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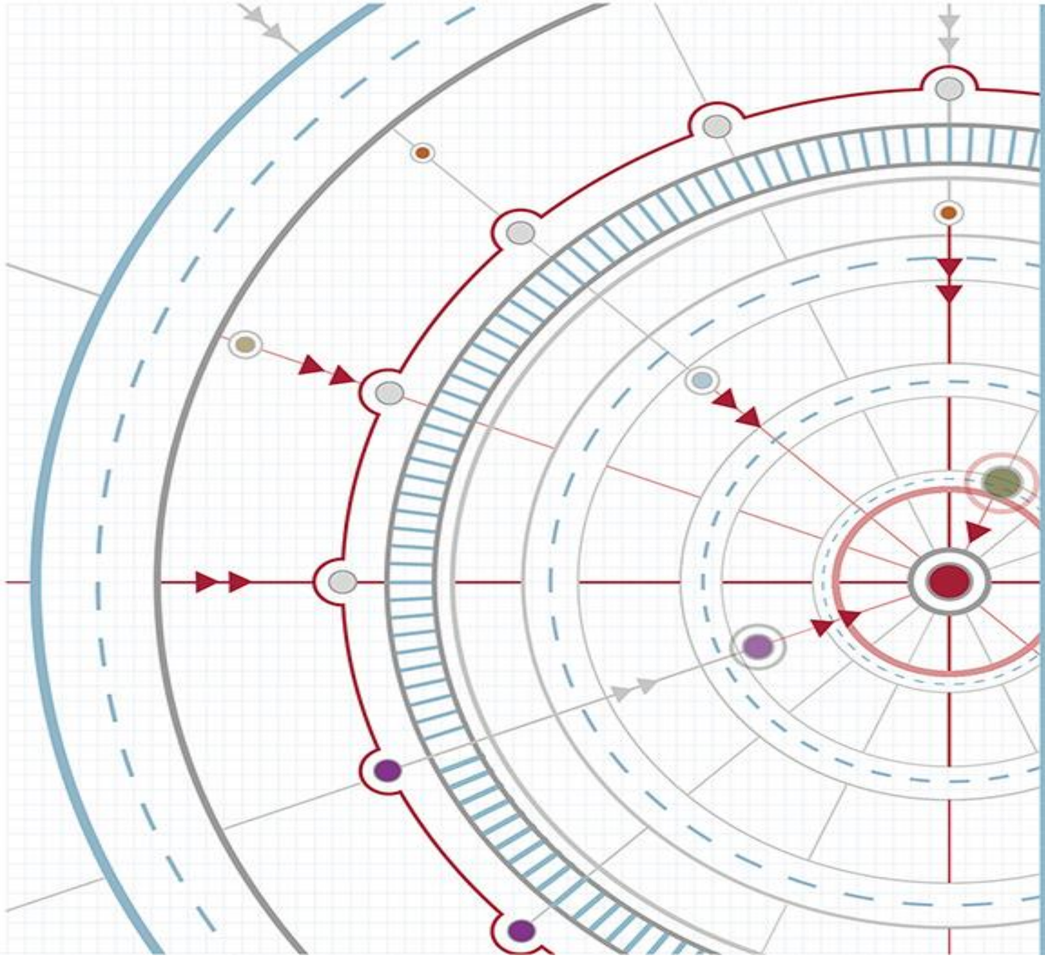

Management Commentary

Stream 3 *Business Model, Strategy, Operating Environment and Risks*

Slide Deck 3 *Strategy*

Consultative group meeting – 3 April 2019

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

Contents

Background

Challenges with current reporting practice

- In Slide deck 1 we have identified the following challenge with reporting strategy in management commentary:

  Strategy discussion focuses on operational tactics without addressing long-term drivers of the entity's success.

- In this Slide deck we explain the staff's proposed approach to addressing this challenge.
- In developing our approach, we have analysed national standard-setters' requirements for describing business model in management commentary or equivalent document (see slide 5).

Analysis of national standard-setters' requirements

- The national frameworks reviewed by the staff[1] provide various levels of guidance for describing strategy:
  (a) some requirements do not specifically refer to strategy (for example, US, Mexico, Russia);
  (b) some ask management for a brief description of the entity's strategy, but leave management to decide what should be included in that description (for example, Spain, Portugal, Japan);
  (c) some include high-level guidance on the aspects of strategy that management should consider discussing in management commentary (for example, UK, Australia). One framework does not require a description of strategy but includes guidance for those entities that choose to report on it voluntarily (Germany).
- Many of the frameworks reviewed discuss management of risks as part of the entity's strategy. However, we propose discussing risks (and the entity's policies for managing the risks) separately (see slide deck 4).
- Most of the frameworks reviewed do not specify the time horizon to be covered when describing the entity's strategy. A few frameworks ask for an indication of the time frames for objectives discussed in management commentary, so that it is clear over what period success in achieving those objectives should be assessed.
- One framework emphasises that goals described in management commentary must be considered 'practically possible'.

[1] The staff's review was based on the outreach performed in July-August 2018. In response to our questionnaire, we received 24 replies from national standard-setters.

- Some frameworks reviewed broadly ask for a description of the entity's or business strategy(ies) without specifying which components of strategy management should consider discussing. Where frameworks provide more guidance on the components of strategy to discuss, they tend to refer to one or more of the following:
  (a) purpose;
  (b) vision;
  (c) objectives or strategic objectives;
  (d) goals or operational strategies; and
  (e) plans.
- The staff note that sometimes more than one of those terms may be used to describe the same component and the difference in terminology may be due to different translation of the terms.
- Other examples from frameworks reviewed of disclosures to be considered in relation to strategy include:
  (a) factors on which the achievement of strategy depends;
  (b) progress in meeting the objectives;
  (c) measures that would allow users to assess the entity's progress against its strategy or objectives;
  (d) the entity's values, desired behaviours and culture.
- Note: two of the reviewed frameworks encourage management to use IIRC's International Integrated Reporting Framework for preparing management commentary.

Staff’s proposed approach for the description of strategy

How we propose to revise the 2010 Practice Statement

The key changes proposed by the staff to the 2010 Practice Statement are summarised below:

[Objectives and strategies]

27 Management should disclose its objectives and strategies in a way that enables users of the financial reports to understand the priorities for action as well as to identify the resources that must be managed to deliver results. For example, information about how management intends to address market trends and the threats and opportunities those market trends represent provides users of the financial reports with insight that may shape their expectations about the entity's future performance. Management should also explain how success will be measured and over what period of time it should be assessed.

28 Management should discuss significant changes in an entity's objectives and strategies from the previous period or periods. Discussion of the relationship between objectives, strategy, management actions and executive remuneration is also helpful.

We are proposing an approach to describing strategy that builds from the entity's purpose, the objectives the management has set in pursuit of the purpose, through to management's plans to achieve these objectives (see slides 8 and 10).

+

We are proposing to introduce a requirement to explain the entity's culture, recognising the role it plays in supporting the execution of strategy (see slide 14).

+

We are proposing to introduce a requirement to discuss the entity's funding strategy to address the entity's ability to finance its strategy (see slide 15).

For today's discussion we would like to focus on whether our overall approach to describing strategy is appropriate, together with specific considerations in relation to (i) the role of 'culture' in the description of strategy and (ii) the description of the entity's 'funding strategy'.

Components of the strategy description

We seek to ensure that the entity's strategy discussion is not confined to explaining the enhancement of earnings in the short-term (for example, efficiency savings, revenue kicks) as (i) longer-term strategies may have a greater effect on the entity's future net cash inflows; and (ii) some short-term strategies may enhance net cash inflows in the short-term but may negatively affect value over the longer term.

We highlight that similar priorities for strategy reporting have also been identified by other organisations – eg. the Japanese Institute of Certified Public Accountants (JICPA), below.

> **How can corporate reporting practice support long-term oriented behaviour of institutional investors?** JICPA, 2017
>
> The medium- to long-term productivity and growth potential of a company depend largely on the future business model of the company. An effective business model can be described as mechanism for creating the values for the society at large in the future economic, social and competitive environments by taking advantage of the company's competence and generating profits, and hence a financial return for the investors. For the investors to understand the future business model of the company, the corporate mission, vision and values are essential.
>
> :
>
> Success of the business model depends on the strategy of the company. We defined the strategy in this report as a method, or approach, to realize the effective business model the company seeks to establish by optimally allocating and leveraging various business resources and relationships of the company including human, physical, financial and other capitals. It is without saying that the intangible resources are getting more and more important for the businesses.

We have previously discussed the difficulties of making explicit references to short / medium / long term in the revised Practice Statement. There is an additional consideration in relation to strategy in that long-term components of strategy may appear to lack specificity unless they are linked to more immediate objectives and plans.

The staff's proposed approach seeks to ensure that the description of the entity's strategy covers all time periods by structuring the discussion of strategy into three related components. It is similar to the approach adopted by the UK's Financial Reporting Council (FRC).

Proposed components for the strategy discussion:

Long term view of strategy:

Purpose
Purpose (or 'mission') that the guides the entity's strategy

Illustration:
Meet consumers' private transport needs

↓

Medium term view of strategy:

Objectives
Objectives to be achieved in pursuit of the entity's purpose

Illustration:
- *Develop vehicles that meet the requirements of a low carbon economy*
- *Develop autonomous driving technology*
- *Market leadership in X, Y, Z*

↓

Short term view of strategy:

Plans*
Management's plans to develop the entity's business model in order to achieve the entity's objectives

Illustration:
- *Closure of diesel engine plant*
- *AI development programme*
- *Strategic partnership in market X to access leasing market*

* In materials for today's meeting we use the term 'plans' as a working term to refer to an entity's operational plans for taking actions the entity will take to execute its objectives. We will consider if there is a more suitable term to use in the revised Practice Statement.

Staff's proposed approach
General considerations and specific considerations

The staff's proposed approach to the description of strategy is summarised below:

Area	*Proposed approach in the revised Practice Statement*	*Ref**
Components of the strategy description	Specify three components to the strategy description: purpose, objectives and plans (see proposals for more detailed guidance on slide 10).	A22
Period covered and changes since the last reporting date	Require management commentary to describe: • the entity's strategy current at the date the management commentary is approved; and • changes and adjustments to the strategy since the last reporting date.	A25
Basis for developing strategy	Require management commentary to: • explain the assumptions relating to the entity's operating environment on which the strategy has been based; • identify and describe both management's aspirations and the challenges management anticipates in executing the strategy and provide references to related discussion both in other parts of management commentary and in financial statements, such as to discussion of risks, if that is necessary for an understanding of those aspirations and challenges; and • distinguish clearly between statements of fact, predictions, and aspirations.	A26–A27
Basis for measuring progress	Require management commentary to describe how management measures the progress in executing the entity's purpose, objectives and plans and provide a link to the discussion of the entity's current performance.	A28
Specific considerations		
Culture	Require management commentary to describe: • the features of the entity's culture that support, and those that hinder, the achievement of the entity's purpose; and • how the entity's culture is monitored and managed. See slide 14 that discusses specific proposals related to culture.	A37
Funding strategy	Require management commentary to describe the entity's funding strategy, including any leverage and credit rating objectives. See slide 15 that discusses specific considerations in describing funding strategy.	A38–A39
Link to management compensation	Discuss how management compensations aligns with the progress in executing the entity's purpose, objectives and plans	A28

** References are to the Illustrative drafting on business model, strategy, operating environment and risks. The illustrative drafting is provided for illustration only and we do not plan to discuss it in detail at the meeting.*

Staff's proposed approach
Guidance on components of the description of strategy

We are proposing an approach to describing strategy that builds from the entity's purpose, the objectives the management has set in pursuit of the purpose, through to management's plans to achieve these objectives. The staff's proposed approach to components of the description of strategy is summarised below:

Component	*Proposed approach in the revised Practice Statement*	*Ref(*)*
1) Purpose	• Anchor strategy description in identifying the entity's purpose that guides the strategy of the entity to support a longer-term perspective. The entity's purpose can be described, for example, in terms of satisfying a market need or achieving a certain outcome for end-users.	A29
2) Objectives	• Link discussion of objectives to the entity's purpose. Objectives can, for example, relate to the enhancement or maintenance of resources and relationships that the entity depends on for its future success. For example, one of an entity's objectives may be maintaining a reputation for quality or building expertise in a new field. • Link the description of objectives to other information in management commentary that helps users evaluate the entity's progress in achieving the objectives and potential implications of that progress for the prospects for the future net cash inflows to the entity. • Indicate qualitative or qualitative milestones by which management intends to measure progress towards achieving an objective if that objective may take a number of years to achieve.	A30–A32
3) Plans	• Link discussion of plans to discussion of the entity's objectives or to trends or factors in the operating environment the plan is intended to address. • Require an overview of what features of the business model are expected to be changed and the investment required to deliver the plan. • Link the description of plans to other information in management commentary that helps users evaluate the entity's progress in achieving the plans and potential implications of that progress for the prospects for the future net cash inflows to the entity. See slide 13 that discusses specific considerations for description of plans in management commentary.	A33–A36

** References are to the Illustrative drafting on business model, strategy, operating environment and risks. The illustrative drafting is provided for illustration only and we do not plan to discuss it in detail at the meeting.*

Application of the principle of narrative coherence

The table below summarises the areas where we propose to make the application of the principle of narrative coherence explicit in relation to the strategy description. If the entity decides to provide information about a feature of its strategy, then the revised Practice Statement would prompt management to determine whether there is material information to be disclosed in the following related areas:

Related content	*Proposed requirement*	*Illustration*
Business model	Provide information about the scale of business activity that is potentially affected by the strategy – proposed in Stream 2	*A manufacturer identifies a regional growth strategy. The business model description explains that in contrast to the rest of the business, sales for that region are made through a resale partner*
	Provide information about the potential impact of the strategy on the business model – proposed in Stream 2	*An entity is implementing a major restructuring programme to support an efficiency objective. It identifies the categories of customer that it will no longer be able to serve as a result of the programme*
	Describe plans to develop the business model including resources and relationships – Stream 3 A33	*A retailer is in turnaround, and has set an objective of delivering the leading in-store experience. It identifies the importance of having knowledgeable and engaged staff on the floor to deliver this, therefore it provides an overview of the major staff training programme that supports this*
	Provide qualitative and quantitative information about features of the entity's business model to help users understand matters identified in other parts of management commentary that could affect the prospects for future net cash inflows to the entity, for example by affecting the entity's ability to pursue its strategy – Stream 3 A7(b)	*A software business announces a strategy to migrate business users to a service contract model. It reports the current proportion of revenues attributable to business users and describes the key features of the new contract model*
Operating environment	Describe trends and factors in the operating environment that could affect the execution of strategy – Stream 3 A40(b)	*A telco has an objective to maintain network quality leadership in its chosen markets. The entity explains how the outcome of next-generation spectrum auctions could affect the achievement of this objective*
Risks	Describe risks arising from the selection and execution of the entity's strategy – Stream 3 A49(b)	*A utilities business's growth strategy is dependent on re-selling additional third party services to its customer base. The entity explains the risk involved in building its re-sale business*
Performance, position and progress	Include analysis and explanations of progress in implementing strategy – discussed in Stream 2	*A manufacturer has acquired a support services business to enable it to generate service revenues attributable to its products. It analyses and explains the proportion of product customers that have also taken a service contract*
	Describe how management measures progress in executing the entity's purpose, objectives and plans and link to discussion of current performance – Stream 3 A28	*A vehicle manufacturer describes its purpose in terms of producing the safest possible cars. It describes how it reports statistics for serious injuries arising from incidents involving its vehicles*
	Link description of objectives to information that helps users evaluate progress made in achieving the objectives – Stream 3 A31	*A vehicle manufacturer has an objective of halving average carbon emissions of its cars over five years. It reports average carbon economy per vehicle sold*
	Link description of plans to information that helps users evaluate progress made in achieving the plans – Stream 3 A35	*A business operates a major water-stressed site and is targeting a 50% reduction in water consumption in the next 12 months in order to maintain the viability of the site. The business reports the site's water consumption and the percentage reduction already achieved*

Specific considerations in describing strategy

Plans

Our research suggests that other management commentary frameworks do not often explicitly require discussing ‘plans’ as part of the strategy description. However, given the varied approaches to describing entity’s strategies we think guidance is desirable in relation to the information to be provided on the entity’s plans to encourage provision of descriptions of strategies starting from long term (purpose) to short term (plans) and including an appropriate level of detail.

We want to avoid the guidance being perceived as a requirement for unnecessary detail that may also be commercially sensitive. Therefore we are proposing that the guidance in the revised Practice Statement:

- requires a description that provides an overview of the entity’s plans only;
- addresses the scope of the description of the entity’s plans to be provided rather than specific features of the plans to be discussed in management commentary.

An overview of the proposed requirements is given opposite.

(*see also paragraphs A33–A36 of Illustrative drafting*).

We propose that the description of the entity’s plans should:

(a) emphasise the role of resources and relationships in relation to the entity’s plans – plans will normally affect, and need to be supported by the entity’s resources and relationships. So we propose that the revised Practice Statement requires an overview of the features of the business model that management expects to change and of any associated potential positive and negative impacts of those changes on the entity’s resources and relationships that the entity depends on for its success.

 We think that users will need information to understand the effects and compromises involved in implementing the plan – for example, withdrawal from an unprofitable business activity may have consequences for the entity’s ability to serve its core customer base.

(b) require an overview of the capital and operating investment* required to support the plan.

 We think this overview is necessary to support discussion of the entity’s funding strategy, and the discussion of investment activities that the Consultative Group covered during *Stream 2*.

In addition, to support the application of the principle of narrative coherence, we propose to require information on the management’s basis for monitoring the progress in achieving a plan, and links to other information in management commentary that helps users evaluate the progress made in achieving the plan and potential implications of that progress for the prospects for the future net cash inflows to the entity.

* Here by capital investment we mean the amounts capitalised in accordance with IFRS Standards.

Culture

- An entity's culture relates to the values, attitudes and behaviours demonstrated in the entity's activities and relationships.
- Out of 24 respondents to the staff's outreach with national standard-setters, only the UK's FRC makes explicit reference to culture:

Extracts from the FRC's *Guidance on the Strategic Report*:

7B.7 An entity's purpose, strategy, objectives and business model are inter-related concepts…A description of an entity's values, desired behaviours and culture will help to explain and put its purpose in context.

7B.10 The purpose, strategy and values should be aligned with the entity's culture (as per Principle B of the Corporate Governance Code)

7B.40 When determining the appropriate level of information to disclose in the strategic report, entities should consider the following (non-exhaustive) list of factors: (a) The extent to which the matter has an effect on an entity's business model, strategy, objectives, purpose, or culture…

- The staff also noted that the International Integrated Reporting Framework lists culture (together with ethics and values) as one of the matters that should be identified in an integrated report.
- As discussed in Slide Deck 1, slide X, we reviewed three Corporate Governance Codes. Although reporting on culture may not be explicitly required by these codes, the values and other aspects of the entity (such as remuneration and diversity policies) may reflect its culture.
- In 2016, the FRC published its report *Corporate Culture and the Role of Boards* which recognised that investors see 'a need for companies to improve reporting on culture and communicate openly about the impact of culture on the business'. The Investment Association referred to and welcomed this research in its *Long-Term Reporting Guidance*.
- In that guidance, the Investment Association said that 'a healthy corporate culture is a valuable asset, a source of competitive advantage, and vital component in the creation and protection of long-term value… [but] it may not be possible to rely on a single metric or corporate statement to gain a proper understanding of the culture of a company.'
- The FRC report discussed a number of indicators that could give meaningful insights into culture, including:
  (a) good explanations of some features of the business model and key risks;
  (b) discussion of management actions which shows whether management means what it says;
  (c) reporting on human capital, employee engagement and retention, and investment in training;
  (d) remuneration practices, incentivisation structures, and whether management's focus is short or long-term;
  (e) customer satisfaction; and
  (f) compliance and health and safety indicators.
- As in the FRC's and Investment Association's reports, we recognise that there cannot be a one-size-fits-all approach to addressing culture in management commentary. However, encouraging reference to culture in management commentary could still be appropriate, in showing how management has considered it and its link to the entity's purpose. Therefore, we propose that management commentary describes features of the entity's culture that support, and those that hinder, the achievement of the entity's purpose. It also describes how the entity's culture is monitored and managed. Information about the entity's culture does not need to be provided as a separate section of management commentary; it can be embedded throughout the report as a coherent thread.
- In addition, users can gain insights into an entity's culture through other information provided in the entity's management commentary. For example, employees affect and are affected by culture. Therefore, discussion of employees and the relationship with them in management commentary also provides some insight into the entity's culture.

Funding strategy

During Stream 2 we discussed potential requirements for providing information on an entity's financing position. That discussion emphasised the need for describing in management commentary both current and historical financing requirements of an entity.

We are proposing to build on this proposal by requiring *a description in the management commentary of the entity's funding strategy including any leverage and credit rating objectives* (see paragraph A38 of illustrative drafting).

The proposed approach is intended to reflect management's view of the entity's funding position including its ability to maintain credit / dividend policies whilst pursuing its stated strategy.

In addition, we propose that the description of the entity's funding strategy should discuss or provide links to a discussion of the potential impact on the entity's funding requirements arising from risks and factors in the entity's operating environment. The proposed approach is intended to support users' evaluation of business viability without requiring management to predict the effect of uncertain future events on the entity's funding requirements.

Accordingly, the proposed approach does not require:

- quantifying identified risks to the funding strategy;
- a statement of the period for which management assesses the entity's funding needs;
- a conclusion on the adequacy of the entity's funding strategy; or
- a stress test of the adequacy of the entity's funding strategy taking account of its risks and operating environment.

We highlight the emergence of *viability reporting* in the UK as a possible precedent. The UK viability reporting requirements are summarised in the appendix (see slide 19).

Link between proposals for discussing financing position and funding strategy :

Area	*Stream 2 – Information about financing position includes:*	*Stream 3 – The description of funding strategy covers:*
Financing arrangements	Analysis of terms and conditions of existing financing arrangements Analysis of covenant ratios	Current financial position and available financial facilities
Working capital	Analysis of changes during the period; Explanation of representative position over the reporting period	Working capital funding requirements
Financing requirements	Explanation of financing requirements taking account of the impact of strategy	Financial resources required to implement the entity's strategy
Cash generation	-	The entity's current ability to generate net cash inflows
Credit Policy	-	Leverage and credit rating objectives
Dividend Policy	-	Dividend policy

Extract from Stream 2 Illustrative drafting:

The management commentary should include information about the entity's financial position to help users assess the entity's ongoing financing requirements. This information should include:

a) explanation of working capital changes during the period if the entity's working capital position at the end of the reporting period is unrepresentative of the entity's working capital during the period;

b) analysis of performance measures and ratios that help users understand the entity's compliance with its financing covenants;

c) analysis of terms and conditions of financial liabilities, guarantees, lease, option and other financing agreements that could give rise to early repayment obligations; and

d) discussion of the entity's financing requirements both for the next period and beyond, including explanations of the impact of the entity's stated strategy on its financing requirements.

Other aspects of strategy

In addition to the three components of strategy (purpose, objectives and plans), culture and funding strategy discussed on the preceding pages, we are proposing to address in the revised Practice Statement one more aspect of strategy as follows:

- Require a discussion of how management compensation aligns with the progress in executing the entity's purpose, objectives and plans (see paragraph A28 of Illustrative drafting). This may provide useful information for users' understanding of the entity's strategy and their assessments of the management's stewardship of the entity's resources.

We discussed the reporting of tax sustainability, at our *Stream 2* meeting. Following that discussion we are consulting more widely on the question of what, if anything, the revised Practice Statement should explicitly address in relation to tax, therefore we have not included any proposals on tax for discussion today.

Questions

Questions for the Consultative Group

1. Do you agree with the proposed components for strategy description, ie purpose, objectives and plans (slides 8 and 10)? If not, why and what do you propose instead?
2. We propose adding a requirement to provide a description of (i) features of the entity's culture that support, and those that hinder, the achievement of the entity's purpose and (ii) how the entity's culture is monitored and managed (slide 14). Do you agree with the proposed approach to describing the entity's culture? If not, why not, and what do you propose instead?
3. We propose that the revised Practice Statement requires a description of the entity's funding strategy including any leverage and credit rating objectives and propose guidance on what information that description should cover (slide 15). Do you agree with the proposed approach to funding strategy? If not, why not, and what do you propose instead?
4. Are there other specific aspects of strategy that should be covered explicitly?

Appendix

Appendix
Overview of UK viability reporting requirements

UK Viability Statement

UK Corporate Governance Code

31 Taking account of the company's current position and principal risks, the board should explain in the annual report how it has assessed the prospects of the company, over what period it has done so and why it considers that period to be appropriate. The board should state whether it has a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary.

UK Viability Statement – Supporting analysis

FRC: Guidance on Risk Management, Internal Control and Related Financial and Business Reporting (September 2014)

The statement should be based on a robust assessment of those risks that would threaten the business model, future performance, solvency or liquidity of the company, including its resilience to the threats to its viability posed by those risks in severe but plausible scenarios. Such an assessment should include sufficient qualitative and quantitative analysis, and be as thorough as is judged necessary to make a soundly based statement. Stress and sensitivity analysis will often assist the directors in making their statement. These simulation techniques may help in assessing both the company's overall resilience to stress and its adaptability and the significance of particular variables to the projected outcome.

UK Viability Statement – Financial Reporting Lab recommended approach to the statement

UK viability reporting requirements include the following provisions:

- consider current position and principal risks;
- explain how the board has assessed the company's prospects;
- explain the period of assessment and why this is considered appropriate;
- draw attention to qualifications and assumptions underlying the board's conclusion;
- conclude on whether the board has a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of its assessment.

Additionally, the guidance requires that the viability statement is based on a robust assessment of risks supported by qualitative and quantitative analysis and emphasises that stress and sensitivity analysis will often be needed to support the statement.

A 2017 Financial Reporting Lab publication highlights that most statements have had a three year look-forward period and emphasises the value placed on insights into:

- the board's own planning horizons and process;
- the board's stress testing and analysis in the context of the company's principal risks; and
- the qualifications and assumptions under which the board's statement is made.

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