STAFF PAPER

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Project	**Management Commentary**
Paper topic	Overview of the likely effects of the proposals

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Purpose of this paper

1. This paper provides an initial assessment of the likely effects of implementing the Board's proposals developed in revising IFRS Practice Statement 1 *Management Commentary* (Practice Statement).

2. The paper does not ask the Board to make decisions but asks the Board for comments.

Structure of this paper

3. This paper is structured as follows:

   (a) approach to effects analysis (paragraphs 4–10);

   (b) likely effects of proposals on the quality of financial reporting, including:

      (i) improved focus and provision of information specific to the entity (paragraphs 13–17);

      (ii) provision of information on topics of particular interest to investors and creditors (paragraphs 18–21);

      (iii) coherence of information (paragraphs 22–24);

      (iv) other improvements to the quality of information in management commentary (paragraphs 25–27);

      (v) likely effects on the quality of electronic reporting (paragraphs 28–30);

(c) likely benefits for jurisdictions of adopting the proposals (paragraphs 31–34);

(d) likely costs:

(i) for preparers of implementing the proposals and of ongoing application (paragraphs 35–38); and

(ii) for investors and creditors of analysing the resulting information (paragraph 39); and

(e) overall assessment of likely benefits compared to likely costs (paragraphs 40–43).

Approach to effects analysis

4. The *Due Process Handbook* (Handbook) as revised in August 2020 describes the effect analysis as the Board's 'process for assessing the likely effects of a proposed IFRS Standard, which is undertaken as the new requirements are developed, culminating in an analysis presented as part of, or with, the basis for conclusions published with the new IFRS Standard that summarises the Board's assessment of the likely effects of the new requirements'.[1] The effects are the likely benefits of implementing the proposed new requirements, the likely costs of implementing those requirements and the likely ongoing application costs.

5. The Handbook suggests assessing the effects:

(a) in comparison to the existing financial reporting requirements; and

(b) in the light of the Board's objective of financial reporting transparency.[2]

6. The Handbook does not specifically require effects analysis to be provided for non-mandatory practice statements. However, the Handbook states that in producing the non-mandatory practice guidance the Board follows the same procedures used for developing the Standards.[3] The staff think that explaining the likely effects of the Board's proposals in the Basis for Conclusions on the forthcoming Exposure Draft could be helpful for:

[1] See the glossary of terms in the Due Process Handbook.
[2] See paragraph 3.76 of the Due Process Handbook.
[3] See paragraph 6.39 of the Due Process Handbook.

(a) jurisdictions considering whether to adopt the revised Practice Statement; and

(b) preparers choosing whether to apply it voluntarily.

7. It is difficult to assess the effects of the Board's proposals on practice in comparison with effects of applying the existing requirements in practice (paragraph 5(a)) because currently there is little evidence of entities applying the Practice Statement. The Practice Statement is non-mandatory, so entities apply it either if it is mandated in their jurisdiction or if they choose to apply it voluntarily. The staff's research identified only one jurisdiction that had adopted the Practice Statement as a voluntary framework for preparing management commentary and found about 50 entities from that jurisdiction using the Practice Statement in preparing management commentary, though only three of them state that their management commentaries fully comply with the Practice Statement. The staff found only a few entities that apply the Practice Statement voluntarily.

8. Accordingly, the effects analysis focuses on assessing the effects of the project proposals in the light of the Board's objective of financial reporting transparency (paragraph 5(b)). In particular, it discusses how the proposals could help improve the quality of financial reporting (paragraphs 11–30).

9. Staff's research also indicated that despite the level of adoption of the current Practice Statement being very limited, it has been influential in the development of local narrative reporting requirements.[4] Therefore, the effects analysis discusses possible benefits for local jurisdictions of adopting the proposals (paragraphs 31–34).

10. Finally, the effects analysis discusses the likely costs for preparers of implementing the proposals and of ongoing application and for investors and creditors of analysing the resulting information (paragraphs 35–39).

Likely effects of proposals on the quality of financial reporting

11. As noted in Agenda Paper 15 *Cover paper*, the project is intended to help preparers better meet investors' and creditors' information needs by consolidating innovations in narrative

[4] See paragraph 25 of November 2017 Agenda Paper 28A *Agenda proposal to revise and update the Management Commentary Practice Statement* for more information.

reporting and addressing the current gaps in reporting. In particular, in revising the Practice Statement, the Board intended to give particular emphasis to:

(a) improving the focus in management commentary and provision of information on matters that are specific to the circumstances of the entity;

(b) reporting on matters of particular interest to investors and creditors, that is matters that could affect the entity's long-term prospects, including intangible resources and relationships and environmental, social and governance (ESG) matters (Agenda Paper 15A *Overview of guidance on matters affecting long-term prospects, on intangible resources and relationships and on ESG matters* provides an overview of the Board's proposals intended to promote provision of information in management commentary on these interrelated matters); and

(c) encouraging a coherent discussion of matters identified.

12. In assessing how the Board's proposals are likely to affect the quality of financial reporting, the staff have first identified possible improvements related to these focus areas—see paragraphs 13–17, 18–21 and 22–24 respectively. In addition, the staff have identified other possible improvements related to:

(a) other aspects of quality of information in management commentary (paragraphs 25–27); and

(b) the quality of electronic reporting (paragraphs 28–30).

Improved focus and provision of information specific to the entity

13. As mentioned in paragraph 5 of Agenda Paper 15, lack of focus on matters that are important to the entity's prospects and lack of entity-specific information about those matters has been identified as a gap in narrative reporting. The Board's proposals are intended to improve the focus of information in management commentary and promote provision of entity-specific information.

14. To do so, the proposals highlight that management commentary needs to focus on matters that are fundamental to the entity's ability to create value and generate cash flows ('key matters') and on material information about those matters. In particular, to help preparers

make judgements in identifying key matters and material information about them, the Board:

(a) clearly defined the set of primary users of management commentary whose information needs management commentary has to meet. The Board reconfirmed that information in management commentary has to meet common information needs of the entity's existing and potential investors, lenders and other creditors (investors and creditors). Some recent developments in narrative reporting, in particular in sustainability reporting, take a multi-stakeholder approach and aim to meet the information needs of a wide range of stakeholders, including not just the entity's investors and creditors but also its employees and customers, as well as non-governmental institutions or society in general. In developing the proposals, the Board noted that management commentary is part of general purpose financial reporting, and the primary users of management commentary are therefore the same as the primary users of general purpose financial reporting as set out in the *Conceptual Framework for Financial Reporting*.

(b) developed draft guidance applicable to all information in management commentary, based on IFRS Practice Statement 2 *Applying materiality*, on making materiality judgements in preparing management commentary, including:

   (i) explaining that information is material if omitting it from management commentary, or misstating or obscuring it within management commentary, could reasonably be expected to influence decisions that investors and creditors make on the basis of that management commentary and related financial statements;

   (ii) providing a principle for identifying key matters as those that could fundamentally affect the entity's ability to create value and generate cash flows; and

   (iii) providing indications that information might be material: for example, if it is used by management for managing the business or if it has been included in the entity's capital markets communications or relates to a matter that management knows to be of interest to investors and creditors, or to other key stakeholders.

(c) developed draft supporting guidance on identifying key matters for each area of content.

(d) developed draft requirements and guidance for each area of content on what information about key matters may be needed by investors and creditors.

15. The Board's approach focuses on helping management to make judgements about information that is material for the entity based on the entity's specific circumstances. This approach based on the principle of materiality differs from the approach taken by some standard-setters, especially in the field of sustainability reporting, who focus on identifying specific matters and metrics that need to be reported by all entities or entities in a particular sector. Although asking all entities to provide specified metrics on the same matters could improve comparability between entities, it could also lead to entities reporting immaterial information or discourage entities from applying judgement in considering whether they need to disclose material information that is not on a list of information specified in the guidance. The Board's approach is designed to lead to an entity's management commentary providing information that is more specific to that entity than is sometimes the case in existing practice.

16. However, the Board has also acknowledged the importance of considering whether information is comparable with information produced by other entities. In particular, the draft guidance states that information should be selected for inclusion in management commentary and presented in a way that supports comparability. If management is aware that entities with similar activities provide particular information to investors and creditors, it should consider whether that information would be material for the entity's management commentary. However, the draft guidance would not permit entities to prioritise comparability over the need to provide material information, so entities would not be permitted to substitute immaterial information that is comparable for material information.

17. The staff expect that providing guidance on materiality would lead to a better understanding and application of the concept of materiality by preparers in preparing management commentary. The proposals could encourage preparers to exercise better judgement, so that management commentary focuses on key matters that could fundamentally affect the entity's ability to create value and generate cash flows and provides material information specific to the entity about those key matters.

Information of particular interest to investors and creditors

18. Agenda Paper 15A provides an overview of draft guidance intended to promote provision of information on interrelated matters of particular interest to investors and creditors, that is information on:

    (a) matters that could affect the entity's long-term prospects;

    (b) intangible resources and relationships; and

    (c) ESG matters.

19. As noted in that paper, the Board took a principle-based approach to identifying and reporting material information in management commentary about matters of particular interest to investors and creditors. Linking the guidance on such matters to the discussion of materiality is designed to:

    (a) make it more likely that investors and creditors will receive material information they need about those matters so that they can assess the entity's prospects for future cash flows and assess how efficiently and effectively management has used and protected the entity's resources in a single report—the management commentary; and

    (b) allow preparers to reassess what information needs to be provided as the entity's circumstances and investors' and creditors' needs evolve.

20. The Board also developed proposals to help management identify which matters should be reported and what information about them could be material. The proposals are expected to lead to management commentary providing material information about all key matters that could fundamentally affect the entity's ability to create value and generate cash flows

over all time horizons, including over the long term, in particular by providing material information to help investors and creditors:

(a) assess resilience, adaptability and durability of the entity's business model and understand management's long-term strategy;

(b) assess the extent to which the entity's business model and management's strategy depend on intangible resources and relationships, including those not recognised in the entity's financial statements, and the entity's ability to continue to access those resources and maintain those relationships;

(c) understand ESG matters that could fundamentally affect the entity's ability to create value and generate cash flows, including ESG matters that could fundamentally affect that ability as a result of the entity's activities disrupting the entity's key relationships with investors, creditors and other stakeholders.

21. Agenda Paper 15 notes that there have been multiple developments in narrative reporting, in particular in sustainability reporting. The draft guidance is intended to help preparers navigate this complex landscape by clarifying the interaction between the Practice Statement and other frameworks, standards and requirements. The draft guidance:

(a) states that narrative reporting requirements and recommendations published by other organisations (for example, by organisations with an interest in sustainability reporting) might help management identify key matters and determine which information about those matters is material; and

(b) would allow entities to include in management commentary information required by local laws, regulations or other requirements that management would not consider material applying the proposals, but only if that information is provided in a way that does not obscure material information.

Coherence of information

22. Fragmented discussion that 'fails to tell a story' has been identified as a gap in current narrative reporting practice, so the Board identified improving coherence in management commentary as one of the focus areas of the project. To help address the gap, the draft guidance asks management:

(a) to consider what information is needed for investors and creditors to assess implications of a key matter for all areas of content. For example, if a key trend is identified in the entity’s external environment, management would need to consider discussing in management commentary the implications of that trend for the entity’s business model, management’s strategy, resources and relationships, risks and the entity’s performance and position.

(b) to provide information in a way that explains the context for the matter discussed and that highlights and explains the relationships between different pieces of information.

(c) to include in management commentary information that is consistent with information provided in the related financial statements.

(d) to identify and explain inconsistencies between the information in management commentary and the information in investor presentations or other publicly available reports or on the entity’s website.

23. The draft guidance is also expected to identify and highlight relationships between different sections of the guidance. This could help management identify how best to link information in their management commentaries.

24. Overall, the Board’s proposals are expected to improve:

(a) coherence of information provided on each key matter throughout management commentary;

(b) coherence between discussions of different key matters in management commentary; and

(c) coherence of information in management commentary with information in the related financial statements and in other publicly available reports.

Other improvements to the quality of information in management commentary

25. Throughout the project, the staff have heard that information in management commentary often lacks characteristics of useful financial information set out in the *Conceptual*

Framework for Financial Reporting such as comparability, balance or verifiability.[5] This could suggest that preparers may struggle to apply the qualitative characteristics of useful information to narrative reporting.

26. The existing Practice Statement requires information in management commentary to have the qualitative characteristics of useful information. The revised Practice Statement would retain that requirement, but also provide guidance to help management provide information with those characteristics.

27. The proposals are designed to make information provided in management commentary:

    (a) more balanced. The proposals explain that management commentary should not give more prominence to favourable information than to unfavourable information, and should not exaggerate or obscure favourable or unfavourable information. For example, in describing its strategy management would be expected to discuss the risks to executing its strategy, not only the opportunities being pursued.

    (b) more complete. For example, for each area of content the proposals provide an explicit disclosure objective and provide suggestions of information that could be provided in management commentary to meet information needs of investors and creditors.

    (c) more comparable. For example, comparability of information from period to period would be improved by asking management to explain why management measures and indicators have changed from the previous reporting period.

    (d) more verifiable. For example, the proposals would ask management commentary to specify which information is based on estimates and approximations and to describe the process and sources used to produce that information, any assumptions and methods of calculation used to produce the information, and the limitations of the information.

[5] In the proposals, the term 'balance' is used as the label for the qualitative characteristic of 'neutrality' described in the *Conceptual Framework for Financial Reporting*.

Effect on the quality of electronic reporting

28. As both financial statements and narrative reports are increasingly used in electronic rather than printed format, the proposals have been developed in a way that is intended to help improve the quality of electronic reporting.

29. Currently, the IFRS Taxonomy contains few elements for information likely to be included management commentary. It allows tagging blocks of information in management commentary using broad IFRS Taxonomy elements, for example ‘nature of business’ or ‘management’s objectives and its strategies for meeting those objectives’. Providing in the revised Practice Statement more structure and more granular guidance than in the existing Practice Statement could facilitate better electronic reporting by providing more specific IFRS Taxonomy elements for management commentary. In particular, the IFRS Taxonomy would include elements reflecting types of information required by the proposed disclosure objectives for each area of content. For example, the IFRS Taxonomy elements could reflect the following required types of information related to management’s strategy:

    (a) the drivers of strategy;

    (b) long-term aims of strategy;

    (c) intermediate milestones on the path towards achieving the long-term aims;

    (d) plans for reaching the intermediate milestones and achieving long-term aims;

    (e) the entity’s capital requirements, management’s plans for funding strategy and capital allocation; and

    (f) progress in implementing strategy.

30. Tagging information in more detail could make it easier for investors and creditors to access the information they need in electronic format. It could also contribute to easier comparison of information both between different entities and over time for the same entity.

Likely benefits for jurisdictions of adopting the proposals

31. In September 2020, the Board tentatively decided that the revised Practice Statement should retain the status of the current Practice Statement. That is the revised Practice Statement would continue to be non-mandatory and would not become an IFRS Standard. Entities would continue to be able to state that their financial statements comply with IFRS Standards without preparing a management commentary that complies with the revised Practice Statement. Individual jurisdictions would continue to determine whether entities should be required to provide management commentaries and if so, whether those commentaries should comply with the Practice Statement and whether they should be subject to any form of external assurance.

32. The Board has been developing the proposals for the revised Practice Statement to help preparers meet the overall objective of management commentary, in particular by developing detailed disclosure objectives for each area of content and guidance supporting those objectives. More structured guidance and clear disclosure objectives are also designed to provide a better basis for:

    (a) enforcement of the Practice Statement; and

    (b) providing external assurance on management commentary.

33. The improved enforceability of the Practice Statement and assurability of management commentary combined with likely improvements to the quality of reporting discussed in paragraphs 11–30, would in their turn provide a better basis for mandating the revised Practice Statement, and could encourage local regulators to do so.

34. Furthermore, as noted in paragraph 9, when the original Practice Statement was issued, it influenced the development of local requirements and guidance rather than being applied directly. In revising the Practice Statement, the Board sought to better meet the information needs of investors and creditors by incorporating innovations in narrative reporting and addressing the gaps in reporting practice. This could encourage jurisdictions to reflect the revised proposals in local requirements.

Likely costs of proposals

Likely costs for preparers of implementing the proposals and of ongoing application

35. As mentioned in paragraph 7, currently few entities apply the Practice Statement. Preparers would need to implement the proposals only if they are required to do so by local jurisdictions or chose to do so voluntarily.

36. In determining whether to mandate the revised Practice Statement or to apply it voluntarily, jurisdictions and entities would consider the costs of implementing and applying the proposals in comparison to the potential benefits of proposals identified in paragraphs 13–34.

37. Implementing the proposals and their ongoing application is unlikely to lead to significant costs in producing information specifically for management commentary. This is because information in management commentary is expected to be derived from information used by management in managing the business and to reflect management’s view.

38. The costs of implementing the proposals and ongoing application are more likely to relate to establishing and maintaining rigorous internal systems for identifying information for inclusion in management commentary and to establishing quality control procedures appropriate for information that is to be published. There would also be some cost, including senior management time, in determining what information is material and how to present the information in a way that is helpful to primary users. The extent of those costs would depend on an entity’s current reporting systems. The costs may be significant for entities that currently do not prepare any management commentary. However, implementation of the proposals and their ongoing application is likely to result in more limited costs for those preparers that currently apply requirements or guidance on management commentary or a similar report issued by other standard-setters if those requirements or guidance:

    (a) set out an overall objective of management commentary similar to the one proposed in the revised Practice Statement, focussing on information needs of investors and creditors;

(b) specify that information in management commentary needs to have characteristics similar to those proposed in the revised Practice Statement; and

(c) cover similar areas of content and have similar disclosure objectives.

Likely costs for investors and creditors of analysing the resulting information

39. The proposals are based on investors' and creditors' information needs and so are expected to make it easier for investors and creditors to perform their analysis and save them costs by providing them with better information for their analysis. In addition, the revision of the Practice Statement and resulting updates to the IFRS Taxonomy are expected to result in more accessible and comparable information in management commentaries in electronic format (see paragraphs 28–30), and this is also likely to reduce investors' and creditors' costs if they access management commentary in electronic format or if better tagging makes it feasible for them to start using management commentary in electronic format.

Overall assessment of likely benefits compared to likely costs

40. In summary, the Board's proposals are expected to result in the following improvements to the quality of financial reporting:

(a) improved focus and provision of information specific to the entity in management commentary;

(b) provision of material information of particular interest to investors and creditors, including information on matters that could affect the entity's long-term prospects, on intangible resources and relationships and on ESG matters;

(c) improved coherence of information within management commentary and with the entity's financial statements and other published reports;

(d) other improvements to the quality of information in management commentary, including information that is more balanced, complete, comparable and verifiable; and

(e) more specific tagging of information in management commentaries that could lead to easier access to management commentary in electronic format.

41. In addition, more structured guidance in management commentary could make it easier for jurisdictions to enforce the revised Practice Statement and for external providers to provide assurance on management commentary, or enhance the level of assurance they provide.

42. In the staff's view, the likely benefits of implementing and adopting the revised Practice Statement would significantly outweigh the likely costs of implementing the proposals and ongoing application.

43. In addition, the staff consider that:

    (a) implementing the proposals would provide significantly more benefits than the existing Practice Statement; and

    (b) the benefits of implementing and applying the proposals would exceed the costs by significantly more than the amount by which the benefits of implementing and applying the existing Practice Statement exceed the costs of implementing the existing Practice Statement.

Question for the Board
Do you have any comments or questions on the overview of the likely effects of the project proposals in paragraphs 11–43?