the use of the term distributions in the financial statements, where distributions are the sum of income distributions and return of capital distributions.**

#### The Support for Recommendation (1)

The CASB and CASB staff have acknowledged the problem of income trusts being excessively priced in the public markets due to investors receiving financial information that does not readily distinguish between income and return of capital. These acknowledgements are contained in the CASB Decision Summaries of November 6-7, 2002, June 8, 2005, March 1, 2006 and May 3, 2006; FYI Accounting Standards Message from the Chair on January 2006; the CASB Report on the Public Meeting of February 16-17, 2006; and, the Accounting Standards Oversight Council ("CASOC") Report on the Public Meeting June 16-17, 2005. **The cited CASOC report says the CASB User Advisory Council (CASB UAC) recently highlighted perceived deficiencies in reporting of distributable cash, and a general lack of clarity in distinguishing between return on capital and return of capital. The CASOC concludes the public interest warrants the involvement of the CASB, possibly in a coordinating role with others such as the Canadian Securities Administrators, the income trust industry association and accounting practitioners.**

**While the CASB has acknowledged the problems of income trusts being excessively priced, its May 3, 2006 decision is to do nothing in accounting standards governing income trusts.** The CASB is passing the buck in the circle of accounting and securities authorities charged with the public interest,

where this circle is defined in the attachment to this letter. The CASB must take leadership in the setting of new accounting standards for income trusts, such as the specific recommendations we make or other alternatives the CASB finds to be more appropriate based on technical considerations. **Since business income trusts are uniquely Canadian securities not permitted in other countries, there are no FASB or IAS considerations to limit what the CASB decides to do on Canadian GAAP for income trusts.**

In addition to the CASB making accounting standard changes within its public interest mandate, the CASOC is right in seeking that the CASB take leadership in coordinating the supplementary actions from each of the provincial securities regulators and the Canadian Securities Administrators. All of the entities in the circle of accounting and securities authorities acting in the public interest need to make a contribution to solutions for the income trust problem within each of their mandates.

The recent Accountability Research Corporation and the Standard and Poors Reports on income trusts set out evidence of the problems in accounting standards and financial reporting of income trusts in Canada. These reports on accounting and financial reporting abuses in the income trust asset class are not just esoteric intellectual debate amongst experts. **The financial reporting abuses and cash yield valuation methodology are contributing to serious investment losses in the market. Appendix II of a report I prepared “Teranet Income Fund – Do Not Be Deceived by Cash Yield and Intensive Marketing” provides a list of 54 business income trust IPOs that have been underwritten since January 1, 2001 and that are trading at a capital loss relative to their IPO price. The total capital losses on these business income trust IPOs in capital loss is \$2,611 million and the average degree of loss on these business income trust IPOs in capital loss is 31%. I conclude that the proposed Teranet Income Fund exhibits the same abuses that have been found in most income trusts.** There is a bona fide high risk that seniors paying \$1,800 million or higher for Teranet Income Fund could suffer a 30% loss of capital value due to the IPO's excessive pricing based on estimated cash distributions that are significantly above the earnings power of the Teranet business.

#### The Support for Recommendation (2)

The recommendation to revise CASB Emerging Issues Committee EIC-107 and EIC-145, is due to a large number of income trusts reporting substantial income tax credits in their income statements, which cause net income after tax to be substantially higher than net income pre tax. This phenomena is inflating valuations for income trusts since the tax liability is a one time future event which become payable if the assets of the corporate subsidiary are sold. The amortized tax credits appear to be at the discretion of management and not subject to any defined smoothing formula. It is a rare situation for a taxable corporation owning a subsidiary corporation to report a net tax credit in the income statement. Mark Walsh says this is the case because taxable corporations have the amortized tax

credit associated with written up assets deducted against taxes that are otherwise payable. So, it is primarily the income trusts that exhibit this unusual phenomena of net income after tax being higher than net income pre tax.

Mark Walsh says EIC-107 and EIC-145 have not been revised for income trusts, since the CASB wants to treat all subsidiary corporations the same, whether these are subsidiary corporations of an income trust or a corporation. There should be no different treatment according to the structure of the parent entity. Peter Martin argued that while the subsidiary corporation of the income trust does manage its affairs to not pay any tax, it is nonetheless a taxable corporation under the Income Tax Act. The income trust may decide in the future to sell the assets in the subsidiary corporation and thereby trigger the income tax liability therein.

In the interest of contributing to a solution for the income trust losses fiasco, the CASB should (a) either deny the use of EIC-107 and EIC-145 for the subsidiary corporations of income trusts; or (b) permit the income tax liability in the subsidiary corporation of income trusts, but deny the amortization of this income tax liability as an income tax credit in the income statement of the parent income trusts. To support (b), this is not the only time where adjustments can be permitted in the balance sheet of a business that do not flow through the income, i.e. unrealized foreign currency translation gains(losses) are not run through the income statement since they are very volatile and therefore distort recurring income. The rationale for not putting amortized tax credits through the income statement of income trusts is also for the purpose of not distorting the recurring income of the income trust.

### The Support for Recommendation (3)

My recommendation for the CASB to add to the Handbook of the Canadian Institute of Chartered Accountants a requirement that income trusts report both income distributions and return of capital distribution, is easy for the CASB to implement, and has virtually no cost to income trusts for the preparation and auditing of the new financial statement terminology. **I strongly believe that the acknowledged financial reporting abuses are much more difficult to execute if the CASB requires both income distributions and return of capital distributions to appear in the income statement, statement of unitholders' equity and statement of cash flows. This is especially the case, when the Handbook contains a prohibition on the use of the term distributions in the financial statements, where distributions are the sum of income distributions and return of capital distributions.**

**The announcement of the CASB accounting standard changes for distributions would itself cause all the players in the income trust market to be warned that cash distributions need to be specified by income distributions and return of capital distributions.** There is no acceptable

Canadian GAAP concept for distributions appearing on the financial statements, so there is no such acceptable reference to distributions in any other financial reporting. **Furthermore, continued attempts for prospectuses and equity research to focus financial advisors and unsophisticated investors onto cash distributions and cash yields would be less successful since there is a hook or reference point in the financial statements that clearly distinguishes the income distributions from the return of capital distributions.**

The CASB arguments against adopting the two defined terms of income distributions and return of capital distributions are not strong ones. **Firstly, Peter Martin says the users of income trust financial statements can look up the definition of distributions in the dictionary. This in my opinion shirks the responsibility of the CASB to set an accounting standard for distributions.** I know of no dictionary that does a good job of explaining that a distribution comprises two components, income and return or capital. I do not know that the income trust and the users of the income trust financial statements would be using the same dictionary. A Handbook or Canadian GAAP definition of income distributions and return of capital distributions would be clear to everyone.

Secondly, the CASB Decision Summaries for May 3, 2006 says:

“The determination of distributable cash is a business decision based on judgment and contractual requirements, similar to a decision by the directors of a business corporation about the amount available for distribution as a dividend.”

Dividends, however, have a conventional definition known throughout the world to be the amount of a company's profits that is paid out to its shareholders. Such dividends are conventionally known to be less than the income of the company, except in unusual circumstances where income has declined significantly below where it has been on a recurring basis. The investment research process I have been involved in monitors dividends compared to income and flags the unusual cases where dividends exceed income and therefore may not be sustainable. On the other hand, the income trust model as it has been uniquely executed in Canada, has the majority of income trusts paying out distributions well in excess of income. The average excess distribution over income is close to 60%. Not only is the situation of income trust distributions exceeding income not flagged for the income investors, so they may consider the sale of the security, the income trusts and the investment banks prepare their financial reporting and marketing materials so that investors do not readily see that the distributions exceed the income. The cash yields being marketed explicitly ignore the return of capital within them, in the apparent hope that the buyers do not have the knowledge or the time to research what the true income yields are.

Most importantly, the concept of dividends being paid out of income is ensconced in the federal and provincial company acts. It is not legal to pay dividends unless there are profits out of which to pay them. It is possible to temporarily pay

dividends that exceed a current year's income, only to the extent there is retained earnings from prior periods to fund it. It is not legal to pay dividends in corporations that have negative retained earnings. It is almost absurd that income trusts are permitted to pay distributions above income on an alleged sustainable basis, including when there is negative retained earnings. The proposed CASB accounting standard change for income distributions and return of capital distributions will at least alert the buyers of income trusts when there is return of capital going on and thus the need for careful study about how long the income trust can do this and how this is affecting the terminal value of amortizable assets and the income trust as a whole. **It is simply not a strong argument to say there is no accounting standard for dividends being in excess of income, since dividends rarely are and dividends are not permitted to exceed income in the long term due to the constraint of negative retained earnings in the company acts.**

I have offered my suggestions for changes in CASB accounting standards in good faith on behalf of seniors and other income seeking investors, many of whom are members of the associations being cc's this letter. We all have a social responsibility to make sure market players are not duping our seniors with misleading financial information. Beyond this basic social justice, the CASB has a specific duty to act in the public interest. **There are changes in accounting standards, such as the specific ones I propose or other alternatives to be found by the CASB, that contribute greatly to curtailing the financial reporting and cash yield valuation abuses in income trusts. The CASB passing the buck to others in the circle of accounting and securities authorities is in my opinion a breach of trust to the public.**

Yours sincerely,

Diane Urquhart

CC:

Tom Scott  
Member of Canadian Accounting Standards Board

Doug Hyndman  
Chairman, Canadian Accounting Standards Oversight Council

David Hope  
Chairman, Canadian Institute of Chartered Accountants Board of Directors

Robert Morgan

Chairman, CASB User Advisory Committee

Mark Walsh  
Chairman, CASB Emerging Issues Committee

Joe Oliver  
President, Investment Dealers Association

David Wilson  
Chairman, Ontario Securities Commission

Robert Shirriff  
Lead Director, Ontario Securities Commission

Ann Leduc  
Secretary General, Canadian Securities Administrators

Jean St-Gelais  
Chairman, Canadian Securities Administrators

Stan Buell  
President, Small Investor Protection Association

Judy Muzzi  
President, United Senior Citizens of Ontario

Art Field,  
President, National Pensioners & Senior Citizens Federation

Lilian Morgenthau  
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CARP, Canada's Association For the Fifty Plus

Ian Thomas  
Kairos Social Ecumenical Justice Initiative

Joan Huzar  
President, Consumer Council of Canada

Eric Kirzner  
Chairman, OSC Investor Advisory Committee

Peter Martin  
Director, Accounting Standards

Greg Edwards

Principal, Accounting Standards

Duff Conacher  
Democracy Watch



# Income Trusts' Accounting, Financial Reporting and Valuation Abuses Causing Losses for Seniors

## Who Are You Passing The Buck To On The Circle Of Accounting And Securities Authorities Serving The Public Interest?

