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**International  
Accounting Standards  
Board**

*This document is provided as a convenience to observers at Standards Advisory Council meetings, to assist them in following the Council's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.*

*Note: These notes are based on the staff paper prepared for the Council. Paragraph numbers correspond to paragraph numbers used in the Council paper.*

## **INFORMATION FOR OBSERVERS**

**SAC Meeting: June 2007, London**

**Project: Management Commentary  
Project update for SAC  
(Agenda Paper 5A)**

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### **Introduction**

1. The meeting held in October 2002 between the International Accounting Standards Board (IASB) and its partner national standard setters recommended that work should begin on a project to examine the potential for the IASB to develop standards or guidance for Management Commentary (MC). A discussion paper "Management Commentary" was published in October 2005 requesting comments by the end of April 2006.
2. An analysis of the comment letters received was presented to the Board in January 2007 as an Education Session. At present MC is not on the Board's active agenda. The purpose of this session is to present to the SAC:
  - (a) The same analysis of the comment letters that was presented to the Board in January (Paragraphs 4 to 44 of this Paper);
  - (b) Observations from the Board expressed at the Education Session (Paragraphs 45 to 46);

- (c) The results of the follow up work that has been undertaken by the MC project team to address concerns raised by the Board in January 2007 (Paragraphs 47 to 57);
  - (d) Anticipated next steps (Paragraphs 58 to 59).
3. This paper addresses all of these points, including a summary of the comments received. A more detailed analysis of the comment letters is available, although it has not been attached to this paper.

### **Analysis of comment letters**

4. A total of 116<sup>1</sup> comment letters were analysed from 26 individual countries. This includes 14 responses from users and user organisations, who collectively manage funds in excess of £7.5 trillion. The MC DP asked respondents to comment on 9 questions. The analysis of the responses to these questions has been grouped around a number of main themes.

### **Is MC an integral part of financial reporting?**

5. Of the comment letters analysed, 104 or 92 per cent of those who answered the question, agree that MC is an integral part of financial reports. Only nine respondents disagreed with the view that MC is integral to financial reporting. The majority of these nine did so due to concerns over MC audit requirements; not because they were against the concept of MC. The audit concerns are discussed in paragraphs 43 and 44 of this paper.
6. Generally the responses to the initial discussion paper question were brief with many simply answering 'Yes' to the question 'Do you think that MC should be considered an integral part of financial reports?'. It was clear from the comment letters that these respondents thought it was obvious that MC is an integral part of financial reporting. Those that did provide further rationale tended to emphasise the relevance of the information to decision making for investors as well as the role MC serves by both supplementing and complementing the accompanying financial statements.

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<sup>1</sup> 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.

## **What were respondents' views on what MC should cover?**

7. Appendix A of the discussion paper included the Management Commentary project team's preliminary views of what should be included in a standard or guidance relating to MC. Specific questions were asked relating to the following areas contained in Appendix A:
- Objective of MC;
  - Principles and qualitative characteristics of MC; and
  - Essential content elements that MC should cover.

### **Objective of MC**

8. The objective of MC put forward by the Management Commentary project team was:

The purpose of MC is to provide information to help investors:

to interpret and assess the related financial statements in the context of the environment in which the entity operates;

to assess what management views as the most important issues facing the entity and how it intends to manage those issues; and

to assess the strategies adopted by the entity and the likelihood that those strategies will be successful.

9. Eighty-eight of the respondents, representing 95 per cent of those who answered the question, agree with the objective and the three elements. Twenty-three did not answer the question. Those supporting the objective, including its three elements considered it to be relevant, straight forward and unambiguous.

### **Principles and qualitative characteristics of MC**

10. The principles put forward were:

MC should supplement and complement information in the financial statements.

MC should provide an analysis through the eyes of management.

MC should have an orientation to the future.

11. The qualitative characteristics put forward were:

MC should be understandable, relevant, supportable, balanced and comparable over time.

12. The majority of the respondents, 86 responses, representing 86 per cent who answered this question, agree with the principles and qualitative characteristics identified by the project team; while 14 respondents, 14 per cent of the responses, disagreed. The question was not answered by seventeen respondents.

13. The majority of the respondents who disagreed had issues with the qualitative characteristics, rather than the three principles put forward in the discussion paper. The only comment of substance with regard to the principles related to the principle 'MC should have an orientation to the future'. Some respondents were concerned about this principle because safe harbour provisions do not exist in all territories.
14. Those that disagreed believe that the terminology used to describe qualitative characteristics for MC should be the same as that used in the IASB Framework. Further discussion on the qualitative characteristics and the relationship with the conceptual framework project is provided in paragraphs 35 and 36.

**Essential content elements that MC should cover**

15. The essential content elements put forward were:
  - (a) the nature of the business
  - (b) objectives and strategies
  - (c) key resources, risks and relationships
  - (d) results and prospects
  - (e) performance measures and indicators.
16. Eighty-six respondents, representing 95 per cent of those who answered the question, agreed with the essential content elements. Twenty-five did not respond. Those supporting the content elements for MC believe that the approach is a practical one because the content elements had been kept to a high level. In their view this was appropriate, because the nature of what needs to be disclosed within MC will differ depending on the nature of the business. Five respondents disagreed with the approach because, in their view, the essential content elements set out constituted a 'list' that could result in a compliance-driven approach to reporting by preparers. Interestingly, only one of the five respondents putting forward this view was a preparer, the other 20 preparer and preparer organisations all agreed with the suggested essential content elements.

**Should guidance be provided to limit the amount of information disclosed within MC?**

17. In addition, a further question was asked as to whether it would be appropriate to provide guidance or requirements to limit the amount of information disclosed within MC or at least ensure that the most important information is highlighted. This question was answered by 92 respondents. Sixty respondents, 65 per cent of those who answered the question, agreed with the proposal; while

32 respondents, 35 per cent of the responses, disagreed. The question was not answered by 24 respondents.

18. The feedback given was that the focus should be on issues relevant to investors; information which enhances understanding of the financial reports and issues of the greatest importance should be highlighted. Guidance should be general in nature and explain how the materiality concept might apply to MC. Actual reported information should be a matter for individual companies, their directors and management to determine. The objective should be that whatever information is disclosed, the emphasis should be 'Quality not Quantity.'
19. The counter argument was that requirements to restrict the amount of reported information would detract from the principle based approach proposed in the MC model. Management and directors must identify the key information and present this in a manner which is most appropriate to their business and industry, reporting style and cultural setting.

### **Did the respondents think that MC requirements should be issued as a standard or non-mandatory guidance?**

20. One hundred respondents, representing 92 per cent of those who answered the question, agreed that there is a need for requirements relating to MC, however, views were split as to the form the requirements should take. In summary, 53 respondents, 48 per cent of those who answered, want guidance, while 44 respondents, 40 per cent of those who answered the question, want a standard, and three want a hybrid system which includes both standards and guidance. Nine respondents do not agree with either option – mainly because they do not think it is the IASB's role to get involved in MC. Seven did not answer or their answers were unclear.
21. Several respondents consider that guidance would be a first step – leaving open the possibility that they would support a standard at a later stage; while another respondent proposed a phased approach suggesting that MC should be developed in three stages, short term, medium term and long term.
22. The argument made by respondents for supporting guidance is the importance of recognising that not all companies, even within the same industry, are similar. This supports the case for non-mandatory guidance that would create a benchmark for best reporting practice against which companies can exercise

flexibility and discretion to tailor their commentaries to their particular requirements. In addition, this approach would permit regulators of MC to align their recommendations or requirements over time with an agreed global benchmark. It should be noted that both the Committee of European Securities Regulators (CESR) and the International Organisation of Securities Commissions (IOSCO) consider that non-mandatory guidance should be issued if the Board decide to take forward the work on MC.

23. The argument made by respondents for issuing standards is that standards deliver a higher quality of disclosure than guidance. Also standards will improve the comparability of disclosure over jurisdictions. Voluntary guidance is considered to provide little value and it would be difficult to encourage compliance. Because some respondents see MC as an integral part of the financial report at least for listed entities, they support a comprehensive set of International Financial Reporting Standards should include a mandatory requirement to prepare a MC.

**Did respondents view the development of requirements for MC as a priority for the Board?**

24. There were 96 responses on this question; 60 respondents, 63 per cent of those who answered the question, agreed that the development of standards or guidance for MC should be a priority for the Board. Of the 60 respondents, 19, specifically stated that MC should be a medium/low priority for the Board. Of the 96 responses, 36 representing 37 per cent of those who answered the question, were of the opinion that this development was not a priority for the Board.
25. The respondents in favour of MC requirements considered that a balanced and objective, principally narrative, discussion of the performance and prospects of the company written in a clear and understandable prose is essential to supplement and enhance the information that is included in the financial statements. Developing principles and guidance for MC will improve the quality of financial reporting in general and help to realise convergence in this area, especially for those territories that do not have local guidance.
26. However, the alternate view is that the IASB should not add an MC project to its active agenda at the present time. The Board has many pressing demands on

its time and if added it could delay the completion of higher priority projects affecting the financial statements themselves.

27. Consistent with the view expressed by the Management Commentary project team in the discussion paper, a number of respondents also highlighted that there is a need for close co-operation with the securities regulators should the IASB consider it appropriate to take forward further work on MC.
28. In particular, CESR believe that a dialogue should be established with the IASB to minimise the risk that any guidance issued by the IASB conflicts with the standards developed by regulators. CESR consider that it is imperative that the IASB's project be designed in such a way as to fit well with the European regulatory framework. In addition, IOSCO point out that they have already developed pronouncements in this area and national disclosure requirements exist in several IOSCO member countries as a result of securities regulations or company law. They point out that any non-mandatory IASB guidance on MC must not conflict with national securities regulations and company law.
29. However, all constituents except one stated that the model the project team put forward in the discussion paper was consistent with their local requirements.

### **What can we learn about the consistency between the Conceptual Framework project and Management Commentary?**

#### **Preliminary views on an Improved Conceptual Framework for Financial Reporting**

30. The Management Commentary project team responded to the consultation on the preliminary views on an improved Conceptual Framework for Financial Reporting in the light of the project's team own experience of developing the MC discussion paper as well as the insights provided by 116 responses to the MC discussion paper. A copy of the response letter is available on request.

#### **Is the focus on the needs of investors appropriate?**

31. In respect of the question as to whether the focus of MC on the needs of investors is appropriate, 68 respondents, 73 per cent of those who answered the question, agreed that investor focus was appropriate while 25 respondents, 27 per cent of the responses, disagreed. It should be noted that 14 of the dissenting responses were from national standard-setters and Institutes of Accountants. The question was not answered by twenty-three respondents.

32. There were very few comments provided in relation to this question. A number of those supporting the focus on investors noted that such a focus is consistent with the current IASB framework's view that if the needs of the investors are met then, largely, the needs of other users of MC would also be met. Other supporters of the focus on investors noted that they would not wish to see the scope of MC extended to a wider range of users, as there would be a risk that the amount of information disclosed would be excessive. A number of respondents explicitly noted that they agreed with the Management Commentary project team's view that MC should not replace other forms of reporting, such as sustainability or corporate social responsibility reports.
33. The alternative view put forward by respondents is that the focus should not be solely on investors, as MC is useful to a broader range of users in making economic decisions. In taking a broader view, a number of respondents referred to the current IASB framework where seven groups of users (investors, employees, lenders, suppliers, customers, government and the public) are identified. Their position was that as the IASB framework refers to multiple users, so should MC.
34. Others took a middle view. They believe that it is an essential that management take a broad view in deciding what should be included in MC – thereby acknowledging the importance of “others” an entity has a relationship with, while still accepting the focus on investors. One respondent group, a consortium of corporations, global investors and other interested parties suggested an amendment to the draft to address this concern. The suggested text is included in the project team's response to the consultation on the preliminary views on an improved Conceptual Framework and is available on request.

**Can the same qualitative characteristics be applied to all components of financial reports?**

35. Initially the project team proposed the same terms for the qualitative characteristics for MC as those in the existing IASB framework. This proposal met with concern from the IASB. Specifically the Board asked the project team to consider whether it was appropriate to relate qualitative characteristics from the Framework to MC. As a result, the team's final view contained in the discussion paper was:

We believe that *understandability* and *relevance* should be applicable in the preparation of MC and accordingly should be reflected in the qualitative



characteristics. Rather than using the *Framework* terms *reliability* and *comparability* we use *supportability*, *balance* and *comparability over time*.

36. As noted in paragraphs 12 to 14, although the majority of respondents (86 per cent answering the question) agreed with the qualitative characteristics put forward by the Management Commentary project team, 14 respondents (14 per cent) disagreed. These respondents disagreed largely because they believe the same qualitative characteristics should be used for both the IASB Framework and MC. Accordingly, they disagreed with the replacement of reliability and comparability with the terms supportability, balance and comparability over time terms as used in the proposal.

**Would the development of placement criteria be helpful?**

37. At the request of the IASB, the Management Commentary project team developed and presented some placement criteria to assist the IASB in determining whether information should be disclosed in MC or the financial statements. The clear objective of adding this section to the discussion paper was to gain some early feedback for the conceptual framework project team.
38. The placement criteria developed by the MC project team and presented in the DP are set out below:
- Information should be disclosed:
- (a) In MC if it provides an investor with information that puts the financial statements into the context of the entity and its operating environment;
  - (b) In the notes if it is essential to an understanding of the primary financial statements and its elements, whether recognised or not.
39. Constituents were asked whether the placement criteria suggested by the project team were helpful, and, if applied, would be likely to lead to more consistent and appropriate placement of information within financial reports. The results to this question were mixed, 62 respondents, 76 per cent of those who answered the question, agreed with the proposal, while 20 respondents, 24 per cent of the responses, disagreed; the remaining 34 did not respond.
40. A significant number of those who did not agree with the proposal did so because they believe that placement criteria should not be part of the MC model, but should be considered within the conceptual framework project.

## **Other matters raised by respondents**

### **Should entities be required to include MC in their financial reports to assert compliance with IFRSs?**

41. Sixty-one per cent of the 92 respondents to this question thought it would be inappropriate for entities to have to include MC to assert compliance with MC. Reasons provided include the complementary nature of MC to the financial statements and the nature of MC itself, being management's analysis of financial information, including forward-looking information that lacks the same degree of objectivity as financial statement information.
42. The other 39 per cent of respondents thought compliance with IFRSs would enhance confidence in MC and that compliance should be required because MC is necessary to be able to interpret and assess the financial statements.

### **Audit implications of MC**

43. Some respondents noted that MC is viewed as an integral part of financial reporting but separate from financial statements. Others, however, are concerned that if MC is considered to be an integral part of financial reporting important consequences for the audit will arise as the audit of MC poses significant challenges compared to an audit of financial statements.
44. Some respondents were concerned that if MC is subject to audit this could result in a box-ticking and compliance-type mind-set to reporting.

### **Observations from the Board following the January session**

45. Board members seemed pleased with the response to the MC DP, and most agreed that MC was an important part of financial reporting and that guidance in this area would be helpful. However, two specific issues were raised by a Board member and IASB staff, namely:
  - (a) A perception that there are conflicting messages being received in response to the MC DP as compared to those received in response to the first DP on the conceptual framework (CF). Specifically, while the MC DP comment letters were overwhelming supportive of the view that MC was an integral part of financial reporting, the observation was that a number of the CF comment letters expressed the view that the conceptual framework should not be extended from financial statements to financial reports; and

- (b) That a similar framework to the one proposed in the MC DP, the mandatory Operating and Financial Review (OFR) in the UK, had been repealed, ‘apparently due to pressure from companies’. The view was that it would be helpful for the Board to understand the background to the decision in the UK and the current state of affairs.

Both of these concerns were followed up by the MC project team and are addressed in paragraphs 47 to 57.

46. The Board asked the project team to develop an agenda proposal.

### **Results of follow up work undertaken by the MC project team**

#### **Perceived discrepancy between comment letters received on the conceptual framework project and the MC project**

47. A concern was expressed by one of the Board members about the perceived discrepancy between the comment letters received by the conceptual framework team as compared to the MC project team. The view was that these discrepancies could be an indication that respondents are not as positive as the MC comment letter analysis suggests, when it comes to considering whether or not the Board should extend its remit beyond financial statements to financial reports.

48. Given this apparent discrepancy, the MC project team analysed the comment letters received by both the MC and CF teams, where:

- Explicit views had been articulated in the CF response relating to the broadening of the scope of the CF from financial statements to financial reports; and
- The respondents had also written a comment letter to the MC project team.

In total, this amounted to 25 comment letters. The MC project team’s analysis has been shared with and reviewed by a member of the CF project team.

49. One respondent did not agree with the view of the MC project team that MC is an integral part of financial reports, and expressed a consistent view in their response to the CF DP. Of the remaining 24 respondents, the views expressed in their comment letters responding to both the CF framework DP and the MC DP were considered to be consistent, with the exception of two respondents. The project team wrote to, and received feedback from, both of these respondents clarifying their views.
50. The views expressed in the CF comment letters, by the 24 respondents who supported the view that MC is an integral part of financial reports, can be analysed into three distinct categories, as set out below:

Description	Number of respondents
While agreeing that MC is integral to financial reports, do not believe the objective of the CF should extend beyond financial statements because they believe: <ul style="list-style-type: none"> <li>▪ There should be two separate frameworks; or</li> <li>▪ The framework should focus on financial statements and MC should be voluntary; or</li> <li>▪ The effort of the Boards should be on financial statements.</li> </ul>	4
Agree that the objective of the framework should be financial reporting	7
Clear that MC is an integral part of financial reporting. However, these respondents have concerns with the broadening of the objective from financial statements to financial reports, as suggested in the CF DP <sup>2</sup> , due to the perceived lack of debate as to: <ul style="list-style-type: none"> <li>▪ What constitutes financial reports; and/or</li> <li>▪ Definition of financial reports.</li> </ul>	13
Total	24

<sup>2</sup> CF DP, paragraph OB16 ‘News releases, management’s forecasts or other descriptions of its plans or expectation, and descriptions of an entity’s social or environmental impact are examples of reports giving financial information other than financial statements or giving only non-financial information’.

51. Comments, such as those raised by one preparer, are typical of the concern raised due to the lack of debate relating to what constitutes financial reports, as set out below:

*“However, we feel that extending the scope without detailing the precise boundaries of the scope leaves constituents in a difficult position in terms of commenting on the first two chapters – the boundaries of the conceptual framework are an integral part of the framework and any comments made prior to the resolution of this may potentially need to be revised in light of future developments.”*

52. In conclusion, it is the MC project team’s view that the apparent discrepancy between the two sets of comment letters does not indicate a lack of support for MC as an integral part of financial reporting, nor a view that the Board should not extend the conceptual framework to incorporate MC. Our assessment is that the views expressed in the CF comment letters indicate a plea, on the part of the respondents, for a debate on defining the boundary of financial reporting. This is scheduled to take place as part of Phase E of the conceptual framework project.
53. As noted earlier in this paper, a member of the CF project team reviewed our detailed analysis and agrees with our conclusion that respondents to the CF DP raised concerns with regard to the scope of the CF due to the lack of definition of what constitutes financial reporting.

### **Concerns as to the changing position with regard to similar requirements in the UK**

54. The Board also requested background to recent events relating to the Operating and Financial Review (OFR) in the UK. The OFR framework, along with others, was utilised by the MC project team in developing the MC DP.
55. Originally the requirement for listed companies to publish an OFR was mandatory and was supported by a Reporting Standard issued by the UK Accounting Standards Board (ASB). Following recent events, the ASB’s Reporting Standard has been converted to a Reporting Statement of best practice.

56. The UK continues to have mandatory reporting requirements in line with the EU's 4<sup>th</sup> and 7<sup>th</sup> Directives as amended by the Accounts Modernisation Directive (AMD). The Directive is for all companies, not just listed companies, to prepare a business review.
57. However, the announcement of the repealing of the mandatory OFR some 18 months ago did not end the evolution of narrative reporting in the UK. The current position is that for quoted companies, the content requirements for the business review under the Companies Act 2006 are very similar to those that were required for the statutory OFR. One outstanding issue for some commentators relates to the lack of guidance underpinning the statutory requirements. On this issue, the Association of British Insurers has noted that the OFR Reporting Statement 'continues to mark a useful benchmark for good practice'.

### **Anticipated next steps**

58. As requested by the Board, the MC project team will develop an agenda proposal which will be presented, first in draft to the IASB in October, then to the SAC in November. Following these meetings, the intention is that the final agenda proposal will be presented to the Board in December 2007.
59. As the project team is made up of staff of its partner standard-setters and others, the drafting of this agenda proposal will not impose a significant burden IASB staff or Board members.