30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**12 December 2007, London**
Project:	**Management Commentary**
Subject:	**Agenda Proposal (Agenda Paper 5D)**

INTRODUCTION

1. This paper sets out proposals for a project on management commentary to be added to the Board's agenda. The paper proposes to use the conclusions reached in the *Management Commentary* discussion paper as the basis for moving the project from the research agenda to the active agenda.

2. The premise for adding a project on management commentary to the active agenda is that a narrative report, accompanying the financial statements, is a necessary component of a general purpose financial report. The need for this narrative report stems from the increased complexity of both the global business environment and the transactions that underpin the financial statements.

3. This paper considers whether a project on management commentary meets the IASB's agenda criteria (paragraphs 18 to 63).

STRUCTURE OF THE PAPER

4. The paper is structured as follows:

- Background—a brief discussion of the history of the research project that culminated in the discussion paper *Management Commentary* and a review of constituents' responses to the Invitation to Comment.

- Mandate—a brief discussion regarding the question of whether a project on management commentary fits within the IASB's mandate.

- IASB agenda criteria—an analysis of the proposed project relative to the agenda criteria set out in the IASB Due Process Handbook (April 2006).

- Appendix—a discussion of existing requirements for management commentary (presented as Appendix B of the discussion paper) in a selection of jurisdictions (see paragraph 6).

5. In developing this agenda proposal, it has become clear that management commentary can be a polarising topic. Contributors to the development of this paper had strong (and often times conflicting) opinions. In this agenda proposal, the staff has sought to consider both the benefits and challenges intrinsic to a management commentary project.

BACKGROUND

6. In late 2002, the IASB established a project team comprising representatives from the national standard-setters in Canada, Germany, New Zealand, and the United Kingdom to examine the potential for issuing a standard or guidance on management commentary. The project team focused its review on the practices in place in the following countries:

- Canada
- Germany
- United Kingdom
- United States
- Australia

The project team also reviewed the EU Modernisation Directive as well as guidance issued by the Technical Committee of the International Organization of Securities Commissions (IOSCO).

7. In October 2005, the IASB published the results of the project team's research in a discussion paper *Management Commentary*. The discussion paper presents an assessment of the role the IASB might play in improving the quality of the management commentary that accompanies financial statements. In the discussion paper, the project team presented their views regarding the users, objective and characteristics of management commentary. The discussion paper also presented essential content elements of management commentary and a possible placement framework for use by standards-setters in distinguishing between information that would appear in the management commentary and information that would appear in the financial statements.

8. At the January 2007 meeting, the Board discussed a summary of the 116[1] comment letters received in response to the discussion paper. Overall, the responses received from respondents were positive. Specifically, of those who answered the related questions:

    - 92 percent agree that management commentary is an integral part of a financial report;

[1] A total of 117 comment letters were received. Respondent 117 was a late submission and while acknowledging that the project is a significant task facing the international business community, it did not answer the specific questions in the discussion paper.

- 95 percent agree with the objective of management commentary, including the three elements of the objective, as it was described in the discussion paper;

- 86 percent agree with the principles and qualitative characteristics identified in the discussion paper;

- 95 percent agree with the five essential content elements put forward in the discussion paper; and

- 92 percent agree that there is a need for requirements relating to management commentary.

9. At its June 2007 meeting, the Standards Advisory Council (SAC) discussed the summary of the responses to the discussion paper. SAC members stressed the need to promote narrative reporting as both complementary to the financial statements and necessary to the production of a high quality financial reporting package.

10. It was pointed out that, given the level of preliminary work that has already been completed on this project, the IASB would realise the greatest benefit if continued work was completed relatively quickly and was based upon the conclusions reached in the discussion paper.

11. Some SAC members indicated their desire to see the IASB focus on the Conceptual Framework project instead of broadening the current work programme. These SAC members think that the completion of the conceptual framework project may make it unnecessary to add a management commentary project to the technical agenda. Additionally, members of the SAC expressed a concern that work done by the IASB on management commentary may infringe upon the work already done in this area by domestic regulators.

12. A draft agenda proposal was presented to the SAC at its November 2007 meeting. SAC members reiterated many of the comments that were made at the June 2007 meeting (see paragraphs 9—11).

IS A PROJECT ON MANAGEMENT COMMENTARY WITHING THE IASB'S MANDATE?

13. The question of whether a project on management commentary is within the IASB's mandate is routinely raised by many of our constituents. Some of the more common arguments are listed below:

- Providing guidance on management commentary is a considerable leap from the standard-setting activities that have previously been undertaken by the Board.

- The desirable content of management commentary is driven by cultural factors and expectations about how companies should do business. As a result, the form and content of management commentary should continue to be regulated by local or regional regulators—not accounting standards-setters.

- The question of how and in what form management commentary information should be communicated to the capital markets is a matter primarily for national stock exchange regulators and lawmakers. Because extensive management commentary requirements have already been issued by these bodies, an IFRS on the same subject would only generate additional reporting requirements without delivering any tangible added value for users.

14. The arguments listed in paragraph 13 point to a fundamental issue regarding management commentary: many of the IASB's constituents tend to use the terms 'management commentary' and 'management's discussion and analysis' (MD&A) interchangeably. The staff thinks that these constituents have the North

American concept of management’s discussion and analysis in mind when they refer to MD&A, which carries with it very specific connotations that are pervasive in the global business environment. The proposed model for management commentary does not conflict with the MD&A requirements found in North America nor does it aim to replicate the content level for any particular jurisdiction’s approach to MD&A.

15. Additionally, should the Board choose to take the management commentary project onto its active agenda, a request has been made that the eventual output should not be cast as anything resembling ‘minimum requirements’. The IASB and securities regulators have overlapping constituencies therefore issuing either a ‘best practices’ document or an IFRS that outlined the minimum requirements for management commentary may have the unintended effect of undercutting the work already completed in this area by regulators. Said differently, if minimum requirements are sufficient for the IASB, the concern is that the constituents would question why it is that they are held to what some may perceive to be a more arduous standard by regulators for a similar type of reporting that the IASB is willing to accept.

16. The project team that prepared the *Management Commentary* discussion paper was sensitive to the question of whether a project on management commentary was appropriate in the light of the IASB’s mandate. In paragraphs 3 to 5 of the discussion paper, the project team reminds readers that both the Constitution of the IASC Foundation and the IASB’s ‘Preface to International Financial Reporting Standards’ acknowledge the importance of ‘other financial reporting’ to assist in the interpretation of a complete set of financial statements and to improve users’ ability to make economic decisions. The staff thinks management commentary, as described in the discussion paper, is within the scope of ‘other financial reporting’. This view is also supported by the Conceptual Framework team and most respondents to the discussion paper.

17. The staff contend that the real issue for many of our constituents is whether narrative reporting can be viewed as an 'accounting' issue. Constituents point to language in the Constitution describing the objectives of the organisation to be centred on developing 'a single set of high quality, understandable and enforceable global accounting standards' (excerpted from paragraph 2(a) of the Constitution). Constituents observe that, while these global accounting standards may 'require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions' (excerpted from paragraph 2(a) of the Constitution), there is no express mandate for the IASB to actually *develop* that 'other financial reporting'.

IASB AGENDA CRITERIA

18. The IASB due process handbook sets out five criteria to be considered in deciding whether to add a potential item to the agenda:

- the relevance to users of the information involved and the reliability of information that could be provided;
- the existing guidance available;
- the possibility of increasing convergence;
- the quality of standards to be developed; and
- the extent of any resource constraints.

Criterion 1: The relevance to users of the information involved and the reliability of information that could be provided

19. The objective of a project should be to address a demand for better quality information that is of value to users of financial statements. In considering this, there are four main factors:

(a) international relevance;

(b) pervasiveness;

(c) urgency; and

(d) consequences of not taking on the project.

International relevance

20. The issues presented in the management commentary discussion paper are relevant to the IASB's constituents. As noted in paragraph 8, ninety-two percent of those who answered the question agreed that there is a need for requirements related to management commentary. Furthermore, all but one respondent indicated that the model for management commentary detailed in the discussion paper was consistent with their local requirements.

Pervasiveness

21. Management commentary affects all stakeholders in the financial reporting value chain in that it provides an additional layer of information for use in making economic decisions. A project on management commentary and its resultant output has the potential for creating significant value added for all users of financial statements. Respondents to the discussion paper were nearly unanimous in their agreement that management commentary is an important communication tool that helps users of financial statements understand the longer term risks and opportunities facing companies.

Urgency

22. The discussion paper *Management Commentary* was well received. Additionally, the conclusions were largely supported by respondents to the Invitation to Comment. Continuing work on this project by adding it to the active agenda sends a signal to the IASB's constituents that their enthusiasm for the topic has

been heard. Moving forward with this project allows the Board to capitalise on the positive sentiment generated by the discussion paper.

23. It should be noted that, when asked whether management commentary should be a priority for the Board, 63 percent of respondents to the discussion paper responded in the affirmative. The substantial minority supported their position by pointing to the IASB's already lengthy technical agenda.

24. While respondents supported the IASB's intention to encompass all aspects of financial reporting in its standard setting, some pointed out the inconsistency of adding a project on management commentary to the technical agenda when the boundaries of financial reporting have not been determined in the Conceptual Framework project. Further, others cited the recent adoption of IFRSs in jurisdictions and the resource burden of convergence with US GAAP as a signal that the IASB's time would be better spent resolving accounting issues instead of introducing a new dimension to financial reporting, *at this stage*.

25. The staff working on the management commentary project and the staff working on the Conceptual Framework do not view the projects as being mutually exclusive in the sense that one must be completed before the other may begin. We view the two projects as being symbiotic, parallel efforts. The CF team was consulted during the development of the discussion paper. The objective of management commentary in the discussion paper was designed such that, regardless of the boundaries of financial reporting, it would be focused enough to fit within them. Similarly, the CF team has revised the qualitative characteristics of the conceptual framework to encompass financial reporting, not just financial statements.

26. The CF team has indicated that work on management commentary will inform their efforts in Phase E of the CF project, particularly in the areas of the purpose of disclosure and the methods for conveying disclosed information. To that end, the placement criteria developed in the discussion paper may prove to be particularly helpful in furthering that discussion.

Consequences of not taking on this project

27. Distinct management commentary requirements currently do not exist within IFRS; guidance is incorporated in IFRS by reference. For example, IFRS 7 *Financial Instruments: Disclosures* establishes a principle that entities should disclose information enabling the evaluation of the nature and extent of risks arising from financial instruments to which they are exposed at the reporting date. This information may be communicated either in the financial statements or may be incorporated by cross-reference from the financial statements to some other statement that is available to users of the financial statements on the same terms and at the same time, such as a management commentary. If the Board does not add management commentary to the active agenda it loses, at least in the short term, the opportunity to define what it is asking its constituents to do when it instructs them to utilise management commentary for disclosure of accounting standard specified information.

28. The Board may choose not to add a project on management commentary to its active agenda and instead monitor the progress being made by IOSCO on its own project to develop disclosure principles for issuers' periodic reports (see paragraph 33). Once IOSCO's work is complete in this area, the IASB may wish to consider adopting IOSCO's work product as its own by reference in an amendment to IAS 1.

Criterion 2: Existing guidance available

29. The discussion paper examined the management commentary requirements applicable to entities operating in select jurisdictions (see paragraph 6). A discussion of existing requirements for management commentary in these jurisdictions was included in appendix B of the discussion paper. For ease of reference, this information has been reproduced in the appendix to this agenda proposal.

30. The purpose of the discussion paper was to examine the potential for the IASB to develop standards or guidance for management commentary. At the time, there was general acknowledgement that guidance on this topic was needed and that preparers of financial statements were looking to the IASB and IOSCO for it.

31. One point of view is that sufficient material presently exists to guide those preparers of financial statements who wish, or are required, to prepare management commentary. Even if it was thought that this current guidance could be improved, the preparation of management commentary (or similar narrative reports) requires the application of considerable judgment by the preparers. Ultimately the quality of such commentary depends more on the ability and diligence of the management who prepares it than the precise content of the framework under which it is written.

32. The counter argument is that the content of the framework under which a management commentary is written has *everything* to do with the quality of such a document. From the staff's perspective, the real issue is whether our proposals are significantly (and appropriately) different from existing guidance such that value is added to the financial reporting chain through their usage.

33. As noted in paragraph 28, IOSCO is working on a project to develop disclosure principles for issuers' periodic reports that will build on its previous work on management commentary. A summary of IOSCO's work is included below in paragraphs 34 through 36.

34. In 1998, IOSCO endorsed the *International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers (International Equity Disclosure Standards)*. Item 5 of the *International Equity Disclosure Standards* establishes disclosure standards for management commentary applicable to the information that foreign issuers should provide in documents used in initial offerings and listings of equity securities by foreign issuers.

35. In its most recent disclosure project, the *International Disclosure Principles for Cross-Border Offerings and Listings of Debt Securities by Foreign Issuers (International Debt Disclosure Principles),* IOSCO published for public comment in October 2005 guidance on the types of disclosures that foreign issuers should provide in documents used in public offerings and listings of debt securities. Item VIII of the *International Debt Disclosure Principles* also contains substantive guidance on the management commentary disclosure that foreign issuers should provide in such documents. The guidance provided in this project reflects regulators' consideration of additional disclosures that could be provided in management commentary in the light of recent financial frauds. IOSCO published a final report on this project in March 2007.

36. In 2003, IOSCO published the *IOSCO General Principles Regarding MD&A* to explain the purpose behind management commentary and to note general precautions for issuers when preparing management commentary disclosure.

Criterion 3: Possibility of increasing convergence

37. This project has the potential for increasing the convergence of aspects of management commentary across different jurisdictions. Convergence will ultimately depend on the extent to which jurisdictions may be persuaded to adopt IASB issued management commentary requirements nationally.

38. In some jurisdictions, mid to large capitalised companies are accustomed to writing management commentary due to either local requirements or regulations imposed by the public exchanges they are traded on, or both. IASB issued requirements would prove useful to companies less seasoned or regulated in the area of management commentary and may help to drive comparability across all entities that apply IFRS, thereby improving the usefulness of the financial reports to users. The existence of IASB requirements may also encourage regulators to adopt those requirements rather than develop their own.

Criterion 4: Quality of the guidance to be developed

Availability of alternative solutions

39. There are several approaches that may be taken with regard to this project. Considerable work has been undertaken by the project team that developed the *Management Commentary* discussion paper. The staff believe that their research and proposals may be developed to form the basis of a comprehensive and consistent framework for management commentary.

40. A discussion about alternative solutions can be reduced to a consideration of the type of work product a project on management commentary may ultimately result in. The staff thinks there are four possible alternatives:

    (a) a 'best practices' document

    (b) an amendment to IAS 1

    (c) an IFRS modelled after IAS 34 *Interim Financial Reporting*

    (d) a 'full' IFRS

41. This agenda proposal does not assess, in detail, all of the issues pertaining to each alternative listed in paragraph 40. If a project on management commentary is added to the active agenda, the first topic for discussion will be determining the appropriate work product for this project. The staff anticipate that the project plan will necessarily evolve based on the Board's work product decision.

42. Some Board members have signalled that they would be unable to make an agenda decision on this project without considering the implications of the ultimate work product. As a result, the staff has included (see paragraphs 43 to 53) a very high level assessment of some of the pros and cons that each alternative would encounter. The pros and cons identified for each alternative are not exclusive to that alternative—there will be overlap, to differing degrees, based upon common elements amongst the alternatives. For example, any alternative

that results in management commentary becoming a mandatory component of financial reporting will confront similar (if not the same) issues.

‘Best practices’ document

43. The issuance of a best practices document, modelled almost exclusively on the *Management Commentary* discussion paper, would give the Board the opportunity to issue management commentary guidance within a fairly short time frame. A ‘best practices’ document would have the credibility associated with the IASB. Additionally, as the content of the guidance would be based on a synthesis of various aspects of management commentary guidance in existence, the IASB will have completed the work for jurisdictions and/or companies that currently do not have such guidance in place and would have looked to other jurisdictions for assistance in furthering their work in this area.

44. A question arises as to whether the IASB should be in the business of issuing ‘best practice’ documents. For some, the idea of issuing this type of document is at odds with the IASB’s current stance regarding the issuance of additional IASB branded application guidance. Others will point to the IASB’s already full active agenda and question why resources are being deployed towards the production of an output that is viewed by some to be ancillary as opposed to necessary.

Amendment to IAS 1

45. The amendment to IAS 1 would involve recasting the document as to address the presentation of financial reporting as opposed to merely the presentation of financial statements. This approach allows the Board to establish narrative reporting as a necessary (and mandatory) component of general purpose financial reports. The staff envisage that once this step is completed, work on management commentary would shift to the Conceptual Framework team. Using the conclusions reached in the discussion paper in tandem with their own work on defining the boundaries of financial reporting, it would be up to the CF team to finalise the principles and qualitative characteristics of management commentary.

46. Once the work by the CF team has been completed, work to establish the content of management commentary would begin. This work would involve consultation with the Financial Statement Presentation team and consist of evaluating existing standards against a placement framework to determine where information is most appropriately presented: in the notes to the financial statements or in management commentary. The actual content of the management commentary would therefore be driven by the accounting standards.

47. This approach gives the Board the opportunity to establish narrative reporting, *within* its existing (and developing) conceptual framework. Concerns regarding both pre-empting work to be done by the CF team and maintaining consistency with the CF project's outcomes are no longer valid. Additionally, the IASB's management commentary becomes a fundamental 'accounting' tool that takes its direction explicitly from the accounting standards. It is in this way that the IASB's approach to management commentary would differentiate from existing requirements (or guidance) on the topic.

48. The primary downside to this approach is the length of time that it will take to reach completion. The staff anticipate that, if the Board were to pursue this alternative, a final product in the form of amended IFRSs to include management commentary requirements would only materialise after many years.

An IFRS modelled after IAS 34

49. The draft version of this agenda proposal that was presented to the SAC at the November 2007 recommended that the final output of the project be an IFRS modelled on the scope of IAS 34. The staff envisages that a Standard in this form would **not** mandate which entities are required to produce management commentary in concert with their financial statements. However, if an entity is required, or elects, to include an IFRS compliant management commentary as part of its general purpose external financial report, it would be required to follow the framework outlined in the Standard. This alternative would not require compliance with the Standard in order to assert compliance with IFRSs.

50. Because of its flexible scope, this approach to developing a management commentary standard does not carry with it the concern that the IASB will be imposing costs that exceed the benefits to its constituents. At the same time, the positioning of the work product as an IFRS affords it the stature of authoritative literature and the IASB brand.

51. The counter point to this argument is that some believe this approach adds little to no value to IFRSs. The subtext to this particular argument is that the *only* way the IASB may add value to IFRSs (specifically) and financial reporting (generally) is to **require** the inclusion of a management commentary in tandem with the financial statements as part of the general purpose external financial reports.

A 'full' IFRS

52. Many of the arguments both for and against management commentary requirements have been articulated in relation to the other alternatives described in paragraphs 43 to 51. Four additional considerations are mentioned below.

53. The discussion paper cast the management commentary guidance as a 'framework'. Some will question the wisdom (and necessity) of establishing a second framework that sits alongside the conceptual framework, as opposed to within it. Secondly, the use of a 'full' IFRS as the final output for management commentary almost necessitates an amendment to the Constitution that explicitly broadens our mandate from accounting standards to financial reporting standards. Thirdly, the costs associated with the mandatory inclusion of management commentary as part of the general purpose external financial reports may be prohibitively significant for many of the IASB's constituents.

Cost/benefit considerations

54. An important aspect of the quality of a new standard is the balance between the benefits of the information produced in accordance with the standard and the costs to entities of providing such information. The staff believe that the implementation of a reporting framework for management commentary may carry

significant costs, specifically for those entities that have little to no experience with narrative reporting in jurisdictions lacking specific regulatory requirements in this area.

55. It will be important to show that the Board has balanced the costs and benefits of providing management commentary reporting in conjunction with the financial statements. The benefits of providing management commentary come in the form of improved financial reporting. Management commentary requirements could improve the quality of management commentary information reported by increasing comparability of management commentary both for an entity over time and between entities. Additionally, management commentary requirements may help to ensure that the management commentary information is consistent, or reconciled, with the IFRS financial information. Management commentary requirements would also impose a discipline for management to report in a more balanced, unbiased way.

56. The cost/benefit discussion ultimately hinges on the output of this project. If the output of the project is a ‘best practices’ document or an IFRS modelled after the scope of IAS 34, jurisdictions and their entities would make their own cost/benefit assessment in determining whether to adopt the provisions of the guidance.

Feasibility

57. Management commentary is an item which has been regulated differently in different countries for many years—cultural differences amongst the IASB’s constituents will impact this project.

58. Many of the issues that arise in this project are closely related to issues currently under debate in the Conceptual Framework project. There are two major cross-cutting issues:

(a) the boundaries of financial reporting, whether management commentary falls within them and, if so, is subject to the Conceptual Framework;

(b) whether the conceptual framework should be extended to be applicable to management commentary.

59. The staff view a project on management commentary as being necessarily coupled with the Conceptual Framework project. The extent of that coupling depends on whether the final work product is authoritative. If the Board chooses to pursue a work product that results in non-mandatory guidance, the staff believe it can conduct work on this project in tandem with the CF project, with an eye towards limiting any significant theoretical discrepancies between the two projects. If the Board chooses to pursue a work product that results in mandatory requirements for management commentary, the staff would advocate deferring to the CF project on decisions regarding underlying principles and qualitative characteristics.

60. Another cross-cutting issue for the management commentary project is its relationship to the Small and Medium-sized Entities (SME) project. In many jurisdictions, management commentary is only required for entities of a certain size, or with certain stakeholder characteristics (such as being publicly listed). These stakeholder characteristics are substantially different from those being considered by the IASB to define SMEs. Depending on the output the Board chooses for this project, the staff may need to conduct analysis as to whether an exemption for SMEs would be appropriate.

Criterion 5: Resource constraints

61. The *Management Commentary* discussion paper was developed in consultation with the Board; the Board had both input and influence over the final product. However, because the Board did not believe that it had sufficiently deliberated either the issues presented or the conclusions reached in the discussion paper, the document was issued as the results of a research process undertaken, not the preliminary views of the Board. In the light of the IASB's due process requirements (see paragraphs 39 and 40 of the IASB Due Process Handbook) the main points of the discussion paper will necessarily be 'redeliberated'—this time from the perspective that the outcome represents the Board's preliminary views.

The extent of the deliberations will need to be determined by the Board in conjunction with the finalisation of the project plan.

Availability of expertise outside the IASB

62. If the Board views the project as a major, long term one then, in accordance with paragraph 90 of the IASB Due Process Handbook, the IASB must consider the establishment of a working group.

Amount of additional research required

63. As the work on this project is being shifted from the project team of partner standard-setters to in-house IASB staff, time will necessarily be reserved for the current staff to get up to speed on the topic. Additionally, research into existing jurisdictional requirements for management commentary in a wider range of countries (China, Japan, India, and the region of South America) than those listed in the discussion paper will be undertaken.

PROPOSED PROJECT PLAN

64. The management commentary project plan will necessarily be dictated by the decisions the Board makes with regard to the final work product. Until that decision is made, the staff is unable to propose a project plan, no matter how tentative it may be, beyond the first meeting for deliberations on this project.

Appendix: Existing Requirements for Management Commentary

(from appendix B of the Management Commentary discussion paper)

Existing requirements for MC

International Organization of Securities Commissions (IOSCO)

B1 The Technical Committee of IOSCO issued a report *General Principles Regarding Disclosure of Management's Discussion and Analysis of Financial Condition and Results of Operations* in February 2003. The report summarises the objectives of MD&A, identifies principles for preparers and highlights areas where preparers should be cautious, eg avoid boiler-plate or stock language. A comparison of matters addressed in the report, and the principles suggested in this paper, is in Appendix C. [Appendix C is not included in this Board paper.]

B2 The report states that:

> The purpose of the MD&A is to provide management's explanation of factors that have affected the company's financial condition and results of operations for the historical periods covered by the financial statements, and management's assessment of factors and trends which are anticipated to have a material effect on the company's financial condition and results of operations in the future. Companies should provide the information that is necessary for an investor's understanding of the company's financial condition, changes in financial condition and results of operations.

Australia

B3 The Corporate Law Economic Reform Program Act 2004 (CLERP 9) amended section 299A of the Corporations Act to require companies to expand their directors' report. For years beginning on or after 1 July 2004

> The directors' report for a financial year for a company or disclosing entity that is a listed public company must also contain information that members of the company would reasonably require to make an informed assessment of:
>
> (a) the operations of the entity reported on; and
>
> (b) the financial position of the entity; and
>
> (c) the entity's business strategies and its prospects for future financial years.

B4 The Australian Stock Exchange (ASX) has a listing rule that is based upon section 299A of the Corporations Act. ASX does not require any particular format to be followed, nor does it specify its content. However, both CLERP 9 and the ASX support the Group of 100 (G100) guidance publication *Guide to the Review of Operations and Financial Condition.* CLERP 9's explanatory memorandum states that the G100 guidance may be used for the purpose of satisfying the legislative requirement, and the ASX reproduces the guidance within its own Guidance Notes.

B5 The G100, a group comprising Australia's major private and public business enterprises and global enterprises operating in that country, originally issued its guide in 1998 and updated it in 2003. These guides have been influenced by both the UK OFR guidance and the Canadian guidance on MD&A.

B6 The guide states that:

> The Review should provide users with an understanding of the company by providing a short-term and long-term analysis of the business as seen through the eyes of the directors. This will be facilitated by providing useful financial and non-financial information and analysis. … A contemporary Review should include an analysis of industry-wide and company-specific and non-financial information that is relevant to an assessment of the company's performance and prospects.

Canada

B7 In Canada the requirements for and the content of the MD&A are mandated by the provincial securities regulatory bodies, collectively known as the Canadian Securities Administrators (CSA). In December 2003, the CSA issued new MD&A requirements applicable in all securities jurisdictions in Canada, contained within National Instrument 51-102 *Continuous Disclosure Obligations.*

B8 NI 51-102 and the related MD&A form do not refer to the CICA Guidance on MD&A issued in November 2002 (paragraph B9), but in several places appear to reflect the intent of that guidance. CSA Form 51-102FI, Part 1(a) describes MD&A as:

> ... a narrative explanation, through the eyes of management, of how your company performed during the period covered by the financial statements, and of your company's financial condition and future prospects.

B9 The CICA released guidance on MD&A disclosure in November 2002 (updated in May 2004) that sets out six principles and a five-part framework of recommended disclosure practices. A comparison of the principles and framework contained in the Canadian guidance and those proposed in this paper is in Appendices C and D. [Appendices C and D are not included in this Board paper.]

B10 The CICA as such has no mandate to issue standards for MD&A disclosure (nor to require MD&As to be issued by companies) – as explained above, that is all a regulatory responsibility and prerogative. The Guidance developed by a separate division (and volunteer board) of the CICA is used by companies on a purely voluntary basis. However, the four largest securities regulators in Canada (ie four members of the CSA) have issued explicit encouragement to companies to use the CICA Guidance, and the latest CSA MD&A requirements show signs of adopting some aspects of the CICA Guidance.

B11 The guidance states:

> … useful MD&A explains the 'why' behind both past performance and future prospects by 'connecting the dots' between otherwise separate pieces of internal and external information … should enable readers to view the company through the eyes of management … providing information important to an investor, acting reasonably, in making a decision to invest or continue to invest in the company … having a forward-looking orientation … focusing on management's strategy for generating value for investors over time.

European Union (EU)

B12 The requirements for MC type reporting are set out in various legal instruments adopted by the EU, in particular the Fourth and Seventh Company Law Directives (the 'Accounting Directives'), as updated by the Modernisation Directive and enhanced by the Transparency Directive. The Accounting Directives state that the annual report:

> … shall also give an indication of any important events after the balance sheet date, the likely future development of the entity, the activities in the field of research and development, and the risks relating to the use of financial instruments including their management.[2]

B13 The Modernisation Directive, which has been implemented in all Member States, requires companies to present an annual report that provides:

> … at least a fair review of the development and performance of the company's business and of its position, together with a description of the principal risks and uncertainties that it faces.

B14 The directive states:

> To the extent necessary for the understanding of the company's development, performance or position, the analysis shall include both financial and, where appropriate, non-financial key performance indicators relevant to the particular business, including information relating to environmental and employee matters. … the annual report shall, where appropriate, include references to and additional explanations of the amounts reported in the annual accounts.

B15 In December 2004, the EU adopted the Transparency Directive, which must be implemented by all Member States within two years. Under the directive, all security issuers will have to provide annual and half-yearly financial reports. These reports must include a management report prepared in accordance with the Accounting Directives. The half-yearly interim management report:

> …shall include at least an indication of important events that have occurred during the first six months and their impact on the financial statements together with a description of the principal risks and uncertainties for the remaining six months of the financial year.

Germany

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[2] Article 46 of the Fourth Directive and Article 36 of the Seventh Directive.

B16 The German tradition of management reporting goes back to 1931, when all public limited companies were required to prepare a business report. Specific requirements were introduced in 1937 requiring management:

(a) to explain the related financial statements;

(b) to identify material changes from the previous financial year; and

(c) to comment on the financial position of the company.

B17 The requirement to prepare a business report was extended to all limited companies in 1986. This has evolved to the management reporting we see today, which is based on the legal requirements of the EU and is almost identical to the EU content mentioned previously. Additionally, a legal requirement for risk reporting was introduced in 1998, and a German accounting standard (GAS 5 *Risk Reporting*) has been in place since 2001. GAS 5 states that:

> Risk reporting … should allow users to form an appropriate understanding of the risks affecting the future developments of the group.

B18 The legislation was amended in December 2004 to emphasise some topics such as an extensive analysis of development and performance of the business during the year, its financial position at the year-end, reporting of financial and non-financial key performance indicators, and the likely future development of the company including its significant opportunities and risks. The objective is an improvement in management reporting.

B19 The DRSC adopted GAS 15 *Management Reporting* in December 2004; it is based on the EU legal requirements and takes into account the SEC requirements, and the Canadian and UK guidance. GAS 15 sets out the principles, and format for content, to be followed in preparing management reporting. A comparison of those areas and the principles and essential content elements suggested in this paper is in Appendices C and D. [Appendices C and D are not included in this Board paper.]

B20 GAS 15 states that:

> The group management report shall present a fair review of the development of the business and of the group's position. Expected developments shall be assessed and discussed together with the significant risks and opportunities. … Management reporting is intended as a vehicle for presenting information to users from management's perspective. … The focus should be on sustainable value creation … The main factors which could influence changes in the value of the enterprise in the future should be disclosed and discussed. … It is recommended that the key performance indicators used internally to manage the group are quantified.

B21 GAS 15 also states that the intention is to reduce:

> … the gap between the information available to users of the financial statements and that available to management.

New Zealand

B22 The New Zealand Securities Commission is the principal regulator of securities when money has been obtained from the public. It has no specific requirements for MC. Rather, the regulator uses the financial reporting framework to manage the content of general purpose financial reports. MC is required for certain items when an entity makes an initial public offering, but those requirements do not extend to annual reports.

B23 The New Zealand financial reporting framework is managed by the Financial Reporting Standards Board. The framework is sector-neutral, covering profit-oriented and public-benefit entities. As such, the framework covers both financial and non-financial reporting. The consequence is that the framework refers to general purpose financial reports rather than the narrower financial statements. The framework includes outputs and outcomes as elements, and the qualitative characteristics apply to this wider set. In practice, public sector entities regularly report on service performance with non-financial measures.

B24 Notwithstanding the wider scope of the New Zealand reports, there is no specific analysis or discussion of MC within the New Zealand framework. However FRS-9 *Information to be Disclosed in Financial Statements* requires that when an entity has published prospective financial information it must present a comparison with actual performance in the period to which the forecast relates.

United Kingdom

B25 UK legislation in early 2005 requires quoted companies to prepare an operating and financial review (OFR). The

UK Government has stated that the statutory requirement for an OFR should be supported by a 'reporting standard'. The Government specified the UK ASB as the body to issue such a standard.

B26 The OFR objective as stated in the legislation is:

> ... a balanced and comprehensive analysis, consistent with the size and complexity of the business, of -
>
> (a) the development and performance of the business of the company during the financial year,
>
> (b) the position of the company at the end of the year,
>
> (c) the main trends and factors underlying the development, performance and position of the business of the company during the financial year, and
>
> (d) the main trends and factors which are likely to affect the company's future development, performance and position
>
> prepared so as to assist the members of the company to assess the strategies adopted by the company and the potential for those strategies to succeed.

B27 In May 2005, the UK ASB issued Reporting Standard (RS 1), which built on its existing statement of best practice on OFRs. RS 1 is a principle-based standard, which makes clear that the OFR must reflect the directors' view of the business. The objective is to assist members to assess the strategies adopted and the potential for those strategies to succeed. The standard also provides a basic framework for directors to apply in order to meet the requirements of the Regulations. It is for the directors to consider how best to use the framework to structure the OFR, given the particular circumstances of the entity. A comparison of both the principles and basic content framework in RS 1 with the proposals contained within this paper is in Appendices C and D. [Appendices C and D are not included in this Board paper.]

B28 RS 1 defines an OFR as:

> ... a narrative explanation, provided in the annual report, of the main trends and factors underlying the development, performance and position of an entity during the financial year covered by the financial statements, and which are likely to affect the entity's future development, performance and position.

B29 Although following a framework approach, the ASB has also prepared implementation guidance to accompany RS 1, as the ASB was conscious that some guidance would be useful to preparers of OFRs. The guidance sets out some illustrations and suggestions of specific content and related key performance indicators that might be included in an OFR.

United States

B30 In the US MD&A is called for by the federal Securities and Exchange Commission (SEC), the US securities regulator. The SEC is charged with administration of, and rulemaking and enforcement under, the Securities Act of 1933 and Securities Exchange Act of 1934. The Sarbanes-Oxley Act of 2002 caused the SEC to undertake significant additional rule-making. A comprehensive overview of the evolution, purpose and content of the MD&A is provided in the Interpretive Guidance released by the SEC in December 2003 (release numbers 33-8350 and 34-48960).

B31 That guidance stated:

> The purpose of the MD&A is not complicated. It is to provide readers with information "necessary to an understanding of [a company's] financial condition, changes in financial condition and results of operations." The MD&A requirements are intended to satisfy three principal objectives:
>
> (a) to provide a narrative explanation of a company's financial statements that enables investors to see the company through the eyes of management;
>
> (b) to enhance the overall financial disclosure and provide the context within which financial information should be analyzed; and
>
> (c) to provide information about the quality of, and potential variability of, a company's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance.

B32 Furthermore:

> … companies should identify and discuss key performance indicators, including non-financial performance indicators that their management uses to manage the business and that would be material to investors.

B33 Since the collapse of Enron (late 2001), the SEC has issued several new releases, rules and proposals on topics including critical accounting policies and estimates, liquidity, capital resources, off balance sheet arrangements, aggregate contractual obligations and transactions with non-independent third parties. Some of these releases arguably call for disclosures that might otherwise be expected in notes to financial statements under US GAAP (the standards that are the responsibility of the US FASB.)

B34 The FASB does not issue guidance about MD&A disclosure. This is left to the SEC as a regulatory matter.