CSA/ACVM Canadian Securities Administrators Autorités canadiennes en valeurs mobilières

CSA STAFF NOTICE 51-319 – *REPORT ON STAFF'S SECOND CONTINUOUS DISCLOSURE REVIEW OF INCOME TRUST ISSUERS*

1. Purpose

This notice reports the findings and recommendations of staff at the British Columbia, Alberta, Manitoba, Ontario and Nova Scotia securities commissions and the Autorité des marchés financiers (collectively, we or staff) arising from a targeted review of business income trust issuers. This notice supplements the guidance and interpretations provided in National Policy 41-201 *Income Trusts and Other Indirect Offerings* (NP 41-201), Multilateral Staff Notice 51-310 – *Report on Staff's Continuous Disclosure Review of Income Trust Issuers*, CSA Staff Notice 52-306 *Non-GAAP Financial Measures* (SN 52- 306) and CSA Staff Notice 41-304 *Income Trusts: Prospectus Disclosure of Distributable Cash*, and the requirements in NI 51-102 *Continuous Disclosure Obligations* (NI 51-102).

2. Objective and Scope

The income trust structure continues to be a preferred vehicle for a diverse range of businesses to complete initial public offerings. As part of our continuous disclosure review program, we periodically assess income trusts for regulatory compliance in their on-going disclosure. Recently, staff selected 45 business income trust issuers, with head-offices throughout Canada, for a full review of their continuous disclosure.

3. Summary of Findings and Comments

The results of our review suggest that, in order to fully comply with the continuous disclosure requirements, 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 Management's Discussion and Analysis (MD&A).

Of the 45 income trust issuers reviewed:

- 7 issuers had to re-file disclosure documents or file disclosure documents that they did not previously file;
- 31 issuers committed to provide disclosure enhancements in future MD&A, financial statements, AIF or press releases; and
- 7 issuers had no identifiable deficiencies in their continuous disclosure.

4. Significant Disclosure Issues

A. MD&A Disclosure

The presentation of distributable cash continues to cause considerable confusion. This figure, which represents the expected net cash to be generated by the income trust's businesses or assets often contains significant estimates and assumptions. The amount the trust actually distributes is at its discretion.

To satisfy the requirements of Form 51-102F1 – *Management's Discussion and Analysis* (Form 51-102F1), income trusts should supplement the distributable cash presentation in their MD&A with comprehensive disclosure of the assumptions, risks and uncertainties, working capital requirements and financing decisions related to the trust. This information helps investors determine whether the amount of estimated distributable cash is reasonable and sustainable.

Of the 45 trusts reviewed, 18 income trust issuers committed to providing disclosure enhancements relating to distributable cash disclosures in future MD&A.

In addition to their deficient distributable cash disclosures, two income trust issuers were required to re-file previously filed MD&A because they had other significant disclosure deficiencies and four issuers committed to prospective overall disclosure enhancements.

During our review, we concluded that distributable cash disclosures in MD&A were significantly deficient in one or more of the three specific areas required by Form 51-102F1, (i) liquidity; (ii) risks and uncertainties; and (iii) overall performance and results of operations.

(i) Liquidity[1]

Form 51-102F1 requires that an issuer discuss in its interim and annual MD&A the issuer's ability to generate sufficient amounts of cash and cash equivalents to meet its planned growth including a description of the sources of funding and the circumstances that could affect those sources that are reasonably likely to occur. In many cases, income trust issuers did not provide sufficient disclosure about their sources of funding relating to current and future cash distributions. To fully comply with the continuous disclosure requirements, there should be a comprehensive discussion of the sources of funding relating to current and future cash distributions. This discussion helps unitholders form a reasoned judgment about a trust's ability to sustain distributions over the long-term.

While income trusts intend to make distributions of their available cash to unitholders, the actual amount distributed depends on numerous factors, including the operating entity's financial performance, working capital requirements and future capital requirements. In many trusts we reviewed, the consolidated financial statements revealed that some portion of distributions to unitholders was funded from sources other than cash

[1] Part 2, Item 1.6 of Form 51-102F1

flows from operations. For example, in some instances, a portion of distributions were funded from operating lines, long-term credit facilities, reserves held-back from prior periods, or a return of a unitholder's original principal proceeds.

Many trusts either provided a "boilerplate" discussion with minimal or no quantification of the sources of cash flows or provided no discussion at all. Here is an example of a liquidity discussion that is not acceptable:

The shortfall between 'Cash available for distribution' and 'Distributions to unitholders' has been funded primarily by working capital. Should any further shortfall arise, Management expects to be able to cover the difference between cash generated and cash distributed through working capital, cash on hand or its credit facility. Working capital has been built up over time from public offerings.

The above discussion provides limited information to investors. Although this trust may have made distributions in excess of its cash flows from operations, it is unclear from the discussion how the trust is funding distributions. The disclosure provides no meaningful information to investors to determine the long-term sustainability of distributions and implies that the trust is paying distributions from proceeds of equity offerings.

Although the instructions in Form 51-102F1 do not specifically state it, to meet the disclosure requirements for liquidity in Form 51-102F1, income trusts should provide sufficient disclosure about their sources of funding relating to current and future cash distributions so unitholders can understand what portion, if any, of the distributions they received were funded by non-operational cash flows. Also, income trusts should quantify these amounts and discuss the impact on the trust's long-term ability to sustain distributions if non-operational cash flows are being used to fund distributable cash.

(ii) Risks and Uncertainties[2]

MD&A provides information to investors to help them assess the potential risks and uncertainties that may materially affect the underlying entity's (the operating entity) performance and, in turn, impact current and future distributions. All of the income trust issuers reviewed provided some disclosure on risks and uncertainties relating to the trust structure, taxation, regulation, and industry specific risk factors. However, 13 of them provided only a "boilerplate" discussion of these commitments, events, risks or uncertainties. Boilerplate discussions generally provide little or no useful information for investors and, in some cases, do not comply with the requirements of the form.

The operating entities are in a diverse range of businesses. Each operating entity has unique risks and commitments that may significantly impact the amount of cash flows that it can indirectly pass on to unitholders through the trust. Our reviews indicate that some of these risks include exposure to fluctuations in commodity price, foreign exchange, working capital commitments, credit risk, economic dependence, and overall economic factors. Under Form 51-102F1, an income trust must discuss known trends and

[2] Part 2, Item 1.2 of Form 51-102F1

risks that have affected the operating entity's financial statements, and trends and risks that are reasonably likely to affect them in the future. Here are two examples of "boilerplate" risks and uncertainties discussions that would not comply with the requirements in Form 51-102F1:

Example 1

The timing and amount of capital expenditures by Trust A will indirectly affect the amount of cash available for distribution to Unitholders. Distributions may be reduced, or even eliminated, at times when Trust A deems it necessary to make significant capital or other expenditures.

This example provides limited information to investors. The risk associated with the maintenance and replacement of the operating entity's capital assets is a significant and primary risk for most income trusts. The cash commitment required to maintain and replace its capital asset base is information an investor needs to assess a trust's ability to sustain distributions over the long-term. The operating entity's capital assets generate the cash flows to pay distributions. Therefore, an adverse change in their composition is likely to have a significant impact on distributions.

Although the instructions in Form 51-102F1 do not specifically state it, to meet the requirement to disclose risks, income trusts should provide a detailed risk factor discussion about the potential commitment to replace and maintain capital assets, including a quantitative discussion about expected annual capital maintenance levels relative to current levels, and the expected effect on distributions.

Example 2

Trust B's profitability is sensitive to fluctuations in wholesale prices of 'commodity X' caused by changes in supply, taxes, price controls and/or other market conditions affecting the 'commodity X' industry generally. Many of these factors are beyond Trust B's control and thus, when there are sudden and sharp increases in the wholesale price of 'commodity X', Trust B may not be able to pass through these price increases to customers through retail sales prices. In addition, the timing of price pass-throughs can significantly affect margins. Wholesale price increases could reduce Trust B's gross profits and could, if continued over an extended period of time, reduce demand by providing economic incentive to consumers to reduce consumption or convert to alternative energy sources.

Again, this example provides limited information in assessing the trust's future prospects and the potential impact that this risk might have on distributions. To comply with Form 51-102F1, income trusts should quantify, if possible, the past and expected future impact of each risk to facilitate the analysis of each risk's relative impact. For some trusts, this might best be presented as a sensitivity analysis of potential fluctuations in the price of the commodity and its impact on distributions. This would provide unitholders with more

meaningful information to assess this risk factor. It would also assist investors in further understanding the relationship between specific risks and their impact on operations. Also, although some of the instructions in Form 51-102F1 do not specifically state it, to accurately describe a risk, an income trust should disclose any steps it has taken, or plans to take, to mitigate the impact of any risk.

(iii) Overall performance and results of operations[3]

Item 1.2 of Form 51-102F1 requires an issuer to provide in its MD&A an analysis of its financial condition, results of operations and cash flows. This required analysis includes a comparison of the performance in the most recently completed financial period to the prior period's performance and an explanation of why changes have occurred or expected changes have not occurred. This discussion should also describe and quantify material variances.

Ten of the income trust issuers we reviewed did not provide an adequate discussion of events in the year that caused variances in specific financial statement line items. In these instances, the trusts did not quantify factors used to explain material variances. A quantification of specific factors causing variances assists investors in understanding the impact of the factor on results for the period. Many trusts simply provided a superficial discussion rather than providing a detailed analysis of overall performance. Here is an example of MD&A with a deficient financial statement analysis (details have been changed):

Revenues
Sales of $13.7 million for the three months ended June 30, 2005 increased by $2.2 million, or 19%, from $11.5 million for the three months ended June 30, 2004. Gross profit percentage in the second quarter was 39.1% compared to 42.2% during the same period last year. Factors causing the decline in gross profit percentage included: 1) freight used to import materials to meet aggressive lead times from customers; 2) more production outsourced than in the prior year in order to satisfy anticipated inventory demands from retailers; and 3) the sales mix in the prior period was heavily weighted in certain items which carry higher margins.

In this example, the trust did not provide information for changes in sales, other than what was readily available from its financial statements. Although the trust listed factors causing decreases in gross profit percentage for the period, these individual factors are not quantified or meaningfully discussed. To comply with Form 51-102F1, an income trust should discuss the individual factors so that investors can assess the relative significance of each factor.

[3] Part 2, Items 1.2 and 1.4 of Form 51-102F1

B. Non-GAAP financial measures

Most income trusts present non-GAAP financial measures. The number of non-GAAP measures presented and the consistency in presentation vary considerably from trust to trust. In some instances, income trusts rely solely on non-GAAP measures as a means of discussing the trust's financial results for a period in earnings releases and for the purposes of MD&A. However, in many instances, the presentation of non-GAAP measures by income trusts issuers does not meet the minimum standards set out in SN 52-306.

(i) Reconcile to GAAP measure

When non-GAAP measures such as distributable cash or EBITDA are presented by income trust issuers, under SN 52-306, the trust should reconcile the non-GAAP measure to the most directly comparable GAAP measure. For distributable cash, we interpret the most directly comparable GAAP measure to be cash flows from operating activities as presented in the issuer's financial statements. Instead, many income trusts reviewed began their GAAP reconciliation with earnings or EBITDA. This leads to many adjustments appearing in the distributable cash reconciliation which provide limited information and are increasingly confusing. In some cases, these adjustments have limited cash flow impact, and therefore may lead to distributable cash amounts that do not accurately reflect the amount of cash that was available for distribution. For example, one trust issuer included an adjustment for "elimination of purchase accounting impact" which increased distributable cash but did not show any cash flow impact.

As stated in SN 52-306, income trust issuers should ensure that when they present distributable cash, the reconciliation to the most directly comparable GAAP measure begins with cash flows from operations from the issuer's financial statements, including changes during the period in non-cash working capital balances.

(ii) Equal Prominence

SN 52-306 also states that when non-GAAP measures are presented, the most directly comparable GAAP measure should also be presented in equal or greater prominence than the non-GAAP measure. In our review, many trusts did not provide this level of equal prominence, and in some instances, did not even disclose a GAAP measure. We required two trust issuers to re-file disclosure documents because the original disclosure gave greater prominence to a non-GAAP measure than to the most directly comparable GAAP measure.

Here is an example of an unacceptable earnings release (details have been changed):

Trust A income fund commented today on its results for the third quarter ended September 30, 2005. On a preliminary basis, sales during the quarter for the Fund were approximately $21.7 million, up from $20.6 million in the comparable period last year. As a result of the sales increase, adjusted earnings before

interest, taxes, depreciation and amortization ("Adjusted EBITDA") for the period are estimated to have increased to $4.4 million from approximately $3.3 million for the comparable period last year. Based on these preliminary results, the Fund estimates that Distributable Cash was approximately $1,750,000 in the quarter, resulting in an increase of $725,000 as the Fund paid cash distributions to Unitholders of $1.9 million during the period. The financial results for the third quarter of 2005 reflect an increase in sales in the United States and a decline in sales in Western Canada which, when combined with the carryover of large dealer inventories resulted in a 18% increase in consolidated sales in the period compared with last year's third quarter.

In this example, the trust only later revealed in its financial statements that it experienced a net loss in the period as opposed to the prior period when the income trust experienced a positive net income. This result is not evident from the earnings release. We find this type of presentation to be misleading. The exclusion or minimal prominence of the relevant GAAP measure does not provide investors with an accurate standardized representation of the issuer's current financial results. As stated in SN 52-306, income trusts should prominently disclose and discuss the most directly comparable GAAP measure whenever presenting non-GAAP financial measures.

C. Goodwill

Our review identified some instances where it appears that the goodwill impairment testing required by CICA Handbook Section 3062 *Goodwill and Other Intangible Assets* (S.3062)[4] was not done in an appropriate timeframe. Generally, S.3062 requires that goodwill should be tested for impairment on an annual basis. However, S.3062 also states that goodwill should be tested for impairment between annual tests when an event or circumstance occurs that more likely than not reduces the fair value of a reporting unit below its carrying amount.

Many businesses enjoyed considerable increases in their value on completion of their income trust IPO or through conversion to a trust. The excess of the fair value of the business over the carrying value of the assets has led to significant amounts of goodwill being recorded in the financial statements of many income trusts.

In some cases, income trusts determined that no impairment testing was necessary even though there were a number of factors that suggest the trust had a potential impairment. Specifically, events such as the deterioration in the underlying entity's business climate or the loss of significant customers, suggested that impairment testing was necessary.

[4] Section 3.1 of NI 52-107 *Acceptable Accounting Principles, Auditing Standards and Reporting Currency* requires issuers to prepare their financial statements in accordance with Canadian GAAP, which is defined in NI 14-101 *Definitions* as generally accepted accounting principles determined with reference to the Handbook.

As stated in OSC Staff Notice 51-706 *Corporate Finance Report (2005)*[5], income trusts should use multiple valuation methods to assess the fair value of reporting units whenever goodwill impairment testing is performed, especially when an approach based on quoted market prices does not appear to generate results consistent with indications from external factors.

D. Executive Compensation

Form 51-102F6 *Statement of Executive Compensation* (Form 51-102F6) sets out the disclosure a reporting issuer must make about the compensation paid to its executive officers. Some income trust issuers use an external management company to provide executive management services to the trust and or operating entity. In some instances that we reviewed, due to this external management structure, compensation paid to these executive officers was not fully disclosed in accordance with Form 51-102F6.

The definition of "senior officer" in securities legislation includes any individual who performs functions for an issuer similar to those normally performed by certain named senior positions. The definition of “executive officer” in NI 51-102 includes an individual who is performing a policy-making function in respect of an issuer. The definitions of “CEO” and “CFO”, for the purposes of Form 51-102F6 include each individual who acted in a similar capacity. As stated in OSC Staff Notice 51-706[6], we generally consider the officers of the external management company to be persons performing functions in respect of the trust and the operating company similar to those normally performed by senior officers of a company, including policy-making functions. Consequently, any requirements of securities legislation that apply to senior officers or executive officers of a reporting issuer would usually apply to the executive officers of the external management company.

In particular, as stated in OSC SN 51-706, in addition to disclosing any management fee, incentive fee or other amounts payable by the income trust to the external management company, income trusts should include the executive compensation disclosure required by Form 51-102F6 for the executive officers of the external management company. This disclosure should include any compensation payable directly by the income trust to the executive officers, as well as any compensation payable by the external management company to its executive officers that can be attributed to the management fee or other payments from the income trust (e.g. any salary, bonus, dividends, distributions or other payments).

[5] Part 2, Item A of OSC Staff Notice 51-706. Not all jurisdictions have issued a similar staff notice, however most income trust issuers are reporting issuers in multiple jurisdictions, including Ontario.
[6] Part 2, Item H of OSC Staff Notice 51-706. Not all jurisdictions have issued a similar staff notice, however most income trust issuers are reporting issuers in multiple jurisdictions, including Ontario.

E. Timely disclosure

We identified some events at the operating entity level that appeared to meet the definition of a "material change"[7] for the trust issuers but for which the trusts did not file material change reports. For example, in three instances, a trust's operating entity breached financial covenants under its credit facilities. As a result, in each instance, the trust issuer either suspended or significantly reduced distributions to its unitholders. Although, the filing of the press release announcing the change in distributions had a significant effect on the market price of the trust's units, the issuers argued that these events do not meet the definition of a material change.

For an income trust, a "material change", as it is defined in NI 51-102, includes an event at the operating entity level that results in a change in the business, operations, or capital of the trust that would reasonably be expected to have a significant effect on the trust's unit price. To comply with the material change disclosure requirements in NI 51-102, a trust must therefore assess events that occur at the operating entity level as they affect the trust, particularly if the events impact distributions to unitholders.

F. Material Contracts[8]

We identified three income trust issuers that 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 issuer did not file the original credit facility agreement and subsequently did not file amendments to that agreement. Since most credit facility arrangements entered into by income trust issuers include restrictive financial covenants over the amount of cash the trust may distribute, the material terms of these arrangements should always be available to investors.

Section 12.2 of NI 51-102 requires an issuer to file all material contracts on SEDAR, except contracts that are made in the ordinary course of business. NP 41-201 advises income trust issuers to consider any contract that has a direct correlation with the anticipated cash distributions of the trust to be a material contract that the trust must file with its prospectus. While NP 41-201 does not specifically state this, income trusts should file any changes to these contracts on SEDAR as well as filing any new contracts of this type.

Conclusion

Our findings suggest that, to meet the requirements of NI 51-102, many income trust issuers need to improve the quality and completeness of their disclosure, particularly as it relates to distributable cash disclosures in MD&A. MD&A provided by income trust issuers is critical disclosure for unitholders. It assists them to understand a trust's financial statements and, most importantly, to assess the value of their investments which, for income trusts, depends on the sustainability of distributions.

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[7] Subsection 1.1 of NI 51-102.
[8] Part 2, item C, section 2.8 of NP 41-201.

Questions and comments may be referred to:

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