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Trust disclosure the real issue

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An important issue is being ignored in the controversy about income trusts. I'm talking about the disclosure of information to investors.

Where do the cash distributions come from? Can they be sustained? How likely are they to be reduced if the business hits a bump?

In other words, can you "trust" the "income" you receive from these tax-advantaged vehicles?

Investors are operating on faith, not facts, when it comes to income trusts, says the Canadian Institute of Chartered Accountants, or CICA.

"People buy income trusts for cash flow, and the valuation of income trusts is driven by cash flow," says institute president Kevin Dancey. "It all comes down to a standard definition of distributable cash, which has been lacking so far."

The accounting body hopes to bring some consistency and reliability to a most unreliable measure.

The group's guidelines, six months in the making, were released this week — and might seem irrelevant after the Oct. 31 announcement of a clampdown on income trusts. But remember one thing: existing trusts won't have to pay the new tax on distributions until 2011.

This means investors can keep buying the trusts for four more years, based on what people think is a higher cash payout than they would get from interest or dividends.

So, here's a summary of the accounting group's key recommendations, arising from discussions with income trust issuers, regulators and investors:

- There should be one standard term, "distributable cash from operations." A recent study by Standard & Poor's found 19 different names used for the concept.

- Cash flows arising from investing — such as the sale of capital assets — or from financing activities should be separately identified.

- What is management's strategy to maintain productive capacity and manage debt? This should be clearly stated.

- What is the "payout ratio," the relationship between the cash distributions paid to investors and the distributable cash from operations? If the ratio is 90 per cent or more, investors deserve to know because of the threat to long-term sustainability.

- What is the cumulative payout ratio since inception? Management should reconcile the difference between distributable cash from operations and the amount of cash distributed to investors.

- Is enough cash being retained to provide for unfunded pension obligations, environmental liabilities and future income tax payments?

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- Will the cash distributions make it less likely for the company to meet its financial commitments, such as loan covenants, in the foreseeable future?

Al Rosen, a forensic accountant and outspoken business columnist, has been vocal about weak disclosure.

In fact, he put out a report last year — prescient, I'd say — warning senior citizens that income trusts were too risky to own.

When reached yesterday while attending a court hearing, the often-cranky critic was quite happy with the guidelines on distributable cash.

"This is good news," he said. "It's much better than anything we've seen. I like what they're trying to do."

But that said, Rosen proceeded to rhyme off all the inadequacies.

"They could have done this three years ago. Why now? They should be criticized for being slow."

He's right. Income trusts have been around for many years and grew to gigantic proportions after the stock-market crash from 2000 to 2003.

Moreover, these are voluntary guidelines. Reporting issuers can decide whether to use the guidelines or not.

"There's no teeth," he complained. "The CICA was under heat for having done nothing, so it rushed this thing out."

The recommendations are open for comment until March 31. Will investors still care by then?

And even if everyone agrees, the changes in reporting distributable cash won't become mandatory unless Canada's securities regulators get behind the proposals.

Rosen also has issues with how the accountants framed the proposals. The group wants income trusts to use the improved disclosure in "management's discussion and analysis" or MD&A, provided to investors every six months.

But what about incorporating the disclosure into annual reports and quarterly financial statements? These are not included.

The bottom line: the institute of chartered accountants has done good work.

(You can see it yourself at http://www.cica.ca on the Internet.)

Yes, it's late in the game. Yes, it's not enough.

But with new taxes looming, income trusts may be forced by marketplace competition to disclose more to investors.

***Ellen Roseman**'s column appears Wednesday, Saturday and Sunday. You can reach her at eroseman @thestar.ca by email.*

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