

CSA Multilateral Staff Notice 51-310**Report on Staff's Continuous Disclosure Review of Income Trust Issuers****Purpose of Notice**

This notice reports the findings and comments of staff of the British Columbia Securities Commission, Manitoba Securities Commission, Ontario Securities Commission and Commission des valeurs mobilières du Québec (collectively, staff or we) arising from a review of the continuous disclosure records of 40 income trust issuers.

Objective and Scope of Review

The income trust structure has become a popular vehicle for public offerings. In an effort to further understand and evaluate the financial disclosure practices of income trusts, staff conducted a coordinated project to review the continuous disclosure records of 40 income trusts. The income trusts were in various industries and eleven of the 40 trusts had existed for more than one year when we began our review. Based on our review of the continuous disclosure records of these trusts, six specific issues emerged that we comment on in this notice:

- Distributable cash
- Comparative figures
- Unitholders' equity
- Future oriented financial information
- Non-GAAP financial measures
- Goodwill and intangibles

We started our reviews in early 2003 and completed them by September 2003.

Summary of Findings

Our findings suggest that many income trust issuers need to improve the quality of their disclosure.

Twenty-nine of the income trusts committed to change disclosure in future Management Discussion & Analysis (MD&A) filings, annual and interim financial statements and press releases.

Two of the income trusts were required to re-file their disclosure documents as a result of our review.

Nine of the income trusts reviewed were not required to change their previously filed disclosure documents or to commit to prospective changes.

Findings for Specific Issues Identified

1. Distributable Cash

Distributable cash generally refers to the net cash generated by an income trust's business or assets that is available for distribution, at the discretion of the income trust, to the income trust's unitholders.

We reviewed the disclosure of the income trusts for the following aspects of distributable cash disclosure:

- Location of information about distributable cash – presented as a separate financial statement, in the notes to the financial statements or within MD&A.
- Reconciliation of distributable cash figures to the financial statements.
- Starting point in GAAP financial statements for the reconciliation of distributable cash – net income from operations, or cash flow from operations.
- MD&A discussion of discretionary amounts such as reserves.

Distributable cash information was presented in a variety of locations. Of the 40 income trusts reviewed:

- Eighteen trusts included a statement of distributable cash in the MD&A
- Sixteen trusts presented distributable cash information in a note to the financial statements
- Three trusts presented distributable cash as a separate statement within the financial statements
- Three trusts did not present distributable cash information

Of the 40 income trusts reviewed, nine trusts presented distributable cash figures without a reconciliation to the audited financial statements. Presentation of distributable cash without a reconciliation to GAAP measures may confuse readers as to the source of the amounts and may mislead them into erroneous conclusions about what the distributable cash presentation communicates. For example, in one occurrence, the income trust presented a statement of distributable cash that covered a different period than the audited financial statements.

Twenty-six of the 40 income trusts provided a reconciliation between distributable cash and net earnings. The remainder of the income trusts provided a reconciliation between distributable cash and some other financial measure such as earnings before interest, taxes, depreciation and amortization (EBITDA), net cash from operations, net sales or cash and cash equivalents.

Fifteen of the 40 income trusts disclosed some type of reserve to arrive at distributable cash. However, in most cases the calculation of the reserve amounts and the reasons for any changes to the reserve amounts were not discussed in the MD&A.

We remind income trust issuers to refer to the disclosure guidance of CSA Staff Notice 52-306 *Non-GAAP Financial Measures* when presenting distributable cash. Specifically, distributable cash should be reconciled to the most directly comparable measure calculated in accordance with GAAP which staff believes is generally cash flow from operations. Income trust issuers should also discuss all reconciling items, especially those items of a discretionary nature, and explain the implications of any difference between distributable cash and cash distributions made.

2. Comparative Figures

Most income trusts continue an existing business that was previously operated under a different legal form. The operating assets or shares of an operating business initially acquired by the income trust may be accounted for at their previous carrying value or at fair value using the purchase method.

For the purpose of our review, we focussed on the presentation of comparative information for the business for periods prior to its transfer to the income trust. Specifically, we reviewed the selected income trusts for the following:

- Presentation of comparative figures in the financial statements when the initial acquisition of the operating business was recorded at previous carrying values.
- Presentation of comparative figures in the MD&A when the initial acquisition of the operating business was recorded using the purchase method.

We reviewed 29 of the 40 income trusts for the inclusion of comparative information in the issuer's first fiscal year. The remaining eleven income trusts had existed for more than one year and therefore were not reviewed for this issue.

Six of the twenty-nine income trusts accounted for the initial acquisition of the operating company using previous carrying values. After being requested by staff, five of the six income trusts included comparative figures in their financial statements, and discussed in their notes to the financial statements the basis of presentation (one issuer restated its quarterly financial statements and the other five included comparatives on a prospective basis). The remaining income trust agreed to include comparative financial information

along with a comparative discussion in future MD&A filings; this approach was considered appropriate given certain unique features of the operating business' history.

The remaining twenty-three income trusts accounted for the initial acquisition using the purchase method. Of these, eight income trusts included some comparative information and discussion in the MD&A, with the remaining fifteen trusts omitting any comparative figures or discussion in both the financial statements and MD&A. In response to staff's comments, each of the fifteen income trusts agreed to include comparative financial information along with a comparative discussion in future MD&A filings.

We direct income trust issuers to proposed National Policy 41-201 *Income Trusts and Other Indirect Offerings* that discusses staff's expectations for the provision of comparative information.

3. Unitholders' Equity

Income trusts present surplus in the financial statements as "unitholders' equity". Total unitholders' equity represents the sum of contributed capital and retained earnings (undistributed earnings). We reviewed the income trusts included in this review project to identify the level of detail provided for unitholders' equity.

Only nine income trusts provided a breakdown of unitholders' equity into each of the main components of capital contributions, income earned, and distributions on a cumulative basis.

For those income trusts that existed for more than one year that did not provide a breakdown of the components of unitholders' equity, it was difficult to determine whether any distributions paid had been distributed from equity contributed from the original issuance of trust units. In one instance, if provided, the breakdown of unitholders' equity would have shown that the income trust had distributed 60% more than its cumulative earnings and that some portion of the distributions were being paid as a return of capital.

We remind income trust issuers that CICA Handbook Section 3250.07 requires that items of surplus be segregated so as to distinguish between those derived from earnings and those derived from contributions.

4. Future Oriented Financial Information

Future Oriented Financial Information (FOFI) portrays prospective results of operations and financial position. We reviewed the income trusts included in this review project for their disclosure of FOFI and consistency with the guidance of National Policy 48 *Future-Oriented Financial Information* (NP48).

Thirteen of the income trusts reviewed provided some form of future oriented information. In eleven of the instances, we did not identify any consistency issues with

the disclosure guidance of NP 48. The remaining two income trusts were not consistent with the guidance of NP48, as they originally included a forecast in their prospectus and did not discuss or compare actual results to the forecast in any of the quarters filed after the prospectus even though variances were considered material. In both instances, at staff's request, the income trusts discussed the variances in the annual MD&A.

5. Non-GAAP Financial Measures

Many income trusts publish non-GAAP financial measures in press releases, MD&A and prospectus filings. Many non-GAAP financial measures are derived from net income determined in accordance with GAAP and, by omission of selected items, present a more positive picture of financial performance. Non-GAAP financial measures may be identified as "pro forma earnings", "operating earnings", "cash earnings", "free cash flow", "distributable cash", "EBITDA", "adjusted earnings", and "earnings before one-time charges".

We reviewed the income trusts included in this review project for their disclosure of non-GAAP financial measures and consistency with the disclosure guidance of CSA Staff Notice 52-303 *Non-GAAP Earnings Measures* (or its successor CSA Staff Notice 52-306 *Non-GAAP Financial Measures*).

All of the income trusts reviewed disclosed some type of Non-GAAP financial measure. The majority of income trusts reviewed did not fully comply with disclosure guidance contained in CSA Staff Notice 52-303 *Non-GAAP Earnings Measures* (or its successor CSA Staff Notice 52-306 *Non-GAAP Financial Measures*). Each of these income trusts confirmed that prospective presentation would be in accordance with the Notice.

6. Goodwill and Intangibles

In many business combinations, some portion of the purchase price should be assigned to intangible assets. Given that income trusts usually acquire mature businesses with a history of operations, it is likely that intangible assets exist and should be recognized in the allocation of the purchase price.

In the course of this review project, we did not identify any specific issues relating to goodwill and intangibles. However, during previous prospectus reviews of several of the income trusts included in this review project, we identified failures to properly record intangible assets. In several instances, income trusts initially did not allocate any fair value to intangibles. When asked to justify this position given contrary evidence detailed in the preliminary prospectus (such as customer contracts, proprietary processes, trademarks), in all instances the issuer agreed to assign value to intangible assets.

As an example, one income trust had recognized minimal intangible assets and significant goodwill on the initial acquisition of the business. In their marketing material, the income trust made various references to established relationships with customers. Although the income trust argued that they did not have long-term contracts with these

customers, these customers placed frequent and significant purchase orders. The income trust made minimal solicitation efforts and enjoyed low customer turnover. Staff concluded that these customer relationships justified the recognition of an intangible asset.

We remind income trust issuers of the requirements of CICA Handbook Section 1581, including the examples of intangible assets included in Appendix A of that section, as well as the guidance contained in EIC-137 *Recognition of Customer Relationship Intangible Assets Acquired in a Business Combination*.

Conclusion

Our findings suggest that many income trust issuers need to improve the quality of their disclosure.

We remind income trust issuers of existing requirements and guidance including, but not limited to:

- CSA Staff Notice 52-306 *Non-GAAP Financial Measures*
- Proposed National Policy 41-201 *Income Trusts and Other Indirect Offerings*
- National Policy 48 *Future –Oriented Financial Information*
- CICA Handbook Section 3250 *Surplus*
- CICA Handbook Section 1581 *Business Combinations*
- EIC-137 *Recognition of Customer Relationship Intangible Assets Acquired in a Business Combination*

We intend to continue monitoring the continuous disclosure provided by income trusts, including disclosure for the six specific issues addressed in this memo.

Questions

Please refer your questions to any of the following people:

British Columbia Securities Commission:

Carla-Marie Hait, Chief Accountant, Corporate Finance: (604) 899-6726

Michael Moretto, Associate Chief Accountant, Corporate Finance: (604) 899-6767

Callers in B.C. and Alberta may also dial (800) 373-6393

Manitoba Securities Commission:

Wayne Bridgeman, Senior Analyst, Corporate Finance: (204) 945-4905

Callers in Manitoba may also dial (800) 655-5244

Ontario Securities Commission:

John Hughes, Manager, Corporate Finance: (416) 593-3695

Sonny Randhawa, Accountant, Corporate Finance: (416) 593-2380

Autorité des marchés financiers:

Francesco Cristiano, analyste, financement des sociétés: (514) 940-2199 Ext. 4259

Nicole Parent, analyste, financement des sociétés: (514) 940-2199 Ext. 4425

February 13, 2004