

CPRAlert

Canadian Performance Reporting

INCOME TRUSTS' ADOPTION OF STANDARDIZED DISTRIBUTABLE CASH GUIDANCE

When evaluating the future prospects of income trusts, investors often look to “distributable cash”, a non-GAAP financial measure with a myriad of definitions. In 2007, the CICA's Canadian Performance Reporting Board published Guidance aimed at standardizing this measure and enhancing the quality of distributable cash reporting. A recent survey indicates a high adoption rate for this Guidance and demonstrates income trusts' commitment to improved financial reporting. This Alert summarizes the survey findings and discusses challenges encountered in applying the Guidance.

BACKGROUND

In July 2007, the CICA's Canadian Performance Reporting Board (CPRB) issued Guidance on reporting Standardized Distributable Cash.¹ The document sought to improve the consistency and comparability of distributable cash, a non-GAAP financial measure commonly reported by income trusts and other flow-through entities. The Guidance complements the Canadian Securities Administrators' 2007 National Policy Statement 41-201 *Income Trusts and Other Indirect Offerings* and the non-GAAP financial measures section of the CPRB's 2004 *Management's Discussion and Analysis: Guidance on Preparation and Disclosure*. In brief, the Guidance provides a framework for calculating a *standardized* distributable cash measure and encourages preparers to address the following:

- How much cash has been generated in the period, and where did it come from?
- Has the entity made sufficient investment to maintain operations?
- What is the impact of the entity's debt management strategy on distributions?
- Are there financial covenants that might restrict future distributions?

Recognizing management's need to communicate issues unique to the business, the Guidance also supports the

calculation of a supplementary entity-specific measure, which would include adjustments *beyond* those included in Standardized Distributable Cash.

In April 2008, a review of income trusts' MD&As assessed the extent of Guidance implementation during the first year.

STUDY PARAMETERS

Sixty-five income trusts, representing 10 sectors, were selected from the 212 income trusts on the TSX at December 31, 2007. Each entity's 2007 Annual MD&A was reviewed for five elements:

- Calculation of Standardized Distributable Cash;
- Description of productive capacity;
- Communication of a strategy for productive capacity management;
- Discussion of the relationship between productive capacity and capital expenditures (capex); and,
- Analysis of the relationship between distributable cash and other sources or uses of cash.

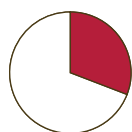
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CALCULATION OF STANDARDIZED DISTRIBUTABLE CASH

The Guidance defines Standardized Distributable Cash as follows:

Cash flows from operating activities

Less: Total capital expenditures
Restrictions arising from financial covenants
Limitations arising from minority interests



31% calculated standardized distributable cash.

Observations

This high first-year adoption rate was tempered by a small minority of income trusts that used *maintenance* capex, rather than *total* capex as the deduction in arriving at Standardized Distributable Cash. While the CPRB concurs that maintenance capex is conceptually preferable, the Guidance advocates total capex because some preparers are unable to separate growth from maintenance capex. In order to improve consistency and comparability, total capex should be used in computing the standardized measure. Entities should distinguish the growth element of their capex through the productive capacity discussion or in a supplementary entity-specific measure of distributable cash.

DESCRIPTION OF PRODUCTIVE CAPACITY

The Guidance encourages preparers to disclose information concerning productive capacity, including:

- A *definition* of productive capacity that reflects the entity's principal business activities;
- A *measure* of productive capacity;
- A recent *history* of the productive capacity measurement; and,
- An explanation for *changes* in productive capacity.



42% provided a description of productive capacity.

Examples

The following entities customized their productive capacity definitions to reflect core business activities:

Canadian Oil Sands Trust. Barrels per calendar day, which is approximately 350,000 bpd on average.

Consumers' Waterheater Income Fund. Total number of installed water heaters and other equipment.

Jazz Air Income Fund. Operating fleet of 136 aircraft.

Northland Power Income Fund. Electricity production capacity in MW.

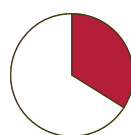
Rogers Sugar Income Fund. Annual nominal production in metric tonnes.

Observations

Many entities supported the Guidance and described productive capacity. Several, however, did not extend this narrative into a quantitative measure that could be compared from period to period. By translating their words into numbers, preparers can better address such questions as: *How has productive capacity changed in recent years? Does current capacity exceed or fall short of targeted levels? When referring to "productive capacity maintenance", what is the level being maintained?*

PRODUCTIVE CAPACITY MANAGEMENT STRATEGY

The Guidance encourages entities to disclose a strategy for managing productive capacity. In particular, management should identify specific strategic actions and associated risks. The impact of emerging technologies and changes to input or output prices are among the factors that should be addressed.



34% presented a strategy for managing productive capacity.

Examples

Royal Utilities Income Fund. Royal Utilities presents a general strategy, which includes transfer of excess equipment between minesites and retention of outside services for equipment repair and replacement. Access to the latest technology is cited as a benefit of the supply and maintenance contracts. The MD&A describes a specific program aimed at improving dragline productivity and identifies the inherent risks and associated risk mitigation strategies.

Trilogy Energy Trust. Trilogy describes its productive capacity strategy, which entails facilities upkeep, sustained

access to third party processing and transportation, and effective management of the reserves base through the replacement of produced reserves at low finding and development costs.

Observations

While several entities described activities for *maintaining* productive capacity, relatively few revealed plans for capacity *growth* or *reduction*. The maintenance-oriented discussions imply a “constant capacity” strategy. To reduce investors’ reliance on inference, preparers are encouraged to provide explicit reference to expectations for changes in capacity. Is there a market price beyond which production might be increased? Is the strategy to consume capacity over time? Such disclosure provides a more complete picture of future activity and enhanced information for predicting future cash flows.

RELATIONSHIP BETWEEN PRODUCTIVE CAPACITY AND TOTAL CAPITAL EXPENDITURES

In addition to defining productive capacity and disclosing a management strategy, an effective discussion ought to answer the following questions. *Has the level of productive capacity increased, decreased, or remained unchanged during the period? What has led to the change in productive capacity, if any? For example, has growth been achieved through acquisition or higher capital spending?* The Guidance encourages reconciliation of periodic productive capacity changes to the total capital expenditures adjustment included in Standardized Distributable Cash.



37% indicated the impact of capital expenditures on productive capacity.

Example

Noranda Income Fund. In its “Productive Capacity” discussion, Noranda defines productive capacity as the number of tonnes of zinc concentrate processed annually. The discussion then reports a 5,000 tonne increase in productive capacity, year over year, stemming from capital expenditures made during 2007.

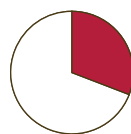
Observations

A significant number of trusts are communicating the relationship between productive capacity and capital spending. However, only about half of these are reconciling the change in capacity to *total* capital expenditures.² This result, while low, is not particularly surprising, given the need for both a quantitative expression of productive capacity and recent history of the capacity to be able to report this information.

Some entities alluded to an increase in productive capacity by denoting a split between maintenance and growth spending. By indicating the *direction*, but not the *magnitude*, of the capacity change, the MD&A communicated only part of the picture. Investors have repeatedly told us that they find discussions about the impact of capital expenditures on productive capacity very meaningful. Accordingly, the CPRB encourages preparers to provide more fulsome discussions in this area.

RELATIONSHIP BETWEEN DISTRIBUTABLE CASH AND OTHER SOURCES/USES OF CASH

Financing and investing activities can complement distributable cash or compete with distributions for its use. Debt financing may be used to fund capital expenditures; in so doing, it supplements Standardized Distributable Cash. Conversely, debt repayment may consume a portion of Standardized Distributable Cash, thereby reducing distributions to unitholders. The Guidance advises that entities discuss the relationship between Standardized Distributable Cash, investing and financing activities, and distributions. The Guidance also encourages disclosure of any changes to long-term unfunded operating obligations that might have a significant impact on distributions.



31% discussed the relationship between distributable cash and other sources/uses of cash.

Examples

Innergex Power Income Fund. A “Net Distributable Cash” table itemizes inflows and outflows beyond standardized distributable cash, including the repayment of long-term debt. The accompanying discussion describes the use of cash on hand to maintain distributions.

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Parkland Income Fund. Parkland makes specific reference to long-term unfunded obligations. Asset retirement obligations and refinery remediation, both of which will be deferred for an extended period, are the Fund's only significant sources of unfunded obligations. While the Standardized Distributable Cash calculation includes no adjustment for these obligations, a deduction for periodic accretion expenditures is already factored into cash flow from operating activities. The MD&A projects that current environmental programs will be adequate to fund its asset retirement obligations.

Observations

Though nearly one-third of the sample MD&As detailed the walk between Standardized Distributable Cash and distributions, the discussions varied in their clarity. Some provided a relatively piecemeal narrative; others itemized investing and financing inflows and outflows in a table similar to that below.

<p>Cash Flows from Operating Activities</p> <ul style="list-style-type: none"> - Total capital expenditures - Limitations arising from minority interests - Restrictions arising from financial covenants
<p>Standardized Distributable Cash</p> <p>+/- Entity-specific adjustments</p>
<p>Adjusted Distributable Cash</p> <p>+/- Inflows/outflows from investing activities</p> <p>+/- Inflows/outflows from financing activities</p>
<p>Distributions to Unitholders</p>

While the Guidance does not prescribe a preferred approach, a tabular format may be the most effective way to communicate this information.

Relatively few entities commented explicitly on changes to *long-term unfunded operating obligations* that may impact distributions. This may stem from the absence of change, or from the absence of unfunded obligations. On the other hand, management may have overlooked the potential impact of such obligations. Preparers might consider including a clarifying statement to avoid ambiguity.

CONCLUSIONS

It is gratifying to see that so many income trusts are striving to improve reporting of distributable cash. By highlighting the preceding challenges and illustrating positive examples of Guidance use, this *CPR Alert* hopes to facilitate more effective disclosure of Standardized Distributable Cash.

During the next few months, the chair of CPRB's Non-GAAP Financial Measures Task Force and staff will be contacting preparers to better understand the difficulties they have encountered in applying the Guidance and to determine whether any supplementary implementation material is needed. In addition, the CPRB contemplates conducting a further follow-up survey of 2008 annual reporting. ■

1. *Standardized Distributable Cash in Income Trusts and Other Flow-Through Entities – MD&A Guidance on Preparation and Disclosure*
2. *Recommendation 6(e) of Standardized Distributable Cash in Income Trusts and Other Flow-Through Entities – MD&A Guidance on Preparation and Disclosure*

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