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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **24 July 2008, London**

Project: **Management Commentary**

Subject: **Discussion Paper Conclusions Revisited (Agenda Paper 12A)**

OBJECTIVE

1. The goal of this meeting is to finalise the Board's tentative decisions (and the basis for those conclusions) for the management commentary project. At the conclusion of this meeting, the staff will ask the Board for permission to begin drafting the exposure draft.

2. The work plan for the project envisages publication of management commentary exposure draft in November 2008.

INTRODUCTION

3. The Board has asked the staff to develop an exposure draft based on the conclusions reached by the project team that developed the discussion paper *Management Commentary*.

4. The conclusions reached in the management commentary discussion paper were premised, in part, on the Board's then current thinking in Phase A of the Conceptual Framework project. Phase A examines:

   - the objective of financial reporting
   - the qualitative characteristics of financial reporting information; and
   - the trade-offs among qualitative characteristics and how they relate to the concepts of materiality and cost-benefit relationships.

5. A discussion paper for Phase A of the Conceptual Framework project was published in June 2006. During the redeliberation period, the Board modified its preliminary views and developed revised tentative decisions. Those revised proposals were published in May 2008 as an exposure draft: *Conceptual Framework for Financial Reporting: Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information*.

6. This paper revisits the conclusions of the management commentary discussion paper in the light of the Board's revised thinking for Phase A of the Conceptual Framework project.

SECTION 1: THE CONCEPTUAL FRAMEWORK

7. In developing this paper, the staff chose to focus on the 'in process' work for Phase A of the Conceptual Framework project. Another approach would have been to use the IASB's existing Conceptual Framework. The justification for using the Phase A ED as the benchmark against which to measure management

commentary is that the staff believe the Board's thinking in Phase A to be sufficiently advanced to warrant primacy of consideration.

8. The staff view the Conceptual Framework project as being a sort of 'umbrella' for the management commentary project. The staff approach to the project is based on the principle that a framework for management commentary must be fully consistent with the broader Conceptual Framework for financial reporting. Said differently, in order to remain consistent, everything in the management commentary project should take its cue from Phase A of the Conceptual Framework. There are implications to accepting this approach, one of which being that the management commentary project cannot proceed faster than phase A of the Conceptual Framework project.

9. A review of the IASB's technical plan indicates that the timing of the two projects is in sync. The comment period for the Phase A ED will end just as the management commentary staff is finalising their exposure draft. This will provide the management commentary team the opportunity to incorporate relevant feedback received during the Phase A ED comment period in the drafting of the management commentary exposure draft. Similarly, the chapters for Phase A of the Conceptual Framework are scheduled to be finalised shortly before the completion of the final document for management commentary, thereby making it particularly important to base the work in the management commentary project on the conclusions reached in Phase A.

Question 1: ***Does the Board agree with the staff's decision to base the work in the management commentary project on the 'in process' work for Phase A of the Conceptual Framework project?***

Objective of management commentary versus the objective of financial reporting

Conclusion reached in the discussion paper by the project team

10. The project team determined that the objective of management commentary is to provide information to help investors:

(a) interpret and assess the related financial statements in the context of the environment in which the entity operates;

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

(c) assess the strategies adopted by the entity and the likelihood that those strategies will be successful.

Basis for the project team's conclusion

11. Management commentary provides context to the financial statements. It provides readers with information necessary to an understanding of a company's financial condition, changes in financial condition and results of operations. Management commentary provides insights into an entity's performance that financial statements cannot be expected to achieve on their own.

12. Management commentary provides management with the opportunity to review, from its perspective (i.e. 'through the eyes of management'), the actual performance and position achieved and explains how and why the outcomes differ from previous expectations. Management commentary can also provide investors with insights into how the circumstance that an entity faced affected the outcomes, along with a comparison of whether the strategies adopted achieved their objectives. Additionally, management provides a rationale and explanation for its current and future strategies and prospects.

Conclusion reached in the Phase A ED

13. The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders and other creditors in making decisions in their capacity as

capital providers. Information that is decision-useful to capital providers may also be useful to other users of financial reporting who are not capital providers.

Staff analysis and recommendation

14. The management commentary discussion paper was drafted under the assumption that management commentary will ultimately fall within the boundaries of financial reporting. The boundaries of financial reporting are to be established at the culmination of Phase E of the Conceptual Framework project.

15. At some point in the long-term, the staff envisage that management commentary will become a formalised part of general purpose financial reports. Said differently, management commentary will sit alongside the financial statements as part of a 'complete' financial reporting package. The interim question is how best to position a non-authoritative management commentary guidance document in relation to the broader Conceptual Framework.

16. The staff have been unable to disconnect management commentary from the Conceptual Framework—attempting to do so yielded conceptually inconsistent results at best. As a result, the overarching principle governing this project is that the management commentary framework described in the discussion paper should be subsidiary to the Conceptual Framework. All of the staff recommendations flow from that principle.

17. Consequently, the staff do not believe that management commentary should have an *objective* that is different from the objective of financial reporting described in the Phase A ED. The staff believe management commentary has a unique *purpose*. If an objective is a goal that is intended to be obtained, purpose is the anticipated aim which guides action to achieving the goal. All of the components of general purpose financial reports have the same objective: to provide financial

information[1] about the reporting entity that is useful. However, each component also has a unique purpose that makes its inclusion in a general purpose financial report relevant.

18. It may seem as though the staff is making a distinction that ultimately yields little difference. However, consider that the discussion paper is written in such a way that the framework for management commentary stands separate and apart from the Conceptual Framework. What we are attempting to do is bring the management commentary framework down a notch so that its relative positioning within IFRS is clear (irrespective of its authoritative status): management commentary travels with the financial statements, both of which are covered under the umbrella of the Conceptual Framework.

Question 2: ***Does the Board agree that the framework for management commentary should be subsidiary to the Conceptual Framework?***

Question 3: ***Does the Board agree with the staff's proposal that the objective of management commentary should be the same as the objective of financial reporting (as it is defined in the Phase A ED)?***

Question 4: ***Does the Board agree that the information in paragraph 10 should be recast as the*** **purpose** ***(as opposed to the*** **objective*****) of management commentary?***

Users of management commentary versus the users of financial reporting

Conclusion reached in the discussion paper by the project team

[1] An argument can be made that management commentary does not contain information that can be categorised *explicitly* as financial information. The answer to that argument ultimately depends on how the Board decides to define the term 'financial' in Phase E of the Conceptual Framework project.

19. The discussion paper identifies investors as the primary users of management commentary.

Basis for the project team's conclusion

20. In most jurisdictions the users of management commentary are confined to 'investors', or even a narrower group such as current shareholders. In some jurisdictions there has been much debate about which users should be the focus of management commentary—with many constituents taking the view that management commentary should meet the needs of all stakeholders.

21. The project team considered whether management commentary should be designed to meet the needs of a wider set of users, largely because the range of information often observed accompanying financial statements is wide. This might suggest, to some, that management views the scope of management commentary, and its intended audience, as also being wide.

22. Ultimately, the project team decided that the key to identifying the essential content elements of management commentary was specifying the users of the financial statements. The existing Conceptual Framework sets out seven classes of users. However, it goes on to conclude that the focus should be on investors for financial statement purposes 'as investors are the providers of risk capital.' The project team concluded that the primary users of management commentary should be the same as for the financial statements it accompanies, namely investors in publicly held companies. This conclusion is consistent with the project team's comparative analysis, which also indicated a strong preference for focusing on the needs of investors.

Conclusions reached in the Phase A ED

23. The Phase A exposure draft identifies present and potential capital providers as the primary users of general purpose financial reporting. The primary user group includes both present and potential equity investors, lenders and other creditors (capital providers, collectively), regardless of how they obtained, or will obtain,

their interests. The information provided by general purpose financial reporting focuses on the needs of all capital providers, not just the needs of a particular group.

Staff analysis and recommendation

24. Changing the primary users of management commentary to present and potential capital providers introduces a 'super' user group whose varied participants may have management commentary information needs[2] beyond that which is presented in the discussion paper. As described in the Phase A ED, capital providers include equity investors, lenders and other creditors.[3] These different capital providers have different amounts of expertise, experience, time, training, sophistication and probably different decision strategies. Accordingly, they use information differently and have different capacities to search and process information.

25. Although it might seem easier to answer the question of "what to disclose in management commentary?" if we focus on experts, not all experts are the same. An arbitrageur who has been running a hedge fund for years is probably going to use information differently from a mid-level buy-side analyst. Furthermore, different users will have different investment strategies, portfolios, risk tolerances and techniques for valuing securities, leading them to use different information in making resource allocation decisions. Complicating things, the information a person finds most useful in evaluating a company will likely vary over time as changes take place within the company or its industry and as macroeconomic factors evolve. In short, different capital providers will focus on different information, even if there is a core set of information that all (or at least most) capital providers want and use.

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[2] Although the discussion here is oriented toward information needed to make resource allocation (buy/sell) decisions, informed decision making also includes informed shareholder voting, as well as other steps capital providers might take to monitor and discipline management. Informed investor decision making is about more than resource allocation.

[3] Employees, suppliers, customers and other groups that make decisions related to providing capital to an entity in the form of credit are considered to be capital providers.

26. Irrespective of the points made in paragraphs 25 and 26, if management commentary is expected to provide context for an associated set of financial statements, it logically follows that the primary users of each component should be one and the same. Consequently, the focus of management commentary should reflect present and potential capital providers as its primary users.

Question 5:	***Does the Board agree that the primary users of management commentary should be broadened to include both present and potential capital providers (as the term 'capital providers' is described in the Phase A ED?***

Qualitative characteristics of management commentary versus the qualitative characteristics of financial reporting

Conclusion reached in the discussion paper by the project team

27. The project team determined that, if management commentary is intended to help investors understand the financial statements, management commentary should be expected to meet, as far as possible, qualitative standards similar to those applicable to the financial statements. To that end, the project team decided that management commentary should be *understandable*, *relevant*, *supportable*, *balanced* and *comparable over time*. The project team concluded that management commentary exhibiting all of these qualitative characteristics is most likely to meet the needs of investors.

Basis for the project team's conclusion

28. In developing the qualitative characteristics for management commentary, the project team considered the applicability of the current Conceptual Framework's qualitative characteristics and reporting objectives to management commentary,

as well as other qualitative characteristics that might help make information in management commentary useful to investors. The current Conceptual Framework indentifies four qualitative characteristics considered important in ensuring that financial statements achieve their objective, namely: *understandability*, *relevance*, *reliability* and *comparability*.

29. Given that management commentary supplements and complements the financial statements management commentary should be expected to meet, as much as possible, qualitative standards similar to those applicable to the financial statements. In the end, the project team determined that *understandability* and *relevance* should be applicable in the preparation of management commentary and accordingly should be reflected in the qualitative characteristics. Rather than using the Conceptual Framework terms *reliability* and *comparability*, the project team chose *supportability*, *balance* and *comparability over time*.

Conclusions reached in the Phase A ED

30. Qualitative characteristics are the attributes that make financial information useful. They can be distinguished as fundamental or enhancing characteristics, depending on how they affect the usefulness of the information. Regardless of its classification, each qualitative characteristic contributes to the usefulness of financial reporting information. However, providing useful financial information is limited by two pervasive constraints on financial reporting—*materiality* and *cost*.

31. Financial reporting information depicts economic phenomena (that exist or have already occurred) in words and numbers in financial reports. For financial information to be useful, it must possess two fundamental qualitative characteristics—*relevance* and *faithful representation*. Enhancing qualitative characteristics are complementary to the fundamental qualitative characteristics. Enhancing qualitative characteristics distinguish more useful information from less useful information. The enhancing qualitative characteristics are *comparability*, *verifiability*, *timeliness* and *understandability*.

Staff analysis and recommendation

32. For the most part, the Board's revised proposals in respect of the qualitative characteristics (as described in the Phase A ED) line up well with the conclusions reached in the management commentary discussion paper, with one important exception (see paragraph 34 to 36).

	Conceptual Framework	**Management Commentary**
Fundamental QC's:	Relevance Faithful representation	Relevance Balance
Enhancing QC's:	Understandability Comparability **Verifiability** Timeliness	Understandability Comparability (over time) **Supportability**

33. The staff believe the management commentary qualitative characteristic of *balance* can be subsumed within the Conceptual Framework's qualitative characteristic of *faithful representation*. The discussion paper project team paid special attention to *balance*, reflecting the commonly held perception that when management commentary is unregulated, it tends not to be even-handed, with an overemphasis placed on positive news. The tone or style adopted in narrative reporting is very important. *Neutrality* (as it is presented in paragraph QC10 of the Phase A ED), is equivalent to *balance* in this context.

34. In paragraph QC2 of the Phase A ED, financial reporting is described as depicting economic phenomena (that exists or that has already occurred) in words and numbers in financial reports. The qualitative characteristics described in the phase A ED work well when applied to 'current' and 'historical' time horizons; some of the qualitative characteristics encounter difficulty when applied to a 'future' time horizon.

35. The qualitative characteristic of *verifiability* implies that the information being presented is capable of being tested, either by observation or experiment.

However, future-oriented information, for example forecasts and projections, cannot be verified. In this context the key test is one of reasonableness: do the assumptions that support the future-oriented information in financial reports make sense? The discussion paper project team refers to that qualitative characteristic as *supportability*. Information is supportable if it faithfully represents factually-based strategies, plans and risk analysis, for example.

36. Some aspects of management commentary can involve more uncertainty than the historical information reported in the financial statements. One overarching consideration for the Board is whether the forthcoming Conceptual Framework (specifically, Phase A) has been developed broadly enough to allow for the inclusion of forward-oriented information in financial reports. If the Conceptual Framework is intended to govern more than the financial statements (i.e. the totality of financial reporting), the Board may wish to consider the applicability of each of the qualitative characteristics to future-oriented information.

37. In the interim, for the purpose of advancing the management commentary project, the staff recommend using the qualitative characteristics described in the Phase A ED for management commentary, with the single exception of substituting *supportability* for *verifiability*. Additionally, the application of the *faithful representation* qualitative characteristic will include a discussion of *balance* in the context of *neutrality*.

Question 6: ***Does the Board agree that the qualitative characteristics described in the Phase A ED should be used as the qualitative characteristics for management commentary (with one exception)?***

Question 7: ***Does the Board agree that* supportability *should be substituted for* verifiability *in the management commentary exposure draft?***

SECTION 2: MANAGEMENT COMMENTARY CONTENT

Conclusion reached in the discussion paper by the project team

38. The project team identified the key elements that reflect the *type* of content expected to be included in management commentary. To meet the objective of management commentary, the project team concluded that an entity should disclose information on:

    a) the nature of its business;

    b) its objectives and strategies;

    c) its key resources, risks and relationships;

    d) its results and prospects; and

    e) its performance measures and indicators.

39. The project team also determined that it is up to management to decide the best way to present the content.

Basis for the project team's conclusion

40. Specifying disclosures for management commentary is more difficult than for information included in financial statements. The types of activities that are critical to an entity will be specific to that entity. As a consequence regulators have tended to identify the key elements that reflect the *type* of content they expect to see in management commentary rather than defining the elements themselves. Specifying a detailed list also encourages a 'tick the box' mentality, which should be avoided.

41. As well as placing the onus on management to decide the actual content of the management commentary, management is required to decide the best way to present the content. Providing flexibility in both the presentation and content of management commentary, and using guidance to demonstrate that there are many

ways to achieve the objective of management commentary, reduces the risk that preparers will use standard bland language, repeated year after year.

Staff analysis and recommendation

42. The staff is comfortable with the proposed *types* of content for management commentary as they are described in the discussion paper. However, at some point in the future, the Board may decide to move beyond specifying *types* of content and instead, require specific content *elements*.

43. It is hard to know what specific management commentary information each type of capital provider should have in order to make effective resource allocation decisions.[4] First, management commentary could be tailored to the median user of the information. This might be a good enough approximation of what each capital provider needs to enable all capital providers to do well enough. Second, management commentary could be tailored to the experts, whose trades and analyses are the key determinants of security prices. A third option might be to tailor management commentary to (unsophisticated) individual capital providers. This, however, might compromise capital market efficiency if it denies the experts key information, although analysts and other experts could always pressure management for other disclosures.

44. Should the Board choose to define specific content elements, two tensions arise. First, a placement framework to help the Board differentiate between disclosure that belongs in management commentary versus the notes to the financial statements has not been adopted. Second, the non-authoritative status of the ultimate work product for this project means that the Board may only *suggest* content elements for disclosure in management commentary. That final point creates an additional challenge when existing requirements in IFRS are considered (i.e. questions about placement arise when existing Standards require

[4] Further, just because a capital provider demands certain information, it does not necessarily follow that the capital provider will make a better decision with the information than without it.

the disclosure of information that is seen to 'belong' in management commentary).

45. At some point in the future, the Board will more than likely need to reconsider, in the broadest sense, disclosure in the context of IFRS. Said differently, with the introduction of management commentary—which is, at its heart, is just a different type of disclosure statement than the notes to the financial statements—we will have added a layer of information for users of financial reports to filter. Instead of merely providing 'more' information to sift through, we will also need to explain—conceptually—how it all fits together. One vision is to eventually revisit all of the disclosure requirements in each of the standards to a) differentiate between that which belongs in management commentary versus the notes to the financial statements; and b) consider whether all of the disclosure required by IFRS makes sense collectively[5].

Question 8:	***Are there any* types *of content that the Board would like to include in the management commentary exposure draft that are not currently covered in paragraph 38 of this agenda paper?***

A few words about the presentation of management commentary

46. As is explained in paragraph 39, the discussion paper project team concluded that management is best positioned to determine the presentation of management commentary. However, a request was made at the June 2008 Analyst's Representative Group (ARG) meeting to develop presentation requirements for management commentary that are linked to those found in IFRS 8 *Segment Reporting*. IFRS 8 was issued in November 2006; consequently; the conclusions reached in it were not considered during the development of the management commentary discussion paper (which was published in October 2005).

[5] Some work is already being done in this area by the Consolidations project team.

47. The staff has not had enough time to adequately consider this request. On the surface, it appears to be a good idea. The staff intend to develop presentation criteria for management commentary during the drafting of the exposure draft and will present it to the Board at the October meeting.