

**The Valuation of Canadian Income Trusts:
Do Investors See Through Distributable Cash Management?**

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Abstract

In this paper, we investigate if and why income trusts manipulate the calculation and reporting of distributable cash, and whether investors see through distributable cash management. Using Standardized Distributable Cash as a benchmark, we find that income trusts use their discretion to overstate distributable cash when they would otherwise report a decrease in Standardized Distributable Cash, when managerial ownership is higher, and when board ownership is higher. Income trusts that experience a decline in yield from the previous year seem to record higher over distributions, while income trusts with higher managerial equity incentives record lower over distributions. Results also seem to indicate that independent directors/trustees constrain managers' ability to pay distributions higher than disclosed distributable cash to protect unit value. Finally, we find that Standardized Distributable Cash and discretionary distributable cash are valued positively, while over (under) distributions are valued negatively. In our view, this finding substantiates the primacy of cash distributions in the valuation of income trusts, with management's use of discretion in the calculation of distributable cash making possible stability in that regard.

Keywords: income trusts, earnings management, non-GAAP measures, cash distributions, corporate governance.

1. Introduction

This paper investigates how investors value Canadian income trusts. More specifically, do investors focus on reported distributable cash or do they see through distributable cash management and adjust for its systematic overstatement? In contrast to corporations, which mandate, constitution and governance are set within the parameters of the Business Corporations Act, each income trust is a distinct legal entity, governed by a private trust deed, and so structured as to control an underlying operating company or a set of income generating assets. The trust's key focus is to maximize its periodic cash distributions to unitholders so that it does not retain any excess cash. Up until October 2006, income trusts were the top-selling product on Canadian securities markets (Toronto Star, October 27 2005). The total market capitalization of income trusts went from less than 20 billion dollars in January 2000 to more than 200 billion dollars in March 2006, i.e. more than 10% of the market capitalization of all companies traded on the Toronto Stock Exchange (TSX) (Standard & Poor's, April 10 2006). Initial public offerings (IPOs) of income trust units dominated the market for new equity issues, and the largest IPO ever made in Canada, the Yellow Pages Income Trust, raised more than 3 billion dollars (Globe and Mail, July 6 2005).

Despite their popularity, income trusts have been criticized extensively. Such criticisms essentially revolve around three issues. First, income trust governance is relatively unchartered, as trusts do not have trustees but trustees, which powers and responsibilities are governed by a private trust deed, not by corporate laws. Second, until 2007, the measurement of distributable cash was solely at the discretion of an income trust's management and completely outside the scope of regulators' standards or

guidelines. This unregulated context contributed to the so-called distributable cash game with income trusts managing the distributable cash figure to deceive investors about the sustainability of cash distributions (Canadian Business, October 10 2005). Third, to assess the value and performance of income trusts, investors and financial analysts examine the level and stability of past cash distributions and forecast future distributions. Rating agencies also publish stability ratings to help in assessing the stability of future distributions.² A trust that either cuts or suspends distributions is called a “fallen angel” because the announcement often results in a large decrease in unit price. Moreover, the yield demanded by investors generally increases with the risk of a cut or suspension in distributions. In light of investors’ fixation on cash distributions, income trusts have strong incentives to maintain a stable or increasing trend in distributions from year to year, possibly in a way that is detrimental to long term value creation.

Our investigation provides the following results. First, it appears that income trusts use their discretion to overstate distributable cash when they would otherwise report a decrease in Standardized Distributable Cash, when managerial ownership is higher, and when board ownership is higher. Second, income trusts that experienced a decline in yield from the previous year seem to record higher over distributions. In contrast, income trusts with higher managerial equity incentives record lower over distributions. Independent directors/trustees impose some constraint upon managers’ ability to pay distributions higher than disclosed distributable cash to protect unit value.

² For example, Dominion Bond Rating System (DBRS) provides stability ratings that measure the volatility and sustainability of distributions per fund unit over time. DBRS’ stability ratings consider seven main factors, among which the stability and sustainability of EBITDA.

Finally, we find that investors value positively Standardized Distributable Cash and discretionary distributable cash if reporting discretionary distributable cash allows income trusts to maintain their cash distributions. However, if the cash distribution exceeds disclosed distributable cash, then the over distribution component is negatively valued as it constitutes a return of capital.

The rest of the paper is organized as follows. Section 2 describes the institutional environment in which income trusts are evolving. Research propositions are developed in Section 3. The method is presented in Section 4. Results are discussed in Section 5. Finally, Section 6 concludes and discusses the paper's contributions.

2. Background

2.1 Income Trusts and their Institutional Environment

An income trust is a legal entity structured to hold equity and interest-bearing debt from an underlying operating company that operates a business (e.g. public, restaurants, consumer product companies and manufacturing companies) or holds a set of income generating assets (e.g. real estate, oil and gas properties, and mining properties). The operating company might be a private company that decides to raise financing through an income trust vehicle in a manner similar to a traditional IPO; a private or public company that decides to spin off part of its business into an income trust; or a public company that decides to convert its common shares into trust units without any new financing (Jog and Wang, 2004). The income trust is legally required to distribute any money generated to its unitholders. To maximize periodic cash distributions to unitholders, the trust ideally owns mature assets that require little ongoing capital

expenditures, face little competition and provide a predictable stream of cash flows (King, 2003) (see Figure 1).

{Insert Figure 1 here}

Income trusts differ from regular corporations because they are a flow-through structure that allows income to be taxed at the investor level only. Interest payments to the income trust reduce the operating company's taxable income and minimize corporate taxes at the operating company level. The income trust then distributes the interest earned to unitholders and claims a deduction on its taxable income for the distributions, to achieve the goal of distributing all taxable income for the year. Finally, investors tax themselves on the distributions according to their individual circumstances. Therefore, they can receive a higher level of cash distribution than is possible when the same assets are held by a corporation (King, 2003).³

Income trusts have a median distribution of 87% of cash flow from operations as compared to a median distribution of 7% of cash flow from operations for comparable corporations (Halpern and Norli, 2003). Rating agencies also publish stability ratings to help in assessing the stability of future distributions. Dominion Bond Rating Services' stability rating measures the stability and sustainability of cash distributions per fund unit over time (DBRS, 2004). Standard & Poor's stability rating measures the prospective relative sustainability and variability of an income trust's distributable cash flows (Standard & Poor's, 2005). Unfortunately, stability ratings are only available for approximately 10% of listed income trusts.

³ While Bill C-52 essentially ended income trusts' tax advantage (except for real estate investment trusts), it did not eradicate them as many have been taken over and others intend to take full advantage of the tax benefits until 2011, at which point they will be subjected to a flat income tax.

Canadian Business reports a 77% average decline in unit price of the 13 business trusts that have suspended distributions in 2006 (Canadian Business, September 25 2006). Investors are then left with an investment that pays less income and has declined in value (Globeadvisor.com, March 29 2006). Consequently, the yield demanded by investors increases with the risk of a cut or suspension in distributions.⁴ Overall, given the impact of a cut or suspension of distributions on unit price and yield, income trusts have strong incentives to maintain a stable or increasing trend in distributions from year to year. In the next section, we discuss the opportunities offered to management by the high degree of discretion allowed in the calculation of distributable cash to meet that objective.

2.2 Distributable Cash

Distributable cash drives the level of cash distributions. Distributable cash generally refers to the net cash generated by the income trust's businesses or assets, as estimated by management, which is available for distribution to unitholders (CSA, 2004). The measurement and recognition of distributable cash is problematic. Staff Notice 52-306 – Non-GAAP Earnings Measures explicitly identifies distributable cash as a non-GAAP financial measure. Hence, income trusts are asked to provide a reconciliation of distributable cash to the most directly comparable measure calculated in accordance with GAAP (preferably cash flows from operations). They are expected to discuss the reconciling items, especially when they are discretionary in nature (CSA, 2003). Unfortunately, Staff Notice 52-306 neither provides a single definition for distributable

⁴ The yield is calculated by dividing the annual distribution rate by the unit price and multiplying the result by 100.

cash nor specific measurement requirements, thus leading a wide range of practices (CICA, 2007).

In a report published in 2004, the CSA reviewed the continuous disclosure records of 40 income trusts, of which 18 included a statement of distributable cash in the MD&A, 16 presented distributable cash information in a note to financial statements, 3 presented distributable cash as a separate financial statement, and 3 did not present distributable cash information. Moreover, 9 trusts presented distributable cash figures without a reconciliation to the audited financial statements; 26 provided a reconciliation between distributable cash and net earnings; and the remainder provided a reconciliation with some other financial measure such as earnings before interest, taxes, depreciation and amortization (EBITDA), net cash from operations, or cash and cash equivalents (CSA, 2004). In a similar report published in early 2006, Standard & Poor's examined distributable cash calculations among a sample of 40 income trusts. 19 different terms (e.g. cash available for distribution, amount available for distribution, net cash available to unitholders) were used to characterize distributable cash (Standard & Poor's, 2006a). After adjusting for an average two-year reporting distortion of 26%, 30% of the income trusts had distributable cash that was lower than what was reported by management and insufficient to cover distributions over a two- to three-year period (Standard & Poor's, 2006b).

The distributable cash game is played by many trusts that take advantage of the lack of consistency and transparency in its measurement and reporting, with many arguing that some trusts with excessive distributions share attributes with Ponzi schemes (Canadian Business, October 10 2005; CSA, 2007).

The CSA (Canadian Securities Administrations) issued revisions to National Policy 41-201 – Income Trusts and Other Indirect Offerings in July 2007. National Policy 41-201 states that “distributable cash is fairly presented only when reconciled to cash flows from operating activities as presented in the income trust’s financial statement, including changes in non-cash working capital”. It recommends the grouping of adjustments to cash flows from operating activities into one of the following categories: 1) capital adjustments; 2) non-recurring adjustments; and 3) other adjustments including discretionary items, together with a detailed discussion of the nature of the adjustments (CSA, 2007). However, it still does not provide a single definition for distributable cash. Within a few days of the issuance of National Policy 41-201, the CICA’s Canadian Reporting Performance Board (CPRB) issued its final Interpretative Release – Standardized Distributable Cash in Income Trusts and Other Flow-Through Entities, a non-mandatory guidance document. The CPRB defines Standardized Distributable Cash as “the periodic cash flows from operating activities as reported in the GAAP financial statements, including the effects of changes in non-cash working capital and any operating cash flows provided from or used in discontinued operations, less adjustments for total capital expenditures as reported in the GAAP financial statements; restrictions arising from compliance with financial covenants restrictive at the date of calculation; and limitations arising from the existence of a minority interest in a subsidiary. No other adjustments for one-time or unusual items should be made to cash flows from operating activities in the calculation of Standardized Distributable Cash” (CICA, 2007). The Interpretative Release provides a conceptual framework to assess

income trusts' calculation and reporting practices prior to its adoption. The conceptual framework, as well as our research propositions, is discussed in the next section.

3. Standardized Distributable Cash and Research Propositions

3.1 Standardized Distributable Cash

In the absence of a standardized definition for distributable cash or specific requirements regarding its calculation and reporting, income trusts' managers can manipulate the distributable cash figure to appear to 1) pay a distribution that is lower or equal to distributable cash; and 2) maintain a stable or increasing trend in distributions. The concept of Standardized Distributable Cash provides a standardized measure of distributable cash.

Prior to the adoption of the CICA's Interpretative Release, there were two identifiable components to the cash distribution: 1) disclosed distributable cash; and 2) the difference between the cash distribution and disclosed distributable cash, which we call the over (under) distribution. Using Standardized Distributable Cash as the benchmark to the calculation of the cash distribution allows us to now split the distribution in three components: 1) Standardized Distributable Cash; 2) the difference between disclosed distributable cash and Standardized Distributable Cash, which we call discretionary distributable cash; and 3) the over (under) distribution. Under the latter, income trusts would have incentives to maximize discretionary distributable cash and minimize over distributions to appear to pay a distribution that is lower or equal to distributable cash; and maintain a stable or increasing trend in distributions.

The example below illustrates the three components of the distribution for a trust that discloses a distributable cash figure higher than Standardized Distributable Cash, and

pays a distribution lower than disclosed distributable cash. In the example, the trust discloses a distributable cash figure of \$1.05 per unit. The calculated standardized distributable cash is \$0.75 per unit. The difference between disclosed distributable cash and standardized distributable cash, discretionary distributable cash is \$0.30 per unit. The declared distribution is \$1.00 per unit. The difference between disclosed distributable cash and the declared distribution, the under distribution is \$0.05 per unit. The example shows how a trust can overstate the distributable cash figure to give the impression of being conservative (i.e. paying a distribution lower than distributable cash) while actually paying a distribution higher than Standardized Distributable Cash, the real cash generated by the operating activities after capital expenditures.⁵ In the next section, we discuss economic and governance factors that could explain such behaviour.

Standardized Distributable Cash	\$0.75
Discretionary distributable cash	<u>\$0.30</u>
Disclosed distributable cash	\$1.05
Under distribution	<u>(\$0.05)</u>
Declared distribution	\$1.00

3.2 Factors that May Influence Measurement of Distributable Cash and Cash Distributions

We now discuss the four factors that, in our view, are likely to influence the measurement of distributable cash as well as cash distributions by income trusts.

⁵ For example, the income trust could exclude the changes in the working capital accounts or capital expenditures from the calculation of disclosed distributable cash.

Smoothing: Given their incentive to show a stable or increasing trend in distributable cash and cash distributions, income trusts are more likely to overstate the disclosed distributable cash figure than to understate a disclosed distributable cash figure that is larger than the previous year. Means to achieve that end include an understatement of maintenance capital expenditures, use discretionary adjustments, drawing down distributable cash reserve, etc. If income trusts overstate disclosed distributable cash to avoid reporting a decrease, then trusts with a decrease in Standardized Distributable Cash will record higher discretionary distributable cash.

Managerial Equity Incentives. Much prior research suggests that equity incentives encourage managers to increase short term share prices with discretionary financial disclosures or accounting manipulations (e.g., Cheng & Warfield, 2005; Lev, 1992; Efendi, Srivastava, and Swanson, 2005). Hence, to avoid a decrease in unit price, managers of trusts with higher equity incentives may have an incentive to overstate disclosed distributable cash and minimize over distributions. If such is the case, trusts with higher managerial equity incentives will record higher discretionary distributable cash. They will record lower over distributions.

Board Ownership. To align the interests of directors/trustees with those of shareholders, regulators and governance activists (e.g. the Coalition for Good Governance) recommend that trustees have a significant investment in the shares of the entities they govern. However, the increase in shareholdings also increases the importance, and potential benefits, of insider trading to trustees, thus encouraging earnings management (Ronen et al., 2006). Therefore, if unit ownership makes trustees more sensitive to changes in unit price and leads them to support managerial opportunism

that results in higher unit prices, then trustees with higher ownership will let managers overstate disclosed distributable cash. However, they will avoid distributions in excess of disclosed distributable cash. If such is the case, trusts with higher director ownership will record higher discretionary distributable cash. They will record lower over distributions.

Board Independence. A board of directors/trustees must promote accurate, high quality and timely disclosure of financial and other material information to the public markets, and to shareholders (Blue Ribbon Committee, 1999). An important function of the board of directors/trustees is also to ensure that management is working in the best interests of the corporation and its shareholders to enhance corporate economic value (Fama and Jensen, 1983). In that regard, there is evidence that an independent board will lead a firm to engage in less earnings management (Agrawal and Chadha, 2005; Beasley, 1996; Dechow et al., 1996; Bedard et al., 2004; Klein, 2002; Xie et al., 2003). Thus, income trusts with a higher proportion of independent directors/trustees on the board will record lower discretionary distributable cash. Independent directors/trustees should also limit managers' ability to declare a distribution higher than disclosed distributable cash to protect unit value. If such is the case, then trusts with a higher proportion of independent directors/trustees on the board will record lower over distributions.

3.3 Valuation of Distribution Components

Our next research question is whether investors see through distributable cash management, i.e. whether and how they value the three components of cash distributions. Prior theoretical work (Bhattacharya, 1979; Miller and Rock, 1985) and empirical evidence (Aharony and Swary, 1980; Asquith and Mullins, 1983) document the potential

information content of dividends. Prior research also shows that a decision by a firm to change its dividend provides investors with a credible signal about its future prospects. In other words, a change in dividends is a benchmark that adds credibility to reported earnings. Sivakumar and Waymire (1993) as well as Cormier et al. (2000) document that in an environment with few mandatory disclosure requirements or restrictions on accounting methods, dividends and dividend changes are value-relevant to a greater extent than reported earnings. This suggests that investors will value positively both standardized and discretionary distributable cash if discretionary distributable cash allows income trusts to maintain their cash distributions. However, if the cash distribution exceeds disclosed distributable cash, then the over distribution component should be negatively valued as it constitutes a return of capital.

4. Method

4.1 Sample and Data

Sample income trusts are drawn from Investcom (www.investcom.com). Financial data is obtained from Compustat, Stock Guide and annual reports. Governance and compensation data is obtained from sample trusts' proxy statements. Investcom lists 241 income trusts as at December 1, 2005, and 176 of the 241 income trusts are found in Compustat. Data is pooled over the 2000-2005 period. Overall, complete data is available for 521 income trust-year observations for the distributable cash management tests and 532 trust-year observations for the valuation tests.

4.2 Models and Variables

4.2.1 Determinants of Discretionary Distributable Cash

The following pooled regression model is used to examine the determinants of discretionary distributable cash:

$$DISCRDCASH_{i,t} = \beta_0 + \beta_2 CHANGESTDDCASH_{i,t} + \beta_3 OPTIONS_{i,t} + \beta_4 TRUSTEESOWN_{i,t} + \beta_5 TRUSTEESIND_{i,t} + \beta_6 OWN_{i,t} + \beta_7 SIZE_{i,t} + TYPE_{i,t} + \varepsilon_{i,t}$$

(1)

Where:

<i>DISCRDCASH</i>	=	Disclosed distributable cash for year t minus Standardized Distributable Cash for year t scaled by the number of units outstanding at the end of year t
<i>CHANGESTDDCASH</i>	=	1 if Standardized Distributable Cash for year t is lower than Standardized Distributable Cash for year t-1; 0 otherwise
<i>OPTIONS</i>	=	Average value of “in the money” stock options held by the top paid executives at the end of year t divided by their total compensation for year t
<i>TRUSTEESOWN</i>	=	Total number of units owned by the trustees at the end of year t scaled by the number of units outstanding at the end of year t
<i>TRUSTEESIND</i>	=	Percentage of outsiders on the board of trustees for year t, as disclosed in the trust’s proxy statement
<i>OWN</i>	=	1 if an external shareholder controls more than 10 percent of outstanding votes at the end of year t (i.e. the trust is closely-held); 0 otherwise
<i>SIZE</i>	=	Natural logarithm of lagged total assets
<i>TYPE</i>	=	Business, real estate, resource or utility trust as per Investcom’s classification

Discretionary distributable cash (*DISCRDCASH*) is the difference between disclosed and Standardized Distributable Cash for year t. Thus, *DISCRDCASH* is positive if disclosed distributable cash is higher than Standardized Distributable Cash (i.e. overstated) and negative if disclosed distributable cash is lower than Standardized Distributable Cash (i.e. understated). Standardized Distributable Cash is calculated in accordance with the CICA’s Interpretative Release, i.e. periodic cash flows from operating activities as reported in the GAAP financial statements less adjustments for

total capital expenditures as reported in the GAAP financial statements and limitations arising from the existence of a minority interest in a subsidiary. Distributions paid to minority unitholders for year t are used to proxy for the limitations arising from the existence of a minority interest in a subsidiary.

CHANGESTDDCASH measures income trusts' incentives to overstate disclosed distributable cash in order to maintain a constant or increasing level of distributable cash from year to year. Accordingly, we expect *CHANGESTDDCASH* to be positively related to discretionary distributable cash. We use the average value of the in-the-money options held by top managers in proportion to their annual compensation (*OPTIONS*) to proxy for the importance of managerial equity incentives. We expect *OPTIONS* to be positively related to discretionary distributable cash. *TRUSTEESOWN* measures board ownership. We expect *TRUSTEESOWN* to be positively related to discretionary distributable cash. Finally, *TRUSTEESIND* is the percentage of independent directors/trustees on the board. We expect *TRUSTEESIND* to be negatively related to discretionary distributable cash.

Two control variables are included in the model (*OWN*, *SIZE*). We control for ownership because prior research shows that reporting incentives of closely-held firms tend to differ (Hogler & Hunt, 1993). Firm size is included as a control variable to proxy for various aspects of the income trust.

4.2.2 Determinants of Over (Under) Distributions

The following pooled regression model is used to examine the determinants of over (under) distributions:

$$EXCDISTR_{i,t} = \beta_0 + \beta_1 CASH_{i,t} + \beta_2 CUMRESERVE_{i,t} + \beta_3 DEVDCASH_{i,t} + \beta_4 OPTIONS_{i,t} + \beta_5 TRUSTEESOWN_{i,t} + \beta_6 TRUSTEESIND_{i,t} + \beta_7 OWN_{i,t} + \beta_8 SIZE_{i,t} + TYPE_{i,t} + \varepsilon_{i,t}$$

(2)

Where :

<i>EXCDISTR</i>	=	Distribution for year t – disclosed distributable cash for year t scaled by the number of units outstanding at the end of the year t
<i>CASH</i>	=	Cash and cash equivalents at the end of year t scaled by the number of units outstanding at the end of year t
<i>CUMRESERVE</i>	=	Cumulative distributable cash reserve at the beginning of year t scaled by the number of units outstanding at the end of year t
<i>DEVDCASH</i>	=	1 if disclosed distributable cash for year t is lower than disclosed distributable cash for year t-1; 0 otherwise
<i>OPTIONS</i>	=	Average value of “in the money” stock options held by the top paid executives at the end of year t divided by their total compensation for year t
<i>TRUSTEESOWN</i>	=	Total number of units owned by the trustees at the end of year t scaled by the number of units outstanding at the end of year t
<i>TRUSTEESIND</i>	=	Percentage of outsiders on the board of trustees for year t, as disclosed in the trust’s proxy statement
<i>OWN</i>	=	1 if an external shareholder controls more than 10 percent of outstanding votes at the end of year t (i.e. the trust is closely-held); 0 otherwise
<i>SIZE</i>	=	Natural logarithm of lagged total assets
<i>TYPE</i>	=	Business, real estate, resource or utility trust as per Investcom’s classification

EXCDISTR is the difference between the distributions declared during year t and disclosed distributable cash for year t. Thus, *EXCDISTR* is positive if declared distributions exceed disclosed distributable cash and negative if declared distributions are lower than disclosed distributable cash. Income trusts are more likely to pay a distribution higher (lower) than distributable cash if they have (don’t have) cash available to pay the distribution. As such, we expect *CASH* to be positively related to *EXCDISTR*. *CUMRESERVE* is calculated by adding the difference between disclosed distributable cash and declared distributions for each sample year prior to year t. *CUMRESERVE* will

be positively related to *EXCDISTR* if trusts use the available distributable cash reserve to justify paying a distribution higher than disclosed distributable cash for the year (i.e. they draw from the distributable cash reserve). It will be negatively related to *EXCDISTR* if it captures trusts' historical tendency to declare distributions lower or higher than disclosed distributable cash. Hence, we do not make any directional prediction for *CUMRESERVE*.

DEVDCASH measures income trusts' incentives to declare distributions higher than distributable cash in order to maintain a constant or increasing level of distributions from year to year. Accordingly, we expect *DEVDCASH* to be positively related to *EXCDISTR*. We use the same proxy for managerial equity incentives. We expect *OPTIONS* to be negatively related to *EXCDISTR*. *TRUSTEESOWN* measures board ownership. We expect *TRUSTEESOWN* to be negatively related to *EXCDISTR*. Finally, *TRUSTEESIND* is the percentage of directors/independent trustees on the board. We expect *TRUSTEESIND* to be negatively related to *EXCDISTR*.

Two control variables are included in the model (*OWN*, *SIZE*). We control for ownership because prior research shows that reporting incentives of closely-held firms tend to differ (Hogler & Hunt, 1993). Firm size is included as a control variable to proxy for various aspects of the income trust.

4.2.3 Valuation of Distribution Components

The following pooled regression is used to examine the value-relevance of distribution components, incremental to book value:

$$\begin{aligned}
 PRICE_{i,t} = & \beta_0 + \beta_1 BVALUE_{i,t} + \beta_2 STDDCASH_{i,t} + \beta_3 DISCRDCASH_{i,t} + \beta_4 EXCDISTR_{i,t} \\
 & + TYPE_{i,t} + \varepsilon_{i,t}
 \end{aligned}
 \tag{3}$$

Where:

<i>PRICE</i>	=	Price at the end of year t
<i>BVALUE</i>	=	Book value at the end of year t scaled by the number of units outstanding at the end of year t
<i>STDDCASH</i>	=	Standardized Distributable Cash for year t scaled by the number of units outstanding at the end of year t
<i>DISCRDCASH</i>	=	Disclosed distributable cash for year t minus Standardized Distributable Cash for year t scaled by the number of units outstanding at the end of year t
<i>EXCDISTR</i>	=	Distribution for year t – disclosed distributable cash for year t scaled by the number of units outstanding at the end of the year t
<i>TYPE</i>	=	Business, real estate, utility or resource trust as per Investcom’s classification

We expect book value per share (*BVALUE*), Standardized Distributable Cash per share (*STDDCASH*), and discretionary distributable cash (*DISCRDCASH*) to be positively related to unit price; and the over (under) distribution (*EXCDISTR*) to be negatively related to unit price.

5. Results

5.1 Descriptive Statistics

Table 1 presents the industry and category distribution of sample income trusts. Investcom.com identifies four different categories of income trusts: Business, Resource, Utilities and Real Estate. We rely on Investcom.com’s classification. The larger sample size is consistent with the increased use of the income trust structure over the period.

{Insert Table 1 here}

Table 2 presents descriptive statistics for the variables included in the regression models. Table 2 shows median (average) Standardized Distributable Cash of \$0.7366 (\$0.4004) per unit and median (average) discretionary distributable cash of \$0.3500 (\$0.9577) per unit. This suggests that the median (average) income trust takes advantage of the available discretion to overstate disclosed distributable cash by 32% (71%).

Sample trusts exhibit a median (average) under distribution of \$0.0716 (\$0.1890) per unit. However, when the distribution is compared to Standardized rather than disclosed distributable cash, the median (average) distribution paid exceeds Standardized Distributable Cash by \$0.2784 (\$0.7687) per unit. Thus, the overstatement of disclosed distributable cash potentially allows sample trusts to mislead investors as to the nature of the distribution they receive (return of capital as opposed to return on capital).

The median income trust experiences an increase in Standardized Distributable Cash as well as in disclosed distributable cash from the year before (both *CHANGESTDDCASH* and *DEVDCASH* have a zero median). The median income trust also does not appear to rely on managerial equity incentives (*OPTIONS* has a zero median). However, this can be partially explained by the fact that trusts that use a management company to manage the operating company tend to disclose the total management fees paid rather than the summary compensation table required by securities regulators. Disclosure improves with time, perhaps as a sign that regulators' pressures were successful. Furthermore, on average, the value of top executives' in-the-money options represents 60.47% of their total compensation. Directors/trustees own an average of 4.84% (median of 1.01%) of the outstanding units, potentially to align their interests with those of the shareholders. Finally, 75% (74.08%) of the directors/trustees on the board of the median (average) trust are independent. This percentage seems high given that governance is not regulated in the income trust industry, with some people going as far as comparing it to the Wild West (Report on Business, October 25, 2006). It could be due to the fact that we base our classification on the information disclosed by the trusts in

their proxy statements. Since there is no standardized definition of an independent director/trustee, trusts can exercise discretion as to whom they consider as outsiders.

The median (average) trust has cash of \$0.1311 (\$0.3538) per unit and a cumulative distributable cash reserve of \$0.0000 (\$0.1864) per unit. Hence, the overstatement of disclosed distributable cash can also allow for the creation of artificial distributable cash reserves. Finally, the median (average) unit price is \$12.55 (\$14.13) and the median (average) book value per unit is \$8.33 (\$8.08).

{Insert Table 2 here}

Untabulated analyses reveal that a high percentage of trusts (79%) pay a distribution that is lower than the distributable cash that they voluntarily report. However, once we replace income trusts' self-reported measures of distributable cash by the CICA's suggested measure of Standardized Distributable Cash, most (68%) trusts exhibit a distribution lower than disclosed distributable cash.

5.2 Multivariate Results

Table 3 presents the results of the pooled regression examining the determinants of discretionary distributable cash. We use the Hausman specification test to decide on the use of a random or fixed effects model. We obtain a Chi2 statistic of 8.02 ($p < 0.237$), which indicates that the random effects is the best model. The random-effects model is significant ($p < 0.000$) with a R^2 of 24.92%. All reported t-statistics are based on robust standard errors. Consistent with our prediction, the coefficient on *CHANGESTDDCASH* is positive and significant ($p < 0.000$). This seems to suggest that income trusts use their

discretion to overstate distributable cash and avoid reporting a decrease in distributable cash and cash distributions. Also consistent with our prediction, the coefficient on *OPTIONS* is positive and significant ($p < 0.038$). This result suggests that managers of trusts with higher equity incentives have an incentive to overstate disclosed distributable cash to avoid a decrease in unit price. The coefficient on *TRUSTEESOWN* is also positive and significant ($p < 0.041$). Thus, it would seem that unit ownership makes trustees more sensitive to changes in unit price and leads them to support managerial opportunism in the form of overstated disclosed distributable cash. A higher proportion of independent trustees on the board does not seem to constrain managers' ability to manipulate the distributable cash figure since the coefficient for *TRUSTEESIND* is positive and not significant ($p < 0.175$). None of the other coefficients are significant.

{Insert Table 3 here}

Table 4 presents the results of the pooled regression examining the determinants of over (under) distributions. We use the Hausman specification test to decide on the use of a random or fixed effects model. We obtain a Chi2 statistic of 404.67 ($p < 0.000$), which indicates that the fixed effects is the best model. The fixed-effects model is significant ($p < 0.000$) with a R^2 of 8.80%. The coefficient on *CASH* is positive, but not significant ($p < 0.333$). This seems to indicate that income trusts are not influenced by the level of cash available to pay the distribution when they decide on the level of the distribution. The coefficient on *CUMRESERVE* is negative and significant ($p < 0.002$). As such, *CUMRESERVE* seems to capture trusts' historical tendency to declare distributions lower or higher than disclosed distributable cash. The coefficient on *SIZE* is negative and significant ($p < 0.000$), suggesting that larger trusts are less likely to pay a

distribution higher than disclosed distributable cash. Finally, the coefficient on *OWN* is not significant.

Our results support most of our research propositions. *DEVDCASH* is positively associated with *EXCDISTR*, and the association is significant ($p < 0.000$). Thus, trusts seem more likely to pay a distribution higher than disclosed distributable cash if they experienced a decline in disclosed distributable cash from the previous year. *OPTIONS* is negatively associated with *EXCDISTR*, and the association is marginally significant ($p < 0.094$). This suggests that managers with higher equity incentives avoid paying a distribution higher than disclosed distributable cash to protect unit price.

TRUSTEESOWN is positive and not significant ($p < 0.402$). Finally, *TRUSTEESIND* is negative and significant ($p < 0.043$). This seems to indicate that independent directors/trustees constrain managers' ability to pay distributions higher than disclosed distributable cash to protect unit value.

{Insert Table 4 here}

Table 5 presents the results of the pooled regression examining the value-relevance of Standardized Distributable Cash, discretionary distributable cash and over (under) distributions, incremental to book value. We use the Hausman specification test to decide on the use of a random or fixed effects model. We obtain a Chi2 statistic of 117.40 ($p < 0.000$), which indicates that the fixed effects is the best model. The fixed-effects model is significant ($p < 0.000$) with a R^2 of 39.01%. The coefficient on *BVALUE* is positive and significant as predicted ($p < 0.000$). Standardized Distributable Cash and discretionary distributable cash are both positively associated with unit price and the association is significant ($p < 0.001$ and $p < 0.003$). This result is consistent with either of

two scenarios: 1) investors are not able to see through distributable cash management and use disclosed distributable cash as a benchmark measure; or 2) investors value both measures positively because discretionary distributable cash allows income trusts to maintain their cash distributions. Finally, the coefficient on *EXCDISTR* is negative and significant as predicted ($p < 0.018$). This seems to suggest that investors appropriately consider over distributions as a return of capital, rather than a return on capital. Similarly, it seems to indicate that investors react positively to the decision to retain available distributable cash by paying a distribution lower than disclosed distributable cash.

{Insert Table 5 here}

6. Conclusion

This paper investigates whether and how reporting incentives and constraints influence income trusts' calculation and reporting of distributable cash and cash distributions. We also examine whether investors see through distributable cash management. Using Standardized Distributable Cash as the starting point to the calculation of the cash distribution, we split declared distributions in three components: 1) Standardized Distributable Cash; 2) the difference between disclosed distributable cash and Standardized Distributable Cash, which we call discretionary distributable cash; and 3) the difference between the cash distribution and disclosed distributable cash, which we call the over (under) distribution.

First, we investigate the determinants of discretionary distributable cash. Our results suggest that income trusts use their discretion to overstate distributable cash when they would otherwise report a decrease in Standardized Distributable Cash, and when managerial and board ownership is higher. Second, we examine the determinants of over

(under) distributions. After controlling for the cash available to pay the distribution and the cumulative distributable cash reserve at the beginning of the period, we find that income trusts that experienced a decline in disclosed distributable cash from the previous year seem to record higher over distributions, but that income trusts with higher managerial equity incentives record lower over distributions. Our results also seem to indicate that independent directors/trustees constrain managers' ability to pay distributions higher than disclosed distributable cash to protect unit value. Finally, we examine whether and how the market values the three components of cash distributions, incremental to book value. Our results show a positive association between Standardized Distributable Cash and unit price, and discretionary distributable cash and unit price; and a negative association between over (under) distributions and unit price. In our view, this finding substantiates the primacy of cash distributions in the valuation of income trusts, with management's use of discretion in the calculation of distributable cash making possible stability in that regard.

On October 31, 2006, the federal government of Canada announced its intention to impose taxes on Canadian flow-through entities (including income trusts) in a manner similar to corporations, and Bill C-52 received Royal assent on June 22, 2007.

Commonly referred to as the "Halloween Massacre", the announcement put an end to the conversion frenzy and resulted in a loss of \$19 billion in market capitalization in the first day of trading alone. Thus, critics have expressed concerns over the fact that the CICA's recommendations are a little late in coming (MacIntyre, 2007). Nevertheless, according to Standard & Poor's (2007a), accounting and disclosure issues remain of utmost importance to the income trust market and are in no way diminished by Bill C-52 because

investors are still exposed to significant information risk in the transition period. Our results support the CSA's and CICA's initiative by showing that income trusts take advantage of the high degree of discretion allowed in the calculation and reporting of distributable cash to overstate distributable cash and maintain a stable or increasing trend in distributions.

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Figure 1
Structure of an Income Trust

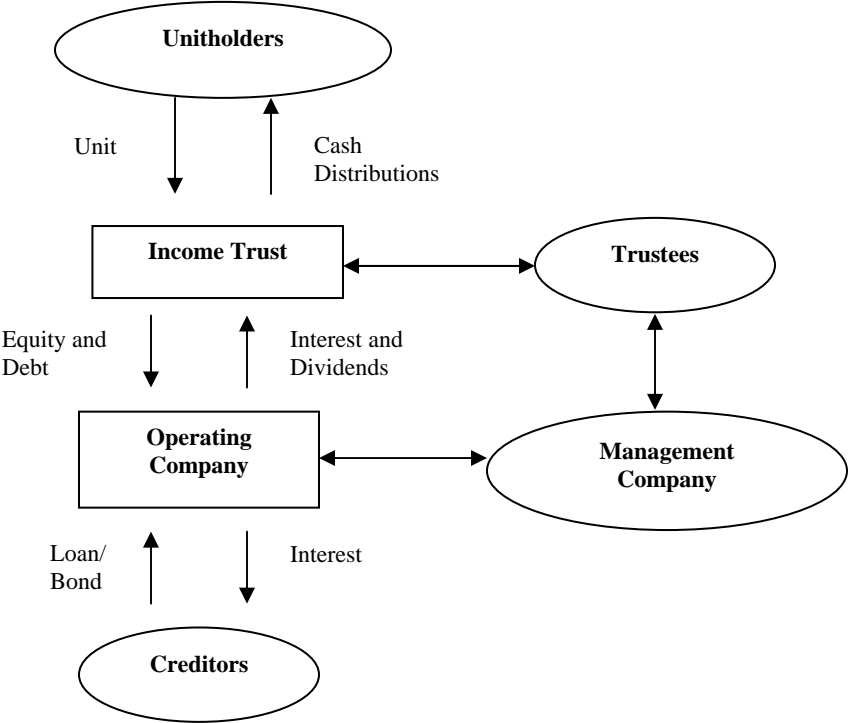


Table 1
Sample by Type and Year

	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>Total</u>
Business	10	10	41	52	63	59	235
Real Estate	11	13	19	24	23	22	112
Utilities	4	3	7	10	13	12	49
Resource	8	11	18	27	29	32	125
Total	33	37	85	113	128	125	521

Table 2
Descriptive Statistics

Variable**	Mean	Median	Minimum	Maximum
<i>STDDCASH</i>	0.4004	0.7366	-18.5092	4.0501
<i>DISCRDCASH</i>	0.9577	0.3500	-1.4450	19.5843
<i>CHANGESTDDCASH</i>	0.2994	0.0000	0.0000	1.0000
<i>OPTIONS</i>	0.6047	0.0000	0.0000	24.2400
<i>TRUSTEESOWN</i>	0.0484	0.0101	0.0000	0.5976
<i>TRUSTEESIND</i>	0.7408	0.7500	0.3333	1.0000
<i>OWN</i>	0.5509	1.0000	0.0000	1.0000
<i>SIZE</i>	6.0036	6.0528	2.5293	8.9057
<i>EXCDISTR</i>	-0.1890	-0.0716	-3.4548	0.6842
<i>CASH</i>	0.3538	0.1311	0.0000	15.2702
<i>CUMRESERVE</i>	0.1864	0.0000	-0.5448	9.9191
<i>DEVDCASH</i>	0.1363	0.0000	0.0000	1.0000
<i>PRICE</i>	14.1279	12.0000	1.8900	92.6700
<i>BVALUE</i>	8.2569	8.6047	0.5536	31.3203

* This table presents descriptive statistics for the variables included in the regression models.

** Variable definitions:

<i>STDDCASH</i>	Standardized Distributable Cash for year t scaled by the number of units outstanding at the end of year t
<i>DISCRDCASH</i>	Disclosed distributable cash for year t minus Standardized Distributable Cash for year t scaled by the number of units outstanding at the end of year t
<i>CHANGESTDDCASH</i>	1 if Standardized Distributable Cash for year t is lower than Standardized Distributable Cash for year t-1; 0 otherwise
<i>OPTIONS</i>	Average value of “in the money” stock options held by the top paid executives at the end of year t divided by their total compensation for year t
<i>TRUSTEESOWN</i>	Total number of units owned by the trustees at the end of year t scaled by the number of units outstanding at the end of year t
<i>TRUSTEESIND</i>	Percentage of outsiders on the board of trustees for year t, as disclosed in the trust’s proxy statement
<i>OWN</i>	1 if an external unitholder controls more than 10 percent of outstanding votes at the end of year t (i.e. the trust is closely-held); 0 otherwise
<i>SIZE</i>	Natural logarithm of lagged total assets
<i>EXCDISTR</i>	Distribution for year t – disclosed distributable cash for year t scaled by the number of units outstanding at the end of the year t
<i>CASH</i>	Cash and cash equivalents at the end of year t scaled by the number of units outstanding at the end of year t
<i>CUMRESERVE</i>	Cumulative distributable cash reserve at the beginning of year t scaled by the number of units outstanding at the end of year t
<i>DEVDCASH</i>	1 if disclosed distributable cash for year t is lower than disclosed distributable cash for year t-1; 0 otherwise
<i>PRICE</i>	Price at the end of the fiscal year
<i>BVALUE</i>	Book value at the end of the year scaled by the number of units outstanding at the end of the year

Table 3
Determinants of Discretionary Distributable Cash*

Variable**	Predicted Sign	Coefficient	P > z ***
<i>CHANGESTDDCASH</i>	+	1.0022	0.000
<i>OPTIONS</i>	+	0.1098	0.038
<i>TRUSTEESOWN</i>	+	2.1464	0.058
<i>TRUSTEESIND</i>	-	0.8597	0.175
<i>OWN</i>	?	0.1104	0.469
<i>SIZE</i>	?	0.0200	0.924
<i>Intercept</i>		-0.4078	0.812
N			521
Wald Chi-2			81.55 (0.000)
R-square			24.92%

*This table presents the results of the pooled random effects regression examining the determinants of discretionary distributable cash. Parameter estimates are based on the following model:

$$(1) \quad DISCRDCASH_{i,t} = \beta_0 + \beta_1 CHANGESTDDCASH_{i,t} + \beta_2 OPTIONS_{i,t} + \beta_3 TRUSTEESOWN_{i,t} + \beta_4 TRUSTEESIND_{i,t} + \beta_5 OWN_{i,t} + \beta_6 SIZE_{i,t} + \beta_7 TYPE_{i,t} + \varepsilon_{i,t}$$

**Variable definitions:

<i>DISCRDCASH</i>	Disclosed distributable cash for year t minus Standardized Distributable Cash for year t scaled by the number of units outstanding at the end of year t
<i>CHANGESTDDCASH</i>	1 if Standardized Distributable Cash for year t is lower than Standardized Distributable Cash for year t-1; 0 otherwise
<i>OPTIONS</i>	Average value of “in the money” stock options held by the top paid executives at the end of year t divided by their total compensation for year t
<i>TRUSTEESOWN</i>	Total number of units owned by the trustees at the end of year t scaled by the number of units outstanding at the end of year t
<i>TRUSTEESIND</i>	Percentage of outsiders on the board of trustees for year t, as disclosed in the trust’s proxy statement
<i>OWN</i>	1 if an external unitholder controls more than 10 percent of outstanding votes at the end of year t (i.e. the trust is closely-held); 0 otherwise
<i>SIZE</i>	Natural logarithm of lagged total assets
<i>TYPE</i>	Business, real estate, utility or resource trust as per Investcom’s classification

***One-tailed if directional prediction, two-tailed otherwise. z-statistics based on robust standard errors.

Table 4
Determinants of Over (Under) Distributions*

Variable**	Predicted Sign	Coefficient	P > z ***
<i>CASH</i>	+	0.0073	0.333
<i>CUMRESERVE</i>	-	-0.0729	0.002
<i>DEVDCASH</i>	+	0.1759	0.000
<i>OPTIONS</i>	-	-0.0114	0.094
<i>TRUSTEESOWN</i>	-	0.2680	0.402
<i>TRUSTEESIND</i>	-	-0.2040	0.043
<i>OWN</i>	?	-0.0399	0.371
<i>SIZE</i>	?	-0.1241	0.000
Intercept		0.7102	0.000
N			521
Wald Chi-2			8.33 (0.000)
R-square			8.80%

*This table presents the results of the pooled fixed effects regression examining the determinants of over (under)distributions. Parameter estimates are based on the following model:

$$(2) \quad EXCDISTR_{i,t} = \beta_0 + \beta_1 CASH_{i,t} + \beta_2 CUMRESERVE_{i,t} + \beta_3 DEVDCASH_{i,t} + \beta_4 OPTIONS_{i,t} + \beta_5 TRUSTEESOWN_{i,t} + \beta_6 TRUSTEESIND_{i,t} + \beta_7 OWN_{i,t} + \beta_8 SIZE_{i,t} + TYPE_{i,t} + \varepsilon_{i,t}$$

**Variable definitions:

<i>EXCDISTR</i>	Distribution for year t – disclosed distributable cash for year t scaled by the number of units outstanding at the end of the year t
<i>CASH</i>	Cash and cash equivalents at the end of year t scaled by the number of units outstanding at the end of year t
<i>CUMRESERVE</i>	Cumulative distributable cash reserve at the beginning of year t scaled by the number of units outstanding at the end of year t
<i>DEVDCASH</i>	1 if disclosed distributable cash for year t is lower than disclosed distributable cash for year t-1; 0 otherwise
<i>OPTIONS</i>	Average value of “in the money” stock options held by the top paid executives at the end of year t divided by their total compensation for year t
<i>TRUSTEESOWN</i>	Total number of units owned by the trustees at the end of year t scaled by the number of units outstanding at the end of year t
<i>TRUSTEESIND</i>	Percentage of outsiders on the board of trustees for year t, as disclosed in the trust’s proxy statement
<i>OWN</i>	1 if an external unitholder controls more than 10 percent of outstanding votes at the end of year t (i.e. the trust is closely-held); 0 otherwise
<i>SIZE</i>	Natural logarithm of lagged total assets
<i>TYPE</i>	Business, real estate, utility or resource trust as per Investcom’s classification

***One-tailed if directional prediction, two-tailed otherwise. z-statistics based on robust standard errors.

Table 5
Valuation of Distribution Components*

Variable**	Pred	Coefficient	P > z ***
<i>BVALUE</i>	+	0.9513	0.000
<i>STDDCASH</i>	+	1.6538	0.001
<i>DISCRDCASH</i>	+	1.4838	0.003
<i>EXCDISTR</i>	-	-2.3991	0.018
Intercept		3.6483	0.004
N			532
Wald Chi-2			27.51 (0.000)
R-square			39.01%

*This table presents the results of the pooled fixed effects regression examining the value-relevance of distribution components. Parameter estimates are based on the following model:

$$(2) \quad PRICE_{i,t} = \beta_0 + \beta_1 BVALUE_{i,t} + \beta_2 STDDCASH_{i,t} + \beta_3 DISCRDCASH_{i,t} + \beta_4 EXCDISTR_{i,t} + TYPE_{i,t} + \varepsilon_{i,t}$$

**Variable definitions:

<i>PRICE</i>	Price at the end of year t
<i>BVALUE</i>	Book value at the end of year t scaled by the number of units outstanding at the end of year t
<i>STDDCASH</i>	Standardized Distributable Cash for year t scaled by the number of units outstanding at the end of year t
<i>DISCRDCASH</i>	Disclosed distributable cash for year t minus Standardized Distributable Cash for year t scaled by the number of units outstanding at the end of year t
<i>EXCDISTR</i>	Distribution for year t – disclosed distributable cash for year t scaled by the number of units outstanding at the end of the year t
<i>TYPE</i>	Business, real estate, utility or resource trust as per Investcom's classification

***One-tailed if directional prediction, two-tailed otherwise. z-statistics based on robust standard errors.