

# Management Commentary

*Stream 2 Performance, position and progress*

*Slide deck 2 Analysis of the financial statements*

Consultative group meeting - 11 January 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.

# Introduction

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- This slide deck focuses on proposals for the guidance to be included in the revised Practice Statement on the analysis and explanations of amounts presented in the financial statements, including analysis and explanations of the matters that affected the entity's current period performance and position at the end of the reporting period.
- The existing Practice Statement indicates which aspects of performance and position should be explained in the management commentary, but does not provide guidance on how to do it. The staff considered the gaps in reporting on performance and position identified by users, and the guidance provided by other standard-setting bodies, and proposes to expand the guidance in the Practice Statement to cover the following aspects of performance and position:

Overview of the entity's performance and position	slides 4-6
Financial performance	slides 7-16
Operational performance	slides 17-20
Investment activities	slides 22-23
Financing position and requirements	slides 24-25
Tax expense	slide 26
Comparisons to previously published forecasts and targets	slide 27

- Slide 3 illustrates how proposed guidance links with the 'Results and prospects' section of the existing Practice Statement.
- Questions for the Consultative Group are on slides 6, 16, 20 and 28.

# Where we are today and staff's proposals for additional guidance

## Existing Practice Statement

24 ...management commentary should include information that is essential to an understanding of:

...

- (d) the results of operations and prospects;
- (e) the critical performance measures and indicators that management uses to evaluate the entity's performance against stated objectives.

### Results and prospects

34. Management commentary should include a clear description of the entity's financial and non-financial performance, the extent to which that performance may be indicative of future performance and management's assessment of the entity's prospects. Useful disclosure on those matters can help users to make their own assessments about the entity's performance, position, progress and prospects.

### Results

35 Management commentary should include explanations of the performance and progress of the entity during the period and its position at the end of that period. Those explanations provide users of the financial reports with insight into the main trends and factors affecting the business. In providing those explanations, management should describe the relationship between the entity's results, management's objectives and management's strategies for achieving those objectives. In addition, management should provide discussion and analysis of significant changes in financial position, liquidity and performance compared with those of the previous period or periods, as this can help users to understand the extent to which past performance may be indicative of future performance

## Staff's proposals for additional guidance

*More guidance on aspects of performance and position already mentioned in the Practice Statement*

Overview of the entity's performance and position (slides 4-6)

Financial performance<sup>1</sup> – focus on the entity's ability to generate cash flows and on matters that affected financial performance (slides 7-16)

Operational performance<sup>2</sup> – focus on matters that affected income and expenses that result from the entity's main business activities (slide 17-20)

Financial position and financing requirements (slide 22-23)

*New guidance on aspects of performance and position not already mentioned in the Practice Statement*

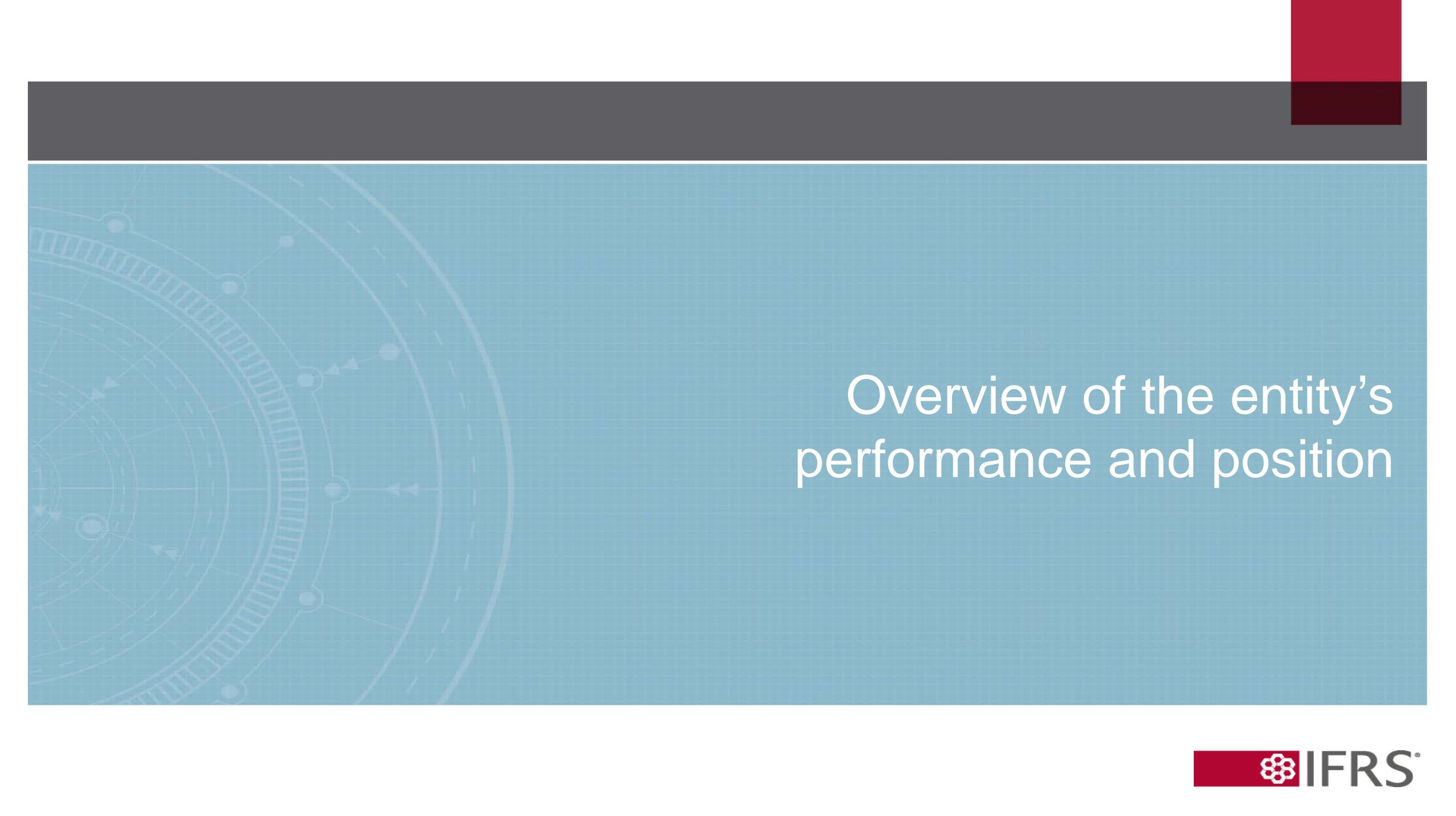
Investment activities (slide 24-25)

Tax expense (slide 26)

Comparisons to previously published forecasts and targets (slide 27)

*Guidance on matters that could affect the entity's future development (slide pack 3)*

- 1 In this slide deck the term 'financial performance' is used to refer to income and expenses reported in the entity's financial statements.
- 2 In this slide deck the term 'operational performance' is used to refer to income and expenses that result from the entity's main business activities. We acknowledge that this term may not be widely accepted or understood, so we may use a different term in the revised Practice Statement.



# Overview of the entity's performance and position

## Where we are today and why revision is needed

- Currently, it is common practice to include in management commentary an overview of the entity's performance and position that acts as an executive summary of the management's view of the most important aspects of the entity's performance and position. In many countries it appears as a CEO's report or review. Including such an overview aligns with users' need to understand management's view of the most important aspects of the entity's performance and position. However, the existing Practice Statement does not discuss how such an overview should be provided.
- Currently such overviews often include adjusted performance measures (see slides 8 and 13). However, there are concerns about reporting such measures (see slide 8).

## Staff's proposed approach

- The staff propose that the revised Practice Statement emphasises that management should identify and highlight the most important aspects of the entity's performance and position but does not require management to provide a separate section containing this overview.
- In addition, the revised Practice Statement should include the following guidance on how to provide such an overview:
  - i. The overview should be based on the performance measures and ratios that management considers to be most important for understanding the entity's performance for the current reporting period; and
  - ii. If adjusted performance measures are used, they should not have greater prominence than their unadjusted equivalents, ie the most directly comparable measures included in the financial statements.

# Questions for the Consultative Group

1. Do you agree that the revised Practice Statement should include the proposed guidance on the overview of the entity's performance and position, in particular:
  - (a) emphasise the need for such an overview, but not require a separate section;
  - (b) base the overview on the performance measures and ratios that management considers most important for understanding the entity's performance;
  - (c) not give greater prominence to adjusted performance measures than their unadjusted equivalents?
  
2. If you think that any other guidance on the overview of performance and position should be provided, what should that guidance be and why is it necessary?



# Financial performance

# Where we are today and why revision is needed

## Where we are today

- The existing Practice Statement provides limited guidance on how management commentary should explain the entity's financial performance. In practice, the scope of information provided and the range of financial performance measures used by entities in management commentaries varies.

## Why revision is needed

- Among other purposes, users use information on entities' financial performance as inputs into valuation models. In order to understand the entity's long-term prospects, users need to distinguish:
  - i. income and expenses that result from the entity's main business activities that are normally indicative of the entity's ability to generate cash flows in the future; and
  - ii. income and expenses that may not be indicative of the entity's ability to generate cash flows in the future.

However, often information on financial performance provided by entities in management commentary does not fully address users' needs. Specifically, management commentaries often fail to provide sufficiently granular information and to discuss aspects of performance that would help users understand the entity's ability to generate cash flows in the future.

- In addition, management often provides adjusted performance measures (measures of the entity's financial performance based on the information included in the financial statements, sometimes referred to as non-GAAP financial measures [NGFMs]), to present their view of the entity's long-term prospects. However, users express numerous concerns about adjusted performance measures. The Board is addressing some of those concerns in its Primary Financial Statements project (see slide 14).

The 2016 CFA Institute survey *Investor Uses, Expectations, and Concerns on Non-GAAP Financial Measures* suggests that adjusted performance measures are often used by users in their analysis.

Several recently published studies have highlighted the upward trending and pervasive reporting of NGFMs by public listed companies in the United States (Black, Christensen, Ciesielski, and Whipple 2016; Ciesielski 2016; and Calcbench 2016). These studies point out that this observed NGFM growth phenomenon occurs across many sectors. In a similar vein, a PwC (2016) review highlights the pervasiveness of NGFMs for public listed UK companies, noting that 95% of UK FTSE 100 companies reported APMs.

The survey lists these concerns about trends in reporting NGFMs:

1. Calculation of NGFMs that results in rosier depiction of performance than GAAP/IFRS:
  - Questionable NGFM adjustments.
  - Not appropriately reflecting strategic choices of businesses (e.g., mergers and acquisitions and restructuring).
  - Cherry picking by recognising gains and excluding similar losses.
2. Companies' communication, transparency, and application of NGFMs:
  - NGFM-related reconciliations and disclosures need enhancement in various respects.
  - Lack of comparability across reporting periods and companies resulting from inconsistent definitions.
  - Greater prominence of NGFMs relative to GAAP. This situation can mislead investors who rely heavily on press releases and those who may rely heavily on data aggregators without considering the performance picture portrayed by GAAP/IFRS measures.
  - Executive compensation linked to NGFM. There is a concern whenever performance-based executive compensation is correspondingly linked to any adjusted measures of performance that misrepresent or mask a company's true economic performance during particular reporting periods.

# The staff's proposed approach to reporting financial performance (1/7)

## An overview

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- The staff propose that the revised Practice Statement should address the need for management commentary to provide better information on financial performance. In particular, it should:
  1. provide guidance on including analysis and explanations of financial performance that would support investors in:
    - i. identifying income and expenses that may not be indicative of the entity's ability to generate cash flows in the future from income and expenses that result from the entity's main business activities; and
    - ii. understanding matters that affect period-to-period trends in the entity's financial performance  
(see slides 10-11).
  2. discuss the use of various methods of explaining the matters that affect financial performance (see slide 12).
  3. provide guidance on adjusted performance measures and ratios in the management commentary (see slides 13-15).

# The staff's proposed approach to reporting financial performance (2/7)

## Entity's ability to generate cash flows in the future

Income and expenses reported in an entity's financial statements result from various transactions and other events. Providing information separately about income and expenses with various characteristics and explaining what matters affected current and prior year income and expenses can help users understand the entity's financial performance and assess the entity's ability to generate cash flows in the future.

The staff propose that the management commentary should provide information to help users evaluate the extent to which current period financial performance is indicative of the entity's ability to generate cash flows in the future. Such information should include analysis and explanations of the following income or expenses that may not be indicative of the entity's ability to generate cash flows and that relate to:

### Unusual and infrequent items

Users need information about unusual or infrequent items to help them assess the persistence or sustainability of an entity's financial performance. In its Primary Financial Statements project, the Board is considering how information about such items should be disclosed in financial statements. In September 2018, the Board tentatively decided to require separate disclosure, in the notes to financial statements, of information about unusual or infrequent items. The Board is planning to develop principle-based guidance to help entities identify unusual and infrequent items. Disclosure in financial statements of information about unusual and infrequent items forms a basis for any explanation of these items in the management commentary.

### Transactions whose economic characteristics might not be inferred from the entity's description of its business model

Users' understanding of the entity's main business activities is obtained from the description of the entity's business model in the management commentary. Where the entity enters into transactions whose economic characteristics cannot reasonably be inferred from that description, users need to understand the effect of any such transactions to evaluate the entity's financial performance. For example, the financial effect of the entity's use of resellers or payment in kind arrangements may need to be described separately if such transactions are outside the scope of the entity's business model as described.

### Changes in accounting estimates and policies

Users need to understand the effect of changes in accounting estimates and policies to evaluate the entity's financial performance. Examples of such income and expenses may be those that relate to changes to provisions for onerous contracts or actuarial assumptions.

# The staff's proposed approach to reporting financial performance (3/7)

## Trends in the entity's financial performance

It is important for investors to understand matters that affect period-to-period trends in the entity's financial performance. Hence, in addition to matters described on slide 10, the management commentary should include discussion of changes in financial performance attributable to:

### Changes in macro economic factors

Entities should consider explaining the effect on the entity's financial performance of changes in macro economic factors such as changes in currency exchange rates on the entity's financial performance.

### Changes to the structure of the reporting entity

Entities should consider discussing separately the effect of changes in the structure of the reporting entity arising from acquisitions and disposals. This could help users evaluate the entity's so called 'organic growth'.

Table 3 of the CFA Institute Member Survey Report *Usefulness of Key Performance Indicators and Other Information Reported Outside Financial Statements* notes that 78% of respondents often or always use comparable or organic sales growth data (eg like for like or same-store sales, constant currency sales) in their analysis. Users use this information to establish period-to-period trends in the entity's financial performance and to identify changes in financial performance attributable to operational matters (see slide 19).

# The staff's proposed approach to reporting financial performance (4/7)

## Methods of explaining matters that affect financial performance

- As the revised Practice Statement will remain principle-based, it cannot prescribe methods of explaining matters that affect the entity's financial performance in management commentary. An entity is expected to choose a method used by management to analyse financial performance and based on users' needs in evaluating financial performance.
- The staff propose that the revised Practice Statement should:
  1. discuss the use of 'bridge analysis' and other forms of hypothetical analysis such as constant currency calculations and pro forma calculations as possible methods of explaining matters that affect financial performance;
  2. state that if such an analysis is included in the management commentary:
    - i. it needs to be provided in a neutral and understandable way and include explanations of the limitations of the analysis. For example, management commentary should discuss not only unusual or infrequent losses, but also unusual or infrequent gains. Similarly, the management commentary cannot use constant currency adjustments only in periods when the outcome portrays the entity's performance in a favourable way. In addition, the explanation of constant current adjustments should comment on whether it would be reasonable to assume that all other factors would have remained unchanged if the exchange rate had remained constant.
    - ii. any adjustments incorporated in the analysis (for example, constant currency adjustments) should solely relate to the matters being analysed (such as changes in currency exchange rate) and be factually supportable.

# The staff's proposed approach to reporting financial performance (5/7)

## Adjusted performance measures and ratios (1/3)

### Existing Practice Statement

40. If information from the financial statements has been adjusted for inclusion in management commentary, that fact should be disclosed. If financial performance measures that are not required or defined by IFRSs are included within management commentary, those measures should be defined and explained, including an explanation of the relevance of the measure to users. When financial performance measures are derived or drawn from the financial statements, those measures should be reconciled to measures presented in the financial statements that have been prepared in accordance with IFRSs.

### The staff's proposed approach

- Management may include adjusted performance measures and ratios in the management commentary. These are measures that incorporate adjustments to the source data, for example, the amounts in financial statements or internal reporting systems. Such measures can be measures of the entity's financial performance, operational performance, financial position or cash flows.
  - As the use of such measures is common in practice and users are concerned about the lack of transparency, comparability and neutrality in reporting such measures, the staff think that it is important to retain the guidance on including such measures in the management commentary and to expand the guidance on particular aspects of reporting those measures to improve the usefulness of provided information.
- The staff propose to expand the guidance on:
    1. identifying adjusted performance measures to require that adjusted measures are not reported with greater prominence than their unadjusted equivalents (ie the most directly comparable measures included in the financial statements). In addition, adjusted measures should be labelled appropriately so that:
      - i. the measure cannot be confused with similar measures included in the financial statements; and
      - ii. the description of the measure does not imply a broader set of adjustments than is the case. For example, a measure should not be described as adjusting for 'one-off items' unless management has determined that the measure does in fact incorporate all such adjustments.
    2. reconciling adjusted performance measures to their unadjusted equivalents in the financial statements to require a description of:
      - i. why the measure provides management's view of performance;
      - ii. the basis of its calculation, identifying any changes in that basis from the previous period or any differences from similar measures published by the entity, for example, in press releases; and
      - iii. each adjustment to the measure's unadjusted equivalent and the reason why management considers the adjustment appropriate in the context of the entity's economic circumstances.
  - In addition, the revised Practice Statement should provide the following guidance:
    - i. the management commentary should not use descriptions such as 'non-recurring' or 'non-underlying' when items of a similar nature may be expected to arise over the entity's business cycle.
    - ii. particular care is needed when reporting adjusted measures that cause ratios to cross a key threshold.
    - iii. where ratios are presented, the nature and scope of the numerator and denominator and any related adjustments must be consistent with each other.

# The staff's proposed approach to reporting financial performance (6/7)

## Adjusted performance measures and ratios (2/3)

### Link with the Primary Financial Statements project

- In December 2016, the Board tentatively decided in its Primary Financial Statements project to explore incorporating some commonly-used performance measures into IFRS Standards, including separate presentation of infrequently occurring items. The Board tentatively decided to focus primarily on adjusted performance measures based on the statement(s) of financial performance (referred to as 'management performance measures' in that project).
- The Board's tentative decisions on including management performance measures in financial statements are provided in Appendix A.

The staff's proposed guidance on reporting adjusted performance measures in management commentary is aligned with the Board's tentative decisions made in the Primary Financial Statements project.

The staff will continue monitoring developments in the Primary Financial Statements project to ensure that the guidance on adjusted performance measures is aligned as both projects progress.

# The staff's proposed approach to reporting financial performance (7/7)

## Adjusted performance measures and ratios (3/3)

### Link to management compensation

#### Need for guidance

- The staff have identified concerns about the lack of transparency in reporting the use of adjusted measures for determining management remuneration.

Nicholas Guest, S.P. Kothari, and Robert Pozen *High Non-GAAP Earnings Predict Abnormally High CEO Pay*, May 2018

Compensation committee reports are opaque in that they are not required to show the differences between GAAP and the non-GAAP metrics they use in their compensation decisions. To the extent managers' compensation is rationalized using (or tied to) non-GAAP earnings, each component of GAAP earnings they choose to exclude would directly impact the managers' compensation. We also find that this latitude to make positive adjustments to GAAP earnings is potentially exploited especially during periods of otherwise poor performance that would suggest the manager should receive less pay. Overall, our evidence suggests that directors on compensation committees are heavily influenced by managers' exclusions in reporting non-GAAP earnings; these same exclusions are typically used by the directors to justify their CEOs' above-normal compensation.

Weijia Li and Steven Young report commissioned by CFA Society of the United Kingdom *An Analysis of CEO Pay Arrangements and Value Creation for FTSE-350 Companies*, December 2016

Our analysis and findings suggest the need to move the spotlight on CEO pay away from a focus on pay levels and broad calls for more performance-related pay arrangements, towards a more refined discussion about the type of performance measures employed. Accordingly, the distinct policy-relevant themes permeating our findings and conclusions are:

- (i) the critical nature of performance measure choice in the debate over CEO pay arrangements; and
- (ii) the need for future recommendations on pay to focus more closely on encouraging contracts that link compensation outcomes directly to metrics that reflect long-term value creation for capital providers.

#### Staff proposed approach

- It is not for accounting standard-setters to determine how management compensation should be set or what performance-related pay should be linked to. However, if the entity has decided that a performance measure is important enough that management compensation should be linked to it, that is going to influence how management run the entity. So information about the link between the measure and management compensation is likely to be useful to investors in understanding how management compensation relates to the entity's purpose, business model and strategy.
- To improve transparency of information on management compensation, the staff propose to include the following guidance in the Practice Statement:

If management compensation includes a component that is linked to the entity's performance, the management commentary should identify the performance measure used in determining the compensation and include:

- (i) a reconciliation of the performance measure used in determining management compensation to its nearest unadjusted equivalent; and
- (ii) a discussion of the entity's performance in the context of that performance measure if it is not already provided in the main discussion of performance.

1. Do you agree with the proposed guidance on reporting financial performance, in particular on:
  - a. providing information about income and expenses that may not be indicative of the entity's ability to generate cash flows in the future (slide 10) and about period-to-period trends in the entity's financial performance (slide 11);
  - b. methods of explaining matters that affect the entity's financial performance (slide 12);
  - c. reporting adjusted performance measures in the management commentary (slides 13-14); and
  - d. reporting the link between adjusted performance measures and management compensation (slide 15)?
  
2. If you think that any other guidance on reporting financial performance should be provided, what should that guidance be and why is it necessary?



# Operational performance

# Operational performance

## Where we are today and why revision is needed

### Existing Practice Statement

35 Management commentary should include explanations of the performance and progress of the entity during the period and its position at the end of that period. Those explanations provide users of the financial reports with insight into the main trends and factors affecting the business...

The existing Practice Statement does not provide any specific guidance on analysing and explaining operational performance, ie income and expenses that result from the entity's main business activities.

### Why revision is needed

- Users need information on the matters affecting the entity's operational performance to understand the results of the entity's operations. However, often information on operational performance does not fully address users' needs.

### How others are supporting reporting on operational performance

- Some management commentary frameworks already require entities to provide information on operational performance.

#### German Accounting Standard No 20 *Group Management Report*

69. Sales (revenue) shall be disclosed and analysed.

70. The analysis shall classify sales (revenue) by e.g. products, regions, or currencies, and shall specifically address e.g. price and volume factors and the influence of the product range and portfolio of services.

71. The disclosures on sales (revenue) shall be replaced by comparable disclosures to the extent that sales (revenue) is (are) irrelevant as a factor because of the group's business model.

Paragraphs 74-75 also require to present and analyse significant items of income and expense, including among others the level of efficiency of production, capacity utilisation, rationalisation measures and quality assurance; personnel expenses and expected trends in those expenses; and raw material and energy costs, including costs of meeting environmental requirements, and expected trends in those costs.

#### U.S. Securities and Exchange Commission Financial Reporting Manual, *TOPIC 9 - Management's Discussion and Analysis of Financial Position and Results of Operations (MD&A)*

**9220.5** Registrants should address the underlying reasons for changes in the price versus volume mix. For example, if sales declined because the volume of goods sold decreased by 20%, but this was offset by a 10% increase in price, the discussion in MD&A should not stop once it identifies the price and volume components. In this example, the underlying factors that contributed to the decline in volume as well as the increase in selling prices should also be discussed. In addition, discussions about changes in the price vs. volume mix should consider changes in foreign currency fluctuations.

# The staff's proposed approach to reporting on operational performance

## Matters that affect operational performance

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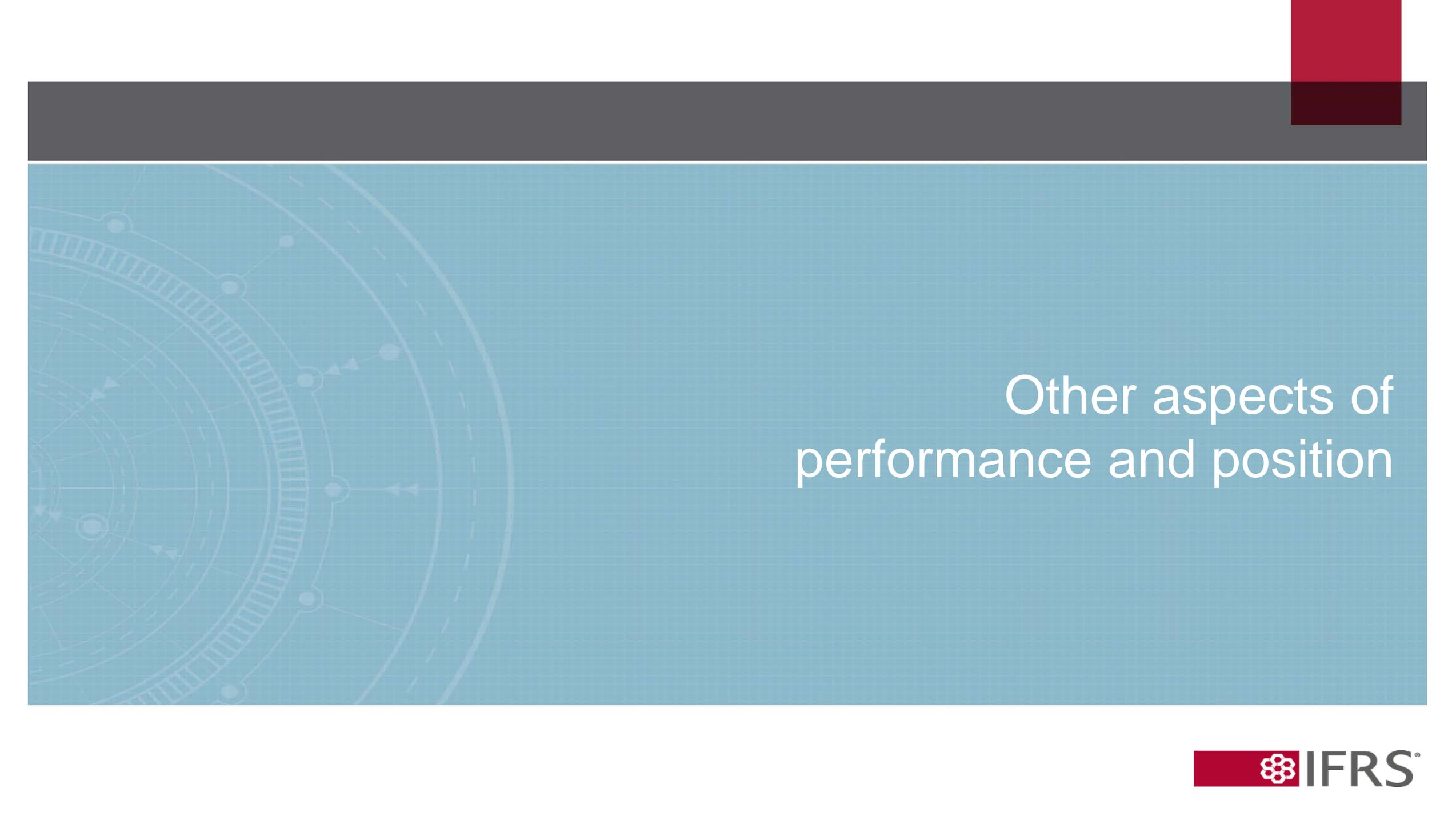
- Management commentary should provide analysis and explanations of the matters that affect the entity's income and expenses that result from the entity's main business activities for the current period and provide comparisons to prior period(s).
- The staff propose that such analysis and explanations should address:
  - i. Analysis of revenue variances, including explanations of price and volume components and analysis of other revenue measures (such as average revenue per customer) used by management to monitor the business;
  - ii. Analysis of cost measures used by management to monitor the business, including explanations of efficiency and utilisation variances;
  - iii. Other indicators (such as fixed-variable cost ratios) that help users understand the relationship between costs and revenues.

# Questions for the Consultative Group

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1. Do you agree with the proposed guidance on analysis and explanations of operational performance?
2. If you think that any other guidance on operational performance should be provided, what should that guidance be and why is it necessary?



# Other aspects of performance and position

# Investment activities (1/2)

## Why revision is needed

### Existing guidance

- The existing Practice Statement does not provide guidance on reporting the entity's investment activities in the management commentary.

### Calls for better information

- The Investment Association's *Long Term Reporting Guidance* (May 2017) emphasises that information about investments made by an entity is important for users' decisions:

One area for possible improvement is how companies explain the extent to which they are able to provide a return on invested capital, whether by managing their cost-base, increasing sales through business investment, or other capital allocation decisions. Our members believe that how well a company utilises its capital has a significant impact on its long term profitability and success. They want to understand the company's approach in making these decisions, and are keen to support well-articulated and reasoned investments that lead to productivity improvements and increased shareholders returns over the longer term.

... Demonstrating return on investment

38. Where possible, companies should demonstrate the returns generated as a direct result of the capital allocation decisions made. In this context, investors acknowledge that it may not always be possible to prove a direct causal link between a specific capital allocation and expected returns.

- A Canadian Performance Reporting Board Publication *Improving the MD&A: Capital Expenditure Analysis* provides suggestions for improving the discussion of capital expenditures in the MD&A, including the following:

Given the significance of capital expenditures to users of financial statements, improving this discussion in the MD&A is a simple way of enhancing the quality of financial reports. Interviews with analysts and preparers indicate several possibilities:

- distinguishing between maintenance and growth expenditures;
- focusing on the objectives and expected consequences of the expenditures; and
- discussing capital expenditures as programs.

Each of these approaches has its merits, but each also has its limitations.

...

### Focusing on the Objectives and Expected Consequences of Expenditures

... For example, the MD&A could qualitatively characterise the objectives and expected consequences of various capital expenditure projects into categories such as:

- new or improved products or services to increase revenues;
- substitution of capital for labour to lower cost of inputs;
- improved flexibility in terms of configuration for inputs or outputs to increase productivity;
- new locations to provide growth or respond to changes in markets, sources of supply, transport costs, or geopolitical risks;
- investment in intangibles such as new information technology to improve customer service; or
- better efficiency in the conversion of raw materials to reduce waste.

# Investment activities (2/2)

## The staff's proposed approach

The staff propose that the revised Practice Statement should include guidance on reporting an entity's investment activities in the management commentary as follows:

- Management commentary should include analysis and explanations of amounts included in the financial statements in relation to capital and operating expenditure that is useful for users' understanding of the extent to which the entity's current levels of investment are consistent with its ongoing needs in the context of its stated business model and strategy.
- Where appropriate, the analysis and explanations should include:
  - a. Analysis of **capital expenditure** between categories that are intended to:
    - i. maintain the entity's ongoing operations; and
    - ii. support the extension of the entity's activities in accordance with its strategy;
  - b. Analysis of **operating expenditure** between categories that are intended to:
    - i. maintain the entity's ongoing operations; and
    - ii. enhance the entity's economic resources and relationships in accordance with its strategy (for example, research expenditure, customer acquisition programmes).
  - c. Explanations of the relationship between the entity's strategy and the nature and the level of expenditures.

In addition, the management commentary should include information about the outcome of the entity's investment activities (sometimes referred to as 'capital allocation outcomes').

- Where possible, the management commentary should include information to help users evaluate the returns generated by past capital allocation decisions. Depending on the nature of the investment, such information may include information about the returns generated by the investment and the amount of the underlying investment.

# Financing position and requirements (1/2)

## Why revision is needed

### Existing requirements

- The existing Practice Statement includes a high level requirement to provide discussion and analysis of significant changes in liquidity, but does not provide any further guidance on this topic:

35 ... In addition, management should provide discussion and analysis of significant changes in financial position, liquidity and performance compared with those of the previous period or periods, as this can help users to understand the extent to which past performance may be indicative of future performance

- In addition, IFRS Standards require particular disclosures of the entity's capital position and liquidity in the financial statements. For example, paragraphs 134-138 of IAS 1 *Presentation of Financial Statements* contain requirements for disclosures on the entity's capital, paragraphs 34-42 of IFRS 7 *Financial Instruments: Disclosures* require disclosures on risks arising from financial instruments and paragraph 17 of IAS 7 *Statement of Cash Flows* requires the separate disclosure of cash flows arising from financing activities.

### Need for further guidance

- The Investment Association's **Long Term Reporting Guidance** (May 2017) emphasises the need for information on the entity's funding requirements:

34. Investors need to understand the approach taken by a company to fund its capital management strategy, the company's appetite for risk, and the potential opportunities for further investment.

35. To help achieve this, our members seek information regarding company's funding arrangements and the nature of funding...

### How others are addressing it

Some management commentary frameworks already require entities to provide information on their financing requirements:

U.S. Securities and Exchange Commission Financial Reporting Manual, **TOPIC 9 - Management's Discussion and Analysis of Financial Position and Results of Operations (MD&A)**

**9210.3** The requirements of the disclosures related to capital resources include a discussion of material commitments for capital expenditures, the general purpose of any commitments and how these commitments will be funded, and material trends in the registrant's capital resources, including expected changes in the mix (equity, debt and any off-balance sheet financing arrangements) and their relative cost.

**9210.4** The liquidity and capital resources discussion should address:

- Material cash requirements;
- Sources and uses of cash, including cash provided by/used in operations, as well as cash provided by/used in investing and financing activities; and
- Material trends and uncertainties related to a company's flexibility in determining when and how to use the available cash flows to satisfy obligations and make other capital expenditures.

**9210.5** It may be necessary for the liquidity and capital resources discussion to address debt instruments, guarantees and related covenants. Disclosure is likely to be necessary if:

- The registrant is, or is reasonably likely to be, in breach of debt covenants or
- Debt covenants impact the registrant's ability to obtain additional debt or equity financing.

German Accounting Standard No 20 **Group Management Report**

95. The main focus of the presentation and analysis of liquidity shall be placed on the group's ability to meet its payment obligations. Liquidity problems that have already occurred or that are foreseeable in the light of the known business trends shall be presented, together with measures adopted to resolve them.

96. The terms and conditions of guarantees, lease and option agreements and other financing arrangements shall be addressed to the extent that these could give rise to substantial early repayment obligations that are of significant importance for the liquidity of the group.

97. Committed but unused credit lines shall be disclosed.

98. Restrictions that could affect the availability of capital shall be presented.

# Financing position and requirements (2/2) – The staff’s proposed approach

## How others are addressing it (cont.)

- Some frameworks go further and require to provide the so-called ‘viability statement’.

The UK **Corporate Governance Code** requires boards to provide a statement of longer-term viability, explaining whether they have a reasonable expectation that *‘the entity 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.’* Taking account of the entity’s current position and principal risks, the board should explain in the annual report how they have assessed the prospects of the entity, over what period they have done so, and why they consider the period to be appropriate.

In its November 2016 the Investment Association issued **Guidelines on Viability Statements** that require directors to consider the entity’s prospects and principal risks when assessing viability. Specifically, they require to:

- Consider the current state of affairs
- Address the sustainability of dividends
- Distinguish risks that impact performance from those that threaten operations
- Separate prospects from viability
- State clearly why the risks are important, and how they are managed and controlled
- Prioritise risks

## Staff’s proposed approach

- As mentioned on slide 24, IFRS Standards already require some disclosures on the entity’s capital position and liquidity. Information that is presented in the financial statements does not need to be repeated in the management commentary unless it is required to support a neutral and understandable discussion.
- Management commentary should include information to help users assess the entity’s ongoing financing requirements as follows:
  - i. Explanation of working capital changes during the period if the entity’s working capital position at the end of the period is unrepresentative of the entity’s working capital during the period.
  - ii. Analysis of performance measures and ratios that help users understand the entity’s compliance with its financing covenants.
  - iii. Analysis of the terms and conditions of guarantees, lease, option and other financing agreements to the extent that they could give rise to early repayment obligations.
  - iv. 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.
- However, the staff do not propose to require entities to report on viability.

## Need for further guidance

- The sustainability of entities' tax strategies has become a high profile issue. IAS 12 *Income Taxes* requires an entity to disclose an explanation of the relationship between tax expense and accounting profit. However, the staff think that users need more information to support their assessment of whether an entity's effective tax rate is sustainable in the context of the entity's income tax strategy.

## Staff's proposed approach

- To provide users with information needed for this assessment, management commentary should discuss factors such as:
  - i. known or expected future changes in applicable tax rates or in tax law;
  - ii. known or expected changes in the entity's income tax strategy that could reasonably be expected to affect the tax consequences of the entity's future transactions and future activities; and
  - iii. known or expected factors that could reasonably be expected to result in the relationship between tax expense and accounting profit for future periods differing from the relationship for the current year.

# Comparisons to previously published forecasts and targets

## Existing requirements

- The existing Practice Statement includes a requirement to explain the differences between forward-looking disclosures made in the prior period management commentary and performance in the current period:

19. Management should explain how and why the performance of the entity is short of, meets or exceeds forward-looking disclosures made in the prior period management commentary. For example, if management stated targets for future performance in previous reporting periods, it should report the entity's actual performance in the current reporting period and analyse and explain significant variances from its previously stated targets as well as the implications of those variances for management's expectations for the entity's future performance.

## The staff's proposed approach

- The staff propose to retain the requirement to explain performance in the context of past forecasts and targets.
- However, we propose to extend the requirement to provide comparisons of the entity's actual performance to past forecasts and targets to those forecasts and targets that were previously published by the entity outside of the management commentary.

1. Do you agree with the proposed guidance on:
  - (a) investment activity;
  - (b) financing position and requirements;
  - (c) tax expense; and
  - (d) comparisons to previously published forecasts and targets?
  
2. If you think that any other guidance on other aspects of performance and position should be provided, what should that guidance be and why is it necessary?

# Appendix A

## Board's tentative decisions on management performance measures

The Board tentatively decided that:

- a. All entities shall identify a measure (or measures) of profit or comprehensive income that, in the view of management, communicates to users the financial performance of the entity. This measure will:
  - (i) often only be a subtotal or total specified by paragraph 81A of IAS 1;
  - (ii) sometimes be identified by management as a measure that is not a subtotal or total specified by paragraph 81A of IAS 1, but would complement those subtotals or totals. Such a measure is a measurement performance measure.
- b. The following requirements apply to management performance measures in (a)(ii):
  - (i) a reconciliation would be provided in the notes between that measure and the most directly comparable subtotal or total required by paragraph 81A of IAS 1;
  - (ii) there should be no specific constraints on management performance measures;
  - (iii) the measure would be labelled in a clear and understandable way so as not to mislead users; and
  - (iv) the following information is required to be disclosed:
    1. a statement that the measure provides management's view of the entity's financial performance and is not necessarily comparable with measures provided by other entities;
    2. a description of why the management performance measure provides management's view of performance, including an explanation of
      - how the management performance measure has been calculated and why; and
      - how the measure provides useful information about the entity's financial performance.
    3. sufficient explanation, if there is a change in how the management performance measure is calculated during the year, to help users understand the reasons for and effect of the change.
- c. The reconciliation between the management performance measure and the most directly comparable subtotal or total required by paragraph 81A of IAS1 should be provided separately from the operating segment information disclosed in accordance with IFRS 8 *Operating Segments*. However, entities would not be prohibited from also including management performance measures within the operating segment information. Furthermore, the following information would be required to be disclosed:
  - (i) an explanation of how the management performance measure differs from the total of the measures of profit or loss for the reportable segments; and
  - (ii) if none of the management performance measures fits into the operating segment information, an explanation of why this is the case.

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