Meeting notes—Management Commentary Consultative Group

The Management Commentary Consultative Group (Consultative Group) held its third meeting on 3 April 2019 at the London office of the IFRS Foundation.

Recordings of meeting discussions, the agenda and related papers are available on the meeting page. For more information on the Management Commentary project please refer to the project page, and information about the Consultative Group can be found here.

Members discussed the following topics:

- overall proposed approach to reporting business model, strategy, operating environment and risks (paragraphs 1–18);
- business model (paragraphs 19–23);
- strategy (paragraphs 24–28); and
- operating environment and risks (paragraphs 29–34).

Overall proposed approach to reporting business model, strategy, operating environment and risks

1. The staff provided an overview of the challenges identified in current reporting practice in relation to business model, strategy, operating environment and risks and narrative coherence, and of the staff's proposed approach to addressing these challenges. The challenges identified included not addressing long-term drivers of success and key resources or relationships, a narrow view of the operating environment, a lack of focus in reporting risks, and not providing sufficient detail to help users assess implications of issues included in management commentary on the entity's prospects. The staff explained that the proposed approach is to build on the existing IFRS Practice Statement 1 *Management Commentary* (Practice Statement) and to provide additional guidance on what to report on the content elements, without prescribing the order to follow.

2. Overall, members agreed that the staff had correctly identified the challenges the project should aim to address. However, a few members suggested additional challenges to consider in the project:

   (a) inadequate disclosure of management compensation—users would like to see summarised and easy-to-find explanations of the link between management compensation and long-term strategy as well as of long-term implications of incentives. A few members said they would like to see a greater emphasis on management compensation in the proposed guidance, and a few other members cautioned against being too prescriptive because that could result in a conflict with local regulations on disclosures of management compensation.

   (b) lack of conciseness—a member highlighted the difficulty in achieving conciseness in reporting in the light of increasing reporting requirements. A few members said that the proposals on cross-referencing can help address this challenge to an extent.

(c) lack of comparability—a member highlighted the difficulty in comparing information about entities' business models. That member referred to an academic study which observed many different descriptions of business models that were considered similar in that study.

(d) difficulty in determining what information is relevant for management commentary—a member said it can be challenging for entities to determine what matters to address in management commentary and noted that different matters can be important for example, for different industries and over time as circumstances change. That member suggested that guidance was needed to help entities identify relevant information in different or changing circumstances.

3. Overall, members agreed with the staff's proposed approach to reporting business model, strategy, operating environment and risks. However, some members commented that they expected explicit discussion of long-term value creation to help users understand an entity's business model and strategy, as well as risks arising from the operation of the entity's business model. They stated that the notion of long-term value creation may have been hinted at in the proposals by references to 'long-term drivers of success' and to 'purpose' but did not think such implicit consideration of long-term value creation was sufficient. A few members further commented that the proposed focus on the prospects for future net cash inflows to the entity could be misunderstood as emphasising the short and medium term and might not result in sufficient discussion of long-term value creation.

4. Some members expressed different views on how business model and strategy relate to each other and should be described in management commentary, in particular:
   (a) business model and strategy should be described together rather than separately;
   (b) 'purpose' of the entity should be discussed either before or together with business model, rather than as part of the discussion of strategy;
   (c) discussion of strategy should address *what* the entity seeks to achieve, and the discussion of business model should address *how* the entity will do that;
   (d) the order and the labels of sections in management commentary (for example, as 'business model' or 'strategy') would not matter for the users and should not be prescribed; it is important that the entity tells its story in a coherent way.

5. The staff clarified that the order of content elements presented in the materials for the meeting was intended to illustrate the links across those content elements and to highlight the need for a coherent story rather than to prescribe a structure for management commentary. A few members suggested that a feedback loop or circular diagram could provide a better illustration of how content elements of management commentary should link to each other than a stacked linear diagram. A few members also emphasised that entities should be allowed flexibility in how they structure their management commentary.

6. Some members expressed the view that the revised guidance needed to also cover opportunities rather than just risks, so that management commentaries include a balanced discussion of both

risks and opportunities. One member commented that opportunities could be more difficult to quantify than risks, but even qualitative information about opportunities would still be useful.

7. A few members commented that the guidance should emphasise that coherence and consistency were not just necessary within management commentary, but also both with other corporate communications (for example, investor day presentations and transcripts), and over time (for example, between quarterly announcements and the annual report). A member commented that users will assess whether there is a disconnect between messaging in different communications. The member suggested that it would be useful to set out principles which management could apply across an entity's corporate communications.

8. Other comments included:

   (a) it was not clear how the staff had selected the items that received particular prominence in the proposals and hence whether the proposals were complete. For example, it was not clear why the proposals explicitly addressed funding strategy but not liquidity strategy.
   (b) the proposals should include guidance on reporting relevant ESG (environmental, social and governance) information because this was a challenging area for preparers. One member stated it was surprising not to see explicit proposals on reporting such information.
   (c) it was not clear what level of detail is expected in management commentaries in discussing the prospects for future net cash inflows to the entity. As proposed, the guidance could be interpreted as requiring forecasts in management commentary.
   (d) the proposed guidance includes a lot of different criteria for determining what information is relevant and should be included in management commentary (for example, matters critical for success of the business, matters that affect or could affect future net cash inflows to the entity, matters that the entity depends on for its long-term success). The varied language used in the proposals could be confusing and difficult to apply and could create challenges from the assurance point of view.
   (e) in developing the revised guidance, it is necessary to consider whether management commentaries should focus on the *changes* from the last reporting period or always provide information about the 'base line' as well. Some members who commented on the topic suggested that the focus on the changes is more appropriate while others including users of financial reports stated that management commentary should not assume the knowledge of the company and should always provide relevant 'base line' information about the company. This could be particularly important in discussing the entity's business model and strategy (see paragraph 25).

Cross-cutting issues

9. The staff explained the proposed approach to overarching considerations in preparing management commentary that were particularly important for the content elements being discussed at the meeting. These considerations were:

(a) commercial sensitivity, where the staff proposed, subject to discussions by the IFRS Foundation Advisory Council, a so called ‘comply or explain approach with constraints’ which would require an entity to explain in management commentary the process undertaken in excluding material information (paragraphs 10–13);

(b) cross-referencing, where the staff proposed a principles-based approach with restrictions on incorporating information in management commentary by cross-reference to the financial statements and other reports (paragraphs 14–17); and

(c) the overlap with corporate governance reporting, where the staff proposed to *not* make explicit reference to corporate governance disclosures in the guidance for management commentary (paragraph 18).

10. On commercially sensitive information, some members expressed concerns about the proposed ‘comply or explain approach with constraints’, particularly the ‘explain’ part of it. Those members stated that an explanation about material information being omitted from management commentary could in itself risk disclosing prejudicial information, or it could be boilerplate. In addition, users would look out for indications that material information was omitted and would ask further questions. Some of those members suggested that preparers should have flexibility to say nothing in management commentary, including not discussing the fact that material information has been omitted. Some members suggested that ongoing litigation and early stages of an acquisitions are examples of circumstances when it may be appropriate for an entity to omit material information in management commentary. A few members expressed concerns about allowing preparers to exclude material information from management commentary. They expressed a view that such an exemption could get used in more scenarios than what it is designed to cover.

11. A few members expressed concerns about the practicability of various aspects of the proposed approach and in particular how preparers and auditors would determine in practice whether information was sensitive and should not be disclosed, and about the potential resulting tension between preparers, auditors and regulators. A few members asked for more clarity and examples of what was meant by various proposed notions such as ‘misleading information’, ‘seriously prejudicial’, ‘adapting tone and content of management commentary’ and ‘describing the process undertaken… to exclude material information’ and expressed concerns about how such notions would be applied in practice.

12. One member suggested that in determining whether potentially sensitive information needs to be disclosed it is necessary to consider if that information has been made available elsewhere and if so, it should also be included in management commentary to ensure equal access to information for all users. A few members emphasised a need for a high threshold for excluding material information from management commentary and suggested referring to the requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, and the European Union’s *Market Abuse Regulation* and the related ESMA guidelines and examples of when it is appropriate to exclude or to delay disclosing confidential information in developing the proposals

on commercially sensitive information. One member referred to the International Standard on Auditing, ISA 701 *Communicating Key Audit Matters in the Independent Auditor's Report*, which allows auditors to omit discussion of confidential matters in particular circumstances without giving any indication that information has been omitted.

13. One member commented that it is necessary to balance users' needs for information with preparers' need to keep sensitive information confidential. That member expressed a view that capital markets will react to the timing and the quality of disclosure and that entities that provide transparent information on long-term strategic matters early on are favoured by the markets whereas entities that withhold information unnecessarily are penalised.

14. In relation to incorporating information in management commentary by cross-reference, members generally commented that, although cross-referencing could make management commentary more concise, it should only be used in limited circumstances when it would allow the entity to communicate information more effectively without making management commentary less coherent and without making important information less visible. One member asked whether the principles considered in the Principles of Disclosure project could apply to cross-referencing in management commentary and whether the Board would be able to address the concerns about cross-references identified in that project.

15. A few members discussed the implications of cross-references for the levels of assurance over information in management commentary because the reports containing the cross-referenced information may be subject to different levels of assurance than management commentary. Those members expressed a view that users are not always aware of the different levels of assurance over reported information.

16. A few members suggested that management commentary should contain all relevant information and tell a complete coherent story, and that cross-referencing should not result in users searching for material information elsewhere. At the same time, those members suggested that it would be helpful to sign-post to *additional* information in other reports, including 3rd party reports, for example to provide further detail or evidence to support information included in management commentary. One member suggested adapting an approach to cross-referencing in management commentary similar to the 'Core & More' concept developed by Accountancy Europe.

17. If incorporating information in management commentary by cross-reference were allowed, members would suggest the following:

    (a) cross-references should be allowed only to regulatory filings (including for example, Solvency II reporting);
    (b) cross-references in electronic format should only require one click (rather than a chain of clicks), and a cross-reference back to management commentary should be provided in the referenced document;

(c) cross-references should be to entity-specific information rather than to boilerplate discussion;

(d) management commentary should provide context for cross-references to make it clear why particular information is included by cross-reference rather than directly; and

(e) maps or lists of cross-references made should be provided.

18. In discussing overlap with corporate governance reporting, members agreed with the staff's proposed approach to not require information about corporate governance in management commentary. Some members commented that information about particular matters, for example information about risk management, would be relevant for both corporate governance reporting and management commentary but the focus of the discussion in those reports would be different. Some members highlighted it is important to discourage boilerplate disclosures.

Business model

19. The staff presented the proposed approach to introduce two components for the description of the business model—a discussion of the structure of the entity and a discussion of business activities. Based on the revised guidance in IFRS 3 *Business Combinations*, the staff proposed that the discussion of business activities would cover inputs, including resources and relationships, processes and outputs and impacts. Members generally agreed with the staff's proposed approach. A few members commented that understanding the business model is fundamental for understanding the financial statements, and also central to assessing narrative coherence of management commentary.

20. Some members expressed concerns about the proposals relating to structure, particularly the proposed discussion of how the legal structure relates to the operating structure. A few members suggested that the discussion of legal structure would not be helpful because legal entities are sometimes set up just to meet regulatory requirements and do not necessarily correlate with the group's operations, for example, in China a legal entity needs to be set up for every project undertaken. A member said that the requirement to list the main subsidiaries under IAS 24 *Related Party Disclosures* addresses the need for information about legal structure. That member also questioned why the requirements in IFRS 8 *Operating Segments* were not specifically referred to in the proposed guidance. The member expressed a view that discussion of operating structure in management commentary should be aligned with segment disclosure in financial statements. A member from the user community stated that information on segmental cash flows would be useful to users. However, a preparer noted that entities may not necessarily prepare this information for internal use. Another member commented that users often do not get sufficient information on the different business units in very large entities, because business units may fall below the entity's materiality threshold.

21. Some members commented on the staff's proposal to link the provision of detailed information about specific features of the business model, including impacts, to the prospects for future net cash inflows to the entity. Some of those members agreed that the discussion of business model

in management commentary needs to be rooted in the effect on future cash flows but asked for more clarity on time horizons. However, a few members suggested that a link to 'value creation' or 'value creation through cash flows' could be more appropriate because the effect on cash flows is often viewed though a financial lens only and could be associated with the short term. One view expressed was that although management commentary is aimed at shareholders, it should also address the impact on and value for other stakeholders and therefore the link to cash flows could be too narrow. In addition, those members were concerned that a reference to cash flows could be read to imply a measurable effect on cash flows but there could be matters or trends whose effect on cash flows was not yet known. Overall, members agreed that management commentary should address those matters which are difficult to measure but will ultimately have an effect on cash flows. However, one member urged the Board to be cautious so that management commentary is not too broad and only includes information about matters that management reasonably expects to affect future cash flows. Another member suggested that providing examples of how entities should consider the effect on future cash flows in preparing management commentary could be helpful.

22. Members also made the following comments in discussing particular aspects of the proposals:

    (a) discussion of impacts in management commentary should be linked to discussion of resources and relationships, for example, discussion of declining resource availability, and should distinguish between resources that the entity controls and those that form part of its environment.
    (b) discussion of intangible resources and relationships should be given more prominence in management commentary, rather than just be subsumed in the discussion of the business model.

23. A few members commented on terminology as follows:

    (a) it was not clear how the definition of business model in the staff's proposals aligns with the definition of business model in IFRS 9 *Financial Instruments*. It is important that the same term does not have two meanings in IFRS literature.
    (b) it would be useful to consider aligning some of the terminology in the staff's proposals with the terminology in the *International <IR> Framework*, for example to use the term 'outcomes' rather than 'impacts' and to use verbs in describing components of 'business activities'. It is counterintuitive to describe 'activities' using nouns such as 'inputs' and 'outputs'.

Strategy

24. The staff introduced the proposed approach to reporting the entity's strategy for the long, medium and short term by discussing the entity's purpose, objectives and plans. Members agreed with this approach, although a few members suggested that the guidance should

specifically address the intended time frames, or that it should emphasise the focus on the long term.

25. One member expressed a view that the proposals seemed to focus on discussing *changes* to strategy, rather than the *existing* strategy, and that the proposed wording may imply that strategy changed frequently. Another member raised the question whether both the discussion of strategy and management commentary as a whole should focus on changes during the year, or provide an up-to-date snapshot containing both fundamental standing data and changes. Most members who commented said they preferred the latter approach.

26. The staff's proposals also included introducing specific guidance on reporting an entity's funding strategy. Members generally agreed with this proposal. Some members suggested that revised guidance should also explicitly address liquidity strategy. Members further suggested that management commentary should specify the period being assessed by management in developing those strategies and include a statement about the entity's ability to meet future commitments. A member commented that extending the proposed guidance to ask for such a statement would be particularly helpful for users who analyse entities in emerging economies which may have no other regulations requiring such or similar statement from management.

27. The discussion on strategy also covered the staff's proposal that entity's culture should be discussed in management commentary. Members agreed that information about culture is useful for users but expressed different views on how culture should be addressed in management commentary. Comments made included:

    (a) a requirement to describe culture could result in a boilerplate disclosure. However, a member from the user community said that a boilerplate disclosure in itself could still be a useful signal for users.
    (b) culture is not a standalone item or a part of strategy that can be described in isolation. Instead, it is a fundamental underlying characteristic of how the entity goes about its business and it should therefore be discernible from the description of the entity's business model, strategy and other matters, particularly management and employee incentivisation.
    (c) culture should only be discussed in management commentary if information about culture is material, for example as is currently the case in the banking industry, or if it is a truly distinctive feature of the entity's business model.
    (d) culture is difficult to measure. However, there are metrics which could help to quantify culture, such as employee surveys and customer satisfaction metrics. Those metrics are particularly useful if tracked over time.

28. In discussing terminology, a member expressed nervousness about the use of the term 'predictions' in the proposals, even if this was done to distinguish from the statements of fact and management's aspirations in discussing the basis for developing the entity's strategy. The

member suggested aligning the wording in the proposals with the terminology used in IAS 36 *Impairment of Assets*.

Operating environment and risks

29. The staff members presented the proposals on how to identify trends and factors in the operating environment, and risks that need to be discussed in management commentary, and what information to report about them. Overall, members agreed with the proposals, but provided comments on particular aspects of the proposals.

30. A few members asked for more guidance on how to identify risks that need to be discussed in management commentary and in particular how to use the magnitude and likelihood of risks as a basis in identifying reportable risks (for example, should a risk meet both the magnitude and likelihood threshold to be reportable or only one of those thresholds). One member cautioned against using both magnitude and likelihood as a basis for identifying reportable risks because in some cases this may lead to disclosing sensitive information. For example, disclosing litigation risks on this basis may be used to an entity's disadvantage by its counterparty in a reported case.

31. One member suggested that it was unclear whether proposed guidance required categorisation of risks in management commentary and expressed reservations about whether categorisation was necessary. The staff clarified that the sources of risk discussed in the proposed guidance were intended to be used as prompts for identifying the risks, not as categories of risks to be reported in management commentary.

32. Members discussed and expressed different views on whether:

    (a) the discussion of risks should distinguish between risks that an entity can and cannot control; and
    (b) risks should be reported before mitigating actions (gross) or after mitigating actions (net).

33. Members discussed the importance of avoiding boilerplate disclosures on risks. One member suggested that the revised guidance on risks should explicitly require management to provide only material information on risks. Another member said that management commentary should explain the process of determining which risks are material.

34. Other suggestions included that management commentary should:

    (a) provide a balanced discussion on both risks and opportunities (including a discussion of those opportunities which an entity decides to pursue);
    (b) address mega trends, such as major technological changes; and
    (c) be clear on the time horizon over which risks are being assessed and reported.