

CPR *Alert*

Canadian Performance Reporting

MD&A DISCLOSURES IN VOLATILE AND UNCERTAIN TIMES – VOLUME 2: analyzing change and liquidity

The financial crisis that paralyzed financial institutions and froze the credit markets in 2008 has spread to Main Street in 2009. Most developed countries now face a deep recession. In this environment, investors will want a frank discussion of what has changed in the entity, with specific attention to an entity's ability to fund its plans for the immediate future, i.e. its liquidity, and its longer term plans for dealing with the effects of the crisis.

The October 2008 CPR Alert *MD&A Disclosures In Volatile And Uncertain Times* suggested matters that may need to be discussed in the MD&A to provide transparent and complete communications during this period of economic uncertainty. This new Alert sets out additional considerations when preparing MD&A in this environment.

Focus on What's Changed

In most entities, for most investors, the most important information to communicate will be the impact of the current economic and financial crisis on the entity, both short-term and long-term. This focus means that the previous MD&A, drafted in different times, may be ineffective as a template for discussing performance. As well, reviewing performance for the year as a whole could be misleading. To understand the impact of the crisis on trends, it will be essential to consider performance by quarter.

An MD&A focused on the impact of the financial crisis may need to be organized according to the major drivers that have changed as a result of the crisis. For many entities these may be able to be summarized as the 5Cs:

- Credit availability and cost
- Customer demand
- Currencies
- Commodity prices
- Counterparties

Credit availability and cost

While banks continue to lend, they are much more cautious, and the secondary markets that provided much of the sales financing for companies have all but disappeared. Some entities have seen credit facilities reduced while others' covenants have been amended. Further, interest rates have often increased. The basic questions the MD&A should address: what is the entity's access to credit if needed? Would its costs be destructive, even if available?

Customer demand

Gross domestic product fell across many industries in October and November 2008, and reduced customer demand has affected many businesses, including for example, the automobile parts industry and much of the retail sector. The basic questions the MD&A should address: what is the outlook for customer demand for the rest of the

What is the outlook for customer demand?

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year and next year? What is the shape of the demand curve that is the basis for management's plans?

Currencies

The Canadian dollar, worth 95c US in the fall is now only worth 80c US, a decline of 16%. This unprecedented volatility has had a significant impact on

How have currency movements affected receipts and disbursements?

companies with exports priced in US dollars and also for entities with US dollar denominated debt. The basic question for the MD&A: how have currency movements affected

(or how will they affect) our receipts and disbursements, and how do we plan on managing any potential volatility arising from currency movements?

Commodities

As of the end of December 2008, Scotiabank's Commodity Price Index had declined 39% from its peak in July 2008. For many commodities, prices are approaching world cash costs, triggering production cuts, new project deferral, and tighter supplies. The basic question for the MD&A: if an entity is a commodity producer, how are changing prices and demand affecting our cash flows? If we are a commodity user, how did price changes get reflected in our costs and margins? Did we hedge and lock in at high or low prices?

Counterparties

Business practices beyond borrowing and lending are affected by counterparty risk. While counterparty issues typically involve financial institutions, they can also extend to customers and suppliers that conduct a significant amount of business with an entity. Creditworthiness of suppliers can become an issue when there are few competitors for the supplier or when the supplier produces goods or services for the entity under a contract or licence agreement. The basic question for the MD&A: are there long-term customer, supplier, and financial instruments counterparties whose declining creditworthiness may cause financial distress?

Impact of Changes in the 5Cs on Performance and Actions

Investors will want to understand which of the 5Cs have affected the entity over the last year, and in

particular the last 90 days, and what impact those changes have had on the entity. They will also want to know the actions the entity has undertaken in response to those changes, the degree of success in the entity's response, including the financial impact, and other actions that are planned.

The types of action an entity may have initiated could include:

- increased marketing efforts;
- personnel reductions;
- production facility closures;
- capital expenditure reductions;
- deferral of payments under renegotiated agreements;
- reductions or suspensions of dividends or distributions;
- sales of assets;
- share issues.

In addition to reporting changes that have already been reflected in financial reports, there should be a discussion of the impact of the crisis on longer term plans. For an entity with a defined benefit pension plan, this would include changes in the plan's investment values and liabilities, excluding actuarial gains and losses, and the entity's plans to fund any shortfall, including the period over which funding is anticipated. As well, entities should discuss how the crisis is affecting planned or in-process acquisitions and other capital projects.

Liquidity

A reasonable definition of liquidity is the ability of an entity to generate cash and to meet existing known and reasonably likely future cash requirements. An entity's liquidity will be of paramount importance to investors. Accordingly, it is suggested that there be a liquidity section of the MD&A which should be able to be read as a stand-alone part of the document. This involves providing historical analysis and expectations about the future, including the risks involved.

Does MD&A present a stand-alone liquidity discussion?

Historical analysis of changes in liquidity

The historical analysis should be presented as simply as possible, identifying how the entity's liquidity was impacted over the last year, and in particular the last 3 months of the year. One obvious source (or use) of liquidity would be cash flows from operations. Recent changes in cash from operating activities should be analyzed in terms of the impact of changes in operations and changes in working capital, quantifying the various components of each. For example, reduced cash from operations may be due to reduced sales volumes and lower prices, while cash utilized due to increased working capital may be the result of decreased turnover in inventories and slower payment of receivables. The discussion of changes in operating cash flows should review cash utilization rates throughout the year, including seasonal or cyclical demands, and should also discuss fixed and variable elements of cash flow, to the extent that this does not communicate competitively sensitive information.

The historical analysis should also discuss the impact of the following non-operating matters on liquidity:

- debt repayments;
- capital expenditures;
- dividends and share repurchases; and
- changes in credit facilities.

Examples of other factors that might influence these discussions include disappearance of bank credit as a source of sales financing, the impact of hedging activities on cash outflows, and demand for cash on or before delivery by suppliers.

The liquidity analysis should be illustrated with measures and ratios used by management in monitoring liquidity. These may include summarized cash flow statements, measures of free cash flow, and ratios such as current assets to current liabilities and net debt to capitalization.

Expectations about future liquidity

The review of the impact of the changes in liquidity during the period needs to be supplemented with a discussion of expectations for the foreseeable future. This involves consideration of matters affecting operating cash flows and other sources and uses of cash.

Operating cash flows

In order to make an assessment about liquidity, investors need to understand an entity's ability to generate cash from operations. In normal circumstances, this can be assessed from trends of past performance combined with a discussion of matters that are known or expected that will change those trends, such as seasonality. In the current environment, however, past trends are unlikely to be a good indicator of the future. Accordingly, management of an entity should discuss its outlook for 2009. This may be achieved without reporting competitive information or information that is overly speculative by reviewing the relationship of the

entity and its industry to forecasts for gross domestic product or other relevant economic indicators. For example, an entity may provide

insight on its expectations of changes in the economy that appear to drive its business. These assumptions would provide investors with insights into the entity's strategy without requiring disclosure of entity-specific forward-looking information.

Any such outlook should discuss the risks that the entity faces in each of the 5Cs or other important drivers. If possible, the sensitivity of the 5Cs to change should be quantified, for example by expressing how % variances in assumptions about demand, currencies, and commodities etc. translate to \$ of sales or EBITDA, or cash flows from operating activities.

Does the outlook discuss the risks the entity faces in each of the 5Cs?

Other matters affecting liquidity

Other items that may need consideration in a discussion of an entity's liquidity include:

- terms and timing of debt maturities and conditions of repayment, including expectations for source of financing;
- terms of debt covenants, including material implications of a breach, the impact of covenants on the entity's capacity for borrowing, and discussion of the entity's proximity to triggers in the covenants;
- sufficiency of unused credit facilities, taking into account demands such as seasonality of operations;
- timing for the renegotiation of credit facilities;

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- capital expenditure plans, separating maintenance expenditures from growth expenditures, and discussing anticipated sources for financing;
- other spending commitments; and
- any anticipated restrictions in accessing funds in subsidiaries.

The risks that traditional sources of financing may be reduced should be discussed, including for example the factors that could influence credit ratings, and the impact of a downgrade in the entity's credit rating on its ability to raise debt and capital. As well, risks related to the creditworthiness of material counterparties should be reviewed, including mitigation and monitoring activities to minimize these risks.

Going Concern

Generally accepted accounting principles require financial statement disclosure of material uncertainties related to events

or conditions that may cause significant doubt about an entity's ability to continue as a going concern. When such uncertainties exist, these should be referenced in the MD&A, including factors that management considered in making its assessment about the uncertainties and any planned activities to address them. Where factors exist that might lead investors to be sceptical about an entity's future, but where management concludes there are no material uncertainties, it would be prudent to discuss those circumstances in the MD&A, including management's reasons for concluding that they do not comprise a material uncertainty.

Conclusion

Investors will be sceptical of managements' assessments in today's unprecedented financial circumstances. A transparent and complete discussion of the issues is essential in this environment.

CPR Alert is also available at www.cica.ca/cpr.

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Contributions to this *CPR Alert* from Deloitte's Peter Chant, FCA are greatly appreciated.