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Project	<b>Management Commentary</b>		
Paper topic	External environment		
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## Purpose of this paper

1. The purpose of this paper is to discuss what guidance should be included in the revised IFRS Practice Statement 1 *Management Commentary* (Practice Statement) on an entity's external environment. In particular, this paper discusses:
  - (a) the disclosure objective for an entity's external environment; and
  - (b) possible guidance supporting that disclosure objective, including on identifying the key factors and trends in an entity's external environment that would need to be addressed in management commentary.
2. This paper asks the Board for decisions on the disclosure objective for an entity's external environment and on describing the key factors and trends in that environment that would need to be addressed in management commentary.
3. The paper does not ask the Board for decisions on other aspects of the supporting guidance but invites comments from the Board. The staff will consider those comments and will either address them in drafting the forthcoming exposure draft or present further analysis to the Board at a future meeting.

## Structure of this paper

4. This paper is structured as follows:
- (a) summary of staff recommendations (paragraph 5);
  - (b) summary of staff's research on external environment (paragraphs 6–29);
  - (c) disclosure objective for an entity's external environment:
    - (i) headline objective (paragraphs 32–41);
    - (ii) main assessments typically made by investors and creditors (paragraphs 42–45); and
    - (iii) types of information that need to be provided (paragraphs 46–52);
  - (d) possible guidance supporting the disclosure objective:
    - (i) how to identify the key factors and trends in an entity's external environment (paragraphs 54–57); and
    - (ii) what information to provide about those key factors and trends (paragraphs 58–69);
  - (e) Appendix A—Extracts from Practice Statement 1 *Management Commentary* on external environment;
  - (f) Appendix B—Summary of feedback from the Management Commentary Consultative Group (MCCG)—external environment; and
  - (g) Appendix C—Overview of other standard-setters' requirements and guidance on external environment.

## Summary of staff recommendations

5. The staff recommend that the revised Practice Statement:
- (a) specifies the disclosure objective for the entity's external environment as follows:

Management commentary shall provide information and analysis to help investors and creditors understand how the environment in which an entity operates affects: the entity's business model; management's strategy for

sustaining and developing that model; the entity’s resources and relationships; or its risks.

That information and analysis helps investors and creditors assess:

- (i) how factors and trends in the external environment affect the entity; and
- (ii) how effectively management monitors and responds to those factors and trends.

That information and analysis shall focus on the key factors and trends and cover:

- (i) a description of the factors and trends in the external environment;
  - (ii) how those factors and trends affect the entity; and
  - (iii) how management responds to those factors and trends.
- (b) specifies that the key factors and trends in the external environment are those that affect the entity’s ability to create value and generate cash flows.

## **Summary of staff’s research on external environment**

### ***The existing Practice Statement***

6. The existing Practice Statement combines guidance on an entity’s business model and its external environment under a heading ‘nature of the business’. This is because there is a close connection between what the entity does and how the entity ‘fits’ in its immediate environment. Furthermore, an entity’s business model is typically designed and developed in the context of the entity’s immediate and wider environment.
7. The Practice Statement requires management to ‘provide a description of the business to help users of the financial reports to gain an understanding of the entity and of the external environment in which it operates’ and states that such information ‘serves as a starting point for assessing and understanding an entity’s performance, strategic options and prospects’.
8. The Practice Statement identifies broad types of information about the nature of the business that may need to be included in a management commentary, including information about:
  - (a) the industries in which the entity operates;

- (b) the entity’s main markets and competitive position within those markets; and
- (c) significant features of the legal, regulatory and macroeconomic environments<sup>1</sup> that influence the entity and the markets in which the entity operates.

9. In discussing strategy, the Practice Statement also states that users of financial reports need to understand ‘how management intends to address market trends and the threats and opportunities those market trends represent’ and explain that such information gives users of the financial reports ‘insight that may shape their expectations about the entity’s future performance’. However, the Practice Statement does not provide any further discussion of the links between the areas of content or any supporting guidance or illustrative examples. Appendix A includes extracts from the Practice Statement in relation to external environment.

***Investors’ and creditors’ information needs and gaps in reporting practice***

10. As discussed in paragraphs 6–9, the existing Practice Statement contains guidance on external environment across various sections of guidance. In developing that guidance, the Board concluded that investors and creditors need to understand:

- (a) the environment in which an entity operates, including both the entity’s immediate environment (such as markets and industries) and its wider macroeconomic environment;
- (b) significant features and trends in the entity’s environment, including both threats and opportunities, and how they have affected and could affect the entity and its markets; and
- (c) how features and trends in the entity’s environment affect management’s strategy and how management plan to address those features and trends.

11. The staff’s research and outreach confirm that information about an entity’s environment is important to investors and creditors. For example, in discussing possible disclosure objective for external environment at the March 2020 meeting of the Capital Markets Advisory Committee (CMAC), one CMAC member emphasised that the external

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<sup>1</sup>The [Oxford English Dictionary](#) defines macroeconomics as the branch of economics concerned with large-scale or general economic factors, such as interest rates and national productivity.

environment is the starting point in understanding an entity’s business model and its value proposition.

12. The staff’s research and outreach also suggest that the existing Practice Statement correctly identifies the main aspects of investors and creditors’ information needs in relation to the entity’s environment (see paragraph 9). However, the staff’s findings suggest that those information needs are not always met in practice. In particular, some management commentaries:
- (a) provide a narrow view of an entity’s environment and fail to address wider macroeconomic factors and trends that affect the entity, in particular environmental and social factors and trends that could affect the entity’s ability to create value and generate cash flows;
  - (b) provide a boilerplate discussion and do not focus on the key factors and trends that affect or could affect the entity and the entity’s prospects, including over a long term;
  - (c) fail to provide a linked discussion across areas of content and to explain how those trends and factors in the external environment have affected and could affect the entity, including over the long term; and
  - (d) include insufficient information about how management considers and responds to the key factors and trends in the entity’s environment.
13. Investor interest in macroeconomic factors and trends (also sometimes referred as systemic factors and trends) has been highlighted in a number of recent investor surveys and publications<sup>2</sup> as well as in the staff’s discussions with MCCG and CMAC. These factors and trends (including those related to environmental and social matters) are those that affect the entity’s ability to create value and generate cash flows over the long term. For example, ‘A Discussion Paper By Global Investor Organisations On Corporate Esg

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<sup>2</sup> Sources reviewed by the staff include: Principle for Responsible Investment (PRI) and the International Corporate Governance Network (ICGN), ‘[Discussion Paper By Global Investor Organisations On Corporate Esg Reporting](#)’, 2018; Aviva, ‘[Investment Research: Time for a brave new world?](#)’, 2017; FCLTGlobal, ‘[Predicting long-term success](#)’, 2019; and CEO of BlackRock, ‘[Letter to CEOs, A Fundamental Reshaping of Finance](#)’, 2020.

Reporting’<sup>3</sup> suggests that ‘both investors and companies need to think more about systemic issues’. The discussion paper then explains that addressing systemic issues ‘is a matter of strategy and sustainable value creation’ for companies.

14. This sentiment was echoed by both the MCCG and the CMAC. Specifically, in discussing possible disclosure objective and supporting guidance on external environment, members of both consultative groups supported the view that investors need information to help them understand systemic factors and trends that affect the entity. One MCCG member pointed out that investors need information about ‘mega’ trends that affect the entity, such as major technological changes. A CMAC member emphasised that investors need to understand not only the economics of an entity’s market but also the entity’s macroeconomic exposure and the regulatory landscape.
15. Another prominent area of focus in recent investor surveys, research and publications is environmental, social and governance (ESG) issues.<sup>4</sup> For example, *Environmental, Social and Governance (ESG) Survey* conducted by the CFA institute in 2017 indicated that 73% of respondents consider ESG matters in their investment analysis and decision making.<sup>5</sup> The survey also indicated that there is an increasing investor interest in those matters.<sup>6</sup>
16. However, the survey also highlighted that investors need material information about ESG issues with 42% of respondents stating that companies do not disclose sufficient material ESG information and 32% of respondents stating that companies disclose so much immaterial information that it is difficult for investors identify what information is material. The PRI’s and ICGN’s Discussion Paper discussed in paragraph 13 also

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<sup>3</sup> This [paper](#) was published in October 2018 by seven reputable global investor organisations including the CFA Institute, the Principle for Responsible Investment (PRI) and the International Corporate Governance Network (ICGN).

<sup>4</sup> Further sources reviewed by the staff include: the Financial Stability Board (FSB) Task Force on Climate-related Financial Disclosures, ‘[Final Report: Recommendations of the Task Force on Climate related Financial Disclosures](#)’, 2017; the CFA Institute, ‘[Environmental, Social and Governance \(ESG\) Survey](#)’, 2017; Global Investor Statement on Governments in Climate Change (seven investor organisations), ‘[Briefing paper on the 2018 Global Investor Statement on Governments in Climate Change](#)’, 2018; the UK Financial Reporting Council’s Financial Reporting Lab, ‘[Climate-related corporate reporting](#)’, 2019; EFRAG, ‘[How to improve climate-related reporting – A summary of good practices from Europe and beyond](#)’, 2020.

<sup>5</sup> CFA Institute received 1,588 valid responses from its members that are portfolio managers and research analysts.

<sup>6</sup> 64%, 50% and 49% of respondents who participated in the survey in 2015 stated that governance, environmental and social issues respectively were important in their analysis. In 2017, those numbers reached 67%, 54% and 54% respectively.

emphasises that ‘investors are primarily concerned with ESG information that is material for their investment decisions’.

17. These findings were echoed by both MCCG and CMAC members who generally stated that material information about ESG matters that affect an entity’s ability to create value and generate cash flows, including over a long term, is important to investors. However, the members of those groups also pointed out that:
  - (a) financially immaterial or boilerplate information about ESG issues is unhelpful and only ‘financially material’ ESG information should be provided in an entity’s management commentary.
  - (b) importance of ESG issues will vary between entities and between industries as well as over time;
  - (c) ‘ESG’ should not be treated as a single type of information. Instead, investors may have different information needs in relation to environmental, social and governance issues and depending on the entity’s particular facts and circumstances. In addition, governance issues are typically addressed by other reporting requirements and are outside the remit of the Practice Statement.
  
18. Most members who commented on the topic also generally supported the staff’s view that the revised Practice Statement should address material information about ESG issues across areas of content instead of including a separate section on ESG issues.
  
19. In reviewing recent surveys, research and publications, the staff also sought to understand how investors and creditors generally think about factors and trends in an entity’s environment and what information they need about those factors and trends. The staff’s review suggests that investors and creditors need to understand:
  - (a) how factors and trends in the entity’s environment affect the entity’s markets or industry and the entity’s performance;
  - (b) how management identifies important factors and trends, including resulting risks and opportunities, and how management monitors and measures the effects of the factors and trends on the entity;

- (c) how management responds to factors and trends, including adjusting the entity’s business model or management’s strategy.
20. Two areas investors consistently highlight are materiality and management’s stewardship. Specifically, investors are interested in material information about factors and trends in an entity’s environment. Some investors also want to understand how preparers decide what information is material in preparing management commentary.
21. Materiality considerations were also highlighted in the discussions with the MCCG. Members agreed with the staff’s view that management commentary should provide material information about key factors and trends in the entity’s environment but also highlighted that identifying what information is material can be a challenging area for preparers and that the revised Practice Statement should provide guidance on this.
22. As highlighted in paragraph 19, investors need information about management’s response to its external environment which helps them assess management’s stewardship. For example, the UK Financial Reporting Council’s Financial Reporting Lab’s report, ‘Climate-related corporate reporting’ states that investors want to understand ‘how boards consider and assess the topic of climate change’. Members of the MCCG also generally supported the staff’s view that management commentaries should explain how management has responded or plans to respond to factors and trends in an entity’s environment and should link that explanation to a discussion of management’s strategy.
23. Appendix B provides further detail about feedback from members of the MCCG on investors’ information needs about the external environment and explains how the staff considered the feedback in developing recommendations for this paper.
24. The staff also reviewed economic theories and models, including the so-called PESTEL analysis<sup>7</sup> and Porter’s Five Forces model<sup>8</sup> that provide detailed discussion of aspects of an

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<sup>7</sup> The foundations of PESTEL analysis are attributed to Francis Aguilar (F. J. Aguilar, ‘Scanning the business environment’, Macmillan, (18th ed.), 1967). The analysis was originally referred to as ‘PEST’ which stood for political, economic, social and technological macroeconomic factors. It has subsequently been developed and is now often referred to as ‘PESTEL’ which also includes environmental as well as legal and regulatory factors.

<sup>8</sup> Porter’s Five Forces is a model that identifies and analyses five competitive forces that, according to the originator of the model, shape every industry and help determine an industry’s weaknesses and strengths. The model is based on a paper by Michael E. Porter (M.E. Porter, ‘[How Competitive Forces Shape Strategy](#)’, Harvard Business Review, Volume 3, 1979).



entity's immediate and wider macroeconomic environments respectively, in order to understand which factors and trends in external environment are typically considered in analysing an entity. PESTEL analysis refers to political, economic, social, technological environmental, and legal and regulatory macroeconomic factors. Porter's Five Forces model identifies and analyses five competitive forces that shape a particular industry or market and include threat of new entrants, threat of substitute products or services, bargaining power of customers, bargaining power of suppliers, and competitive rivalry within an industry or market. The staff considered these factors in developing possible supporting guidance on external environment.

***Overview of other standard-setters' requirements and guidance***

25. In developing recommendations on external environment, the staff reviewed requirements and guidance issued by other standard-setters.
26. The national frameworks for management commentary reviewed by the staff provide various amount of detail in guidance on describing external environment in management commentary or equivalent document and organise that guidance in various ways:
  - (a) some include specific guidance on discussion of the business or external environment;
  - (b) some address aspects of external environment in guidance on business model, strategy, risks or key performance indicators;
  - (c) some discuss factors and trends affecting the entity in addition to, or instead of, referring to external environment.
27. Specific aspects of the external environment on which disclosures are typically required by different national frameworks in a management commentary or equivalent document include:
  - (a) industries, markets and locations the entity operates in;
  - (b) the entity's competitive environment; and
  - (c) macroeconomic factors and trends that affect the entity, including laws and regulations, the political environment, environmental issues and any related

government intervention (for example, reducing emissions), employee issues, and community and social issues.

28. A few national frameworks also emphasise the need to discuss both risks and opportunities arising from an entity's external environment in management commentary or include specific linkage requirements related to trends and factors in the external environment. In contrast, many frameworks include overall requirements to disclose material information about external environment and to link all areas of content.
29. Appendix C provides further detail about how the staff conducted the review and provides an overview of requirements and guidance on external environment in other standard-setters' frameworks.

### **Disclosure objective for an entity's external environment**

30. As discussed in paragraph 7, the existing Practice Statement states that 'management should provide a description of the business to help users of the financial reports to gain an understanding of the entity and of the external environment in which it operates'. This statement can be seen as a broad objective for disclosure about the external environment. However, it may not be sufficiently prominent or specific to help preparers identify information needed to meet this implied objective.
31. As explained in Agenda Paper 15 *Cover Paper*, the staff recommends that for each area of content the revised Practice Statement should set out:
  - (a) a headline objective (paragraphs 32–41);
  - (b) the main assessments typically made by investors and creditors (paragraphs 42– 45); and
  - (c) the types of information that needs to be provided (paragraphs 46–52).

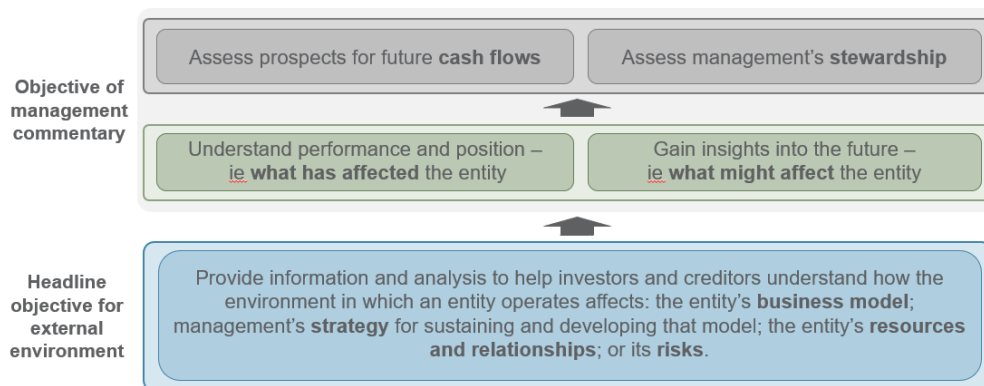
### ***Headline objective***

32. In developing the recommended disclosure objective for external environment, the staff considered what information investors and creditors need about the external environment to help them assess the entity's prospects for future cash flows and management's stewardship of the entity's economic resources.

33. As noted in paragraph 6, the existing Practice Statement discusses external environment together with the nature of the entity's business. The important role of information about external environment in understanding an entity's business model was emphasised by a CMAC member at the March 2020 CMAC meeting who explained that information about an entity's environment serves as a starting point for understanding the entity's business model and its value proposition (see paragraph 11).
  
34. However, the staff's research also indicates that investors need to understand how factors and trends in the external environment affect the entity, what risks and opportunities result from those factors and trends, and how management responds to those factors and trends in developing the entity's business model and formulating the strategy (see paragraph 19). In other words, understanding the external environment provides not only a starting point for understanding the entity's business model but also a context for understanding management's strategy, the entity's resources and relationships, and its risks. Figure 2 in Agenda Paper 15 illustrates the relationships between information about an entity's environment and the other areas of content in management commentary.
  
35. In addition, as discussed in paragraph 12, investors highlight that a common gap in current reporting practice is a lack of linkage between information about external environment and other types of information in management commentary.
  
36. Accordingly, to help meet information needs of investors and creditors and address the gaps in current reporting practice the staff think that the headline disclosure objective for external environment should emphasise the contextual role of information about the external environment not only for understanding an entity's business model but also for understanding other information in management commentary.
  
37. In particular, the staff think that there is an important link between an entity's environment and risks the entity faces. That importance of that link has been highlighted by the staff's research (see paragraph 19(b)). External environment can give rise to an entity's risks and it can also affect the entity's exposure to existing risks. Accordingly, the staff think that this link should be highlighted in the disclosure objective for external environment.

38. External environment is not the only source of the entity’s risks. Risks can also arise from the entity’s internal processes related to operation of the entity’s business model or can relate to management’s strategy. This agenda paper and the staff’s analysis focus on external environment, what external environment affects and what information about external environment to provide in management commentary. Agenda Paper 15A *Risks* addresses what information to provide about risks, including an entity’s both external and internal risks.
39. To conclude, the staff think that explaining the effects of factors and trends in an entity’s environment would both help investors and creditors understand what has affected the entity’s performance in the reporting period and provide insights into how these factors and trends might affect the entity in the future, including over the long term. That information, together with information about management’s response to those factors and trends, would also help investors and creditors assess the entity’s prospects for future cash flows and assess management’s stewardship.
40. Accordingly, the staff recommend that the headline disclosure objective for external environment should be to provide information and analysis to help investors and creditors understand how the environment in which the entity operates affects the entity’s business model, management’s strategy for sustaining and developing that model, the entity’s resources and relationships, and its risks.
41. The relationship between the headline disclosure objective for external environment and the overall objective of management commentary is illustrated in Figure 1.

**Figure 1**



**Main assessments typically made by investors and creditors**

42. As explained in Agenda Paper 15, disclosure objectives for the areas of content include a description of the main assessments that investors and creditors typically make in relation to an area of content in order to support the headline objective and help preparers identify information needs to be provided in management commentary.
43. The staff's research indicates that in relation to external environment investors and creditors are looking to understand:
- (a) how factors and trends in the external environment affect the entity; and
  - (b) how effectively management monitors and responds to factors and trends in external environment.
44. Investors and creditors' focus on these areas is apparent from the staff's review of recent investor surveys and publications (see paragraphs 15 and 19). The importance of these assessments has also been confirmed in the staff's discussions with the MCCG (see paragraphs 14, 17 and 22). Finally, lack of sufficient information about how the external environment affects the entity and how management responds to factors and trends in the environment is identified as one of the gaps in reporting practice.
45. The staff note that in many cases investors and creditors may generally be familiar with the entity's industry and markets as well as the prevalent macroeconomic and industry trends. However, in assessing the entity's prospects for future cash flows, including over the long term, and in assessing management's stewardship, investors and creditors need to understand how those general factors and trends affect the particular entity and how effectively management identifies and monitors relevant developments and adjusts the entity's course to mitigate the risks and to take advantage of available opportunities.

***Note on terminology—'factors and trends'***

- The term 'factors and trends' is commonly used in relation to external environment in research and publications reviewed by the staff as well as in other frameworks. Accordingly, the staff adapted this term in discussing 'features' of the entity's external environment.

- The staff note that there is a difference between a factor and a trend. The term ‘factor’ refers to a circumstance or influence that is present in the external environment. The term ‘trend’ emphasises that the circumstance or the influence is evolving over time.

### ***Types of information that need to be provided***

46. The staff further considered what broad types of information need to be provided in management commentary to help investors and creditors make the assessments discussed in the previous section and to support the headline disclosure objective for external environment as well as the overall objective of management commentary. On the basis of research into investors and creditors’ information needs and of the guidance provided by other standard-setters, the staff think that management commentary should cover:
- (a) a description of factors and trends in the external environment;
  - (b) how those factors and trends affect the entity; and
  - (c) how management responds to those factors and trends.
47. In particular, investors first need to have an understanding of an entity’s environment as the context for their analysis. As noted in paragraph 8, the existing Practice Statement already requires information about an entity’s industries, main markets and significant features of an entity’s macroeconomic environment. However, as highlighted in paragraph 13, there is increasing investor interest in understanding macroeconomic issues (‘mega’ trends) and how they will affect the entity’s ability to create value and generate cash flows, including over the long term. Investors also identify lack of sufficient information about such issues and their effect on the entity as a gap in reporting practice (see paragraph 12). The staff therefore plan to emphasise the need for information about macroeconomic issues and how they affect the entity in the supporting guidance on external environment).
48. Secondly, as noted in paragraph 43, investors and creditors have highlighted that they need to understand how factors and trends in external environment affect the entity and

how information about the entity’s environment is connected to information for other areas of content in management commentary. The need for information about the effects of those factors and trends is already reflected in the headline objective and in the assessments of external environment and should also be reflected in the types of information to be provided.

49. Finally, as highlighted in paragraph 20, investors are interested in management’s stewardship in relation to developments in the external environment. Insufficient information about management’s response to factors and trends in an entity’s environment has been identified as a gap in the reporting practice. Accordingly, the staff recommend that entities should provide information about how management responded to those factors and trends or plans to respond to them.
  
50. As also highlighted by the staff’s research and outreach, investors and creditors need material information about factors and trends in the entity’s environment and point out that immaterial and boilerplate information is unhelpful for their analysis. The lack of focus on important factors and trends that affect or could affect an entity, including over the long term, has also been identified as one of the gaps in reporting practice.
  
51. The existing Practice Statement already refers to ‘main markets’ and ‘significant features of the legal, regulatory and macro-economic environments’ and the staff think it is important to retain and emphasise the requirement for preparers to focus on key factors and trends in an entity’s environment. The staff’s discussion and recommendations on how to define key factors and trends and what supporting guidance to include in the revised Practice Statement are provided in the following section.
  
52. To conclude, the staff recommend that the revised Practice Statement should require that the information and analysis on external environment in management commentary focuses on key factors and trends and covers the following types of information:
  - (a) a description of factors and trends in the external environment;
  - (b) how those factors and trends affect the entity; and
  - (c) how management responds to those factors and trends.

## Question 1 for the Board

The staff recommend that the revised Practice Statement specifies the disclosure objective for external environment as follows:

- (a) management commentary should provide information and analysis to help investors and creditors understand how the environment in which the entity operates affects: the entity's business model; management's strategy for sustaining and developing that model; the entity's resources and relationships; or its risks.
- (b) that information and analysis helps investors and creditors assess:
  - (i) how factors and trends in the external environment affect the entity; and
  - (ii) how effectively management monitors and responds to factors and trends in the external environment.
- (c) that information and analysis should focus on the key factors and trends and cover:
  - (i) a description of factors and trends in the external environment;
  - (ii) how those factors and trends affect the entity; and
  - (iii) how management responds to those factors and trends.

Do you agree with these recommendations?

### Possible guidance supporting the disclosure objective

53. To help preparers apply the disclosure objective for external environment recommended above, the staff considered what supporting guidance could be included in the revised Practice Statement on:

- (a) identifying key factors and trends in an entity's environment (paragraphs 54–57); and
- (b) each broad type of information set out in the disclosure objective:
  - (i) a description of factors and trends in the external environment (paragraphs 58–63);
  - (ii) how those factors and trends affect the entity (paragraphs 64–68); and
  - (iii) how management responds to those factors and trends (paragraph 69).



***How to identify key factors and trends?***

54. In July 2019, the Board tentatively approved a draft of guidance on making materiality judgements in preparing management commentary. Generally, information is considered material if it can reasonably be expected to affect investors’ and creditors’ assessment of the entity’s prospects for future cash flows and of management’s stewardship of the entity’s economic resources.
55. That guidance would apply to all types of information that might need to be included in management commentary. To help preparers apply that guidance in identifying material information about their entity’s external environment, the staff suggest providing guidance on identifying key factors and trends in an entity’s environment, information about which is likely to be material to investors and creditors’ assessments.
56. In discussing key features of an entity’s business model, key aspects of management’s strategy for sustaining and developing that model and key resources and relationships of the entity, the Board concluded that key items are those that relate to the entity’s ability to create value and generate cash flows. This definition is consistent with investors’ and creditors’ focus on the entity’s prospects for future cash flows, including over the long term. The staff think that the same principle is equally appropriate for the external environment and recommend that the revised Practice Statement defines key factors and trends in an entity’s external environment as those that affect the entity’s ability to create value and generate cash flows.
57. Furthermore, the staff think that the revised Practice Statement could provide examples of such key factors and trends. As discussed in paragraph 19, investors and creditors focus on how an entity’s environment affects the entity’s business model, management’s strategy for sustaining and developing that model, the entity’s resources and relationships and its risks. Accordingly, the staff think that possible examples of key factors and trends in an entity’s environment include those that have affected or may affect:
- (a) the entity’s business model (for example, political or social factors may affect the entity’s ability to operate in certain locations);

- (b) management’s strategy for sustaining and developing the entity’s business model (for example, potential new market entrants may affect that strategy);
- (c) the entity’s resources and relationships (for example, changing customer preferences or demand may affect customer loyalty); and
- (d) the entity’s risks or opportunities (for example, increasing protectionist policies in global markets may threaten global supply chains or climate change may create risks and opportunities for some companies in the global transition to a low-carbon economy).

**Question 2 for the Board**

The staff recommend that the revised Practice Statement specifies that the key factors and trends in an entity’s external environment are those that affect the entity’s ability to create value and generate cash flows. Do you agree with this recommendation?

***What information to provide about the external environment?***

***A description of factors and trends in the external environment***

58. On the basis of staff’s research and outreach summarised in paragraphs 6–29, the staff think that a description of factors and trends in an entity’s environment could address the following two aspects:
- (a) the entity’s immediate environment which may cover the entity’s industries and markets, and the entity’s competitive position within those markets, as well as the levels of supply and demand; and
  - (b) the entity’s macroeconomic environment which includes, for example, legal and regulatory environment, political environment, technology considerations, the natural environment, social and cultural landscape. Macroeconomic environment relates to factors or trends that exist in the economy as a whole rather than in a particular industry or region.
59. The staff think that making a distinction in guidance on management commentary between the description of the entity’s immediate environment and the description of the entity’s macroeconomic environment is helpful because these aspects of the environment

differ in nature. The staff also think that it could be helpful to highlight in management commentary the relationships between particular trends and factors in an entity's environment, for example explain how particular macroeconomic factors or trends affect the entity's industries and markets. For example, the 2020 pandemic is a social macroeconomic factor that has given rise to an increase in online shopping against the backdrop of a trend that already existed in particular industries such as food distribution and fashion industry.

60. In discussing factors and trends in the entity's environment, it is helpful to describe them in a way that facilitates investors' and creditors' understanding of developments over time. For example:
- (a) management could provide a description of an unfavourable investment climate in particular countries which has affected the growth of the entity's industry in those jurisdictions in the past and consequently the entity itself;
  - (b) in describing a long-standing low interest rate environment, management could discuss whether this is likely to have a long-term effect on their consumer lending patterns.
61. Generally, in describing a factor or trend, management commentary might need to explain both the current profile of the factor or trend and any changes that occurred during the reporting period. In some cases, it may also be helpful to include an indication of how long the factor or trend is expected to be present. Management might also need to discuss its assumptions in relation to the factor or trend if they informed management's decisions about adjustments to the entity's business model, strategic objectives, risk mitigation or resource allocation.
62. Furthermore, in discussing the factor or trend, management may need to describe the source of information used to identify or monitor the factor or trend or to assess their effects on the entity or provide qualitative or quantitative information derived from that source. For example, management may need to indicate whether external statistics<sup>9</sup> or

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<sup>9</sup> External statistics are quantitative information that can include industry benchmarks and leading indicators or measures.

external stakeholder engagement is used to monitor the factor or trend as well as to specify the date to which information relates.

***Link to other areas of content – performance, position and progress***

- The staff plan to discuss guidance on providing quantitative information from external sources in a future agenda paper on performance, position and progress.

63. Finally, in describing a factor or trend, management commentary should provide a link to the feature of the entity's business model, the aspect of management's strategy, the resource, relationship or risk which the factor or trend affects, as highlighted in the disclosure objective for external environment.

***Link to other areas of content—business model***

- April 2020 Agenda Paper 15B *Business Model* discussed that in describing the range, nature and scale of the entity's operations, management commentary may need to provide an overview of the entity as a whole and cover the entity's operating structure and the locations of the entity's operations and markets. That agenda paper also stated that the description of the entity's business model might explain the entity's value proposition.
- There is a close relation between describing the entity's value proposition and describing its competitive position within its markets or industry. As previously discussed by the Board, the revised Practice Statement will not prescribe the structure of management commentary and where particular information should be provided. However, the staff will consider in drafting how to organise the guidance in the Practice Statement in the most effective way to help preparers develop management commentaries.

***How factors and trends in the external environment affect the entity***

64. As discussed in paragraphs 13–14 and 19, investors and creditors need to understand not only *what* factors and trends affect the entity but also *how* they affect the entity. In addition, as discussed in paragraph 12(c), they need to understand how information about factors and trends in an entity’s environment relates to information in other areas of content in management commentary. Accordingly, the staff think that management would need to discuss how the factor or trend has affected or could affect:
- (a) the operation of the entity’s business model (for example, new regulation may require an entity to reorganise its structure and make adjustments to its business model);
  - (b) management’s strategy (for example, the emergence of alternative solutions to meet customer needs may affect management’s plans for developing the entity’s value proposition);
  - (c) the entity’s resources and relationships (for example, increasing demand for skilled workforce may affect the entity’s ability to retain key staff); and
  - (d) the entity’s risks (for example, a trade war could create a risk of disruption to the entity’s supply chain).
65. In describing how a factor or trend affects the entity, management commentary might need not only need to indicate what has been or could be affected (as discussed in paragraph 64 above) but also what those effects are. Specifically, management commentary may need explain whether those effects are positive or negative and may also need to describe the outcomes in the reporting period or the range of potential outcomes in the future.
66. For example, outcomes that may need to be discussed in management commentary include:
- (a) new opportunities that management plans pursue (a positive effect);
  - (b) new risk identified or an increased exposure in a previously identified risk (a negative effect);

- (c) a decrease in exposure to a previously identified risk (positive effect); or
- (d) outcomes indicating whether the entity’s business model is operating as intended or whether management’s strategy has been effective (a positive or negative effect).

67. Some factors and trends in the external environment could create both a risk and opportunity for an entity (for example, for a tobacco company a population’s increased focus on a healthy life style creates both a risk to continued demand and an opportunity to develop less unhealthy alternatives).

68. In explaining how factors and trends have affected or could affect an entity, management commentary may need to:

- (a) provide both qualitative and quantitative information. For example, in explaining how the factor or trend has affected the operation of the entity’s business model in the reporting period, management may need to refer to discussion of the entity’s performance, position and progress;

***Link to other areas of content—performance, position and progress***

- The staff plan to cover guidance on management performance measures in discussing performance, position and progress.

- (b) discuss both how the factor or trend has affected the entity and how it could affect the entity in the future, including over the short, medium and long term. Particular factors and trends such as currency fluctuations and commodity prices may have a significant effect in the short term but not result in any lasting consequences. Other factors and trends such as climate change may have limited immediate effects but may affect an entity significantly over the long term.
- (c) describe any uncertainties related to the factor or trend (for example, it is uncertain whether mortality trends over the last few decades will continue in future decades).

***Note on next steps—more than one business model***

- Some factors or trends might affect the entity as a whole and some others may affect a particular business model within a large company, or they might affect different business models in different ways. Accordingly, some information would need to be provided at the entity level and some would need to be provided at the business model level, if an entity has several business models. The staff plan to address in a future paper how to provide information about several business models, including how reporting several business models interacts with segment reporting applying IFRS Standards.

***How management responds to factors and trends in external environment***

69. As described in paragraph 22, investors want to understand how effectively management monitors and responds to factors and trends in an entity's environment, for example by identifying and pursuing opportunities or managing risks. Accordingly, management commentary could cover how management has responded or plans to respond to the factor or trend and how successful management's past responses have been, including information about how management adjusted:
- (a) the entity's business model (for example, an outsourcing business may identify significant changing patterns in its primary customers' procurement strategy and explain how it plans to adjust its business model to continue operating);
  - (b) management's strategy (for example, an entity in the extractives industry may explain that it is developing a cutting-edge new strategy to address challenges presented by the climate change);
  - (c) the use of resources and relationships (for example, a technology designer may explain that it identified increased competition from substitute products and explain management's plans for how the entity will continue meeting the needs of its customer base); and

- (d) the entity's management of risks (for example, a credit scoring business may explain the developments in data privacy legislation and how it plans to enhance its controls over data security).

***Link to other areas of content—business model, strategy, resources and relationships and risks***

- In discussing how management responds to a particular factor or trend in the external environment that affects the entity's business model, management's strategy, the entity's resources and relationships or its risks, management should also consider guidance for the related areas of content.

**Question 3 for the Board**

Paragraphs 58–69 provide staff's discussion of the possible guidance supporting the disclosure objective for external environment that could be included in the revised Practice Statement. Do you have any questions or comments on that discussion?



## Appendix A—Extracts from Practice Statement 1 *Management Commentary on external environment*

### Nature of the business (*emphasis added*)

- 26 Management should provide a description of the business to help users of the financial reports to gain an understanding of the entity and of *the external environment in which it operates*. That information serves as a starting point for assessing and understanding an entity's performance, strategic options and prospects. Depending on the nature of the business, management commentary may include an integrated discussion of the following types of information:
- (a) *the industries in which the entity operates;*
  - (b) *the entity's main markets and competitive position within those markets;*
  - (c) *significant features of the legal, regulatory and macro-economic environments that influence the entity and the markets in which the entity operates;*
  - (d) the entity's main products, services, business processes and distribution methods; and
  - (e) the entity's structure and how it creates value.

### Objectives and strategies (*emphasis added*)

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

**Appendix B—Summary of feedback from the Management Commentary Consultative Group (MCCG)—external environment**

In April 2019, the MCCG discussed the staff’s initial ideas for possible guidance on management commentary on an entity’s external environment. In presenting those ideas, the staff combined guidance on the external environment with guidance on risks.

In December 2019, the MCCG discussed revised ideas, which included disclosure objectives and clarifications about how the staff intended to address:

- opportunities arising from the external environment that management intends to pursue; and
- mega trends that arise over the long-term, such as technological changes.

The following table summarises the feedback received from members of the MCCG on the ideas presented by staff and explains how the feedback has been considered in developing the staff recommendations in this paper.

<b>Feedback</b>	<b>Staff’s response</b>
Overall, members confirmed the conclusion of the staff’s research that one of the primary gaps in current management commentary reporting practice is a narrow view of the operating environment with insufficient detail to help users assess the implications for the entity’s prospects.	The staff have discussed that gap in reporting practice with the Board and the MCCG and used these gaps in developing a draft of additional guidance.

<b>Feedback</b>	<b>Staff's response</b>
<p>Suggestion that the Practice Statement should address mega trends, such as major technological changes.</p>	<p>The staff recommend requiring a description of key factors and trends in the external environment that could affect the entity. The staff have explained that such factors include industry-specific or entity-specific factors as well as macroeconomic factors. And that macro-economic factors include political, economic, social and cultural, technological, environmental, and legal and regulatory factors.</p> <p>The staff do not think the revised Practice Statement should list so-called 'mega-trends' that may need to be considered because we do not think we could anticipate the mega-trends that may most significantly affect an entity now or in the future.</p>
<p>Suggestions that discussion in management commentary about factors in the entity's external environment that affect the entity should be linked to discussion of resources and relationships—for example, discussion of declining resource availability—and should distinguish between resources that the entity controls and those that form part of its environment.</p>	<p>The disclosure objective recommended in this paper would require management commentary to discuss the effect of factors and trends in the external environment on the entity's resources and relationships—both in how factors and trends affect the entity and how the entity responds to factors and trends. Requirements for the entity's own resources and relationships will be discussed in requirements and guidance on the content area of resources and relationships whereas requirements for resources or relationships held by other parties will be discussed in requirements and guidance on the content area of external environment.</p> <p>The explanation of the link will create the required distinction between resources and relationships used by the entity and those accessed through the wider external environment.</p>
<p>Suggestion in April 2019 that the Practice Statement should include guidance on reporting relevant environmental, social and governance (ESG) information because this was a challenging area for preparers.</p> <p>However, in December 2019, members expressed overall support for</p>	<p>The staff recommend that the identification of intangible resources and relationships and environment and social matters to report in management commentary should be based on materiality, supported by guidance on identify 'key' resources, relationships and matters. Consideration of wider macroeconomic factors includes both social and environmental aspects of the external environment. Governance</p>

<b>Feedback</b>	<b>Staff's response</b>
the proposal that identification of intangible resources and relationships and ESG matters to report in management commentary should be based on materiality .	matters are beyond the scope of management commentary as noted below.
Suggestion that the revised Practice Statement should clarify that assessments of materiality are not based solely on quantitative factors, and should extend to the long term.	The staff recommend a concept of 'key' items, and to require disclosure of information that affects the entity's ability to create value and generate cashflows, including over the long term. The staff intend the discussion of materiality to clarify that assessments of materiality consider both qualitative and quantitative factors.
Suggestion that the revised Practice Statement does not need to provide guidance on reporting governance matters because such matters are typically covered by other reporting requirements and are outside the remit of management commentary.	The staff agree governance matters are beyond the scope of management commentary. However, the paper does discuss management stewardship of an entity's economic resources though how management monitors and responds to its external environment.
One member suggested that management commentary should provide information about the potential effect of intangibles and ESG matters on prospects for the entity's future cash flows. However, another member argued that providing such estimates could lead to litigation.	The staff recommend that management commentary should provide information that could help investors understand the potential effect of a matter on the entity's prospects for future net cash inflows, but should not be required to forecast the outcome.

## Appendix C—Overview of other standard-setters’ requirements or guidance on external environment

The staff reviewed reporting frameworks issued by other standard-setters to identify themes reflected in their requirements or guidance on external environment disclosures. The staff’s review covered responses from 24 national standard-setters to the staff’s request for information about requirements and commonly applied non-mandatory guidance in their jurisdictions.<sup>10</sup> The staff also reviewed EU Non-financial Reporting Directive (2014/95/EU) and the related European Commission Guidelines on non-financial reporting, and the International Integrated Reporting <IR> Framework, because some jurisdictions require or encourage management to refer to these sources in preparing management commentary.

The following tables and guidance summarise, for the frameworks that provide requirements or guidance on external environment disclosures:

- a) the scope of the guidance on the external environment; and
- b) specific aspects or areas of the external environment addressed by the guidance.

### A. Table: Scope of the other standard-setters guidance

Country	Includes a requirement to disclose information about the external environment?	Requirement is in a separate external environment section?	If not, the section that includes the requirement. <sup>11</sup>	Trends and factors mentioned in any section of the requirements or guidance.
Namibia	X	N/A		
South Africa	All listed companies in South Africa are required to apply the <IR> Framework.			
Hong Kong	✓	X	Additional disclosure and separate environmental social and governance report	✓
Indonesia	✓	✓	Corporate social and environmental responsibility only	X
Japan	✓	X	Operating policy, operating policy and tasks to address	✓
South Korea	✓	X	Business Model	✓
Malaysia	✓	X	Disclosed as part of a forward-looking statement	✓
Australia	✓	X	Subpart ‘Prospects for future financial years’ groups external	X

<sup>10</sup> See Appendix A of November 2018 Agenda Paper 15B *Summary of research into the objective of management commentary* for further details.

<sup>11</sup> Different frameworks have different ways of describing areas of content to be covered in management commentary. We have noted the locations of types of information or factors that we would regard as relating to the entity’s external environment.

Country	Includes a requirement to disclose information about the external environment?	Requirement is in a separate external environment section?	If not, the section that includes the requirement. <sup>11</sup>	Trends and factors mentioned in any section of the requirements or guidance.
			environment and risks.	
New Zealand	✓	X	Material environmental, social and governance (ESG) factors and practices	✓
Canada	✓	X	Business model	✓
Mexico	X		N/A	
USA	✓	X	Part of an overall list of requirements	✓
Germany	✓	✓	N/A	X
Italy	✓	X	Business Model	X
France	✓	X	Business Model – with reference to environment and social consequences of the business	✓
Georgia	✓	X	Business model–‘Review of the business’	✓
Greece	✓	X	Business Model	X
Portugal	X		N/A	
Russia	✓	X	Risks	✓
United Kingdom	✓	✓	N/A	✓
EU	✓	X	General Context	✓
International	✓	✓	N/A	✓

**B. Guidance on specific aspects of the external environment:** The table below contains extracts from three of the frameworks that address specific aspects of the external environment in most detail.

Guidelines or requirements	Extract
International Integrated Reporting <IR> Framework	<p><b>4A Organizational overview and external environment</b></p> <p>4.4 An integrated report should answer the question: What does the organization do and what are the circumstances under which it operates?</p> <p>4.5 An integrated report identifies the organization’s mission and vision, and provides essential context by identifying matters such as:</p> <ul style="list-style-type: none"> <li>• The organization’s: <ul style="list-style-type: none"> <li>○ culture, ethics and values</li> <li>○ ownership and operating structure</li> <li>○ principal activities and markets</li> <li>○ competitive landscape and market positioning (considering factors such as the threat of new competition and substitute products or services, the bargaining power of customers and suppliers, and the intensity of competitive rivalry)</li> <li>○ position within the value chain</li> </ul> </li> </ul>

	<ul style="list-style-type: none"> <li>• Key quantitative information (e.g., the number of employees, revenue and number of countries in which the organization operates), highlighting, in particular, significant changes from prior periods</li> <li>• Significant factors affecting the external environment and the organization’s response.</li> </ul> <p><b>External environment</b></p> <p>4.6 Significant factors affecting the external environment include aspects of the legal, commercial, social, environmental and political context that affect the organization’s ability to create value in the short, medium or long term. They can affect the organization directly or indirectly (e.g., by influencing the availability, quality and affordability of a capital that the organization uses or affects).</p> <p>4.7 These factors occur in the context of the particular organization, in the context of its industry or region, and in the wider social or planetary context. They may include, for example:</p> <ul style="list-style-type: none"> <li>• The legitimate needs and interests of key stakeholders</li> <li>• Macro and micro economic conditions, such as economic stability, globalization, and industry trends</li> <li>• Market forces, such as the relative strengths and weaknesses of competitors and customer demand</li> <li>• The speed and effect of technological change</li> <li>• Societal issues, such as population and demographic changes, human rights, health, poverty, collective values and educational systems</li> <li>• Environmental challenges, such as climate change, the loss of ecosystems, and resource shortages as planetary limits are approached</li> <li>• The legislative and regulatory environment in which the organization operates</li> <li>• The political environment in countries where the organization operates and other countries that may affect the ability of the organization to implement its strategy.</li> </ul>
<p>[UK] FRC Guidance on the Strategic Report</p>	<p>7A.21 To the extent necessary for an understanding of the development, performance or position of the entity’s business, the strategic report must include the main, trends and factors likely to affect the future development, performance and position of the entity’s business .</p> <p>7A.22 Trends and factors affecting the business may arise as a result of the external environment in which the entity operates or from internal sources. They may have affected the development, performance or position of the entity in the year under review or may give rise to opportunities or risks that may affect the entity’s future prospects. In considering the external trends, it is important that entities consider both the trends in the market in which the entity operates and the trends and factors relating to society more generally. For instance, an entity should consider the risks and opportunities arising from factors such as climate change and the environment, and where material, discuss the effect of these trends on the entity’s future business model and strategy.</p> <p>7A.23 The strategic report should also cover other significant features of its external environment and how those influence the business. This could include trends in the regulatory, macro-economic environment and changes in societal expectations. The strategic report should set out the directors’ analysis of the potential effect of the trends or factors identified on the future development, performance or position or future prospects of the entity.</p> <p>7A.24 The discussion of internal trends and factors will vary according to the nature of the business, but could, for example, include the development of new products and services or the benefits expected from capital investment.</p>

	<p>7A.25 Where practicable and relevant, the trend or factor should be quantified and the source of the evidence underpinning it identified.</p> <p>7A.26 Given the influence trends and factors might have on many aspects of the entity’s development, performance, position or future prospects, the linkage of this type of information to other areas of the strategic report and the annual report more broadly will be particularly important.</p>
<p>[Germany] German Accounting Standard No. 20 (GAS 20) <i>Group Management Report</i></p>	<p><b><i>Report on economic position</i></b></p> <p><b>53.</b>  <b>The group management report shall present, analyse and assess the course of business (including the business performance) and the position of the group. The macroeconomic and sector-specific environment shall also be discussed. This report should enable a knowledgeable user to obtain an overview of the development of the group during the reporting period and the economic position of the group at the reporting date.</b></p> <p><i>Macroeconomic and sector-specific environment</i></p> <p><b>59</b>  <b>The macroeconomic and sector-specific environment for the group’s business activities shall be presented and discussed to the extent necessary for an understanding of the analysis of the course of business and the economic position of the group.</b></p> <p>60  The sector-specific environment includes in particular the sector’s economic situation and the group’s competitive and market position.</p> <p><b>61</b>  <b>Significant changes in the macroeconomic or sector-specific environment compared with the previous year shall be presented and their significance for the group shall be assessed.</b></p>