

CMAC meeting, 1 November 2018
Agenda Paper 4

Management Commentary

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The views expressed in this presentation are those of the presenter, not necessarily those of the International Accounting Standards Board (the Board) or IFRS Foundation.

Objective of the meeting

To seek CMAC members' views on:

- Objective of management commentary
- Applying materiality in preparing management commentary
- Principles for preparing management commentary

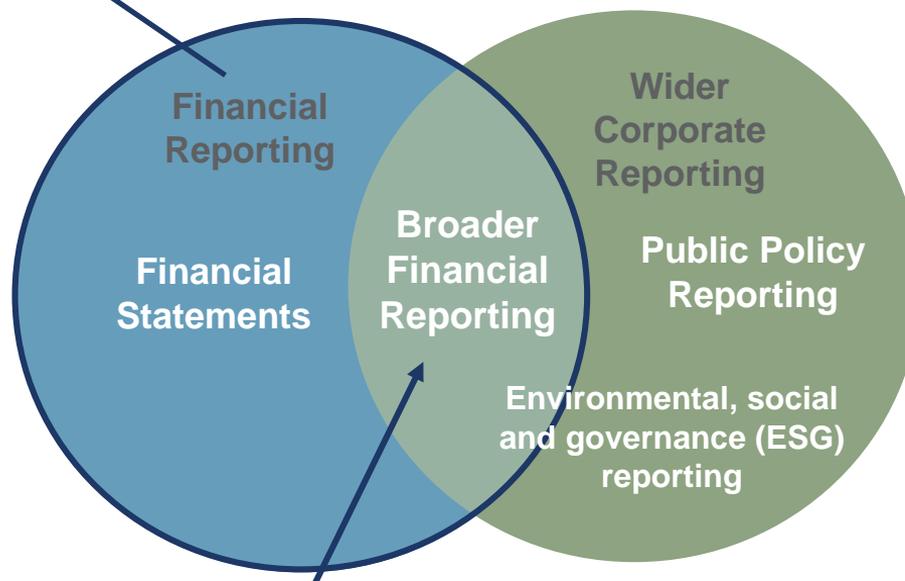
Note: The staff is seeking feedback from the Global Preparers Forum (GPF) on the same topics at its meeting on 6 November 2018

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Reminders and update

Scope of Management Commentary project

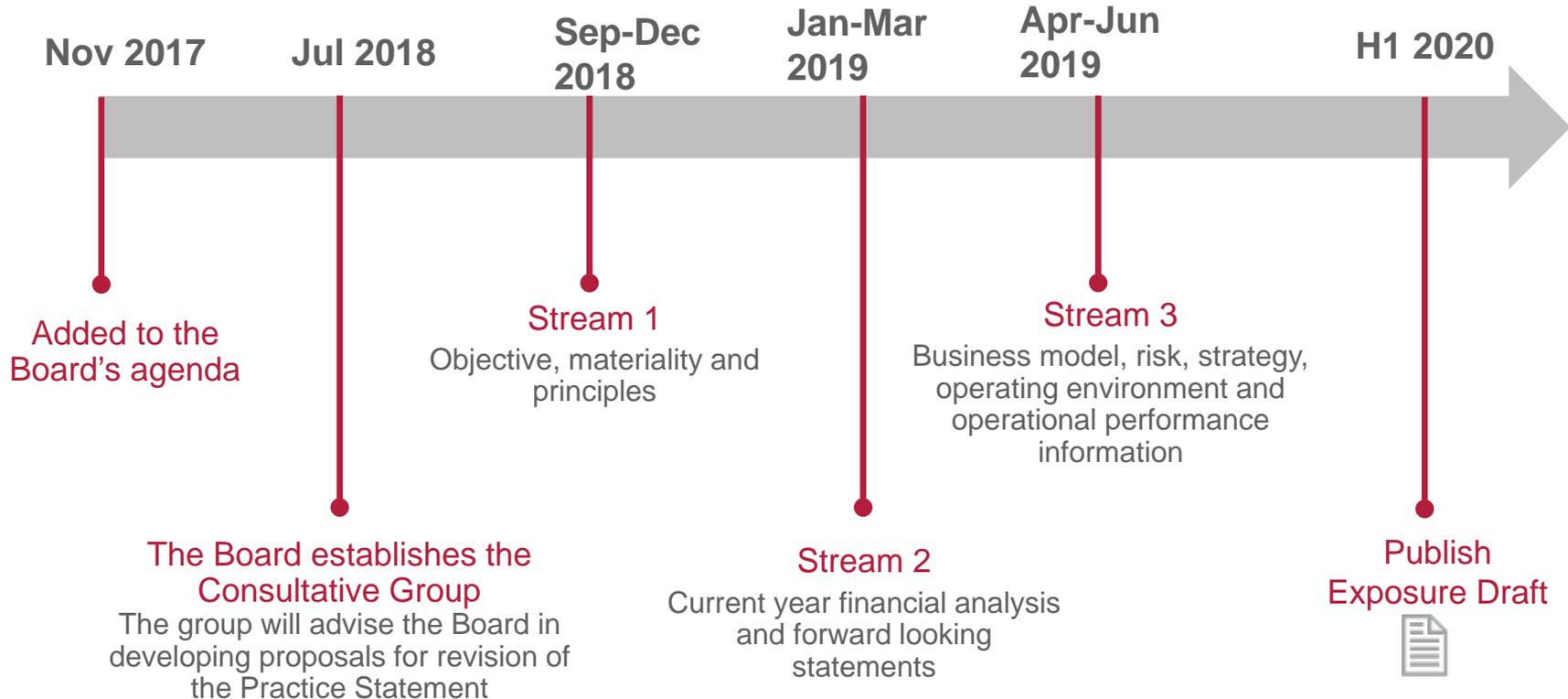
The Board's interest lies in financial reporting



Management commentary is a narrative report aimed at **primary users** of financial reports that provides context for and additional insight into an entity's financial statements.

The **primary users** of financial reports are defined in the *Conceptual Framework for Financial Reporting* as **existing and potential investors, lenders and other creditors**.

Project timeline



Link between past discussion with CMAC and the staff's proposed approach and Consultative Group feedback

June 2018 CMAC discussion focused on:

business strategy (including business model and risks)

medium-term operational performance

long-term operational performance

The staff's proposed approach:

Addressed in discussion supporting the objective of management commentary but to be covered in more detail as a content element

Addressed implicitly through objective which includes reference to references to the **assessment of prospects of future net cash inflows**, which implies value creation along a time horizon across the whole life of the entity

Feedback from Consultative Group members:

Emphasised the importance of an entity's **purpose** and how its business model links to the purpose, as well as disclosures on risks and risk management

Some members think that reference to different time horizons should be made more explicit in the Practice Statement



Today's discussion

Topic	Staff's approach on what to include in Practice Statement	Consultative Group feedback	Reference material
Objective of management commentary	<ul style="list-style-type: none"> • Reflect the objective of financial reporting as per the revised <i>Conceptual Framework</i> • Emphasise that users need information for their assessments of prospects of future net cash inflows and of stewardship of the entity's economic resources • Retain the concept of 'management's view' from the existing Practice Statement • Include practical guidance 	<ul style="list-style-type: none"> • Emphasise users' needs and what is important in running the business • Management commentary should provide context for the financial statements and include additional insights on the entity's prospects • Some concerns that wording in the Practice Statement on future cash flows could be misinterpreted as a need to disclose forecasts; others wanted additional emphasis on cash flow variability 	Pages 19-25

1. Do you agree with introducing explicit references to the assessments of prospects for future net cash inflows and of management's stewardship of the economic resources in the revised Practice Statement?
2. Do you think this approach addresses sufficiently the notion of whole life cash flows and value creation or does the Practice Statement need to include explicit reference to long-term horizons?
3. Do you agree with the suggested content as set out on [page 25](#) to support the objective of management commentary? Is there anything else we should include?

Topic	Staff's approach on what to include in Practice Statement	Consultative Group feedback	Reference material
Applying materiality	<ul style="list-style-type: none">• Emphasise that materiality is applied in the context of user assessments of cash flow prospects and stewardship• Introduce a two stage approach to identifying material information: (i) identification of business matters on which information is needed; (ii) identification of the information users need to assess those matters• Add specific application guidance for management commentary, based on the Materiality Practice Statement	<ul style="list-style-type: none">• Some agreed on separate consideration of matters and information• Materiality assessment for management commentary should be combined with that for the financial statements• What is discussed by an entity's board should be considered material for management commentary• Notion of "future" materiality	Pages 26-30

4. Do you agree with discussing in the revised Practice Statement the proposed distinction between matters that need to be addressed in management commentary and material information about those matters?
5. Should we include any other considerations for materiality assessments in the revised Practice Statement?

Topic	Staff’s approach on what to include in Practice Statement	Consultative Group feedback	Reference material
Principles	<ul style="list-style-type: none"> • <i>Completeness:</i> <ul style="list-style-type: none"> ▪ an approach to completeness based on ensuring a coherent narrative across the content elements for each business issue raised, referred to as the linkage approach; ▪ include practical considerations for assessing completeness – information used for other capital market communications or internal decisions and knowledge of external factors and insights from other stakeholders 	<ul style="list-style-type: none"> • Different views on what “coherence” means, so clear language in the Practice Statement is needed • Specific reference to how management remuneration links with purpose and performance metrics • Overlap of guidance between completeness and materiality 	Pages 31-36

Topic	Staff's approach on what to include in Practice Statement	Consultative Group feedback	Reference material
<p>Principles</p>	<ul style="list-style-type: none"> • <i>Neutrality</i>: to include guidance on the five different aspects contributing to a neutral or balanced management commentary <ul style="list-style-type: none"> - Overall tone & content - Prominence, obscurity, or omission of matters - Selection & presentation of information - Range of potential outcomes discussed - Consistency • <i>Comparability</i>: to include guidance on information published outside the annual report, previous forecasts and industry metrics 	<ul style="list-style-type: none"> • Align segmental information in the notes and management commentary • Preparer concerns on sensitive information and comparability with peers 	<p>Pages 37-38</p>

6. Do you agree with the proposed linkage approach to support a coherent narrative?
7. Do you agree with the five aspects of neutrality that management needs to consider in preparing management commentary?
8. Do you agree with the staff's approach to comparability?
9. The Consultative Group highlighted “verifiability” as an important principle. Are there any other principles which you think should be prominent in the revised Practice Statement?

Next steps

November 2018 – January 2019	The staff will consider feedback from the Consultative Group, CMAC and GPF in preparing Board Papers on the objective, application of materiality and principles for preparing management commentary
January 2019	2 nd Consultative Group meeting
January – April 2019	The staff will consider feedback from the Consultative Group, CMAC and GPF as it drafts proposals on the detailed content elements of management commentary for discussion at subsequent Consultative Group meetings and presentation to the Board

Briefing materials to read before meeting

Objective of management commentary

Where we are now

- IFRS Practice Statement 1 *Management Commentary**, published in 2010, emphasises **context** for financial statements **through the eyes of management** as the objective. Its principles describe how management commentary can **help users** in their understanding of financial reports.
- The *Conceptual Framework for Financial Reporting*, revised in 2018, clarifies the objective of general purpose financial reporting and discusses the information that users need and the assessments that users make on the basis of that information. See next page.

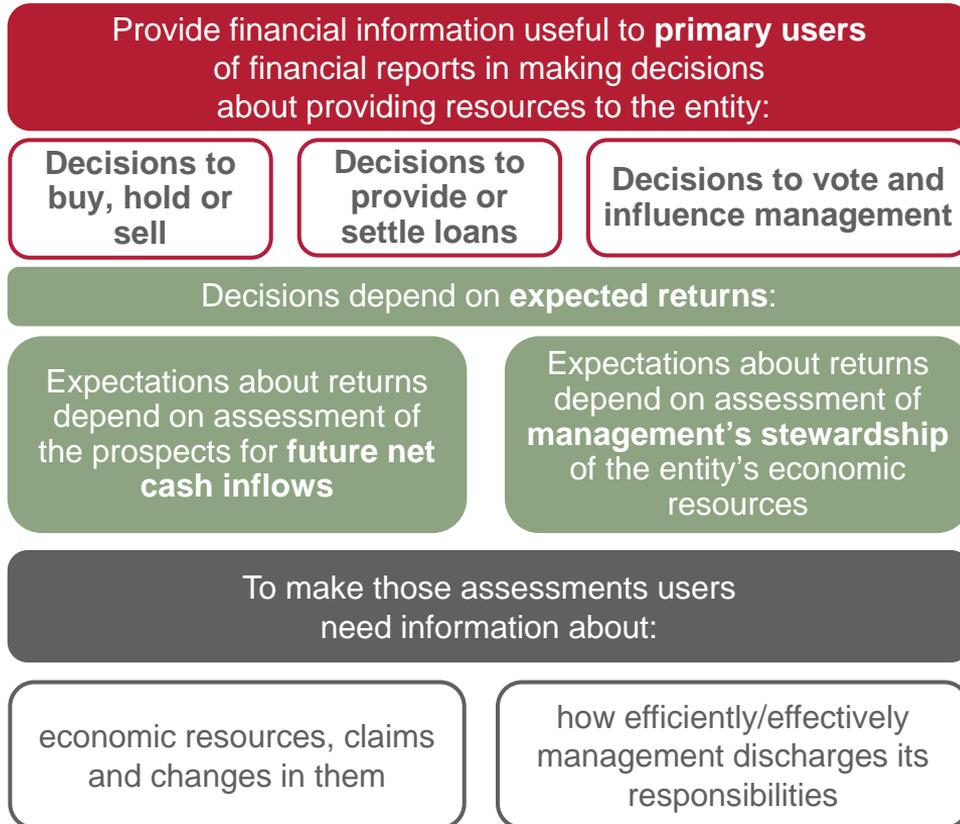
Why revision is needed

Need for more detailed guidance:

- The objective in the existing Practice Statement is set at a high level and only limited supporting guidance is provided.
- The staff think there is a case for expanding the guidance to support consistent application of the Practice Statement in the light of:
 - user calls for better management commentary information that aligns with their decision making
 - concerns over the perceived narrow focus of management commentaries with calls for improvement related to:
 - implications of external trends
 - key resources and relationships
 - strategic challenges

*See page 22 for extracts from existing Practice Statement

The objective of financial reporting as per the *Conceptual Framework*



The staff consider that the explicit reference to the **assessments of prospects for future net cash inflows** and **of stewardship** included in the *Conceptual Framework* needs to be reflected in the revised Practice Statement.

See page 23 for detailed extracts from the *Conceptual Framework*

Paragraph 9

Management commentary should provide users of financial statements with integrated information that provides a context for the related financial statements. Such information explains management's view not only about what has happened, including both positive and negative circumstances, but also why it has happened and what the implications are for the entity's future.

Paragraph 14

Management commentary should provide information to help users of the financial reports to assess the performance of the entity and the actions of its management relative to stated strategies and plans for progress. That type of commentary will help users of the financial reports to understand, for example:

- (a) the entity's risk exposures, its strategies for managing risks and the effectiveness of those strategies;
- (b) how resources that are not presented in the financial statements could affect the entity's operations; and
- (c) how non-financial factors have influenced the information presented in the financial statements.

Extract from the *Conceptual Framework* in relation to the objective of financial reporting

1.2 The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity. Those decisions involve decisions about:

- (a) buying, selling or holding equity and debt instruments;
- (b) providing or settling loans and other forms of credit; or
- (c) exercising rights to vote on, or otherwise influence, management's actions that affect the use of the entity's economic resources.

1.3 The decisions described in paragraph 1.2 depend on the returns that existing and potential investors, lenders and other creditors expect, for example, dividends, principal and interest payments or market price increases. Investors', lenders' and other creditors' expectations about returns depend on their assessment of the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity and on their assessment of management's stewardship of the entity's economic resources. Existing and potential investors, lenders and other creditors need information to help them make those assessments.

1.4 To make the assessments described in paragraph 1.3, existing and potential investors, lenders and other creditors need information about:

- (a) the economic resources of the entity, claims against the entity and changes in those resources and claims (see paragraphs 1.12–1.21); and
- (b) how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's economic resources (see paragraphs 1.22–1.23).

The objective and application guidance: suggested revisions

Objective

The objective will retain the reference to management commentary providing primary users with context for the financial statements and insights about the entity's prospects, but will be updated to reflect revisions to the Conceptual Framework.

Users' assessments of prospects and stewardship

Introduce explicit references to the assessments of prospects for future net cash inflows and of stewardship of the entity's economic resources, and provide guidance setting out information that users need to make such assessments.

'Management's view'

Retain the concept of 'management's view' in the existing Practice Statement and provide additional guidance to help preparers identify information to be included in management commentary about what matters to the entity's success.



Suggested content to support the objective

Users need to assess the entity's strategy for developing and sustaining the entity's future net cash inflows; its progress in implementing that strategy; the factors affecting that progress; and the potential implications for and variability of the entity's future financial performance.

The information to support this assessment should address the matters considered by management in exercising stewardship over the entity's economic resources or that management considers could influence users' assessment of the entity's future net cash inflows. Ordinarily, these matters will include:

- (a) the entity's **purpose and business model**, including:
 - (i) the **tangible and intangible economic resources** on which the entity depends for success, irrespective of whether it is appropriate to recognise them in the entity's financial statements;
 - (ii) the **relationships** that affect the entity's ongoing success and the **impact of the entity's activities on those relationships**;
- (b) the entity's **financial and operational performance** during the reporting period and its **progress against its strategic objectives**
- (c) the **external trends and factors** affecting the entity's financial and operational performance and position for the reporting period, as well as those expect to affect future performance; and
- (d) the **opportunities and risks** in relation to the above matters.

Applying materiality

Where we are now

- The existing Practice Statement refers to materiality as a principle to be applied in preparing management commentary. However, it provides no guidance on *how* that principle should be applied.
- The IFRS Practice Statement 2 *Making Materiality Judgements* (the “Materiality Practice Statement”) provides application guidance on applying materiality in preparing general purpose financial statements.
- *The Conceptual Framework* defines materiality as an entity-specific aspect of relevance that could influence primary users’ decisions.

Why revision is needed

- **Difficulties in applying materiality to narrative:** The staff are aware that some preparers find the application of materiality to management commentary challenging.
- **Need for application guidance:** The existing Practice Statement does not include sufficient application guidance to address these challenges. The staff think that reiterating and adapting what is included in the *Conceptual Framework* and the Materiality Practice Statement in the revised Practice Statement will support preparers in assessing what is material for their management commentary.

Extracts from existing Practice Statement and *Conceptual Framework* on materiality

Existing Practice Statement §21: Materiality

Management should include information that is material to the entity in management commentary. Materiality will be different for each entity. Materiality is an ‘entity-specific aspect of relevance’; thus information that is relevant for an entity will also be material.

Definition of Materiality in the *Conceptual Framework*:

Information is material if omitting it or misstating it could [reasonably be expected to]* influence decisions that the primary users of general purpose financial reports make on the basis of those reports, which provide financial information about a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity’s financial report. Consequently, the Board cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.

**The clarification ‘reasonably be expected to’ is currently in paragraph 7 of IAS 1 Presentation of Financial Statements. In a forthcoming amendment to the definition of material, the Board will import that clarification to the definition of materiality in IAS 1 as well as the Conceptual Framework.*

IFRS Practice Statement 2 *Making Materiality Judgements* §33:

The steps identified as a possible approach to the assessment of materiality in the preparation of the financial statements are, in summary:

Step 1—identify. Identify information that has the potential to be material.

Step 2—assess. Assess whether the information identified in Step 1 is, in fact, material.

Step 3—organise. Organise the information within the draft financial statements in a way that communicates the information clearly and concisely to primary users.

Step 4—review. Review the draft financial statements to determine whether all material information has been identified and materiality considered from a wide perspective and in aggregate, on the basis of the complete set of financial statements

The staff's proposed approach

Suggested revisions to the Practice Statement:

Distinguish between **matters** and **information about those matters**. Management will first need to consider whether a matter is important to the entity's current and future cash flows, and then considers what information in relation to that matter is material.



Clarify that information is material to the management commentary if it could reasonably be expected to influence a user's assessment of the amount, timing, or uncertainty of the entity's cash flows or a user's assessment of management's stewardship of the entity's economic resources.



Provide clear and practical application guidance for preparers on making materiality judgements by building on the *Conceptual Framework* and the Materiality Practice Statement.

Example:

Matter – the entity's brewery in a desert region may have to close

Information on that matter – water usage in that brewery has decreased compared to last year

Principles

Principles for preparing management commentary

The need for narrative coherence in preparing management commentary

Neutrality in management commentary

Comparability of management commentary

Although there are other principles, we have focused on coherence (in relation to completeness) and neutrality due to their necessity for faithful presentation. We also discuss comparability since this enhancing qualitative characteristic features regularly in discussions on management commentary.

Coherence, neutrality and comparability: Where we are now and why revision is needed

33

Where we are now

- The existing Practice Statement states that management commentary should provide management's view of the entity's performance, position and progress; and supplement and complement the financial statements.
- It states that management commentary should include forward looking information and information that possesses the **qualitative characteristics** of useful financial information as described in the *Conceptual Framework*, ie:
 - be relevant; and
 - provide a faithful representation and therefore be complete, neutral and free from error.

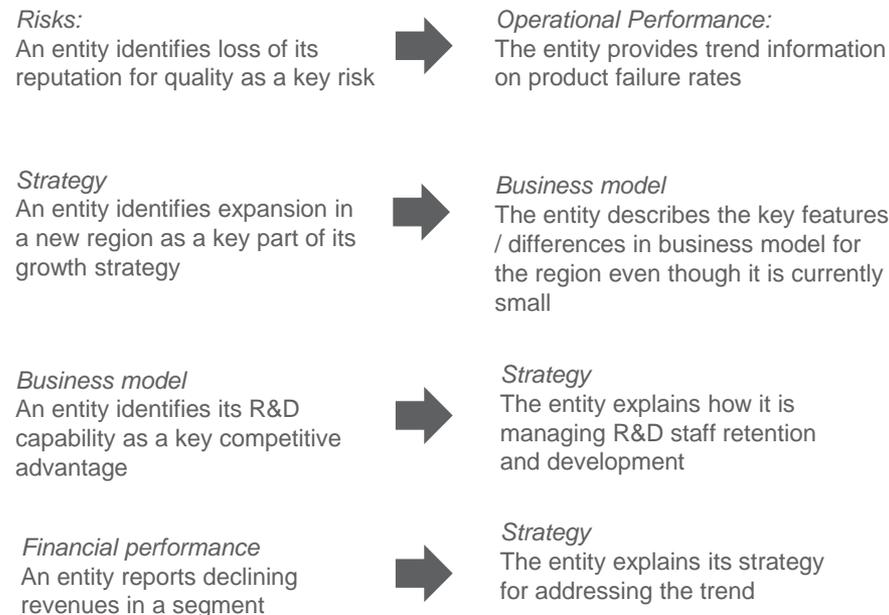
Why revision is needed

- **Clarify how applying Practice Statement achieves information objectives:** The existing Practice Statement does not elaborate on how to achieve the qualitative characteristics in management commentary (except for reference to including both positive and negative circumstances, which addresses neutrality in part).
- **Address concerns about quality of narrative:** Concerns have been raised about narrative coherence, neutrality and comparability in management commentary.
- **Introducing application guidance would help:** Staff think that application guidance needs to be included in the revised Practice Statement to promote disclosures which better meet the qualitative characteristics.

Linkage approach

- We suggest that the revised Practice Statement will state a requirement for coherent narrative, which is referred to as “linkage” in this slide deck.
- The essence of the linkage approach is requiring an entity to build the content of a management commentary in a methodical manner that **supports the characteristic of completeness**. This approach is illustrated opposite, and further described on the next page.
- The linkage approach is built around management's view of **what is important to the future of the business** and provides a test for whether the report leaves unanswered questions.
- The staff think this approach will support rigorous discussion of the most important issues, with less focus on less important areas.

Illustrative examples of the linkage approach



The staff's proposed approach – Coherence (2/3)

Applying the linkage approach across the content elements in management commentary:

Linkage thought process



Simplified illustration

We make red widgets. The market is maturing so we are increasingly exposed to low cost offerings.

We plan to sell an improved 'blue widget' design to our red widget customer base to meet this challenge

Of our red widget customers ordering a replacement, 70% have upgraded to a blue widget

During the year the retail price of blue widgets averaged 1.6 times that of red widgets

We are targeting a 70:30 blue : red widget sales mix. The average during this year was 40:60

Staff's observations

- Business model discussion describes the entity's dependence on the red widget market.
- Discussion of external trends addresses red widget market trends as a key factor affecting the business.
- The strategy discussion explains how the business is dealing with the challenge identified in the external trends discussion.
- Performance discussion provides KPIs that show the entity's progress in implementing its strategy.
- Performance data is provided to help users assess the potential impact of implementing the strategy on financial returns.

Further guidance to support narrative coherence in management commentary

Internal information

- The entity considers information used internally in setting strategy and monitoring the financial and operational performance of the business—eg management information packs; operating reviews.
- This perspective is consistent with the approach of reporting 'through the eyes of management'.

External factors

- The entity considers factors it is aware of in the external environment or from its routine engagement with stakeholders.
- It is not suggested that the entity should undertake additional engagement with stakeholders in order to support the preparation of the management commentary.

Capital markets communication

- The entity considers information it has or intends to communicate directly to capital markets participants (eg investor presentations)
- Information provided through investor relations channels will ordinarily be relevant to users' decision making. In practice this information is typically much richer than that provided in a management commentary and incorporates, for example, additional analysis of strategy, disaggregated information about performance, and operational measures that relate to the entity's strategy.

The staff's proposed approach – Neutrality

The staff propose that the revised Practice Statement will describe how management could apply the following aspects of neutrality that could alter a user's assessments. Specific guidance for content elements may be provided.

Key aspects	Proposed approach	<i>Illustrative problems it could address</i>
Overall tone & content	Entity considers whether the management commentary as a whole provides a balanced view to support an assessment of the entity's prospects for future net cash inflows and management's stewardship of its economic resources	<i>Positive language that is not representative of overall performance / outlook</i>
Prominence, obscurity, or omission of matters	Entity considers whether undue emphasis, obscurity, or omission of discussion of a matter might affect a user's interpretation of information in management commentary.	<i>Significant drop in order book, not yet reflected in the financials</i>
Selection & presentation of information	Entity considers whether choice and form of information presented on each matter (including level of aggregation) could be expected to cause a user to take an unjustified view of the matter	<i>Aggregate water usage reported, but key water stressed site not identified</i>
Range of potential outcomes discussed	Entity considers whether an unduly wide or narrow range of potential outcomes discussed in relation to a matter might influence a user's view of the matter	<i>Initial indications suggest reserves could be as much as...</i>
Consistency	Entity considers whether changes in the basis of presentation or calculation of information might unduly influence a user's view of the matter	<i>Change in definition of same store sales</i>

The staff do not propose to prescribe specific disclosures or to define subject-based performance measures as this would not be consistent with a principles-based approach. However, the Practice Statement could include principles-based guidance, aligned with the *Conceptual Framework*, that could support better comparability of information in relation to:

Other information published by the entity (whether within or outside the management commentary and financial statements)

Estimates, forecasts and targets previously provided by the entity

Measures and methodologies common to the industry

Furthermore, the staff propose that:

- To help users assess limitations of comparative analysis, entities should provide explanations of scope and basis of preparation for information presented in the management commentary and the assumptions underlying the information provided
- Entities should provide an explanation on the rationale and methodology where their calculations or presentation of metrics differ from a prevalent industry practice
- Where trend information is useful for users' analysis, entities should consider the appropriate period over which to present it (eg in some cases 5 years)

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