

# CPR Alert

Canadian Performance Reporting

## YEAR END MD&A ROUND-UP

As 2009 draws to a close, this *CPR Alert* highlights some matters entities may wish to consider when preparing the annual MD&A.

### CHANGEOVER TO IFRSs

With the changeover to IFRSs just over a year way, most entities should be well advanced with their IFRS changeover plan. The Canadian Securities Administrators' Staff Notice 52-320 sets out the securities regulators' expectations about disclosure in the period leading up to the changeover. The MD&A should discuss the progress towards changeover, including key activities, deadlines and accomplishments to date. A sample reporting format is set out in the Canadian Performance Reporting Board (CPRB) publication *Pre-2011 Communications About IFRS Conversion*.

Staff Notice 52-320 also requires entities to discuss identified differences in accounting policies, commencing with the 2009 annual MD&A for December year ends. While many entities will be unable at this time to quantify the impact of the changeover, there should nevertheless be a discussion of the accounting issues identified and alternative accounting policies under consideration.

In the first period of reporting under IFRSs, the many changes between IFRSs and old Canadian GAAP will be disclosed in several reconciliations required to be included with the financial statements. A recent CPRB publication, *Transition to IFRSs – Communicating the Impact of the Changeover* suggests ways to summarize the impact of these changes in the MD&A, including their likely impact on future reporting. The tabular format examples in this new guide may provide ideas

for ways in which to summarize the accounting issues identified and options under consideration for 2009 annual reporting.

### REPORTING IN UNCERTAIN TIMES

While the economy seems to be starting to recover, much uncertainty remains and liquidity continues to be a hot topic. Investors will want to understand what impact the financial crisis has had on an entity's ability to generate cash and its cash utilization requirements, including the reasons for and the effects of changes in working capital (especially when EBITDA is used as a proxy for cash flow). An entity should also consider disclosing the proximity of its financial ratios to debt covenant triggers, and the strategy for dealing with debt maturities, for example, rollover or repay.

Entities with defined benefit pension plans should consider what disclosure they should provide in light of the effects of the financial crisis. In view of the "fair presentation" test in the CEO and CFO certification rules, future funding requirements may need to be discussed in the context of the fair value of plan investments and expected returns on plan assets, even though funding requirements may not have been recently evaluated.

Another area that will interest investors is the impact of the financial crisis on an entity's productive capacity. Entities may wish to address the extent to which pro-

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ductive capacity is underutilized because of declines in demand, and how capacity is expected to be affected by any changes to capital expenditure plans.

## TIPS FOR EFFECTIVE RISK REPORTING

Effective risk frameworks rely on four key processes: *risk identification, quantification, management, and disclosure*. Last year's market meltdown has accentuated flaws, to varying degrees, in each of these processes. Such flaws not only compromise entities' ability to navigate uncertainty, but they also cloud investors' understanding of the risks to which they are exposed. The following considerations for risk disclosures are provided as a result of a recent review of risk reporting. While various matters addressed below have been the subject of earlier CPRB guidance, they are repeated here because of the continuing need to improve risk disclosure, noted both by the CPRB's report *Striving for Improvement*, and securities regulators' continuous disclosure reviews.

Entities should avoid adhering too rigidly to a fixed reporting template

of all conceivable risks. The MD&A should focus its discussion on those risk factors that are particularly relevant, probable, and impactful.

**Shifting priorities.** Entities should avoid adhering too rigidly to a fixed reporting template. They might consider revising the structure of disclosures, in terms of the depth of discussion or order in which risks are presented, to reflect changing conditions.

**Insightfulness of explanations.** A pitfall of fixed templates is their highly generalized language, which tends to be broad enough to suit a range of business conditions. While such templates offer convenience to preparers, they provide a disservice to readers by failing to convey the current state of affairs. Effective analyses are those that are current, as well as clear, concise, and devoid of boilerplate language.

**Level of preparedness.** For each of the identified risks, entities should state their strategies for minimizing the likelihood or impact of those risks.

### Number of risks discussed.

To improve the utility of their disclosures, entities should avoid providing a laundry list

**Potential severity.** Users want information about the potential impact of a risk. Often this may be communicated by indicating ranges, directions, or scenarios based on market research and industry analyses. When providing such information, preparers should adhere to securities regulators' requirements related to forward-looking information.

**Integrated reporting.** Though the use of separate sections in the MD&A allows readers to navigate the information more readily, the MD&A should be recognized as an integrated document. Where it makes sense to provide supplementary disclosure *outside* the designated risks section, entities should not hesitate to do so. Such disclosure may flow naturally from a related discussion and provide a more complete picture to readers.

**Consistency of reporting.** During the preparation and review of the annual report, entities should ensure that all sections are internally consistent with respect to content and tone, regardless of the extent to which a section is subject to regulatory oversight.

**Risk identification.** Entities might consider conducting a review of media commentary and analyst reports for issues influencing sell or hold decisions, and key questions raised during conference calls. Though management may disagree with certain opinions about the importance of a risk, it is advisable to confront these concerns head-on.

## NON-GAAP FINANCIAL MEASURES

A CICA review of over 250 Canadian entities' 2008 annual MD&As identified approximately one-third that reported EBITDA as a stand-alone measure, while 12% reported free cash flow. An examination of 30 of these entities' disclosures indicates that, while more information is being provided about the components of these measures, peer comparisons continue to be hampered by differences in entities' computations.

Many entities introduced adjustments over and above those implied by the term E-B-I-T-D-A, including restructuring charges, interest income, gains or losses on foreign exchange and disposal of investments, unrealized losses on derivatives, unspecified non-cash items, and "special charges". Similarly, there were

inconsistent practices in reporting free cash flow, particularly with respect to adjustments for non-cash working capital, dividends on common shares, proceeds from or cash used in financing activities, and “other investing activities”.

## Differences in computing EBITDA hamper peer comparisons

The variance in observed methodologies likely stems from divergent reporting objectives. For example, some use EBITDA to indicate the ability to generate liquidity or service debt, while others seek to capture operating performance on a consistent basis. Still others strive to accommodate analysts’ need for EBITDA as a business valuation measure. Clearly, different motives call for different adjustments.

Many users currently focus on non-GAAP financial measures and these will likely receive even more attention as Canada transitions to International Financial Reporting Standards in 2011. In this environment, clear disclosure of comparable measures will become increasingly relevant. To enhance comparability, the CPRB advocates the use of standardized EBITDA and free cash flow, as described in the October 2008 publication *Improved Communication with Non-GAAP Financial Measures*.

The CPRB guidance encourages preparers to disclose adjusted EBITDA and adjusted free cash flow, in addition to the standardized measures, so long as the adjusted measures are clearly defined as such and reconciled to the standardized measures. One-third of the entities examined already reports EBITDA and adjusted EBITDA measures, apparently confirming a view that there ought to be a base EBITDA from which entity-specific measures can also be derived.

For convenience, the CPRB’s standardized definitions of EBITDA and free cash flow are set out below.

### STANDARDIZED EBITDA

Net income/loss before discontinued operations (per GAAP financial statements), including net income/loss related to non-controlling interest, excluding amounts disclosed in arriving at net income/loss in accordance with GAAP for:

- income taxes

- interest expense
- amortization/impairment charges for capital assets

### STANDARDIZED FREE CASH FLOW

Cash flows from operating activities (per GAAP financial statements), including operating cash flows provided from/used in discontinued operations, less:

- total capital expenditures minus proceeds from the disposition of capital assets other than those of discontinued operations (per GAAP financial statements)
- dividends, when stipulated, unless deducted in arriving at cash flows from operating activities

## SECURITIES REGULATORS’ REVIEWS

The Canadian Securities Administrators published two Staff Notices in 2009 that discussed their review of continuous disclosure and certification compliance. Entities may wish to consult these as they consider changes to MD&A disclosure for 2009 annual reporting.

Staff Notice 51-329, published in July, reported the results of the continuous disclosure review program for the year ended March 31, 2009. The general reviews identified several MD&A deficiencies. As well as the usual list of culprits, such as the absence of a quantitative analysis of results, the notice took issue with the non-compliant reporting of non-GAAP financial measures, inadequate disclosures around assumptions for critical accounting estimates, insufficient disclosure of working capital requirements, and inadequate disclosure of the circumstances that could affect an issuer’s sources of financing. In addition, Staff Notice 51-329 discussed the results of several more focused, issues-oriented reviews, including those related to the market turmoil and credit crisis, defined benefit pension plan disclosures, and forward-looking information. This Notice also hints at topics that the continuous disclosure review may address in 2010, including IFRS changeover plan reporting.

Staff Notice 52-325, published in September, discusses the results of the securities regulators’ reviews of compliance with the CEO and CFO certification requirements. These reviews identified several deficiencies in annual MD&A disclosures, including incomplete disclosure of the conclusions about the effectiveness of

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an entity's internal control over financial reporting and disclosure controls and procedures, and inappropriate qualifications about the effectiveness of such controls.

In addition to the above, many of the messages in Staff Notice 51-328 *Continuous Disclosure Considerations Related to Current Economic Conditions* will continue to be relevant for 2009 reporting.

## RELATED READING

### CSA NOTICES

- CSA Staff Notice 52-325 – Certification Compliance Review, September , 2009  
[http://www.osc.gov.on.ca/documents/en/Securities-Category5/csa\\_20090911\\_52-325\\_cert-comp-review.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category5/csa_20090911_52-325_cert-comp-review.pdf)
- CSA Staff Notice 51-329 – Continuous Disclosure Review Program – Activities for the fiscal Year Ended March 31, 2009, July 2009  
[http://www.osc.gov.on.ca/documents/en/Securities-Category5/csa\\_20090724\\_51-329\\_cdrpa-fiscal-2009.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category5/csa_20090724_51-329_cdrpa-fiscal-2009.pdf)
- CSA Staff Notice 51-328 – Continuous Disclosure Considerations Related to Current Economic Conditions, January 2009  
[http://www.osc.gov.on.ca/documents/en/Securities-Category5/csa\\_20090108\\_51-328\\_continuous-disclosure.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category5/csa_20090108_51-328_continuous-disclosure.pdf)
- CSA Staff Notice 52-320 – Disclosure of Expected Changes in Accounting Policies Related to Changeover to International Financial Reporting Standards, May 2008  
[http://www.osc.gov.on.ca/documents/en/Securities-Category5/csa\\_20080509\\_52-320\\_fin-rpt-standards.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category5/csa_20080509_52-320_fin-rpt-standards.pdf)

### CICA GUIDANCE (all available at [www.cica.ca/cpr](http://www.cica.ca/cpr))

- Transition to IFRSs – Communicating the Impact of the Changeover, December 2009
- MD&A Guidance on Preparation and Disclosure - Comprehensive Revision, Update #3, July 2009
- CPR Alert Issue 10 - MD&A Disclosures in Volatile and Uncertain Times - Volume 2: Analyzing Change and Liquidity, February 2009
- Improved Communication with Non-GAAP Financial Measures, October 2008
- CPR Alert Issue 8 - MD&A Disclosures in Volatile and Uncertain Times – Volume 1, October 2008
- CFO Beyond-GAAP Briefing: Forward Looking Information, May 2008
- Building a Better MD&A - A Guide for Smaller Issuers, November 2007

*CPR Alert* is also available at [www.cica.ca/cpr](http://www.cica.ca/cpr)

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