CSA Staff Notice 41-304 - Income trusts: prospectus disclosure of distributable cash

Purpose

This notice provides guidance on staff's expectations about the nature and extent of disclosure necessary to ensure transparency when an income trust issuer presents information about estimated distributable cash in a prospectus. Estimated distributable cash is a non-GAAP financial measure for which disclosure expectations are outlined in CSA Staff Notice 52-306 *Non-GAAP Financial Measures* (Staff Notice 52-306) and National Policy 41-201 *Income Trusts and Other Indirect Offerings*. This notice expands on guidance provided in those documents.

Issue

Most income trust issuers present information about estimated distributable cash in their prospectuses. Staff Notice 52-306 directs issuers to provide with this non-GAAP financial measure a quantitative reconciliation to the most directly comparable measure calculated in accordance with GAAP.

Based on the disclosure that income trust issuers have provided, it is often difficult to assess the transparency of the estimated distributable cash information. Specifically, the discussion surrounding each reconciling adjustment often provides limited information on the underlying significant estimates and assumptions used to determine the adjustment. In addition, it is difficult to assess whether the reconciliation includes all adjustments that would be necessary for full, true and plain disclosure of estimated distributable cash.

The nature of the reconciling items also varies significantly. In some cases, the reconciling adjustments are based on the issuer's own historical amounts or on the historical amounts of other entities. For example, an income trust issuer may estimate the impact of a recent acquisition based on the acquired entity's previously reported results. In other cases, the adjustments are based entirely on anticipated strategies, programs and actions, which may or may not involve contractual commitments. When any reconciling adjustment is based on the expected economic effects of anticipated future events, it is clear that this presentation is providing a forward-looking perspective on estimated distributable cash. In these instances, the presentation therefore raises many of the same issues that have concerned staff with other forms of future-oriented financial information (FOFI).

Staff Expectations

National Policy 48 *Future-oriented financial information* describes the general expectation that an issuer present FOFI in a prospectus in the format of historical financial statements and that it prepare them in accordance with CICA Handbook Section 4250 *Future-oriented financial information* (a S.4250 forecast). Although this might not always be necessary for the presentation of estimated distributable cash in a prospectus, the issuer should provide sufficient disclosure to help an investor determine whether the adjustments made by management represent a balanced and complete assessment of all factors affecting estimated distributable cash.

General Presentation

We expect issuers to consider the best way to provide transparency about the presentation of each adjusting item including a discussion of the work that was done by the issuer to ensure the completeness and reasonableness of the estimated distributable cash information.

To achieve adequate transparency, the reconciliation of estimated distributable cash to the most directly comparable GAAP measure should be accompanied by detailed disclosure that:

- explains the purpose and relevance of the estimated distributable cash information;
- describes the extent to which actual financial results are incorporated into the reconciliation;
- explicitly states that the reconciliation has been prepared using reasonable and supportable assumptions, all of which reflect the trust's planned courses of action given management's judgment about the most probable set of economic conditions; and
- cautions investors that actual results may vary, perhaps materially, from the forward-looking adjustments.

Underlying Assumptions

We expect adjustments made in the reconciliation of estimated distributable cash to the most directly comparable GAAP measure to be supported by:

- a detailed discussion of the nature of the adjustments;
- a description of the underlying assumptions used in preparing each element of the forward-looking information and the forward-looking information as a whole, including how those assumptions are supported; and
- a discussion of the specific risks and uncertainties that may affect each individual assumption and that may cause actual results to differ materially from the estimated distributable cash figure.

For assumptions to be supportable, they should take into account the past performance of the underlying operating entity, the performance of other entities engaged in similar activities, and any other sources that provide objective corroboration of the assumptions used. Further, for assumptions to be considered reasonable, we believe that they should be consistent with the anticipated plans of the income trust issuer.

In some circumstances, assumptions may be consistent with the issuer's anticipated plans but may not provide an adequate level of transparency about the sustainability of estimated distributable cash. For example, capital expenditures to replace productive capacity may be relatively low in initial years but may rise significantly in later years. In these instances, adequate disclosure of the adjustment for estimated future capital maintenance expenditures might include a discussion of the time period over which the issuer anticipates incurring capital maintenance expenditures at the level disclosed and any expected long-term plans to replace productive capacity.

Another example of providing adequate transparency about the sustainability of estimated distributable cash relates to instances where an issuer makes prior arrangements with investors. For example, for some income trust issuers, the original vendors' entitlement to cash distributions based on their continuing interest is subordinated to that of other investors. The original vendors will not receive cash distributions for a defined period of time if the estimated level of distributable cash disclosed in the prospectus is not achieved. Estimated distributable cash available for distribution to other investors may be higher in the short term while cash distributions are not paid to the original vendors, however may decrease once the subordination conditions are satisfied. In these instances, the key terms and impact of these arrangements should be summarized in proximity to the estimated distributable cash information.

S.4250 forecast and other alternative disclosures

If the estimated distributable cash information includes forward-looking adjustments that are based on significant assumptions[1], and those adjustments materially affect estimated distributable cash, we expect the quantitative reconciliation to begin with a GAAP measure that is derived from a S.4250 forecast. We expect these forward-looking adjustments to be integrated into the S.4250 forecast, and the S.4250 forecast to be included in the prospectus.

A S.4250 forecast may not be necessary if the adjusting items are derived from historical amounts and those amounts can be adequately explained by alternative disclosures. This may include:

- Historical financial statements that support the adjustments. In some cases, a recent acquisition may not be considered significant under the significant

[1] An assumption would usually be considered significant when: (a) it reflects an expectation of economic conditions significantly different from those currently prevailing, (b) there is a relatively high probability of a sizeable variation, or (c) a small change in the assumption would have a significant impact on the forward-looking information.

acquisition tests set out in OSC Rule 41-501 *General Prospectus Requirements* (Rule 41-501) or the equivalent rule in the applicable jurisdiction for purposes of providing financial statements of the acquired entity. However, the acquisition's anticipated impact on distributable cash may be clearly material. In these cases, issuers may choose to provide financial statements of the acquired entity in the prospectus in addition to those required by Rule 41-501, and, when appropriate, to incorporate these financial statements into pro forma financial statements of the issuer; or

- Other historical financial information that supports the calculation of the adjustments.

In some cases, an issuer may include adjusting items that are based on recent contracts or agreements for which historical financial statements or other historical financial information cannot be provided. In these cases, alternative disclosure may include a detailed description of the contract or agreement including the relevant terms and conditions of the contractual commitment and any other financial information that supports the amount of the adjusting item.

We also remind income trust issuers to include appropriate and specific cautionary language and risk disclosure in the prospectus. A simple statement in the prospectus that 'actual results may vary materially from the amounts presented' is not sufficient.

Summary

If an income trust issuer includes forward-looking information such as estimated distributable cash in its prospectus, the prospectus should contain adequate disclosure about any forward-looking adjustments. We advise income trust issuers that the expectations in this notice will be reflected in our prospectus review comments. The expectations in this notice will also be considered by staff when analyzing similar issues arising in other contexts or documents. We remind issuers that staff may recommend to the Director that a receipt for a prospectus not be issued where, due to inadequate disclosure, issuing a receipt for the offering would appear to be contrary to the public interest.

We invite feedback on this notice. We plan to continue monitoring developments with respect to the issues addressed in this notice, as well as any feedback that we receive. We may provide future additional guidance by updating this notice or through other instruments.

Questions or feedback on this notice may be referred to:

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