

Management Commentary

Slide Deck 2 *Objective of management commentary*

IFRS Management Commentary
Consultative Group 28 September 2018

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

Agenda for the session

Current position and challenges

1. Where we are today
 - Objective in IFRS Practice Statement 1 *Management Commentary* (Practice Statement) and the *Conceptual Framework for Financial Reporting* (Conceptual Framework)
2. How others have approached the objective
 - Staff's summary of the findings in the survey of national standard-setters
3. Why is revision needed?

The staff's proposed approach

1. An overview
2. Objective of the management commentary
3. Supporting guidance—users' information needs
4. Supporting guidance—identifying information to be included in management commentary 'through the eyes of management'
5. Other considerations—value creation & time horizons

Where we are today (1/2)—the Practice Statement

- The Practice Statement issued in 2010 emphasises providing the **context** for financial statements within the objective of a management commentary.
- It also makes it clear that management commentary provides information **through the eyes of management**.

Objective – application guidance
Extract from the Practice Statement § 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.

- The Practice Statement emphasises the need to provide information that is **useful to users** of financial reports and provides supporting **guidance for preparers** on how to achieve that.

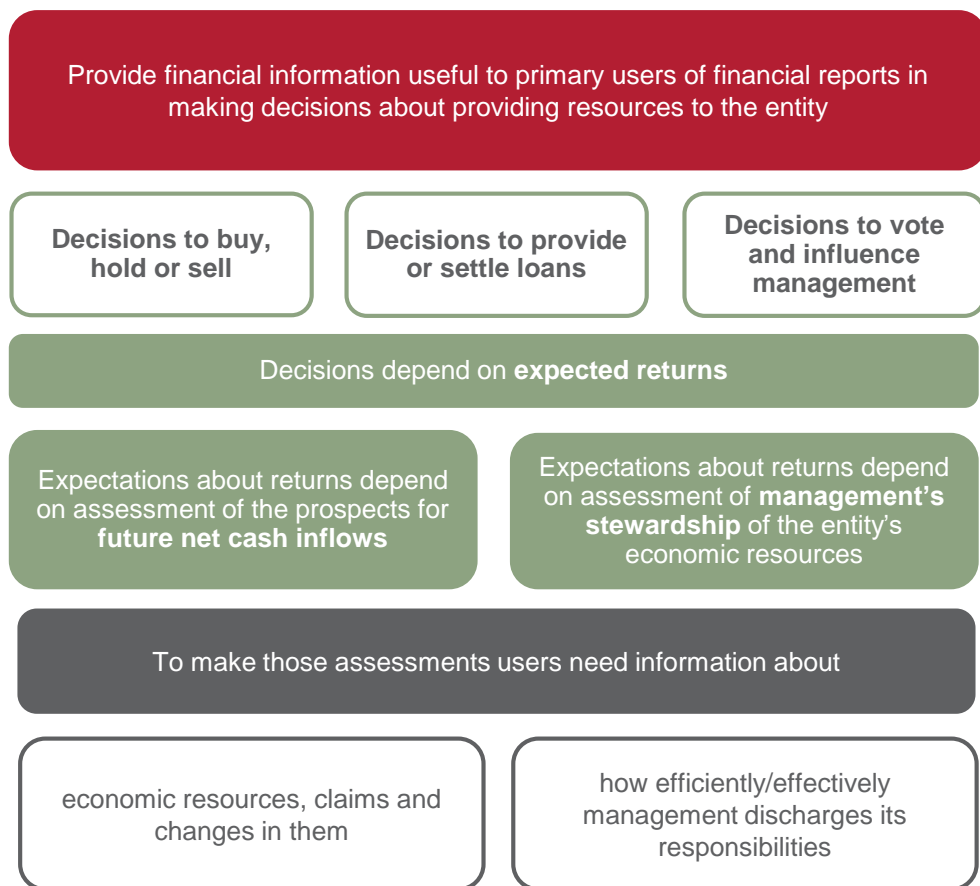
Objective – application guidance
Extract from the Practice Statement § 14

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.

Where we are today (2/2)—the *Conceptual Framework*

- The *Conceptual Framework* revised in 2018 clarifies the objective of general purpose financial reporting, discusses the information that users need and the assessments that users make on the basis of that information.



Objective and supporting guidance

Extract from the *Conceptual Framework* §1.2, 1.3, 1.4

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).

How others have approached the objective

The table below provides the staff's summary of the objectives of management commentary based on the staff's survey of national standard-setters conducted in July-August 2018. The table is not all-inclusive and is designed to summarise common themes in setting objectives. There is a variety in how national guidance and regulations set the objective of management commentary. These objectives are by no means contradictory, but there is considerable diversity in emphasis.

	Africa		Asia - Oceania					Australia & New Zealand		Europe									North and Latin America		
	NAM	ZAF/ <IR>	HKG	IDN	JPN	KOR	MYS	AUS	NZL	EU	DEU	ITA	FRA	GEO	GRC	PRT	RUS	UK	CAN	MEX	USA
Financial statements context			✓				✓	✓				✓					✓	✓	✓		✓
Development	✓							✓		✓	✓	✓	✓	✓	✓	✓		✓		✓	
Performance	✓		✓			✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓		✓	✓	✓	✓
Position	✓					✓	✓	✓		✓	✓	✓	✓	✓	✓	✓		✓	✓	✓	✓
Impacts										✓								✓			
Prospects	✓		✓		✓	✓	✓	✓			✓			✓				✓	✓		
Earnings quality																			✓	✓	✓
Strategy								✓	✓									✓			
Risks	✓						✓		✓		✓	✓			✓			✓	✓		✓
Resource stewardship					✓						✓							✓			
Investment decisions				✓	✓												✓				
Value creation	✓	✓																			

Note: The staff's classification is subjective and a feature that is not identified as a headline objective will often be covered as a principle or other characteristic.

Why is revision needed?

The staff have identified two considerations for revising the objective in the Practice Statement:

1. 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 (*see panel opposite*)
 - concerns over the perceived narrow focus of management commentaries¹ with calls for improvement related to:
 - discussion of the potential implications for the entity of external trends, including systemic matters such as those identified by the Financial Stability Board’s Task Force on Climate Change² irrespective of whether they are expected to crystallise in the financial statements in the short-term.
 - the importance of key resources and relationships to the sustainable success of the entity, and the impact of the entity’s behaviour on the strength of those relationships (sometimes discussed in the context of the so called ‘stakeholder relevance’).
 - frustration over the focus of narrative discussion and of operational performance disclosures that do not address the strategic challenges of the business, particularly those that relate to its long-term success.
2. The explicit reference to the assessment of stewardship introduced in the revised *Conceptual Framework* needs to be reflected in the revised Practice Statement.

Illustrations of user calls for better information:

CFA Institute: Usefulness of Key Performance Indicators and Other Information Reported Outside Financial Statements

‘An analysis of the relative application by investors of information contained across 11 identified broad categories within the MD&A/narrative reporting portion of the annual report shows that the top three most commonly applied categories were (1) operational metrics, (2) contextualizing strategy and business model descriptions, and (3) supplemental financial information’

Blackrock letter to S&P 500 CEOs:

‘We are asking every CEO to lay out for shareholders each year a strategic framework for long-term value creation....CEOs should be more focused in these reports on demonstrating progress against their strategic plans than a one-penny deviation from their EPS targets’

¹Agenda Paper 28A November 2017 Board meeting discusses *gaps in narrative reporting practice that indicate that the ambition of the MCPS [the Practice Statement] and other developments such as the <IR> Framework is not being met.*

²TCFD Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures (June 2017)

The staff's proposed approach (1/4)—an overview

The staff's proposed approach

- Bearing in mind the diversity of objectives of management commentaries, the staff propose an approach that combines retaining a clear concise objective with developing additional guidance that would discuss information that a management commentary is expected to provide in a way that can be readily understood by preparers, users, regulators and others – a 'test of success' for a management commentary.
- Other areas that are sometimes described as objectives in other frameworks can be incorporated within the principles and content elements of the revised Practice Statement without undermining the clarity of the objective as summarised below:

Potential objective	Proposed approach in the Practice Statement
Financial statements context	Objective
Development	Information that users need
Performance	Information that users need
Position	Information that users need
Impacts	'Through the eyes of management'
Prospects	Information that users need
Earnings quality	Address within Performance content element
Strategy	Information that users need
Risks	'Through the eyes of management'
Resource stewardship	Objective
Investment decisions	Aligns with the objective
Value creation	Aligns with the objective

The objective and application guidance: suggested revisions

Objective and the assessments users make

Revise the objective to reflect the revised *Conceptual Framework* and make an explicit link between information in management commentary and assessments of prospects for future net cash inflows and of management's stewardship



Information that users need to assess prospects and stewardship

Provide additional guidance setting out information that users need to make assessments of prospects of future net cash inflows and of stewardship



'Through the eyes of management'

Provide additional guidance to help prepares identify information to be included in management commentary

Objective and the assessments users make

Revise the objective to reflect the revised *Conceptual Framework* and make an explicit link between information in management commentary and assessments of prospects for future net cash inflows and of management's stewardship

Stewardship assessment and management commentary

- The staff think the role of management commentaries in supporting users' stewardship assessments should be made an explicit part of the objective. That would be consistent with the recent revision to the *Conceptual Framework*. Besides, the availability of information to support stewardship assessments is a common and growing area of concern.
- The staff note that the term '*stewardship*' is sometimes interpreted broadly in the field of wider corporate reporting (stewardship for whom?) and therefore there is a risk that this broader interpretation may lead to a loss of focus in applying the requirements of the Practice Statement. Therefore staff think it is helpful to emphasise the links between the primary users of financial reports (existing and potential investors, lenders and other creditors), stewardship of an entity's economic resources and its prospects for future net cash inflows.

Insight into the prospects for future net cash inflows

- The staff think that the focus on users' assessment of an entity's prospects for future net cash inflows in the *Conceptual Framework* provides clarity over the objective of a management commentary and should be made explicit in the Practice Statement.
- The staff do not intend for this approach to require management to anticipate the decision-making strategies of users; instead, management would be expected to provide information that it considers useful for assessing the entity's prospects. In other words, information is provided 'through the eyes of management'.

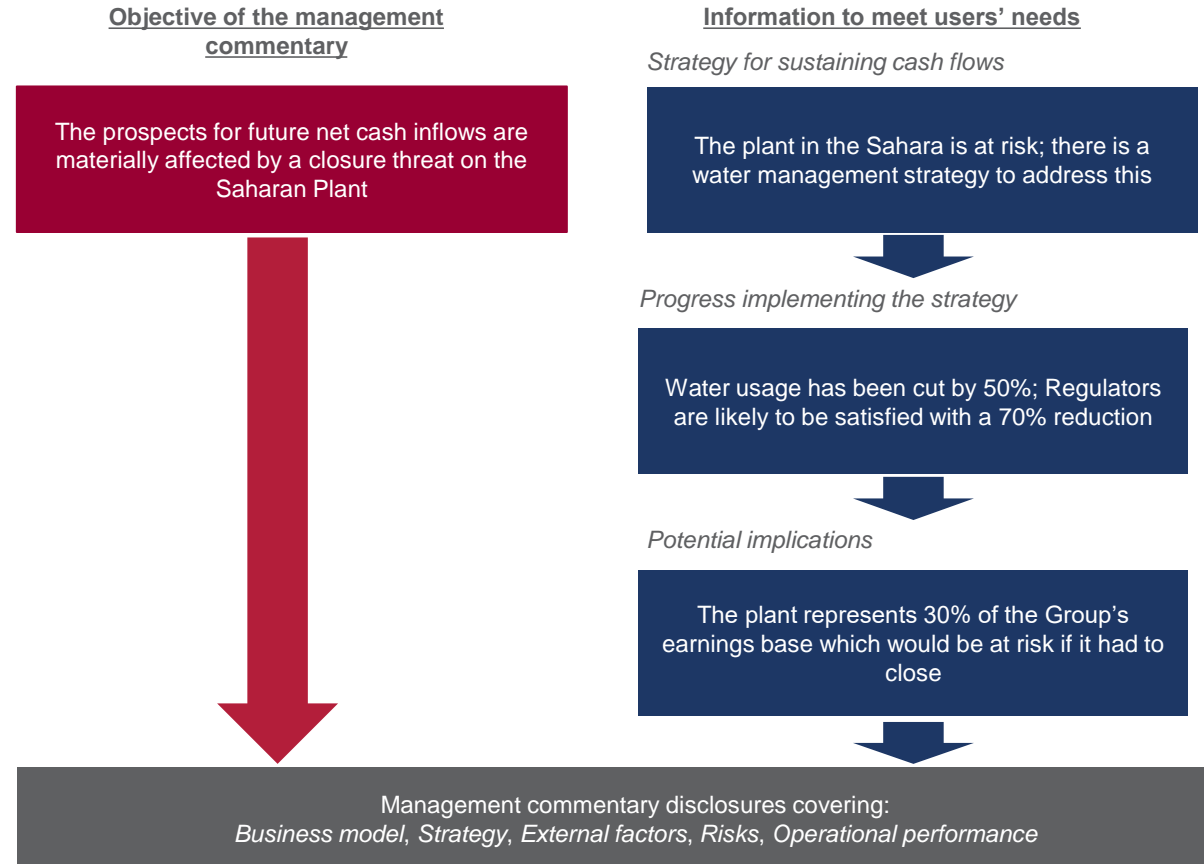
The staff's proposed approach (3/4)—users' needs

Information that users need to assess prospects and stewardship

Provide additional guidance setting out information that users need to make assessments of prospects of future net cash inflows and of stewardship

- The staff think the revised Practice Statement should provide additional guidance to help preparers understand what information supports users' assessments of the entity's prospects of future net cash inflows and of stewardship.
- The staff's proposed approach would align with cash flow valuation methodology by considering information needed to understand the entity's current position and performance, its strategy for developing them, and the progress and implications of that strategy.
- Note that the 'eyes of management' approach that is already adopted in the existing Practice Statement makes it clear that management commentary should reflect the thought process behind management's actions.

Water-stressed assets: An illustration of how this guidance can be applied to support the objective of a management commentary



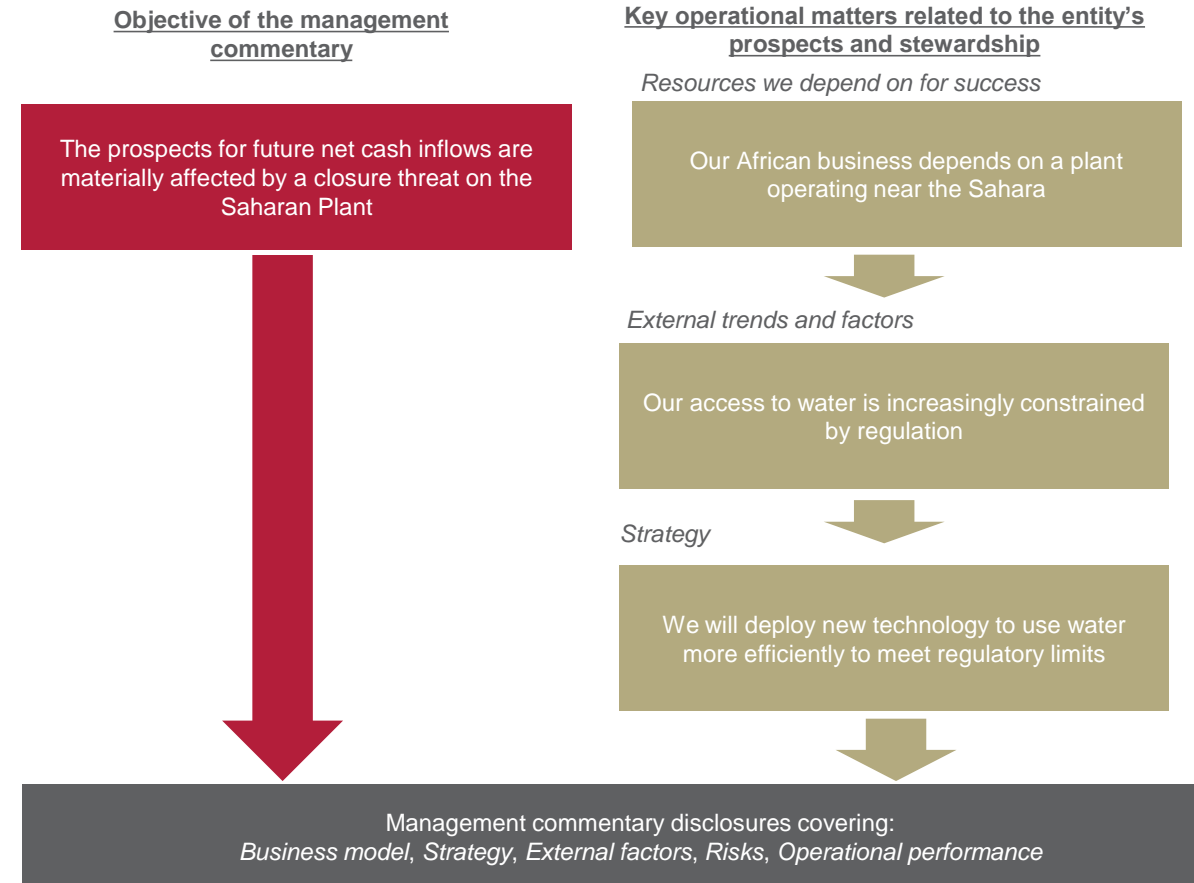
The staff's proposed approach (4/4)—preparers view

'Through the eyes of management'

Provide additional guidance to help preparers identify information to be included in management commentary

- The staff think that given the still-maturing nature of narrative reporting, the Practice Statement should set out expectations of the matters that a management commentary would ordinarily need to address. This would provide a basis from which preparers can consider the specific matters relating to their business that should feature in the management commentary.
- These matters are pervasive across the content elements of the management commentary. *For example*, if the business identifies a business-critical resource that is at risk, users may need information on the nature of a business risk, the entity's strategy for dealing with it, and its progress in managing that issue.
- As the revised Practice Statement is not expected to provide an all-inclusive inventory of information expected to be included in a management commentary, the staff think it is helpful to emphasise that a management commentary, taken with the underlying financial statements, should include all information available to management that it considers necessary to support users' assessments of prospects for future net cash inflows and of stewardship.

Water-stressed assets: An illustration of how this guidance can be applied to support the objectives of a management commentary



Other considerations (1/2)—value creation

- In considering revisions to the objective of the management commentary, the staff have assessed how the revised Practice Statement could best reflect the concepts of:
 - value creation; and
 - reporting that considers various time horizons.

‘Value creation’ in the context of a management commentary

- Value creation is an important concept in the current reporting debate and features explicitly as part of the objective of an integrated report that is defined in terms of reporting on value creation that can be captured by the organisation. The staff note this concept aligns well with the staff’s proposed focus on information for the assessment of the entity’s prospects for future net cash inflows.
- However, practice has shown that the term ‘value creation’ is subject to a variety of different interpretations. Accordingly, the staff think the emphasis on prospects for future net cash inflows provides a better base for the Practice Statement that also aligns with the revised *Conceptual Framework*.

Integrated Reporting Implementation Review: Key observations (Q4)

Based on the feedback, materiality and value creation appear to be among the most important issues, if only because of their central importance to Integrated Reporting.

While many responses called for further guidance, clarification and ‘concreteness’, there was also a sense that experimentation, evolution and innovation should continue.

Other considerations (2/2)—time horizons

The role and importance of time horizons in a management commentary

- The staff recognise the importance of management commentaries addressing material matters irrespective of the time horizon over which they are expected to crystallise.
- However, care is needed in addressing longer-term horizons as this could result in a loss of clarity over the objective of the management commentary, leading to questions such as:
 - ‘what period does the long term/medium term cover?’
 - ‘how do I balance the relative importance of different time horizons?’
 - ‘should discussion of a matter be omitted if management believe they can address it in the long term?’
- A particular concern arises because an explicit focus on the long term might provide cover for non-disclosure of otherwise material matters that management anticipates it can resolve before they impact long-term prospects.

Illustration: The UK Financial Reporting Lab has highlighted a deterioration in quality of business model disclosures following the first year of requirements to report on business impacts, noting that it has resulted in ‘some of the detail behind what the company does and how it generates value being missed’

- The staff think these issues can be avoided by simply referring to the entity’s future cash flows in the Practice Statement, whilst ensuring that the principles and content requirements drive disclosures across the whole time horizon. Nevertheless, an explicit statement that future cash flows include matters affecting the long term may be desirable. The staff think this can be further developed in the application guidance to be included in the revised Practice Statement.

Illustration: How the proposed emphasis on the assessment of prospects for future net cash inflows, and on management’s stewardship of the business, supports understanding of the business across time horizons.

Cash flow horizon	Addressing matters relating to...	Information to support an assessment of...
Short-term cash flows	description of ‘business as usual’	the earnings capability of the business today and management’s stewardship of the business
Medium-term cash flows	how are we protecting and enhancing the business?	the impact of known factors on earnings potential and management’s stewardship of the business
Long-term cash flows	is the business sustainable in the long run?	the perpetuity prospects of the business and management’s stewardship of the business

The staff's illustrative drafting of the objective and supporting guidance is provided in Appendix A to this slide deck. We seek your views on the main features of staff's proposed approach to the objective of management commentary and supporting guidance (see slide 7), in particular:

1. Do you agree with the staff's proposed objective of management commentary that focuses on providing context for the financial statements and users' assessments of prospects of future net cash inflows and of management's stewardship of an entity's economic resources (see slide 8 and Appendix A)? If not, what do you propose instead and why?
2. Do you agree with the staff's proposed discussion of user information needs (the entity's current position and performance, its strategy for developing them, and the progress and implications of that strategy, see slide 9)? Are there any other types of information that should be considered?
3. Do you agree with the staff's proposed discussion of information that a management commentary would normally be expected to include (see Appendix A)? Are there any additional types of information that should be discussed?

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APPENDIX A—Illustrative drafting on the objective of management commentary and supporting guidance

The appendix is provided for illustration only and the staff do not plan to discuss it in detail at the meeting.

Illustrative text

The objective

- A1. The objective of management commentary is to provide financial and operational information that gives context for the underlying financial statements by providing information that is useful for primary users of management commentary in assessing the prospects for future net cash inflows to the reporting entity, and in assessing management’s stewardship of the entity’s economic resources.
- A2. The primary users of management commentary are those existing and potential investors, lenders and other creditors who rely on management commentary and financial statements for much of the financial information that they need. (See paragraphs 1.2 and 1.5 of the *Conceptual Framework for Financial Reporting*, replacing references to financial reports with specific reference to management commentary and financial statements).

Information that users need to assess an entity’s prospects for future net cash inflows and of management’s stewardship of the entity’s economic resources

- A3. To achieve its objective, the management commentary provides financial and operational information through the eyes of management that is useful for users’ assessment of the entity’s prospects for future net cash inflows, and of the management’s stewardship of the entity’s economic resources. That information covers:

- (a) the entity's performance for the reporting period and its position at the end of the reporting period;
- (b) management's strategy for developing and sustaining the entity's future net cash inflows;
- (c) the entity's progress in implementing its strategy and the factors affecting that progress; and
- (d) information that supports users' assessments of:
 - (i) the potential implications for the entity's future financial performance of that strategy and of those factors; and
 - (ii) the related opportunities and risks.

Identifying information to be included 'through the eyes of management'

- A4. The management commentary includes information on matters considered by management in exercising stewardship over the entity's economic resources. Ordinarily, this will include information on:
- (a) the entity's financial and operational performance for the reporting period and its position at the end of the reporting period;
 - (b) external trends and factors potentially affecting the entity;
 - (c) 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;
 - (d) the relationships that affect the entity's ongoing success and the impact of the entity's activities on those relationships; and
 - (e) the entity's business model and strategy, including the opportunities and risks in relation to the above matters.
- A5. To comply with the Practice Statement, a management commentary is not required to include forecast information, except where previously published by the entity.