

CPR *Alert*

Canadian Performance Reporting

MD&A DISCLOSURES IN VOLATILE AND UNCERTAIN TIMES

Communicating how an entity is dealing with the current financial crisis, where past results may not be indicative of the future, will likely involve some significant changes to Management's Discussion and Analysis (MD&A). This *CPR Alert* suggests matters that may need to be discussed in the MD&A to provide the transparent and complete communications that investors will be expecting.

Introduction

The US sub-prime lending debacle has sent global financial markets into crisis. Some of the world's most famous financial institutions have vanished and stock market values have plunged. This volatile and uncertain environment poses new challenges for businesses, including communication challenges. In these uncertain times, it is essential for entities to be transparent in their financial reporting. In particular, the MD&A should explain, through management's eyes, the effects of market volatility on an entity's performance, financial condition, and future prospects¹.

This *CPR Alert* suggests some matters for consideration in preparing MD&A or other communications during this period of economic and financial market uncertainty. These include:

- strategy for dealing with the volatile credit and customer markets;
- effect of recent volatility on an entity's results, distinguishing, if possible, between periods of growth and no growth, or decline brought on by changes in markets;

- impact of the current crisis on an entity's management of liquidity and the funding of operations;
- impact of significant uncertainty on estimates involving data, balances, and transactions that an entity reports; and
- assessment of the factors that will contribute to a turnaround or recovery, or, alternately, factors that may challenge an entity's ability to continue to finance its operations in the normal course of business and continue as a going concern.

In the current volatile environment, significant changes in an entity can occur very quickly. Events occurring as a consequence of the current turmoil may give rise to material changes, necessitating a material change report, required even when the matter is subsequently discussed in the MD&A. Previous disclosure as a material change does not absolve an entity from discussing the matter in the MD&A. The MD&A should put such items into the larger perspective of the entity's financial condition as of the date of the publication of the MD&A.

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¹ The general requirements for MD&A disclosures are set out in Canadian Securities Administrators' (CSA) National Instrument 51-102. CICA's *Management's Discussion and Analysis: Guidance on Preparation and Disclosure* helps entities meet these requirements by structuring and integrating MD&A disclosures within a broad organizational reporting context and disclosure framework. In considering the adequacy of their MD&A, CEOs and CFOs should also remember that they must certify that financial information in interim and annual filings is "fairly presented". The "fair presentation" test applies to the financial information as a whole, is not limited by GAAP, and extends to an entity's financial condition, results of operations, and cash flows. While financial condition is not defined, the CSA explain that it reflects the overall financial health of the entity and includes the entity's financial position and other factors that may affect its liquidity, capital resources, and solvency.

The following discussion highlights several areas where the MD&A would be expected to communicate the effects of recent market developments.

Strategy and risk management

In order for an investor to understand an entity's financial condition and future prospects, the MD&A should discuss the entity's strategy. This discussion should include the entity's response to the economic conditions in general and the circumstances of its specific industry. This part of the MD&A will likely need significant modification given the current economic and financial market volatility. For example, a retailer focused on exclusive apparel may need to discuss its views about the prospects for disposable income of its typical customer profile and changes to

that customer's purchasing habits in difficult times.

Similarly, an auto parts manufacturer may need to discuss its supply chain relationship with major automobile companies and its view of the impact of the downturn on sales in the industry.

How is the entity responding to the economic conditions generally and the circumstances of the industry?

The extent of an entity's discussion about external issues will depend on their significance to understanding the entity's financial prospects. In any entity, however, the macro-level changes in the economy and industry need to be translated to the company level. The impact of the current crisis on an entity's risk management, operating and financing strategies may be the most important matters to discuss. Sensitivity of the cost of capital to volatility in interest rates and foreign exchange rates etc. may need discussion. If debt maturities loom in the foreseeable future, there should be a discussion of the pursuit of new financing arrangements. For transactions in process, such as business combinations or the construction of significant assets, investors will want to understand their status and any changes in plans, including those emanating from difficulties in funding such projects. Entities with defined benefit pension plans should discuss how the market environment has affected pension plan investments, the present value of liabilities, and the implications for pension plan funding. As well, entities may be restricted in the financing alternatives that

they can provide to customers, and this may affect sales outlooks. In addition, investors will want to understand an entity's response to reduced customer demand, which may include cost containment initiatives. Finally, investors will want to know how dividend policies may be affected by the crisis.

The risk management aspect of financing strategies may be influenced by current market conditions. For example, many entities will be affected by changes in exchange rates. The effect of foreign exchange, including the cash and accrued effects of hedging strategies, and any changes therein, should be discussed. This would include a consideration of the effects on income and cash flows of any hedging strategies discontinued as a result of market conditions or cancelled transactions.

Results analysis

The MD&A should provide information about the quality and potential variability of an entity's earnings and cash flow, to assist investors in determining if past performance is indicative of future performance. The basic premise that reviewing past performance should help investors look at the future may need reassessment in the current environment, where there is heightened risk that past performance will not be indicative of the future. In fact, an analysis of results for the year as a whole may be misleading for this purpose and entities may wish to consider including a caveat to this effect. They may wish to focus their results analysis on a quarter by quarter basis, rather than the year as a whole, and distinguish between growth periods and periods when the markets for the entity's products were flat or in decline. As well, in a

volatile business climate, it may be appropriate not to view interim MD&A as being an update of the previous annual MD&A, but rather as a stand-alone document.

Should the focus for the results review be on a quarter by quarter basis, rather than the year as a whole?

The significant change in the economic climate will mean the MD&A's

What impact is the crisis having on the entity's risk management, operating, and financing strategies?

forward-looking orientation takes on additional significance. At the same time, however, entities may be reluctant to provide forward-looking information because of greater uncertainty about future prospects. Notwithstanding such reluctance, entities should be transparent in providing a qualitative discussion of their prospects for the year. Quantitative information that is not forward-looking, such as past trends, may be used to illustrate the sensitivity of Key Performance Indicators to changes in critical factors, and the risks attached to those factors. For example, a manufacturer may wish to discuss how various changes in sales volumes affect EBITDA, or a mining company may discuss how changes in commodity prices affect revenues. Investors can do their own extrapolations from such data.

Liquidity

The CSA have previously noted that liquidity discussions in MD&A need improvement, citing concerns from investors about general statements such as “adequate cash resources to finance future foreseeable capacity expansions”. In a credit crunch, clear communication of an entity’s ability to continue to meet liabilities takes on particular significance for

investors. This discussion should avoid boiler-plate or generic statements and be specific to the entity’s circumstances at the time the MD&A is prepared. In determining the adequacy of liquidity discussions, entities should consider their cash generating potential, cash utilization requirements, and impact of working capital requirements on cash needs. This may involve discussion of the following:

Does the liquidity discussion address cash generating potential, cash utilization requirements, and impact of working capital requirements?

Cash generating potential

- adequacy of available credit facilities to finance operations and the cost of that credit, particularly if operating cash flows are negative or declining, including a discussion of the extent of unused facilities at the date of reporting, and the timing of their renegotiation
- restrictions on the ability to transfer a subsidiary’s cash to the parent, including the impact on available cash resources

- nature of short-term investments and creditworthiness of the counter-party and its ability to provide cash on maturity

Cash utilization requirements

- cash needed to fund operations and how the amount varies depending on the level of activity
- fixed and variable elements of cash outflows
- terms of debt or lease agreements that could trigger additional or accelerated payments
- circumstances under which off-balance sheet arrangements could result in funding requirements for the entity, including the amounts involved and any plan the entity has to fund or mitigate such requirements (this might include, for example, sales currently financed through a variable-interest entity)
- arrangements to fund committed capital expenditures, the timing for payments, if known, circumstances that could negate or cancel such financing requirements, and sensitivity to rate, cost of capital, or financial market liquidity fluctuations

Working capital requirements

- reasons for changes in the components in working capital from the previous quarter, and for the year as a whole, for example changes in terms of supplier or customer contracts, changes in policy around inventory levels to be maintained, or changes in the period for receivables collection
- analysis of how changes in activity levels affect working capital components and alternatives for funding any anticipated increase in working capital

The liquidity discussion should also report any defaults or significant risk of default in the terms of a debt covenant or other agreement, the consequences of the default, and steps being taken to remedy the situation.

Critical accounting estimates

Critical accounting estimates are those that require an entity to make assumptions about matters that are highly uncertain at the time the estimate is made. As well, to be “critical”, the estimate must be subject to significant change, either by virtue of the degree of uncertainty involved, or because the volatility of the situation can create differences from period to period. When a critical accounting estimate exists, the MD&A needs to disclose the nature of any changes

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Do any new critical accounting estimates exist as a result of current conditions?

in the estimate, and uncertainties and the likelihood of further changes, among other things².

Entities may need to reconsider whether some accounting estimates that in normal circumstances would not be viewed as critical

might meet that test in the current environment. Examples include estimates in fair valuing financial instruments, estimates used in computing the recoverability of long-term assets, and impairment charges (or the lack of same), as well as the collectibility of accounts receivable, and the effects of obsolescence and adverse price movements on inventory carried at the lower of cost or net realizable value.

Going concern

When preparing financial statements, management must make an assessment about the entity's ability to continue as a going concern, taking into account all available information about the future, which is at least twelve months from the balance sheet date. When management is aware of material uncertainties related to events or conditions that may cause significant doubt about an entity's ability to continue as a going concern, those uncertainties are disclosed in the financial statements. In such circumstances, the MD&A should explicitly draw attention to the financial statement disclosure and should discuss the factors that led management to its conclusion.

If an entity is experiencing negative operating cash flows, high cash requirements to construct projects in progress, substantial refinancing requirements that cannot be met out of existing cash balances, or is highly leveraged, investors will have heightened scepticism about an entity's ability to continue as a going concern. The MD&A should explicitly address those circumstances (as well as others) and provide insight into management's basis for concluding the entity will continue as a going concern, or, if there are uncertainties, the nature of such uncertainties and the plans and events which may govern their resolution, such as increased liquidity in banking markets. Even when management concludes that material uncertainties do not exist, it would be prudent to ensure that the MD&A discusses all the factors that management reviewed, for example expected profitability levels, debt repayment schedules, and sources of replacement financing for maturing debt.

Conclusion

In the current volatile economic and financial market conditions, investors will expect transparent financial reporting to minimize uncertainty, reducing the risk premium for those entities that clarify their circumstances, and challenging the valuations of those with poor disclosure. Accordingly, entities should take extra care with their MD&A to ensure that it communicates a transparent and balanced reporting of management's insights about the entity's prospects. To achieve this, entities may wish to reconsider the overall structure of their MD&A and ensure it highlights the most important issues and links changes in the entity's strategy to changes in results and financing needs.

Does the MD&A address circumstances that may make investors sceptical about the entity's ability to continue as a going concern?

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