

CPR *Alert*



*Income Trusts—
Reporting
Distributable
Cash in MD&A*

*Importance of
High Quality
Financial
Reporting by
Income Trusts*

*Importance of
Distributable
Cash*

This *CPR Alert* discusses distributable cash disclosure considerations. It does not attempt to set new guidance for disclosure but rather consolidates and discusses the application of existing Canadian Securities Administrators' (CSA) policies and notices:

- December 16, 2005, OSC Staff Notice 51-706 – Corporate Finance Report
- August 26, 2005, CSA Staff Notice 41-304 – Income Trusts: Prospectus Disclosure of Distributable Cash
- December 3, 2004, National Policy 41-201 Income Trusts and Other Indirect Offerings
- February 13, 2004, CSA Multilateral Staff Notice 51-310 – Report on Staff's Continuous Disclosure Review of Income Trust Issuers
- November 21, 2003, Revised CSA Staff Notice 52-306 – Non-GAAP Financial Measures

Income trusts are becoming an increasingly important segment of Canada's capital markets. As of December 31, 2005, 232 income trusts had a market value of \$178.3 billion, representing 10% of the total TSX quoted market value. Accordingly, it is important that this sector provide clear, unambiguous financial reports to enable investors to assess risk and opportunities and review performance.

Even as income trusts are gaining importance in Canada's capital markets, there is increasing concern with their financial disclosures. In part, this might be due to the newness of the sector where managements and investors are still trying to understand how to approach each other. Clearly, however, distributable cash reporting is an issue. This is a term that does not have a generally accepted definition. Accordingly, there is no consistency in the way it is used or measured, even within an industry. Two recent Standard and Poors reports, prepared after reviewing a random sample of 40 income funds, concluded that the calculation of distributable cash should be more thoughtful and the related disclosure significantly improved. An OSC Corporate Finance Report, published as Staff Notice 51-706, also noted concern with income trust distributable cash disclosures.

Distributable cash is a term unique to trusts. It is important because it is generally understood to describe the amount of cash generated from the trust's business or assets that is available for distribution to unit holders. As a measure then, it may best be described as a hybrid – a cash-based performance measure. Although not discussed in CSA materials, some income trusts also disclose a pay-out ratio – a comparison of distributions paid to distributable cash - that is presented as an indicator of the trust's conservatism and its ability to continue to make distributions to unit holders at current rates.

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Distributable Cash – a Non-GAAP Measure

Distributable cash, or similar terms such as cash that is available for distribution, available distributable cash, distributable cash flow, fund distributable cash, and distributable income are not defined in generally accepted accounting principles (GAAP). As a numerical measure of cash flow that is not required by GAAP, distributable cash is classified as a non-GAAP financial measure by the CSA. Any pay-out ratio computed from distributable cash would also constitute a non-GAAP measure. CSA Staff Notice 52-306 states that it is not appropriate to present non-GAAP financial measures in the GAAP financial statements.

Disclosure Considerations

The CSA have recognized that reporting non-GAAP financial measures in MD&A may provide additional information that assists investors in understanding critical components of an entity's financial results. They caution, however, that such measures should not be presented in a way that confuses or obscures the GAAP measures or otherwise misleads investors. Accordingly, the below-noted points may need consideration when assessing whether the MD&A discussion of distributable cash is "fairly presented" for purposes of the CEO and CFO certifications, required by securities regulators under Multilateral Instrument 52-109. This becomes even more important in Ontario's post Bill 198 environment of a statutory civil liability regime for secondary market disclosures.

Purpose

An entity should disclose information in its MD&A that enables readers to view it "through the eyes of management". Accordingly, there should be a discussion of the relevance of distributable cash and how management uses this information.

Non-GAAP Measure not Comparable Between Entities

There should be a statement that distributable cash is a non-GAAP measure and that since it has no standardized meaning it will not necessarily be comparable with similar measures presented by other entities. It would also be useful to discuss the provisions of the trust declaration that relate to distributable cash and in particular the discretion that management has in determining this amount. Notwithstanding the lack of a standardized meaning, management may be well advised to compare their approach to determining distributable cash calculations with others in the same industry and to evaluate and explain differences in approach in assessing whether their presentation is "fair" in the circumstances.

Change in Composition

The elements of distributable cash should not normally change from one reporting period to another. Should management determine that a change is necessary, the change should be explained, including the reason for making the change. A change might relate to a new or deleted element, or a significant amendment to the way in which an element is computed.

Reconciliation

As noted in CSA Staff Notice 41-304, distributable cash should be reconciled to its most directly comparable GAAP measure. This should be a quantitative reconciliation, generally to cash flow from operating activities, the GAAP measure that includes changes in working capital. A reconciliation to EBITDA would not be appropriate as this is neither a GAAP measure nor a cash flow measure. Reasons for reconciling items should be provided, together with explanations of how they are computed (also see *Maintenance Capital Expenditure, Working Capital Changes, and Other Adjustments* below).

Forward-looking Information

When an adjustment in arriving at distributable cash is based on the expected economic effects of anticipated future events, securities regulators have noted that the presentation provides a forward-looking perspective on the distributable cash. In that case it will be necessary to provide, in appropriate cautionary language, a description of the factors that may cause actual results to differ materially from the forward-looking information, a discussion of material assumptions and risks, and a statement that the information is forward-looking.

Maintenance Capital Expenditure

As a cash-based performance measure, distributable cash calculations often exclude depreciation and amortization expense in favour of a charge commonly referred to as "maintenance capital expenditure". This is usually an estimate of that element of capital expenditure that relates to the replacement of capital assets necessary to sustain current levels of economic activity. In view of the absence of a generally accepted definition for maintenance capital expenditure, the discussion of distributable cash should explain:

- what this item represents;
- how it is calculated;
- how it is expected to relate to the capital asset replacement cycle over the next few years; and,
- its relationship to the depreciation and amortization expense.

As well, when the trust has a growth strategy that involves capital asset expenditure in excess of maintenance capital expenditure, this should be discussed, including the nature of and purpose for the additional capital expenditure and how this will be financed.

Working Capital Changes

The cash actually available for distribution at the end of a year would normally need to reflect changes in working capital. Increases and decreases in working capital can arise for various reasons, however, and they may not always be relevant in determining cash available for distribution on an ongoing basis. Accordingly for most purposes distributable cash should be reported after taking into account changes in working capital. When changes in working capital in the current period are not expected to be representative of future periods, this should be explained and the anticipated impact on future distributable cash quantified.

Other Adjustments

In arriving at distributable cash, other adjustments may be necessary if they are funded by cash from operating activities, for example debt repayments and asset retirement costs. In addition, the impact of matters such as these on future years' distributable cash should be discussed.

Relationship of Distributable Cash Discussion to Other MD&A Disclosures

The MD&A discussion of distributable cash cannot be considered in isolation. To avoid being misleading, it needs to be compatible and consistent with other disclosure documents, and other aspects of the MD&A, and in particular the discussions of material assumptions and risks, and financial condition, liquidity, and capital resources. Specific points that may need consideration are noted below.

- It is important that investors understand the extent to which distributions represent a return on capital, as opposed to a return of capital. Accordingly, consideration should be given to the nature of cash distributions in the period and the extent to which they have arisen from the entity's earnings. The CSA have stated that the breakdown of distributed cash between return on capital and return of capital

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Relationship of Distributable Cash Discussion to Other MD&A Disclosures
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should be provided, if available. This becomes particularly important when a trust without income borrows funds to make a distribution. In this regard, it should be noted that assessing whether a return of capital has occurred, and the corresponding disclosure, should be based on the impact of the distribution on the GAAP financial statements, not on information provided for tax purposes, which is determined based on tax legislation and often significantly different to GAAP.

- There is a presumption that the trust will have ready access to all cash flows. This is not always the case, however. For example an operating subsidiary may not be able to distribute all its cash flow to the trust because of a debt covenant restriction. In circumstances that restrict liquidity, such as this, the amount in question should be eliminated from distributable cash or the restriction should be clearly explained in the distributable cash discussion, whichever is more appropriate for balanced and fair disclosure.
- The MD&A should set out an analysis of the trust's ability to generate sufficient amounts of cash and cash equivalents in the short term and long term to maintain capacity and meet planned growth. As well, trends or expected fluctuations in liquidity should be analysed. Accordingly, the MD&A for an income trust should discuss the trend of distributable cash compared against cash distributions and comment on the entity's ability to continue making distributions at current levels and the source for such distributions, particularly when distributions are expected to be made from borrowings. This discussion should also include the key risks that the trust faces, for example reductions in commodity prices have recently forced some energy trusts to cut back on distributions.

While the income trust sector presents some unique reporting issues, following a policy of complete and transparent disclosure should help to ensure that investors have all the information they need to assess a trust's performance and its future prospects. As part of this process, before signing off on the CEO and CFO certifications, management should conduct a critical review of the MD&A as a whole and ensure that the distributable cash discussion is complete, fair, and balanced, and consistent with other aspects of the MD&A.

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