



Management Commentary

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

Slide Deck 4 *Operating Environment and Risks*

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.

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Background

Operating environment and risks

Challenges with current reporting practice

- In Slide Deck 1 we identified the following challenges with reporting operating environment and risks in management commentary:
 - (a) narrow view of the operating environment is taken, omitting discussion of some factors and trends and of their effects on the prospects for the future net cash inflows to the entity;
 - (b) lack of focus in reporting risks resulting in key risks obscured by reporting of many risks; and
 - (c) varied approaches to identification of key risks
- In this Slide deck we explain staff's proposed approach to addressing these challenges.
- In developing our approach, we have reviewed national standard-setters' requirements for describing operating environment (see slide 7) and risks (see slide 13) in management commentary or equivalent document.

Operating environment and risks

How we propose to revise the 2010 Practice Statement

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

Extracts from 2010 Practice Statement:

[Description of the business]

26 Management should provide a description of the business to help users of the financial reports to gain an understanding of the entity and of the **external environment** in which it operates. That information serves as a starting point for assessing and understanding an entity's performance, strategic options and prospects. Depending on the nature of the business, management commentary may include an integrated discussion of the following types of information:

- a) the industries in which the entity operates;
- b) The entity's main markets and competitive position within those markets;
- c) significant features of the legal, regulatory and macro-economic environments that influence the entity and the markets in which the entity operates;
- d) the entity's main products, services, business processes and distribution methods; and
- e) the entity's structure and how it creates value.

...

29 Management commentary should include a clear description of the most important resources, **risks** and relationships that management believes can affect the entity's value and how those resources, risks and relationships are managed.

31 Management should disclose an entity's principal risk exposures and changes in those risks, together with its plans and strategies for bearing or mitigating those risks, as well as disclosure of the effectiveness of its risk management strategies. This disclosure helps users to evaluate the entity's risks as well as its expected outcomes. Management should distinguish the principal risks and uncertainties facing the entity, rather than listing all possible risks and uncertainties.

32 Management should disclose its principal strategic, commercial, operational and financial risks, which are those that may significantly affect the entity's strategies and progress of the entity's value. The description of the principal risks facing the entity should cover both exposures to negative consequences and potential opportunities. Management commentary provides useful information when it discusses the principal risks and uncertainties necessary to understand management's objectives and strategies for the entity. The principal risks and uncertainties can constitute either a significant external or internal risk to the entity.

'External environment' forms part of the description of the business in the 2010 Practice Statement. Risks are covered alongside resources and relationships. We would like to emphasise a strong interaction between operating environment and risks. Therefore, we are proposing to make them separate content elements rather than embedding them in one of the other elements.

In relation to trends and factors in the operating environment, we are proposing specific guidance when they are monitored through the use of external statistics and external engagement or feedback.

We are proposing a more explicit link between (a) the identification of material information in relation to operating environment and risks and (b) the prospects for future net cash inflows to the entity.

Management considers the likelihood and magnitude of the potential impact of trends and factors in the operating environment and risks on the prospects for the future net cash inflows to the entity. This addresses the challenge with current practice of reporting many trends and factors or risks which have a remote likelihood of occurring or would be of a low magnitude, that could undermine the overall clarity of information in management commentary.

We are proposing specific guidance on the information to be reported for each risk identified.

Note: Subtitles and other emphasis in bold added for clarity



Operating environment

Operating environment

Analysis of national standard-setters' requirements

- The national frameworks for management commentary reviewed by the staff¹ provide various levels of guidance for describing operating environment in management commentary or equivalent document:
 - (a) some include specific guidance on discussion of the business or external environment;
 - (b) some refer to trends or factors affecting the entity in addition to, or instead of, referring to the operating environment;
 - (c) some discuss aspects associated with the external environment in the discussion of information required on business model, risks and key performance indicators, rather than setting out explicit requirements for information on the operating environment;
 - (d) some require specific consideration of environmental, social and governance (ESG) issues in discussing the entity's operating environment; and
 - (e) some refer to discussion of both opportunities and risks.
- Specific aspects of the operating environment on which disclosures are required by different national frameworks include:
 - (a) industries and locations the entity operates in;
 - (b) the entity's competitive environment;
 - (c) laws and regulations;
 - (d) the political environment;
 - (e) macro-economic factors;
 - (f) environmental issues (including related government intervention, on for example, reducing emissions);
 - (g) employee issues; and
 - (h) community and social issues

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.

Operating environment

Staff's proposed approach – Overview of the approach

Staff's proposed approach to discussion of operating environment is summarised below:

Area	Proposed approach in the revised Practice Statement	Ref (*)
Identifying trends and factors to be discussed	Require identification of trends and factors that (i) affected current period performance, progress and position, and (ii) could affect business model, strategy or performance, progress and position.	A40
	Emphasise range of time periods to be covered (see slide 9 for more detailed guidance).	A41
	Require that trends and factors should be described whether they indicate opportunities or risks.	A42
Application of materiality	Emphasise that to identify information on trends and factors that is material, management should consider their likelihood and the magnitude of their potential impact on the prospects for the future net cash inflows to the entity.	A43
	Require that information is provided to help users evaluate impact of trends and factors on prospects for future cash flows to the entity (see slide 9 for more detailed guidance).	A44
Information on monitoring trends and factors	Require description of the use of external statistics and external engagement and feedback when they are used to monitor trends and factors in the operating environment (see slide 10 for more detailed guidance).	A45-46
Narrative coherence	Emphasise the need to link the discussion of operating environment to the strategy discussion {Note: Other content elements address the link to operating environment} (see slide 11 for more detailed guidance).	A47

* 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.

The 2010 Practice Statement asks for a description of the business to help users understand the external environment in which it operates (paragraph 26). It includes a list of information that may need to be included in the description of the business:

- the industries in which the entity operates;
- the entity's main markets and competitive position within those markets;
- significant features of the legal, regulatory and macro-economic environments that influence the entity and the markets in which the entity operates.

We are proposing that this guidance should be replaced with a principles-based approach that requires discussion of trends and factors in the entity's operating environment that either:

- (a) have affected the entity's performance, progress, or position in the reporting period; or
- (b) could affect the operation of the entity's business model, the execution of its strategy, or the entity's performance, progress or position.

We are also proposing guidance to:

- (a) illustrate that management commentary should discuss both (i) shorter-term factors, ie those that can have an immediate effect on the prospects for the future net cash inflows to the entity (for example, currency or commodities price exposures) and (ii) longer-term factors, ie those that may crystallise over a longer period (for example the emergence of alternative technologies, or potential effects of climate change or related regulations).

- (b) highlight that trends and factors should be described in management commentary both if they provide or indicate opportunities for the entity and if they create or indicate risks;
- (c) emphasise that to determine which information on trends and factors is material, management should consider the likelihood and magnitude of their potential impact on the prospects for the future net cash inflows to the entity;
- (d) require that management commentary provides information to help users evaluate the potential impact of the trend or factor on the prospects for the future net cash inflows to the entity; if that potential impact is sensitive to small changes in assumptions (for example, if it could cause a business activity to become loss-making), management commentary provides information to help users evaluate the potential impact across the range of potential outcomes that management considers to be realistic.

We have identified for consideration two areas where specific guidance may be needed on the information about operating environment to be reported in the management commentary:

- (a) If management uses **external statistics** to monitor trends and factors in the entity's operating environment (for example, market size, resource availability), we propose to require management to identify in management commentary:
- (i) the source of the information;
 - (ii) date to which the information relates; and
 - (iii) the part of a business activity, segment or financial statements line item to which the information relates.

This is because external analysis may not fit the structure in which the entity reports its performance. For example, the data may relate to only a part of the reporting period or a part of a business activity which could cause users to draw invalid inferences from the information presented.

- (b) If management monitors a trend or factor in the operating environment through **external engagement or feedback**, we propose to require management to include in management commentary:
- (i) the material information relating to its findings from the engagement or feedback;
 - (ii) the nature and scope of the engagement undertaken;
 - (iii) the date to which information relates; and
 - (iv) the part of a business activity, segment or financial statements line item to which the information relates.

Again, users may over-generalise analysis presented in the management commentary if the scope of the engagement or feedback is not clearly described. For example, if management commentary summarises findings from customer interviews that are applicable to one class of customer only, this needs to be explained in management commentary. Describing the nature and scope of engagement undertaken will help users interpret the findings.

Operating environment

Application of the principle of narrative coherence

The table below summarises the areas where we propose to provide guidance on the principle of narrative coherence in relation to the entity's operating environment. If the entity decides to provide information on a trend or factor in the operating environment, then the revised Practice Statement would prompt management to determine whether there is material information to be provided in the following related areas:

<i>Related content</i>	<i>Proposed requirement</i>	<i>Illustration</i>
Business model	Provide overview of the business model and more detailed quantitative and qualitative information that helps users' understanding of the entity's ability to respond to opportunities and risks in its operating environment – Stream 3 A7(b)	<i>An outsourcing business identifies changing patterns in local government procurement strategy. In describing the business model, management commentary reports the proportion of revenue attributable to local government contracts.</i>
Strategy	<p>Explain how the entity plans to respond to the trends and factors in the operating environment, linking to the discussion of strategy – Stream 3 A47</p> <p>Discuss funding requirements arising from trends and factors in the operating environment (in description of funding strategy) – Stream 3 A39</p>	<p><i>Technology designer identifies increasing competition from clone products. Management commentary explains strategy to keep customers using its product.</i></p> <p><i>An extractives business identifies external factors that are significantly increasing time from initial exploration to development. Management commentary explains how the funding strategy takes into account the longer investment funding period.</i></p>
Risks	Describe risks arising from trends or factors in the operating environment – Stream 3 A49(c)	<i>Credit scoring business identifies developments in data privacy legislation. Management commentary identifies data security as a risk and reports on progress managing that risk.</i>
Performance, position and progress	Analyse and explain progress in managing trends and factors in the operating environment – proposed in Stream 2	<i>A utility business identifies that it is subject to increased levels of regulatory scrutiny. Management commentary reports on compliance with regulatory KPIs.</i>

Risks

Risks

Analysis of national standard-setters' requirements

- The national frameworks for management commentary reviewed by the staff¹ provide various levels of guidance for describing risks in management commentary or equivalent document:
 - (a) most require a description of 'principal', 'major' or 'key' risks, and discussion of the entity's risk management strategy and mitigating actions;
 - (b) some frameworks state that the identification and management of risks is the responsibility of the entity's board;
 - (c) some frameworks require disclosures on both risks and uncertainties; and
 - (d) some frameworks list examples or types of risks to be disclosed.
- Where national frameworks list the types of risks they require or expect disclosures on, these include:
 - (a) financial instruments risks (including disclosures on hedging);
 - (b) market risks (such as price, credit, liquidity and cash flow risks);
 - (c) ESG risks (as a broad descriptor without specifying the types of risks);
 - (d) environmental risks (including climate change);
 - (e) health and safety risks; and
 - (f) bribery and corruption risks.

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.

Risks

Staff's proposed approach – Overview

Staff's proposed approach to discussion of risks is summarised below:

Area	Proposed approach	Ref (*)
Selecting risks to be described	Identify risks affecting prospects for future net cash inflows to the entity, taking into account likelihood and magnitude of impact of risks on entity's future net cash inflows (see slide 15 for more detailed guidance).	A48
Types of risk	Identify risks arising from (i) operation of business model; (ii) selection and execution of strategy and the operation of the entity's culture; and (iii) trends or factors in the operating environment (see slide 15 for more detailed guidance).	A49
Providing information on other risks	Identify separately information about risks other than those that affect the prospects for future net cash inflows to the entity that is not necessary for meeting the objective of management commentary but is required by law or regulation (see slide 15 for more detailed guidance).	A50
Information to be provided	Provide information on (i) how risk is managed, (ii) the progress in monitoring and managing the risk, (iii) mitigating actions if the risk crystallises; and (iv) information to help users evaluate potential impact of risk on the prospects for future net cash inflows to the entity (see slide 16 for more detailed guidance).	A51
Other information considerations	Provide information on (i) changes in likelihood and magnitude of the potential impact of the entity's risks during the reporting period, and (ii) those risks that are considered interdependent (see slide 16 for more detailed guidance).	A52

** 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.*

The 2010 Practice Statement uses the term '*principal risks*' and asks for the identification of *strategic, commercial, operational and financial risks that may significantly affect the entity's strategies and progress of the entity's value*. It also notes that the *risks can constitute either a significant external or internal risk to the entity*.

As discussed in slide 4, we identified two challenges in current practice on reporting of risks in management commentary - (i) a lack of focus in reporting risks resulting reporting of many risks which obscure key risks; and (ii) varied approaches to identification of key risks. In practice, concerns include:

- (a) bias towards the identification of either just internal or just external categories of risk;
- (b) bias towards smaller, shorter-term risks such as commodity price variability, and a failure to identify high impact but lower likelihood risks;
- (c) failure to identify risks to achieving the strategy (as they are not perceived as resulting in financial loss although they may affect the entity's value); and
- (d) identification of generic risks, reflecting national focus areas, for example 'loss of staff' may be identified as a risk by most entities operating in a particular country.

As a result, we think that the revised Practice Statement should emphasise the consideration of risks specific to the entity rather than requiring management to work through general categories of risk. This can be addressed by referring to the sources of risk in the Practice Statement. The application of the principle of narrative coherence also helps support the identification of risks.

We also observe that practice in some countries gravitates to the identification of twenty or more 'principal risks', and that it would not be practical to incorporate consideration of so many risks into an assessment of an entity's prospects for future net cash inflows. To address the concern that principal risks are not obscured by discussion of many risks, we propose that:

- (a) instead of using the term 'principal', emphasise that the risks included in management commentary are those that affect the prospects for future net cash inflows to the entity, taking into account the likelihood and magnitude of the potential impact on those prospects; and
- (b) separately identifying information about other risks, that is not necessary to meet the objective of management commentary but is required by law or regulation.

Proposed illustrative drafting: Risks to be discussed in the management commentary

Management commentary describes the risks that affect prospects for future net cash inflows to the entity, taking into account the likelihood and magnitude of the potential impact of the risk on the entity's future net cash inflows.

Proposed requirements on the identification of risks:

Area	Risks arising from:
Business model risk	The operation of the entity's business model and the resources and relationships on which the entity depends for its success (for example, a major manufacturing quality failure affecting the entity's reputation)
Strategy risk	The selection and execution of the entity's strategy, (for example, misjudging the needs of a new market) and the operation of the entity's culture
Operating environment risk	Features of the entity's operating environment, including long-term and systemic risks such as climate change and related regulation

The following types of risk are sometimes reported but we do not think they align with the objective of management commentary in helping users assess the prospects for the future net cash inflows to the entity:

- (a) the risk of fluctuations in the entity's own share price or the risk of a change to the entity's dividend policy; and
- (b) risk of reporting misstatement due to error or fraud.

We are proposing clarifications and additional requirements for information to be provided on each risk:

- Mitigating actions available should the risk crystallise*

Mitigating actions that aim to prevent the risk from crystallising are commonly reported. We think it is also important for users to understand the actions available to management should the risk crystallise. This information is needed to support users' assessment of potential impact of the risk on future cash flows, and users' evaluation of the effectiveness of risk management policies.
- Information to help evaluation of impact of risk on prospects for future cash flows*

It is anticipated that information to help users evaluate the potential impact of the risk on the prospects for future net cash inflows to the entity would ordinarily be provided as part of the description of the entity's business model (see discussion on the application of the principle of narrative coherence on slide 17)
- Interdependent risks*

Risks are often inter-related. For example, a product quality failure may give rise to regulatory intervention. While this interdependency may often be evident, we think it is helpful to require the identification of risks that management considers interdependent.

- Changes in risks*

The staff propose to clarify that in discussing changes in risks, an overview of the changes in likelihood and magnitude of the potential impact of the entity's risks during the reporting period should be provided. This would help users' assessment of the impact of the risk on the prospects for future net cash inflows to the entity, based on historical information about how the risk is evolving.

Proposed requirements on the information to be provided on each risk:

<i>The 2010 Practice Statement</i>	<i>Proposed requirement</i>
Changes in risks	Provide an overview of the changes in likelihood and magnitude of the potential impact of the entity's risks during the reporting period
Plans or strategies for bearing or mitigating risks	Describe how the risk is managed Describe the actions that management plans to take to mitigate the impact of the risk should it crystallise
Effectiveness of risk management strategies	Describe the progress in managing the risk including quantitative indicators where they are used to monitor the risk
n/a	Provide information necessary for users' assessment of the potential impact of the risk on the prospects for future net cash inflows to the entity
n/a	Identify risks that management considers interdependent

Risks

Application of the principle of narrative coherence

The table below summarises the areas where we propose to provide guidance on the principle of narrative coherence in relation to the entity's risks. If the entity decides to provide information on a risk, then the revised Practice Statement would prompt management to determine whether there is material information to be provided in the following related areas:

Discussion of the entity's risks may give rise to related disclosures in relation to:

<i>Related content</i>	<i>Proposed requirement</i>	<i>Illustration</i>
Business Model	Information to help users evaluate the potential impact of the risk on prospects for future net cash inflows to the entity – Stream 3 A51(d)	<i>A food manufacturer identifies availability of palm oil as a key risk. In describing the business model, management commentary identifies the proportion of revenue attributable to palm oil based products.</i>
Strategy	The description of the entity's funding strategy provides links to the discussion of the potential effect on the entity's funding requirements arising from risks or trends and factors in the entity's operating environment – Stream3 A39	<i>A manufacturer's discussion of its funding strategy explains (but does not quantify) how the strategy takes into account the interdependent risks associated with a product recall and reputational damage.</i>
Performance, position and progress	Analyse and explain progress in managing opportunities and risks – proposed in Stream 2 Describe the progress in managing the risk including quantitative indicators used to monitor the risk – Stream3 A51(b)	<i>A pharmaceuticals business has suffered the loss of key staff in recent years and continues to identify the risk of key staff loss affecting its longer-term R&D pipeline. The management commentary reports on R&D staff retention rates and compares them with previous year's rates.</i>

Questions

1. Do you agree with the staff's proposed approach to identifying information on trends and factors in the entity's operating environment to be included in management commentary (slide 9)? If not, why and what do you propose instead?
2. Do you agree with the proposed requirements on including information about external statistics and external engagement and feedback when they are used to monitor trends and factors (slide 10)? If not, why and what do you propose instead?
3. Do you agree with the proposed approach to identifying risks to be discussed in management commentary by considering:
 - (a) where risks arise from; and
 - (b) the likelihood and magnitude of the potential impact of the risk on the prospects for the future net cash inflows to the entity (slide 15)? If not, what do you propose instead and why?
4. Do you agree with the proposed requirements for the information on risks to be provided in management commentary (slide 16)? If not, why and what do you propose instead?

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