

## CSA Report Finds Income Trust Reporting Still Leaves Room For Improvement

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On Aug. 4, 2006, the Canadian Securities Administrators (CSA), which includes the Alberta, British Columbia, and Ontario securities commissions, released its second report on the continuous disclosure practices of income trust issuers (see CSA Staff Notice 51-319 “Report on Staff’s Second Continuous Disclosure Review of Income Trust Issuers”, available at [www.osc.gov.on.ca](http://www.osc.gov.on.ca)). Here, Standard & Poor’s Ratings Services summarizes the more salient points of the CSA report and underscores the financial reporting issues mentioned earlier this year (see “Canadian Income Funds And The Perceptions Of Distributable Cash: Part 1”, and “Canadian Income Funds And The Perceptions Of Distributable Cash: Part 2”, on [www.stabilityratings.com](http://www.stabilityratings.com)).

### **CSA Finds Trouble Spots**

In summarizing its 2006 findings, the CSA said “...income trust issuers need to significantly improve the nature and extent of their disclosure. In particular, they need to improve the distributable cash disclosure in MD&As.” The CSA did not disclose the names of the income trusts reviewed. Below are the more notable findings.

- The CSA report indicates that 84% of the 45 trusts examined had “identifiable deficiencies” in their disclosures and 16% of them had to re-file disclosure documents or file disclosure documents that they did not previously file. This is a significant turn of events, given that in 2004 only two of the 40 trusts sampled by the CSA had to re-file their disclosure documents as a result of the review.
- Liquidity disclosures appear to have been quite poor. In many cases issuers apparently did not provide disclosures about their sources of funding related to current and future cash distributions. The financial statements revealed that, often, some portion of distributions

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was funded from sources other than cash flow from operations, yet this fact was not mentioned by the income trusts. The CSA specifically noted the use of operating lines, long-term credit facilities, and reserves held back from previous periods as ways in which the sampled trusts funded distributions.

- Lack of timely disclosure was often consequential. The CSA identified some events at the operating entity level of certain trusts that appeared to meet the definition of a “material change” for the trusts but for which the trust did not file material change reports. For example, certain trusts breached financial covenants under their credit facilities in three different instances, resulting in the trusts either suspending or significantly reducing distributions. Surprisingly, when discussing the matter with the CSA, the issuers argued that these events did not meet the definition of a material change.
- Three trusts obtained waivers for financial covenants and made amendments to their credit facilities, but did not file the amended credit agreements on SEDAR. In one instance, the trust did not file the original credit facility agreement, or the amendments to it. We continue to view the filing of credit facilities on SEDAR as a critically important practice in ensuring a sufficiently protected and well-informed investor.
- In some cases, the adjustments made by management, ironically, had limited cash flow impact. In those instances, the CSA points out that distributable cash did not accurately reflect the amount of cash that was available for distribution.

### ***Financial Reporting Quality Has Deteriorated Since 2004***

There is compelling evidence that the financial reporting risks we have identified this year are indeed quite meaningful and have increased in significance since the CSA’s 2004 staff review. Provided below are what we view as key trends and patterns in the CSA’s findings from 2004 to 2006.

- In 2006, three times as many income trusts had to re-file disclosure documents or file disclosure documents that they did not previously file compared with 2004.
- The 2006 report mentions that covenant breaches and financial waivers occurred for which sufficient appropriate disclosure was lacking by certain trusts. This issue was not mentioned by the CSA in the 2004 report. This is of critical importance to investors given the potential for distributions to be cut or suspended as a result of a financial covenant breach.
- We believe that the lack of improvement in distributable cash presentation between 2004 and 2006 has been the motivating factor behind the CSA’s amendment and revision of Staff Notice 52-306 “Non-GAAP Financial Measures” to more explicitly state that distributable cash is fairly presented only when reconciled to GAAP cash flows from operating activities. The CSA also mentioned that it is not appropriate to present non-GAAP measures in the GAAP financial statements (which includes the notes to the financial statements). This is a potentially misleading practice that 48% of trusts sampled in the CSA’s 2004 review engaged in when reporting distributable cash. Specifically, this practice creates the misconception that the distributable cash figure was subject to an audit or interim financial statement review, which is typically not the case.

***Conclusion***

Notwithstanding the CSA findings, Standard & Poor's employs several measures we believe can reasonably mitigate the potential effect of information risk and reporting distortions on the ratings process. For instance, ongoing access to management of rated income fund issuers provides the opportunity to discuss issues and events such as covenant breaches or other material events that might otherwise go undisclosed in publicly filed documents. Furthermore, our analytical process focuses on distributable cash metrics that consider, but are not dictated by the as-reported numbers of management. This is most evident in the analytical adjustments we make, which often result in the reversal or amendment of certain adjustments made by management. We include those adjustments along with meaningful discussion regarding our rationale, in issuer-specific stability rating reports available at [www.stabilityratings.com](http://www.stabilityratings.com).

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