Meeting notes—Capital Markets Advisory Committee

The Capital Markets Advisory Committee (CMAC) held its last meeting on 26 March 2020 at the London offices of the International Accounting Standards Board (Board).

Recordings of meeting discussions, the agenda and related papers are available on the meeting page. For more information on CMAC, the Board's independent investor advisory group, please click here.

Members discussed the following topics:

- Primary Financial Statements (paragraphs 1—18);
- Financial Instruments with Characteristics of Equity (paragraphs 19—28);
- IBOR Reform and its Effects on Financial Reporting Phase 2 (paragraphs 29—35);
- Management Commentary Project (paragraphs 36—49);

Primary Financial Statements (Agenda Paper 1)

1. In December 2019 the International Accounting Standards Board (Board) published the Exposure Draft *General Presentation and Disclosures*. The purpose of this session was to answer questions about the Exposure Draft and to seek preliminary feedback from CMAC members on the proposals.

2. The staff provided CMAC members with an overview of the Board's proposals, including those relating to:
   (a) subtotals and categories in the statement of profit or loss;
   (b) disaggregation;
   (c) management performance measures; and
   (d) the statement of cash flows.

Subtotals and categories in the statement of profit or loss

3. Most members welcomed the proposed new subtotals and categories in the statement of profit or loss.

4. Members questioned the usefulness of introducing a distinction between integral and non-integral associates and joint ventures. Some members said that in their analyses, they would not use such a distinction, nor would they use the 'operating profit and income and expenses from integral associates and joint ventures' subtotal. One member was concerned that entities will avoid classifying associates and joint ventures as 'non-integral' because investors may question why an entity is holding an investment that is not an integral part of its operations.

5. The Board is proposing to prescribe the classification of some items, such as interest on pensions and income and expenses from cash and cash equivalents, so that they are in the same category for all entities. Two members said they agreed with the proposals and that the Board should not allow any options in the classification of interest on pensions. However, another member said that the exercise of judgement in the classification of income and expenses from cash and cash equivalents should be permitted.

6. One member suggested that the investing category should be labelled differently to avoid confusion with the investing section in the statement of cash flows.

Disaggregation

7. Many members said that analysis of operating expense by nature is more useful to them than analysis by function, so they welcomed the Board's proposal to require by-nature information in the notes if an entity analyses expenses by function in the statement of profit or loss. One member said such information should always be required in the statement of profit or loss; another member said disclosure in the notes is sufficient.

8. Two members said they would prefer the analysis by nature to be provided in a matrix format with each functional line item, such as 'cost of sales', broken down by nature. One Board member responded that the Board did consider a matrix approach but received general feedback that it would be too costly.

9. One member said an analysis of operating expenses by nature in the notes should also be required in interim reports.

10. Many members said the restrictive definition of unusual income and expenses is helpful. One member commented that they would consider as unusual only the income and expenses arising from restructuring programmes that fundamentally change a business, rather than all restructuring expenses entities report.

11. Two members commented that operating profit should not include any unusual items. One member's preference was for unusual items to be presented as a line item on the face of the statement of profit or loss.

Management performance measures

12. Most members agreed with the proposals on management performance measures. One member commented that the proposal to restrict the numerator of adjusted EPS to management performance measures is especially helpful.

13. One member suggested performance measures other than subtotals of income and expenses, such as free cash flows and net debt, should also be considered management performance measures.

14. One member asked how management performance measures can be audited. The staff responded that the feedback received from some auditors so far suggested these measures can be audited.

15. One member commented that linking the definition of management performance measures to public communications is key, and doing so should not be problematic because 'public communications' is a familiar notion in the regulatory environment of some jurisdictions, such as the United States.

The statement of cash flows

16. Members expressed differing views on how to classify particular cash flow items from interest and dividends. Two members said interest paid and received, and dividends received, should be classified in operating cash flows, consistently with US GAAP. One member said interest and dividend cash flows should be required as minimum line items in the statement of cash flows to enable users to reclassify them easily.

17. One member asked for clarification on the alignment between the statement of cash flows and the statement of profit or loss. The member also asked whether the disaggregation principles would also apply to the statement of cash flows, and the staff said the principles would apply.

Next steps

18. The CMAC will continue to discuss the proposals set out in the Board's Exposure Draft *General Presentation and Disclosures* at its next joint meeting with the Global Preparers Forum. The next joint meeting is currently planned to be held in June 2020.

Financial Instruments with Characteristics of Equity (Agenda Paper 2)

19. CMAC members discussed potential refinements that could be made to the disclosure requirements which were proposed in the 2018 Discussion Paper *Financial Instruments with Characteristics of Equity*. CMAC members' feedback on the potential refinements will help shape the disclosure proposals to be presented to the Board. CMAC members discussed disclosures in the notes to the financial statements on:

    (a) the priority of financial liabilities and equity instruments on liquidation of the issuer;

    (b) the potential dilution of ordinary shares resulting from ordinary shares an entity may need to issue in the future to settle its financial instruments currently outstanding (additional ordinary shares); and

    (c) the terms and conditions of issued financial instruments.

Priority of financial liabilities and equity instruments on liquidation of the issuer

20. CMAC members generally agreed with the potential refinements. CMAC members favoured an entity separately disclosing the priority on liquidation of the parent and each material subsidiary's financial liabilities and equity instruments, provided that the entity also provides a reconciliation to the amounts disclosed in the consolidated financial statements. A CMAC member suggested including an extra column for 'other entities and amounts eliminated on consolidation' so that these amounts can be reconciled to the consolidated amounts. CMAC members also commented that they would prefer an entity to also disclose quantitative information and that disclosing only the carrying amount would suffice. One CMAC member suggested such disclosure be provided for any subsidiary that issues material amounts of financial instruments rather than for material subsidiaries.

Potential dilution of ordinary shares

21. CMAC members generally agreed with the potential refinements. However, some members disagreed with some details of the refinements.

22. A CMAC member said that it would be useful for an entity to disclose the minimum and maximum number of additional ordinary shares, because the information would indicate a range of the potential dilution of ordinary shares. Another member said that disclosing only the maximum number is sufficient because they consider that number more important. This member added that requiring both minimum and maximum number of additional ordinary shares might encourage a company to imply in its financial statements that it will likely only issue the minimum number of additional ordinary shares, which could, in turn, reduce the transparency of the disclosures.

23. A CMAC member said that a reconciliation between the opening and closing numbers of additional ordinary shares would be useful because it would help users of financial statements assess the possibility of dilution. This member suggested that should such reconciliation prove too difficult, it is at least necessary for an entity to explain significant changes in the number of

additional ordinary shares during the reporting period. Other CMAC members said that disclosing the number at the end of the reporting period would be sufficient.

24. A CMAC member commented that it would be ideal if an entity disclosed potential dilution from share-based payment transactions (in the scope of IFRS 2 *Share-based Payment*) using the same bases it uses for other financial instruments—which would indicate the total potential dilution of the entity's ordinary shares. However, other CMAC members said they agreed with the potential refinement suggesting that the Board only require an entity to provide a narrative describing potential dilution from such transactions.

25. A CMAC member said disclosures of potential dilution would only be relevant for listed entities because of the impact on share prices or returns. Another member commented that, if possible, unlisted entities should also be required to provide such disclosure because the disclosure would provide relevant information about potential dilution of economic interest. This member added that although investors are usually able to obtain information about potential dilution in other ways, for example, via due diligence, disclosure would still be useful.

Terms and conditions of financial instruments

26. CMAC members generally agreed with the potential refinements. A CMAC member suggested that it is more important to understand key terms and conditions of financial instruments than to know whether a financial instrument is classified as equity or as a financial liability. CMAC members commented that requiring an entity to disclose terms and conditions of financial instruments would reduce the time they spent reading each financial instrument's term sheets and would assist them in assessments, such as scenario analyses in equity valuations. Some CMAC members added that information about terms and conditions could assist them in determining the priority of financial instruments on liquidation and estimating the potential dilution of ordinary shares.

27. CMAC members suggested that it would be useful for entities to disclose information about:

    (a) early repayment conditions, including issuer penalties for repaying a financial instrument earlier than its contractual maturity;

    (b) debt covenants; and

    (c) contingent consideration.

Next steps

28. The Board will consider feedback from CMAC members and other users of financial statements. The feedback will inform proposals for the Board's deliberations on disclosures about the financial instruments entities issue.

IBOR Reform and its Effects on Financial Reporting—Phase 2 (Agenda Paper 3)

29. The purpose of the session was to provide CMAC members with an overview of the proposed amendments which were expected to be included in the Board's then forthcoming Exposure Draft *Interest Rate Benchmark Reform—Phase 2*; and to seek CMAC members' preliminary views on what were then the Board's expected proposals on disclosures. The Board published its Exposure Draft *Interest Rate Benchmark Reform—Phase 2* on 9 April 2020 with a 45-day comment period.

30. CMAC members broadly agreed with the Board's proposals on disclosures.

31. The objective of interest rate benchmark reform is to replace interest rate benchmarks with alternative benchmark rates that are based, to a greater extent, on actual transactions. Given this objective, two CMAC members asked whether the notion of ‘economically equivalent’ reflects how the reform is expected to be effected in practice. In other words, if the benchmark rate preceding the reform is expected to be different from the alternative benchmark rate, how is the notion of ‘economically equivalent’ expected to be applied in practice?

32. Board member Sue Lloyd said that the market expectation is that entities could achieve the economic equivalence by adding a fixed spread to compensate for a basis difference between an existing interest rate benchmark and an alternative benchmark rate. However, the Board noted that an entity could, during its negotiations with a counterparty to agree on changes to the contractual cash flows required by the interest rate benchmark reform, simultaneously negotiate changes to the contractual terms that are not a direct consequence of the interest rate benchmark reform, or are not economically equivalent to the previous terms and conditions (such as changes in credit spread). For these reasons, the Board’s proposals distinguish between changes required by the interest rate benchmark reform—for which the Board provided a practical expedient—and other changes—for which the Board is not proposing any amendment; that is, an entity would account for any other changes in accordance with the existing requirements in IFRS Standards.

33. These CMAC members highlighted the importance of information about how an entity determined which changes met the Board’s conditions to be determined as required by the interest rate benchmark reform including any significant judgement the entity made to determine the qualifying changes. In particular, how those changes satisfied the Board’s second condition—that is, the new basis for determining the contractual cash flows is economically equivalent to the previous basis (ie the basis immediately preceding the modification).

34. A member of the technical staff said that an objective of the Board’s expected proposals on disclosures is to provide information to enable users of financial statements to understand the entity’s progress in transition from interest rate benchmarks to alternative benchmark rates. Given that objective, the Board would expect that such disclosures would highlight instances when, for example, an entity has made comparatively limited progress in completing the transition as required by the interest rate benchmark reform relative to its peers.

Next steps

35. The staff will consider the preliminary views from CMAC members as part of its analysis of feedback on the Exposure Draft *Interest Rate Benchmark Reform—Phase 2*. The analysis will be reported to the Board at a future Board meeting. The Board is aiming to issue the final amendments by the third quarter of 2020.

Management Commentary Project (Agenda Paper 4)

36. The staff provided an update on the project to revise IFRS Practice Statement 1 *Management Commentary* (Practice Statement). In particular, the staff discussed the Board’s tentative decisions on the revised objective of management commentary and introduced the initial ideas for disclosure objectives for each of the following areas of content in management commentary:

    (a) business model;

    (b) resources and relationships;

    (c) strategy;

    (d) operating environment;

    (e) risks; and

(f) performance, position and progress.

37. The purpose of this session was to seek CMAC members' views on:

(a) the disclosure objectives for each area of content; and

(b) what information users need for each area of content and how they use that information.

38. CMAC members were also invited to provide views on the possible supporting guidance to be included in the revised Practice Statement to support each disclosure objective.

39. Regarding the overall approach to the disclosure objectives and supporting guidance, CMAC members made the following comments:

(a) **design of disclosure objectives:** overall, members supported introducing disclosure objectives for areas of content in management commentary and supported the staff's suggested structure of those objectives that included the focus or an overall principle accompanied by a brief discussion of what information users need and what assessments users make. One member expressed support for the specific wording used by the staff 'provide information to help [investors] understand…' In his view, that wording sets the appropriate boundary between management's responsibility to identify information that is relevant to investors and investors' responsibility to make their assessments based on that information.

(b) **connections between disclosure objectives:** a few members highlighted that disclosure objectives for individual areas of content complement and build on one another. One member suggested it may be helpful to provide guidance to management on how to link the discussion in management commentary. Another member asked whether management commentary will be expected to follow the structure set out in the revised Practice Statement. The staff responded that entities will not be required but may find it helpful to follow that structure.

(c) **link between management commentary and the financial statements:** a few members suggested that it is important to emphasise the need for coherence between management commentary and the related financial statements across all areas of content. They further highlighted that clear links between the discussion in management commentary and financial information are often missing in entities' reports. One member commented that a good management commentary would allow investors better understand the entity's financial statements.

(d) **use of the term 'value' in disclosure objectives:** some members highlighted that although it is important for them to understand how the entity creates value, 'value' is a vague notion that can be understood differently by different parties and that it is therefore important for the revised Practice Statement and for management commentary to focus on cash flows. These members stated that it is important for them to understand how value created by the entity is monetised and reflected in the financial statements as revenue and cash flows. One member suggested that investors need not only information to help them forecast entities' future cash flows, but also information to help them understand risks and uncertainty of those cash flows and determine the appropriate discount rate.

(e) **neutrality:** one member expressed the view that in practice management commentaries often display a 'positive' bias and focus on 'positive' information—for example, they discuss assets and revenues but not liabilities and expenses. Therefore, that member suggested that the revised Practice Statement should require a balanced discussion of both positive and negative developments, risks and opportunities and assets, liabilities, income and expenses.

(f) **environmental, social and governance (ESG) matters:** members expressed diverse views on whether the revised Practice Statement should provide guidance on ESG information. Many members who commented argued the Practice Statement should not provide specific guidance on ESG information. They expressed a concern that guidance on ESG could lead to broad discussion in management commentaries that lacks focus. They also pointed out that stakeholders' understanding of what 'ESG' means may vary by stakeholder. They argued that a requirement to provide financially material information would cover ESG matters that could have an impact on the company. Other members expressed a view that the Practice Statement could not be silent on this issue. In particular, they argued that environmental matters are very important for the prospects of some businesses (for example, management commentary of an entity in the oil industry should discuss the effects of climate change, including the risk of transition to a low carbon economy). Some also pointed out that 'ESG' is not a single type of information. Instead, investors may have different information needs related to environmental, social and governance factors. A few members commented on the relevance of some environmental and social information in particular cases and one member commented that governance information that is relevant should also be included in management commentary because governance affects performance and is linked to business model and strategy.

(g) **interaction with other frameworks**: one member raised a question about the interaction of the revised Practice Statement with jurisdictional requirements. One member asked whether the revised Practice Statement is expected to mandate some requirements and guidance in other frameworks (for example, issued by the Task Force on Climate-related Financial Disclosures). The staff explained that the revised Practice Statement will be principles-based and is therefore expected to be compatible with local requirements.

Business model

40. CMAC members made the following comments on the suggested disclosure objective and the information to be provided about an entity's business model:

(a) an entity should make a distinction between an entity's major and minor activities for each of the entity's main types of operations (ie what is the entity's 'bread and butter' vs 'icing on the cake'). In addition, an entity should explain the scale of its main types of operations and how the entity would be affected if that activity was discontinued or reduced.

(b) an entity should explain whether its business model is 'one-sided', 'two-sided' or 'multi-sided' (for example, a global publishing company may generate revenue from two sides, such as subscriptions and advertising). The member suggested that information should be disclosed about how each 'side' of an entity's business model performs and contributes to 'making money'.

(c) investors want to understand an entity's value proposition for different categories of the entity's customers and understand the economics of relationships with different categories of customers, including the important contractual terms.

(d) the starting point in investors' understanding of the entity is the operating environment rather than the business model. Investors first need to understand the economics and the structure of the market, then how the entity positions itself in that environment, what the entity's mission or purpose is, how the entity executes its strategy and how it measures success, why those measures are appropriate and how efficiently resources are used in achieving the entity's objectives.

(e) the revised Practice Statement should not refer to 'destroying value' in the disclosure objective for business model. This is because although entities' operations may unintentionally destroy value, they are not designed to do so.

Resources and relationships

41. CMAC members made the following comments on the suggested disclosure objective and information to be provided about an entity's resources and relationships:

    (a) entities should provide information about their supply chains. For example, the coronavirus outbreak has impacted supply chains and entities' performance.

    (b) entities should explain their flow of materials (supply chain, processing and sale), flow of information and flow of cash.

    (c) entities should link information about resources and relationships in management commentary to financial information about resources in the related financial statements. For examples, disclosures about intangible resources and relationships in management commentary should be linked to disclosures about intangible assets in the related financial statements.

Strategy

42. CMAC members made the following comments about the suggested disclosure objective and information to be provided about management's strategy:

    (a) an entity's purpose is the starting point in understanding its strategy. It is then important for investors to understand how an entity executes its strategy and how it measures success of execution (including why the chosen measures of success are appropriate). This disclosure should be linked to discussion of performance, position and progress.

    (b) disclosure about different scenarios ('what can go wrong') is important for assessing the entity's strategic objectives. This disclosure should be linked to disclosure of risks but provided within the discussion of strategy.

    (c) management's strategy is typically assessed relative to an entity's market or industry (eg using Porter's Five Forces model). Investors also consider the entity's past and present success in achieving its strategies and whether management's incentives are aligned with the strategy.

    (d) disclosure of capital allocation and capital structure is particularly important because it helps investors understand an entity's priorities for spending its free cash flows.

Operating environment

43. CMAC members made the following comments about the suggested disclosure objective and information to be provided about operating environment:

    (a) operating environment is the starting point in understanding the entity's business model and its value proposition.

    (b) investors need to understand factors such as economics of the market, regulation and an entity's macroeconomic exposure.

Risks

44. CMAC members made the following comments about the suggested disclosure objective and information to be provided about risks:

    (a) investors need information about two dimensions of risks—the potential magnitude of the impact (ie severity) and the probability of occurrence (ie frequency).

    (b) investors need information about both long-term and short-term risks. If there are no explicit requirements in the revised Practice Statement, entities may exclude from management commentaries information about long-term risks.

(c) the suggested wording of the disclosure objective for risks (‘disrupt the direction in which the management plans to take the entity’) could be better aligned with the other areas of content and refer to ‘disrupting the operation of the entity’s business model and its strategy.’

Performance, position and prospects

45. CMAC members made the following comments about the suggested disclosure objective and information to be provided about performance position and progress:

(a) various non-GAAP and management performance measures are used in practice. Management commentary should explain why the selected performance measures are appropriate and how the entity is progressing against those measures.

(b) investors need information about shareholder return, information on dividend policies and share buyback information.

Next steps

46. The staff will consider the feedback from CMAC members in preparing future agenda papers for the Board.