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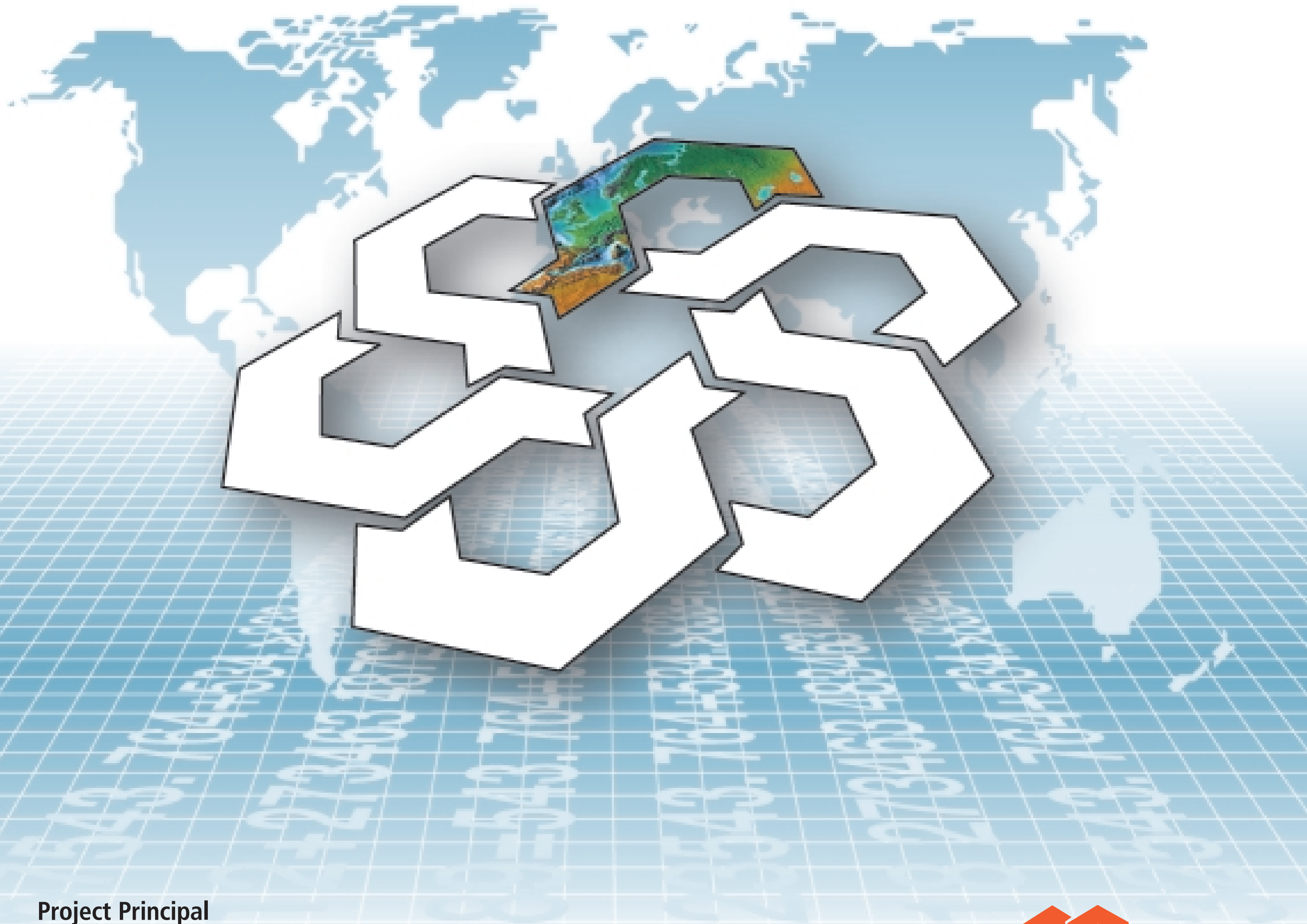
DISCUSSION PAPER

# Management Commentary

## A paper prepared for the IASB by staff of its partner standard-setters and others

Comments to be submitted by 28 April 2006




**Project Principal**
Alan Teixeira

**Project Team**
Regine Buchheim
Chris Hicks
Janice Lingwood
David Loweth
Alan Willis



International Accounting Standards Board®

Discussion Paper

# Management Commentary

A paper prepared for the International Accounting Standards Board
by staff of its partner standard-setters and others
and published for comment by
the International Accounting Standards Board

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This Discussion Paper *Management Commentary* is published by the International Accounting Standards Board (IASB) for comment only. The Discussion Paper was prepared by staff of three of the IASB's partner standard-setters and the Canadian Institute of Chartered Accountants and presents the preliminary views of the authors. Accordingly the recommendations do not necessarily represent the views of the IASB or its partner standard-setters.

The IASB is publishing this Discussion Paper to contribute to the debate on management commentary and to seek views on the topic from interested parties. Comments on the Discussion Paper should be submitted in writing so as to be received by **28 April 2006**.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence. If commentators respond by fax or email, it would be helpful if they could also send a hard copy of their response by post. Comments should preferably be sent by email to: **CommentLetters@iasb.org** or addressed to:

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## The Management Commentary project

The meeting held in October 2002 between the International Accounting Standards Board (IASB) and its partner national standard-setters recommended that work should begin on a project to examine the potential for the IASB to develop standards or guidance for management commentary (MC).* There was general acknowledgement that guidance on this topic was needed and that preparers of financial statements were looking to both the IASB and the International Organization of Securities Commissions (and others) to provide it. Views were divided on the status any IASB guidance should have. Some wished to see a mandatory standard while others preferred non-mandatory guidance.

The consensus at that meeting supported the eventual inclusion in IAS 1 *Presentation of Financial Statements* of a requirement to prepare a narrative report, coupled with non-mandatory implementation guidance on what ought and ought not to be included in such a report. This was to be the starting point for the MC project team.

The Board asked the Financial Reporting Standards Board (FRSB) of the Institute of Chartered Accountants of New Zealand to provide staff to lead the project. The UK Accounting Standards Board (ASB), the Canadian Institute of Chartered Accountants (CICA) and the Deutsches Rechnungslegungs Standards Committee e.V. (DRSC) were asked to provide staff to assist with research and drafting.

The Project Principal is Alan Teixeira. Alan was General Manager – Standards and Quality Assurance at the Institute of Chartered Accountants of New Zealand during the development of the Discussion Paper, but has since joined the staff of the IASB. Other team members are: David Loweth, Secretary of the ASB; Janice Lingwood, a Director at PricewaterhouseCoopers and Consultant to the ASB; Alan Willis, Consultant to the CICA; Chris Hicks, Principal, Knowledge Development, of the CICA; and Regine Buchheim, Project Manager, of the DRSC.

The Board thanks its partner standard-setters for making staff available and funding travel and other costs related to this project. It also thanks the authors.

* Initially, the project team used the term 'MD&A' as a working title for this project. This is the term used in Canada and the United States. However, the ASB in the United Kingdom, for example, refers to 'Operating and Financial Review' and the DRSC in Germany refers to 'Management Reporting'. The generic abbreviation MC is used throughout the Discussion Paper.

 

## Invitation to Comment

The Board has discussed the Discussion Paper at public meetings but has not developed tentative views on its recommendations. The Board has agreed that if it adds the project to its agenda, it will regard the Discussion Paper as the first stage in its due process. In that case, the Board could publish an exposure draft as the next phase of such a project.

The Board invites comments on the Discussion Paper, particularly on the questions set out below. Comments are most helpful if they:

(a) comment on the questions as stated;

(b) indicate the specific paragraph or group of paragraphs to which the comments relate;

(c) contain a clear rationale; and

(d) include any alternative the Board should consider, if applicable.

Respondents need not comment on all of the questions and are encouraged to comment on additional issues in the Discussion Paper.

## Requirements for management commentary (MC)

The project team concluded that an entity's financial report should be viewed as a package comprising the primary financial statements, accompanying notes and MC (section 1). They also concluded that the quality of MC was likely to be enhanced if the Board issued requirements relating to MC (section 6).

Question 1: Do you agree that MC should be considered an integral part of financial reports? If not, why not?

Question 2: Should the development of requirements for MC be a priority for the Board? If not, why not? If yes, should the IASB develop a standard or non-mandatory guidance or both?

Question 3: Should entities be required to include MC in their financial reports in order to assert compliance with IFRSs? Please explain why or why not.

 

## Purpose of MC

The project team concluded that the objective of MC has three elements (section 2). The project team also concluded that the primary focus of MC is to meet the information requirements of investors.

Question 4: Do you agree with the objective suggested by the project team or, if not, how should it be changed? Is the focus on the needs of investors appropriate?

## Principles, qualitative characteristics and content of MC

The project team concluded that it is not appropriate to specify the precise information that must be disclosed within MC, or how it is presented. Rather, they believe that any requirements for MC should set out the principles and qualitative characteristics, as well as the essential areas of MC, necessary to make the information useful to investors. It is up to management to determine what information is necessary to meet these requirements, and to determine how the information is presented. The project team have also suggested that it is appropriate to consider ways to limit the amount of information management discloses, as a way of ensuring that only relevant information is presented to investors (see sections 3 and 4).

Question 5: Do you agree with the principles and qualitative characteristics that the project team concluded are essential to apply in the preparation of MC? If not, what additional principles or characteristics are required, or which ones suggested by the project team would you change?

Question 6: Do you agree with the essential content elements that the project team concluded that MC should cover? If not, what additional areas would you recommend or which ones suggested by the project team would you change?

Question 7: Do you think it is appropriate to provide guidance or requirements to limit the amount of information disclosed within MC, or at least ensure that the most important information is highlighted? If not, why not? If yes, how would you suggest this is best achieved?

Question 8: Does your jurisdiction already have requirements for some entities to provide MC? If yes, are your local requirements consistent with the model the project team has set out? If they are not consistent, what are the major areas of conflict or difference? If you believe that any of these differences should be included in an IASB model for MC please explain why.

 

## Placement criteria

The project team concluded that it would be helpful to establish criteria to guide the Board in determining whether information it requires entities to disclose within financial reports should be placed in MC, or in the general purpose financial statements. The project team have suggested placement criteria (section 5).

Question 9: Are the placement criteria suggested by the project team helpful and, if applied, are they likely to lead to more consistent and appropriate placement of information within financial reports? If not, what is a more appropriate model?

# CONTENTS

## Acknowledgements

The project team gratefully acknowledge the input of Mary Keegan (HM Treasury and formerly ASB), Liesel Knorr (DRSC) and Andrew Lennard (ASB) in the early stages of the project. Feedback from individual IASB members is also acknowledged. The team also thank Michael Butcher, the IASB Editorial Director, for his editorial support.

Any errors remain the responsibility of the authors.

## Abstract

The importance of information accompanying financial statements is acknowledged in the *Preface to International Financial Reporting Standards*. A number of regulators and standard-setters also recognise its importance, as evidenced by the principles and requirements captured in the Management Discussion and Analysis (MD&A) required in Canada and the United States, and recommended by the International Organization of Securities Commissions (IOSCO), the Management Reporting required in Germany and the Operating and Financial Review (OFR) required in the United Kingdom.

We believe the International Accounting Standards Board (IASB) can help improve the quality of financial reports by developing a standard for what we call management commentary (MC).

This paper sets out to identify how the IASB could go about developing requirements for MC. Any IASB requirements would need to sit alongside the requirements that exist in local jurisdictions. We therefore set out to see whether the existing requirements for the disclosure of this 'other information' have common principles and content characteristics. Our goal was to use this analysis to develop an approach that could help bring about convergence in this area.

We found many common threads in our analysis of existing MC principles and requirements. On the basis of our analysis we developed a definition, and objective, of MC. We also developed principles and qualitative characteristics that we believe underlie the preparation and presentation of MC and could be implemented by the IASB.

Rather than specifying disclosure requirements we have developed an MC disclosure framework. This framework identifies the areas that management should consider when preparing and presenting MC. Within this framework, our model relies on management to decide what information should be disclosed, and how it is presented, within MC. We also developed examples to illustrate the type of information we envisage would be in MC under our model.

We view MC as an integral part of financial reporting. The development of MC requirements should not be viewed in isolation. There are several areas where our work overlaps, or has implications for, other IASB projects. There are also implications of our model relating to assurance that are beyond the scope of the IASB.

 

## Section 1 Financial reporting

1 The starting point for this project was a recommendation at a meeting of the IASB and its partner standard-setters that IAS 1 *Presentation of Financial Statements* should eventually include a requirement to prepare a narrative report. Just what the tone, style and content of such a report should be was left to us to discuss. It was clear, however, that the IASB and its partner standard-setters had in mind some type of commentary by management. Management's discussion and analysis (MD&A) is an essential element of the core reporting package for public companies in North America and the meeting discussed whether there should be an equivalent requirement under IFRSs.[1]

2 To assess the viability of the recommendation that emerged from the meeting, and to give substance to what this narrative report should contain, our first step was to consider the relationship between narrative reporting and the financial statements.

### The scope of financial reporting

3 Historically, the IASB has focused its activities on the development of global accounting standards relating to financial statements. However, the Constitution of the IASC Foundation provides for a broader focus in its first objective, which is:

> ... to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements *and other financial reporting* to help participants in the world's capital markets and other users make economic decisions;[2] [emphasis added]

[1] Initially, we used the term 'MD&A' as a working title for this project. This is the term used in Canada and the US. However, the ASB in the UK, for example, refers to 'Operating and Financial Review' and the DRSC in Germany refers to 'Management Reporting'. In this paper we use the generic abbreviation MC.

[2] IASC Foundation Constitution, paragraph 2.

4 This objective is repeated in the *Preface to International Financial Reporting Standards* (IFRSs), which states within the section entitled 'Scope and authority of International Financial Reporting Standards' that:

> Other financial reporting comprises information provided outside financial statements that assists in the interpretation of a complete set of financial statements or improves users' ability to make efficient economic decisions.[3]

5 The objectives and scope in the Constitution and *Preface* indicate that 'other financial reporting' is a legitimate topic for the IASB to consider and, in our view, this could include the MC that we envisage.

## The importance of other information

6 The IASB *Framework for the Preparation and Presentation of Financial Statements* acknowledges that financial statements are not, of themselves, sufficient to meet the objectives of financial reporting.[4] To bridge the gap between what financial statements are able to achieve and the objectives of financial reporting it may be necessary for the financial reports to include additional information.

7 In our view, if financial statements are not sufficient to meet the objectives of financial reporting, then the IASB should consider requiring the disclosure of other information to help the financial reports meet their objective. However, we also acknowledge that this will be achieved only if companies provide clear and meaningful information, and avoid boiler-plate disclosures.[5]

8 Figure 1.1 shows our view of financial reporting. It highlights the difference in scope between the Constitution and the *Framework*. The scope of the *Framework* is being considered within the joint project the IASB has with the US Financial Accounting Standards Board (FASB).

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3 *Preface*, paragraph 7.

4 *Framework*, paragraph 13.

5 The term boiler-plate in this context means a unit or section of writing that can be reused over and over without change. An entity could, for example, make a statement that 'it operates strong corporate governance practices'. This would be considered a boiler-plate statement because it is generic and does not relate the practices to the circumstances of the entity. This expression has been attributed to the US newspaper sector where the term boiler-plate meant a standardised printers plate used by more than one newspaper.

 

The IASC Foundation Constitution and *Preface* refer to financial reporting and acknowledge the role of information accompanying the financial statements in meeting the objectives of the IASB.

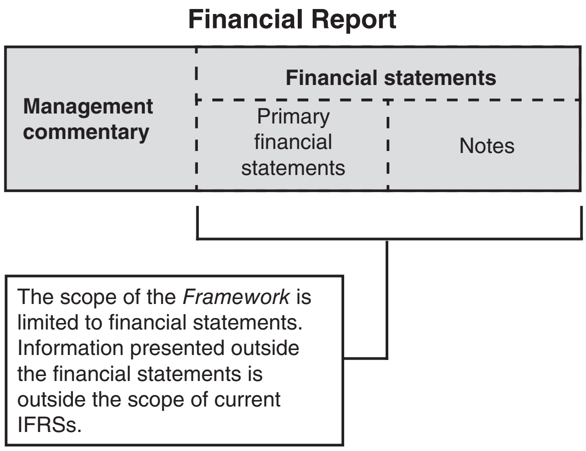


Figure 1.1 The IASC Foundation Constitution, the *Preface* and *Framework* and their relationship to financial reporting

## Section 2 Management commentary

9 The importance of ‘other information’ has long been recognised by regulators and standard-setters. In Canada, for example, the financial statements and MD&A for public companies are required to be approved by the board (or, in the case of interim reporting, the audit committee), and neither document is to be distributed without the other. As long ago as the 1930s Germany had MC requirements and in 1978 the European Union introduced a requirement that the reporting package of financial information consists of financial statements and the annual report. The annual report ‘... must include at least a fair review of the development of the company’s business and of its position.’[6]

10 The involvement of regulators and standard-setters in developing requirements for information accompanying financial statements has increased markedly over the last few years. Unfortunately there is virtually no empirical research to assist in assessing the relative effectiveness of the different approaches to MC and its regulation. We did not set out, and we were not asked, to fill this gap. To do so would require a much deeper analysis of user needs and the relative ability of alternative information to meet those needs.

11 Our objective was to see whether an analysis of the existing requirements for the disclosure of this ‘other information’ would reveal common principles. We also assessed whether there were common expectations of the sort of information we should expect management to provide in financial reports. Our goal was to use this analysis to develop an approach that could help bring about convergence in this area.

12 In the first part of our analysis we reviewed existing requirements and assessed the level of concordance between them. Our focus was, primarily, on the MC requirements and guidance in place in Canada, Germany, the UK and the US, as well as guidance issued by the International Organization of Securities Commissions (IOSCO).[7]

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6 Article 46 of the Fourth Directive of 25 July 1978.

7 See Appendices B-D.

 

13 Where, in our view, the requirements had a common thread we then considered whether those requirements were likely to generate information that would be useful to investors.[8] From there we expressed the concept in a way we believe captured its essence. We also generated examples of the type of information we envisage would be consistent with those concepts.

## What is MC?

14 There is a consistent view among those issuing requirements that MC supplements and complements financial information, providing insights into an entity's performance that financial statements cannot, and should not, be expected to achieve on their own. This might be achieved through the presentation of non-IFRS financial information and non-financial information.

15 MC also provides management with the opportunity to review through its eyes the actual performance and position achieved, and explain how and why the outcomes differ from previous expectations. MC can also provide investors with insights into how the circumstances that an entity faced affected the outcomes, along with a comparison of whether the strategies adopted achieved their objectives. Management therefore provides a rationale and explanation for its current and future strategies and prospects.

16 The Canadian and UK requirements provide definitions of their equivalents of MC. The Canadian definition is that:

> MD&A is a narrative explanation, through the eyes of management, of how your company performed during the period covered by the financial statements, and of your company's financial condition and future prospects.[9]

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8 We focused on investors for the reasons explained in paragraph 25. For this part of the assessment we relied on academic research and the research outputs of the PricewaterhouseCoopers *ValueReporting* initiative.

9 See paragraph B8.

17 The UK Reporting Standard 1 *Operating and Financial Review* (UK RS 1) defines it as follows:

> An OFR is a narrative explanation, provided in the annual report, of the main trends and factors underlying the development, performance and position of an entity during the financial year covered by the financial statements, and which are likely to affect the entity's future development, performance and position.[10]

18 Other jurisdictions describe MC although often no formal definition is given. For example, IOSCO refers to a 'narrative explanation' that accompanies financial statements to improve disclosure and transparency.[11]

19 We view MC as the primary component of the information within the term 'other financial reporting provided outside the financial statements' referred to in the *Preface* and we define it as follows:

> Management commentary is information that accompanies financial statements as part of an entity's financial reporting. It explains the main trends and factors underlying the development, performance and position of the entity's business during the period covered by the financial statements. It also explains the main trends and factors that are likely to affect the entity's future development, performance and position.[12]

20 The main differences between our definition and the Canadian and UK definitions are:

(a) we have not used the term 'narrative', as it could be interpreted by some to mean that MC does not need to contain quantified measures. As we discuss later, we believe that quantified performance measures and indicators are an essential element of MC.

(b) we have not included the phrase 'through the eyes of management'. We prefer to express this as a principle underpinning MC.

(c) a reference to 'the main trends and factors that are likely to affect the entity's future' has been added. We did so to make it clear

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10 See paragraph B28.

11 See the IOSCO principles in paragraphs B1 and B2.

12 In some jurisdictions reference is made to 'condition' rather than 'position'. They are taken to mean the same thing in this paper.

 

that an assessment of trends and factors is not limited to those that occurred 'during the period covered by the financial statements'. Management is also expected to comment on those trends and factors it expects to be important in future periods.

21 Historically, the purpose of MC appears to have been limited to providing a narrative explanation of the performance, position and future prospects of the entity. One exception is in the EU, where legal requirements have for many years required 'at least a fair review of the *development* of the company's business and of its position'.[13] [emphasis added] We thought it appropriate for the definition of MC to encompass how the entity has grown or changed in the current year, as well as how it expects to grow or change in the future. The term 'development' is intended to reflect this aspect.

22 Another key element of the definition is that MC 'accompanies financial statements and explains the main trends and factors underlying the development, performance and position …' Accordingly, MC should not be seen as the vehicle for presenting an alternative set of financial statements. It is meant to 'accompany' and 'explain' the financial statements.

23 As far as positioning goes, MC may accompany the annual financial statements in a printed report to shareholders or, as it is in some jurisdictions, be contained within separate annual regulatory filings.[14] We considered whether it would be desirable to incorporate MC within the financial statements, perhaps by adding textual material and other information within the explanatory notes. We rejected this idea on the ground that MC should complement and supplement the financial statements. In our view, MC should sit alongside the financial statements and not be placed within them.[15]

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13 Article 46 of the Fourth Directive.

14 In this paper financial statements are defined as the collective primary financial statements along with notes, comprising a summary of significant accounting policies and other explanatory notes. This is consistent with IAS 1, paragraph 8.

15 We also believe that if the MC has been prepared in accordance with the IASB's requirements it should be necessary to make an assertion to that effect. It would be more appropriate to place this assertion within the MC than within the financial statements.

 

## The users of MC

24 Defining the scope of MC and specifying the classes of users whose needs are expected to be met by MC were among the more contentious issues we considered. The UK ASB and German DRSC both experienced great interest in these aspects when developing their MC requirements. We decided early in our deliberations that the key to identifying the essential content elements of MC was specifying the users of the financial statements.

25 The *Framework*, which applies to general purpose financial statements but not MC, sets out seven classes of users. However, it goes on to conclude that the focus should be on investors for financial statement purposes 'as investors are the providers of risk capital'.[16] We believe that the primary focus of MC should be the same as for the financial statements it accompanies, namely investors in publicly listed companies. This is consistent with the comparative analysis, which indicated a strong preference for focusing on the needs of investors.

26 Notwithstanding our view, we considered whether the scope of MC should extend to meeting the needs of a wider set of users. After all, the range of information often observed accompanying financial statements is wide. This might suggest, to some, that management views the scope of MC, and its intended audience, as also being wide. Furthermore, despite a preference for an investor focus our analysis of existing guidance and regulations shows that some jurisdictions acknowledge the rights of a wider set of 'users'.[17]

27 In most jurisdictions the users of MC are confined to 'investors', or even a narrower group such as current shareholders. In some territories there has been much debate about which users should be the focus of MC—with many constituents taking the view that MC should meet the needs of all stakeholders.

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[16] *Framework*, paragraph 10.

[17] The term 'user' is used in the German GAS 15. Furthermore, the UK DTI consultative document states that the OFR will be 'relevant to all users of accounts who include … creditors … and other stakeholders (including employees) and the wider public, who have a … relationship with the business.' That said, the UK legal requirements for the OFR make clear that the review is addressed to 'members' (ie current shareholders) of the business. In North America, the regulators have always recognised investors as the primary users of MC.

 

28 As we noted earlier, the *Framework* considers a wider range of users than investors. Importantly, it asserts that financial statements are 'directed toward the common information needs of a wide range of users.'[18] In the case of general purpose financial statements, their role is generally confined to financial information. Amounts recognised within the financial statements must fit within the element definitions and recognition criteria. This provides a financial model that is well understood and focused on investor information requirements.

29 Outside the financial statements, the information models are less well defined. Take for example the information needs of employees. As noted in the *Framework*, employees are concerned 'about the stability and profitability of their employers', as well as 'information which enables them to assess the ability of the entity to provide remuneration, retirement benefits and employment opportunities.'[19] Outside the financial statements, the information needs will vary by employee, and could include training and development opportunities, maternity/ paternity and disability pay regimes, rates of employee involvement, as well as diversity and work/life balance issues. As noted by a task force on employees in the UK:

> … there is no single set of HCM (Human Capital Management) practices widely accepted as "best practice" applicable to all organizations, nor agreement on a set of universally relevant indicators.[20]

30 In our view, the information provided by MC should focus on meeting the needs of investors. It should not be expanded to fulfil the information needs of an extended range of users. Furthermore, MC should not be seen as a replacement for other forms of reporting addressed to a wider stakeholder group.[21] For example, sustainability and corporate social responsibility reports are prepared by many companies nowadays and are aimed at the needs of a broad class of stakeholders.

18 *Framework*, paragraph 6.

19 Ibid., paragraph 9(b).

20 Task Force on Human Capital Management *Accounting for People.*

21 This is also the view explicitly expressed in the UK ASB's RS 1 paragraph 8.

31 The existence of an IASB standard or guidance on MC that focuses on the needs of investors would not prevent a jurisdiction from developing reporting requirements for the benefit of other defined users, but we believe that any such requirements would be outside MC unless they align with the objectives of MC and financial reporting.

## The objective of MC

32 In considering what could be an appropriate objective of MC, we were guided by the objectives stated in existing requirements and guidance. Our review included those of the US Securities and Exchange Commission (SEC), one of the earlier requirements that is still in force (see paragraph B30), and the Companies Act 1985 (OFR and Directors' Report etc) Regulations 2005 in the UK, the latest jurisdiction to mandate such reporting (see paragraph B25). Interpretative guidance issued by the SEC in December 2003 states that the purpose of MC is 'not complicated'. It is to provide readers with information 'necessary to an understanding of [a company's] financial condition, changes in financial condition and results of operations.'[22] This is consistent with the *Preface*, if one views MC as being part of 'other financial reporting'. Put simply, MC provides context to the financial statements.

33 Some jurisdictions build many concepts into their MC objective, such as the nature of MC. We took the view that a simpler expression of the objective could be developed with the additional concepts discussed separately.

34 We believe that the objective of MC has three elements: it is to provide information to help investors:

- to interpret and assess the related financial statements in the context of the environment in which the entity operates;
- to assess what management views as the most important issues facing the entity and how it intends to manage those issues; and
- to assess the strategies adopted by the entity and the likelihood that those strategies will be successful.

35 Fulfilling this objective may mean that MC contains non-IFRS financial and non-financial measures, as well as narrative explanations. The next sections explore these aspects in more detail.

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[22] SEC - Item 303 of Regulation S-K.

 

## Section 3 The characteristics of high quality MC

36 Having defined MC and specified its objective, we embarked on our next step—to determine the concepts that underlie the preparation and presentation of MC for investors. This was largely completed using the cross-jurisdictional analysis documented in Appendices C and D.

37 In developing the discussion we were keen to use a framework and language that would be familiar to readers. Despite strongly converging themes, each party developing MC guidance or requirements has its own way of describing the concepts underpinning MC. To illustrate, the notion of MC being expressed 'through the eyes of management' is common to all the MC literature we reviewed. Yet the SEC and IOSCO build this concept into the objective of MC, the CICA, ASB and DRSC treat this as a principle and the Australian Group of 100 top listed entities (G100) does not provide a label. IOSCO classifies the main features within objectives, principles and precautions whereas the CICA uses objectives and principles and the SEC, generally, avoids categorisation.

38 We agreed that it is helpful to organise the characteristics for discussion purposes. In this section the characteristics of high quality MC are organised into principles and qualitative characteristics.

39 Although there are obvious wording differences and emphasis, the comparative analysis indicated a high level of agreement about the principles and qualities MC should possess. Given this concordance we focused on developing wording that would capture these concepts in an IASB context. We concluded that MC should:

(a) supplement and complement financial statement information;

(b) provide an analysis of the entity through the eyes of management; and

(c) have an orientation to the future.

40 MC should also possess the attributes that make the information useful to investors, which this DP refers to as qualitative characteristics; namely: understandability, relevance, supportability, balance and comparability over time.

## Principles

### Supplement and complement financial statement information

41 This principle is effectively formalising a statement already made in the *Preface*, namely that:

> Other financial reporting comprises information provided outside financial statements that assists in the interpretation of a complete set of financial statements or improves users' ability to make efficient economic decisions.[23]

42 In supplementing the financial statements, MC includes additional explanations of amounts reported in the financial statements and explains the conditions and events that shaped the information in the financial statements.

43 In complementing the financial statements, MC includes financial and non-financial information about the business and its performance that is not reported in the financial statements.

44 Supplementing and complementing are not the same as replicating. Indeed, replicating financial statement information in MC should be avoided unless it is necessary to provide context for the commentary. We note that the close relationship between the financial statements and MC implies that MC must be consistent with the financial statements. For example, when key measures are held out as being extracted from the financial statements they must be consistent with the IFRS measures, or reconciled if they differ (see also paragraphs 89-95).

45 The purpose of MC is to focus on those matters affecting the development, performance and position of the reporting entity, both current and future. MC is not intended to supplement or complement (extend) the objective of financial reporting.

### *Through the eyes of management*

46 All five of the current requirements or guidance reviewed feature 'through the eyes of management' as a guiding principle. This, no doubt, shows the influence of the US SEC requirements for MD&A, where the

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23 *Preface*, paragraph 7.

 

principle reflects the intent of the regulatory requirements. Since the 1980s the SEC has stated that the first of the three principal objectives of MD&A requirements is:

> … to provide a narrative explanation of a company's financial statements that enables investors to see the company through the eyes of management.[24]

47 This requirement has also been enshrined in securities regulation in Canada, and appears as the first principle in the UK RS 1.

48 Clearly then, the cross-jurisdictional analysis highlights wide agreement on this principle. External research undertaken by PricewaterhouseCoopers (PwC) across 14 countries, and 16 industries, involving more than 3,100 participants, suggests that users' needs are consistent with this principle. This research suggests that, with few exceptions, the information important to management in managing the business is the same information that is important to investors in assessing performance and future prospects.[25]

49 The adoption of this principle raises the issue of what is meant by 'management'. IFRS 7 *Financial Instruments: Disclosures* uses the term 'key management personnel' as defined in IAS 24 *Related Party Disclosures*, meaning 'those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.'[26]

50 In the UK, the OFR regulations require an OFR to be 'the directors' analysis'. Accordingly, management is taken to mean the entity's directors. Furthermore, it is the directors who are responsible for approving the OFR. There is a similar requirement in Canada and Germany.

51 Determining who prepares and approves MC is likely to depend on jurisdictional requirements. In order to allow for jurisdictional differences, and reflecting the definition of 'key management personnel' already adopted in IFRSs, we define management as:

> those responsible for the decision making and oversight reflected in the MC, who may include executive employees and members of a governing body.

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[24] SEC - Item 303 of Regulation S-K.

[25] PwC Trends 2005.

[26] IAS 24, paragraph 9.

### An orientation to the future

52 Ever since MD&A was introduced in North America in the 1980s, it has had a forward-looking as well as historical orientation. The analysis in Appendix C highlights that this principle, 'an orientation to the future', is now shared by all five of the jurisdictions featured. In the same way that the principle 'through the eyes of management' has its roots in regulation, so does this principle. The third of the SEC objectives is:

> ... to provide information about the quality of, and potential variability of, a company's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance.[27]

53 Again, this US regulatory requirement for a focus on information that helps investors assess future prospects is found in other jurisdictional requirements, such as Canadian securities regulations and the European Modernisation Directive. The Directive has in turn influenced various regulations, such as those in Germany and the UK.

54 The *Framework* implicitly recognises that users require both historical and forward-looking information in order to make economic decisions:

> ... financial statements do not provide all the information that users may need to make economic decisions since they largely portray the financial effects of past events ...[28]

55 Our definition and objective of MC both build on a forward-looking orientation. The definition of MC refers to '... main trends and factors that are likely to affect the entity's future development ...' One of the elements of the objective of MC refers to '... assessing the strategies adopted by the entity and the potential for successfully achieving those strategies.' Establishing 'an orientation to the future' as a separate principle is simply reinforcing one of the fundamental aspects of MC.

56 An 'orientation to the future' is about communicating, through management's eyes, the *direction* the entity is taking, by, for example, setting out future strategies and goals.

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27 SEC - Item 303 of Regulation S-K.

28 *Framework*, paragraph 13.

57 How, and the extent to which, MC is oriented towards the future will be influenced by the regulatory and legal environment within which the entity operates. Explanations of past events can help investors develop models of the entity from its past performance and current state. Although disclosure of forward-looking information is encouraged in many jurisdictions this does not equate to making forecasts or projections. In some jurisdictions there are 'safe harbour' provisions to restrict liability claims or regulatory provisions, or both, that require cautionary statements relating to forward-looking information. These involve identifying the forward-looking information as such, explaining the assumptions that were applied, and any material factors that could cause results to differ.

## Qualitative characteristics

58 As we noted earlier, the *Framework* was developed to relate to the financial statements. The *Framework* itself excludes MC from its scope. In contrast, the FASB Concepts Statements apply to general purpose financial reporting: they cover financial statements as well as other financial and non-financial information including, for example, 'descriptions of an enterprise's social or environmental impact …'[29]

59 The IASB and FASB have a joint project to achieve the convergence of the US and IASB frameworks. The scope of the frameworks has already been identified as a convergence issue by that joint project team. Notwithstanding the status of the *Framework,* we considered the applicability of its qualitative characteristics and reporting objectives to MC, as well as other qualitative characteristics that might help make information in MC useful to investors.

60 The *Framework* identifies four qualitative characteristics considered important in ensuring that financial statements achieve their objective, namely: *understandability, relevance, reliability* and *comparability*. Given that MC supplements and complements the financial statements we concluded that these characteristics should be considered in relation to MC. If MC is intended to help investors understand the financial statements, we should expect MC to meet, as far as possible, qualitative standards similar to those applicable to the financial statements.

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[29] FASB CON 1, paragraphs 5-8.

 

61 We consider the four qualitative characteristics in the following paragraphs. We believe that *understandability* and *relevance* should be applicable in the preparation of MC and accordingly should be reflected in the qualitative characteristics. Rather than using the *Framework* terms *reliability* and *comparability* we use *supportability*, *balance* and *comparability over time*.

62 MC that exhibits all of these qualities—understandability, relevance, supportability, balance and comparability over time—is most likely to meet the needs of investors.

### Understandability

63 Paragraph 25 of the *Framework* states that 'an essential quality of the information provided in financial statements is that it is readily understandable by users.' We regard this characteristic as equally important for MC.

64 MC should be written in plain language and a style appropriate to investors' needs. Graphs, diagrams and tables should be used where these enhance MC. The form and content of MC will vary between entities, reflecting the nature of their business, the strategies adopted and the regulatory environment in which they operate. A contents guide may help investors locate information relevant to their needs.

### Relevance

65 The *Framework* states, at paragraph 26, that 'To be useful, information must be relevant to the decision-making needs of users.' Information has the quality of relevance when it has the capacity to influence the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.

66 We concluded that management should be required to decide what MC information is necessary to meet the objective of MC. In a similar manner the SEC Guidance states that MC disclosure should 'emphasize material information that is required or promotes understanding and de-emphasize (or, if appropriate, delete) immaterial information that is not required and does not promote understanding.'[30] Although the existing definition of materiality was designed for financial information prepared under IFRSs this has not prevented the SEC, for example, using the term in the context of MC.

[30] SEC Interpretation MD&A, III B.

 

67 The onus is on management to determine what information is important enough to be included in MC to enable an investor to 'understand' the financial statements and meet the objective of MC.

68 Providing too much information, such as, for example, disclosing all risks that the entity faces, could reduce the relevance and understandability of MC, as this would simply clutter up MC and obscure the important risks.

69 Materiality implies upper and lower bounds for the provision of information. Failure to disclose material events or uncertainties means users have insufficient information to meet their needs. Unnecessary detail, such as might result from adopting a boiler-plate approach, can, in the SEC's words, 'obscure information'.[31]

70 Generally, disclosure requirements in IFRSs are designed to identify the minimum information that the IASB believes should be disclosed to meet the stated objective of the disclosure. For MC, we believe that consideration should be given to ways to limit disclosure. This is because one of the elements of the objective of MC is to help investors to identify and assess what management views as the most important issues facing the entity, and its approach to those issues. Allowing management to present a plethora of information about all the risks facing an organisation conflicts with that objective.

71 We are aware of anecdotal assertions that most businesses have 'around five' key risk areas or key non-financial measures. But we would not support a requirement that management should identify no fewer than and no more than a set number of disclosures for a content element. The appropriate number of disclosures will reflect the nature of the entity and its activities, and to imply that there is a single optimal number of disclosures conflicts with the objective of MC.

72 In some jurisdictions we believe entities disclose more information in MC than is appropriate because the environment in which the regulations operate forces entities to disclose more, rather than less, information. In those circumstances we believe it would be appropriate for management to rank or classify the information to help investors identify which elements management views as being more important. We are not suggesting that an ordinal ranking is appropriate. Rather, it should be incumbent on management to convey relative importance in a meaningful way.

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[31] SEC Interpretation MD&A, III B.

### *Reliability*

73 Paragraph 31 of the *Framework* states that, to be useful, 'information must also be reliable.' Information has the quality of reliability when it is free from material error, faithfully represents that which it either purports to represent or could reasonably be expected to represent, and is free from bias.

74 We address 'free from material error' and 'represents faithfully' in our discussion of 'supportability' (see paragraph 75). 'Free from bias' is discussed in our section on 'balance' (see paragraph 78).

### *Supportability*

75 It is our view that all the information contained within MC must be supportable. Information is supportable if it faithfully represents factually-based strategies, plans and risk analysis, for example.

76 Some aspects of MC can involve more uncertainty than historical information reported in the financial statements. Measurement uncertainty should not be confused with the idea that MC information should be free from material error. The fact that there is measurement uncertainty is important information. Investors require sufficient information to assess the extent of the uncertainty surrounding the information to enable them to make a judgement regarding the extent to which they will rely on that information. MC should include a cautionary note to ensure that users are made aware of areas of uncertainty; this is likely to be particularly important for forward-looking information. It is also appropriate for management to explain any material assumptions relating to forward-looking information.

77 This is consistent with RS 1 in the UK which states:

> Directors shall consider the evidence underpinning the information to be included in the OFR. Where relevant, directors shall explain the source of the information and the degree to which the information is *objectively supportable*, to allow members to assess the reliability of the information presented for themselves.[32] [emphasis added]

This is also consistent with the German GAS *Management Reporting*.

[32] ASB RS 1, paragraph 20.

### *Balance*

78 We paid special attention to balance, reflecting commonly held perceptions that when MC is unregulated, it tends not to be even-handed, with an overemphasis placed on positive news. The tone or style adopted in narrative reporting is very important.

79 Among the 'precautions' the Technical Committee of IOSCO advises is the need to make 'an objective analysis', which may require the disclosure of information that 'could reflect negatively on the company's financial condition, changes in financial condition and results of operations.'[33]

80 The equivalent to this in the CICA guidance is 'fair and balanced', as part of the principle of 'completeness and materiality'. The guidance goes on to state that MC should be 'free from deliberate or systemic bias' and 'balanced (that is, includes "bad news" and does not focus only on "good news")'.[34] The UK standard suggests that MC should be 'balanced and neutral, dealing even-handedly with both good and bad aspects'.[35] The German standard requires information about opportunities and risks that is free from bias.[36]

81 The EU Modernisation Directive requires 'a balanced and comprehensive analysis'. The SEC guidance on MD&A states that 'whether favorable or unfavorable ... the analysis should consist of material substantive information, and present a balanced view of the underlying dynamics of the business.'[37]

### *Comparability*

82 The *Framework* states that because users 'wish to compare the financial position, performance and changes in financial position of an entity over time, it is important that the financial statements show corresponding information for the preceding periods.'[38] The *Framework* also states that users 'must also be able to compare the financial statements of different

33 IOSCO (2003).

34 CICA MD&A Guidance, paragraph 230.1.

35 ASB RS 1, paragraph 23.

36 GAS 15, paragraph 14.

37 SEC Interpretation MD&A, III B 4.

38 *Framework*, paragraph 42.

entities in order to evaluate their relative financial position, performance and changes in financial position.'[39] Accordingly, the *Framework's* discussion of 'comparability' has two distinct meanings, comparability over time and comparability between entities.

83 Of the two meanings, comparability between entities is the problematic one. This is because MC is designed to reflect the perspectives of management and the circumstances of the entity. As a consequence, MC provided by two entities in the same industry can differ because the managements have different perceptions of what is important and how they measure and report it.

84 We also recognise that there is limited precedent on how to define and calculate non-financial measures and non-IFRS financial measures. Professional firms have, for example, undertaken surveys with the purpose of identifying 'best practice'. However, in many cases those surveys have also highlighted inconsistencies in the definition and calculation of the measures observed.

85 The SEC takes the view that cross-sectional comparison can be enhanced through an understanding of how non-financial 'metrics' have been calculated. The SEC guidance states that, when a company discloses information and there is no commonly accepted method of calculating a particular non-financial metric 'it should provide an explanation of its calculation to promote comparability across companies within the industry.'[40]

86 We believe that the development of measurement standards or guidance would be helpful, but it is not a short-term imperative. As part of the section on the implications of developing IASB requirements on MC we have provided some examples of potential directions for future development (see paragraphs 144-150).

87 The UK RS 1 acknowledges the issues surrounding comparability between entities by qualifying the title of its last principle 'The OFR shall be comparable over time'.[41] Furthermore, the background to the RS states:

> The seventh principle is that the OFR shall be comparable over time. This reflects the principle of comparability in the Board's existing Statement. There is also an encouragement for the OFR to be

39 *Framework*, paragraph 42.

40 SEC Interpretation MD&A, III B 1.

41 ASB RS 1, paragraphs 25 and 26.

 

comparable with reviews prepared by other entities in the same industry or sector, although it is anticipated that such comparability will evolve over time. However, a number of respondents to RED 1 raised concerns that comparability within an industry should not be seen as a major focus. For example, with regard to KPIs, those included in the OFR should be the KPIs used by the directors to manage their own business and monitor progress against stated objectives. The Board shares this view.[42]

88 Given that comparability has two dimensions within the *Framework* we believe that it is better not to use the term 'comparability' on its own, but instead to refer to 'comparability over time'.

### Comparability over time

89 As noted in paragraph 82, we regard the ability to compare information in an entity's financial statements from year to year as included within the *Framework's* qualitative characteristic 'comparability'. As we have indicated, viewing comparability between entities as a qualitative characteristic conflicts with the objective of requiring management to convey what it believes is important. However, we concluded that the ability to compare the MC of an entity over time is important.

#### Consistent disclosures

90 We concluded that MC should include corresponding information for the previous period, which is consistent with the conclusion within the *Framework*, and that the disclosures should align with the financial statements to which they relate. Accordingly, corresponding disclosures should be provided in respect of trends and indicators reflected in MC.

91 Under current financial statement reporting requirements this would require MC to cover the current period and the prior period. This does not mean that the prior period MC would be repeated in the current year. Rather, the current period MC will reflect and discuss changes in previously reported targets, expectations, strategies and content, such as key resources, risks and relationships. For example, if a matter was viewed as a key risk by management in the prior year but is no longer viewed as being crucial this would be explained in the current year's MC. When non-financial and non-IFRS financial measures or trend analysis are reported, corresponding measures for the prior period would be required.

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[42] ASB RS 1, paragraph C32.

 

92 This would not prevent individual jurisdictions from requiring or encouraging longer periods of comparison. Some jurisdictions, for example the German GAS *Management Reporting*, encourage information on key measures for up to five years.

### *Changes in measures*

93 Non-financial and non-IFRS financial measures and indicators will have been calculated on the basis of some predetermined definitions. Management should explain how these key measures and indicators are defined and calculated. Suggestions for the type of information that needs to be disclosed for each key measure are outlined in paragraphs A52-A57.

94 We think it is appropriate that any measures or indicators disclosed in MC should be consistent with those disclosed in the prior period, if they are still used by management to manage the business. Furthermore, the indicators and measures disclosed in MC will be those used by management in monitoring achievement or progress towards stated goals and objectives. Accordingly, it is reasonable to expect that if an entity's strategies change, the measures used to monitor progress against these strategies may also change. In these circumstances, management should explain why it has changed an indicator or measure. That said, we envisage that changes in indicators would not occur every year, but would be triggered by events such as a comprehensive strategic review.

95 Under IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, unless a standard requires otherwise, changes in accounting policies are required to be applied retrospectively. Coupled with this is a requirement to measure any comparative amounts as if the new policy had been applied to them. We believe that a similar approach should be adopted for MC only when the methodology for calculating a measure or indicator is changed. To illustrate, a mobile phone retailer might assess customer satisfaction using churn rates. Changing the denominator from opening customer numbers to average customer numbers is a change in calculation method. The corresponding measures should be adjusted to reflect this new way of measuring churn. In contrast, changing the key measure of customer satisfaction to the number of complaints received is a change in the key measure. An explanation for why the measure was changed would be appropriate. A change in

measure reflects a change in what management thinks is important. Although it is likely to be difficult to calculate retrospectively newly adopted measures and indicators, disclosure would be useful to the investor if the information is available.

## Section 4 MC content

96 This section presents our analysis of what we regard as the essential content elements for MC.

97 Specifying disclosures for MC is more difficult than for information included in financial statements. The types of activities that are critical to an entity will be specific to that entity. As a consequence regulators have tended to identify the key elements that reflect the *type* of content they expect to see in MC rather than defining the elements themselves. Specifying a detailed list also encourages a 'tick box' mentality, which should be avoided.

98 As well as placing the onus on management to decide the actual content of the MC the proposals would also require management to decide the best way to *present* the content. In our view, providing flexibility in both the presentation and content of MC, and using guidance to demonstrate that there are many ways to achieve the objective of MC, reduces the risk that preparers will use standard bland language, repeated year after year.

### MC disclosure framework

99 The comparative analysis provided in Appendix D shows a high level of agreement, in the jurisdictions analysed, on appropriate MC content. We were influenced by the recent UK RS 1, which we believe provides a helpful structure. In drafting recommended wording, however, we modified some terms and explanations used in the UK material, drawing mainly on guidance and standards from the CICA and DRSC.

100 Our assessment suggests that, to meet the objective of MC, an entity should disclose information on:

(a) the nature of its business;

(b) its objectives and strategies;

(c) its key resources, risks and relationships;

(d) its results and prospects; and

(e) its performance measures and indicators.

101 As with the principles, although there was a high degree of agreement on the content elements, we also considered the fundamental question 'Does this present the information that investors need?'

 

102 The *Framework* acknowledges that financial statements alone are not sufficient to enable users to make economic decisions, because they 'do not provide all the information that users may need to make economic decisions since they largely portray the financial effects of past events and do not necessarily provide non-financial information.'[43] We are not suggesting that MC will fill all of the gap, but we believe that MC can add significantly to the information the entity provides to investors in financial reports.

103 Furthermore, a recent survey by Deloitte found that:

> Strikingly, 92% of respondents agreed that financial indicators alone cannot adequately capture their companies' strengths and weaknesses. Although financial measurements received a high rating from survey respondents in helping the board and the CEO make short-term decisions and in formulating strategy, these data are considerably less helpful in making mid- and long-term decisions and in achieving what respondents consider an appropriate valuation in the capital markets.[44]

104 In addition, the PwC research referred to in paragraph 48 asked respondents (management and investors) to rate a number of industry-specific measures. Interestingly:

> Even in the banking and insurance industries, where traditional financial measures might be expected to have greater importance, more than 75 percent of the measures that management and investors ranked as important were contextual and non-financial. In other industries, the disparity was even more pronounced: averages of only 16 percent of the measures ranked as important were financial.[45]

105 PwC has codified the insights gained from its research programme into a corporate reporting framework, which it calls the *ValueReporting* framework. This identifies four broad categories of information that all industries share in common. These categories support the content elements we selected, as illustrated in the following table.

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43 *Framework*, paragraph 13.

44 Deloitte (2004) *In the dark.*

45 PwC Trends 2005.

 

| **Discussion Paper content elements** | ***ValueReporting* categories** |
|---|---|
| Nature of the business | Market overview - consisting of competitive, regulatory and macro environments |
| Objectives and strategies | Strategy and structure |
| Key resources, risks and relationships | Managing for value - financial/physical resources and relationships, processes required to manage company's risks |
| Results and prospects | Performance - both financial and non-financial |
| Performance measures and indicators | Not a separate category in the *ValueReporting* framework, each category is underpinned by measures and indicators |

106 As shown above, the content elements identified in paragraph 100 have also been identified by external research as important to investors. A point to note is that the suggested disclosure around 'resources, risks and relationships' is limited to those that are 'key'.[46] The intention is not that an entity should provide a list of all its resources, risks and relationships, but that it should identify and describe those that are critical to the successful implementation of its strategy and the achievement of its objectives. This is an issue we discussed in paragraph 71.

107 Furthermore, there is a great deal of overlap between the essential content elements proposed in this section for MC and the type of information that auditors should understand about their clients in order to assess the risks of material misstatement, as set out in International Standard on Auditing 315, Appendix 1. The headings provided in the auditing standard are:

(a) Industry, regulatory and other external factors (including the applicable financial reporting framework).

(b) Nature of the entity.

46 In the UK RS 1 the term used is 'principal' rather than 'key'. The Canadian guidance and the German GAS 15 use the term 'key' with regard to 'key performance drivers'.

(c) Objectives and strategies and related business risks.

(d) Measurement (key ratios, operating statistics and key performance indicators) and review of the entity's financial performance.

## Illustrative examples

108 Even though we believe that management should determine MC content and how it is presented, we thought it would be helpful to set out some illustrative examples of MC.

109 With the exception of the UK RS 1, where implementation guidance accompanies but does not form part of the Reporting Standard, very little guidance exists as examples of MC. In developing RS 1, the ASB reviewed a range of material relating to performance measurement, including some specific content elements relating to resources, risks and relationships. The ASB found that there are many performance measures and indicators in use and that their use varies by entity and industry. Furthermore, the ASB noted that numerous publications exist with the aim of providing guidance on content areas envisaged within the disclosure framework. The ASB decided that some guidance on performance measures and indicators, and areas of content, would be useful to preparers. We concur with this view. Accordingly, we have incorporated in this section some illustrative examples that we developed. The examples build on the UK implementation guidance and examples of actual disclosure identified by others as being of high quality.[47]

110 There is a risk that including examples suggests that they are the best or only way of presenting MC. We emphasise therefore that the examples included in this section are illustrative and should not be taken to imply that they are best practice, nor that they feature generally accepted definitions or calculations. We have provided them solely to demonstrate the information that could be included within MC.

111 The examples illustrate how some aspects of essential content elements envisaged within this paper could be presented. They are not intended to illustrate all of the matters we have identified. They are included to help readers see the type of disclosures that are consistent with the principles,

[47] PwC Trends 2005.

 

qualitative characteristics and content suggested by the model we have proposed. They may also be helpful in developing non-mandatory implementation guidance to accompany an MC standard, if the IASB decides to develop such guidance.

### *Nature of the business*

112 One of the elements of the objective of MC is to help investors 'interpret and assess the related financial statements in the context of the environment in which the entity operates'. We regard a description of the business an entity is engaged in and the external environment in which it operates as essential in providing this contextual information.

113 To illustrate, suppose a company operates in the serviced apartments industry. A simple description of its activities could be:

> The company is a leading provider of serviced apartments. It operates in the major cities of Europe and the Far East. The company's presence comprises over 3,250 serviced apartments in 27 cities across 10 countries, with a further 415 apartments due to come on line over the next 12 months.

114 Its management may decide that it is important to describe its segments, service offerings, business structures and apartment locations and number of serviced apartments, as illustrated below, to provide essential contextual information.

| **Continent/Country/City** | **Number of serviced apartments** | |
|---|---|---|
| | Currently open | Opening within 12 months |
| **Continental Europe** | | |
| France | 235 | 33 |
| ***…**details* | | |
| **UK** | | |
| • Birmingham – Grand | 127 | |
| • Bristol - Quay | 95 | |
| • London - Tower | 176 | |
| • London – Queens *(opening next spring)* | | 112 |
| • London – South Bank | 215 | |
| | | *continued...* |

| | | |
|---|---|---|
| Subtotal UK | 613 | 112 |
| **Asia** | | |
| Singapore | 53 | 6 |
| ***...details*** | | |
| Subtotal Asia | 400 | 20 |
| **Total** | 3,271 | 415 |

115 The quantified data might be accompanied by narrative, setting out management's rationale for operating in this industry as well as its business model. For example, does it own or lease the apartments? If it does not own them does it manage the apartments itself or do the owners operate them on a franchise-like arrangement? Additional explanation of the significant features of the regulatory, legal and macro-economic and social environment that affects the business might also be appropriate.

116 Additional quantified data could include an analysis of the trends and factors underlying the development and performance of the entity, both current and prospective, as a consequence of the external environment in which it operates. These will be the factors management already monitors in managing the business in order to determine future prospects and strategies. In the serviced apartment example this might include trends in GDP rates and foreign investment figures, as shown below.

Key determinants of the health of the overall market for serviced apartments continue to be GDP growth and foreign investment rates. GDP growth in Asia, and Singapore in particular, is currently low because of the Iraq war and concerns about terrorist activities. However, the AsiaPac Economic Network (external association) believes that as businesses get used to working with these pressures, these factors will not dampen GDP growth as significantly over the coming months. Foreign investment, which has not been as drastically affected as GDP growth, is forecast to improve over the short term as shown below:

| Market review | | | |
|---|---|---|---|
| | *2004* | *2005* | *2006* |
| GDP growth | 2.2% | 0.8% | 3.9% |
| Foreign investment | €6.5b | €6.4b | €7.3b |
| Source: AsiaPac Economic Network, 4th quarter forecast | | | |

117 In developing MC content, it will be essential that preparers bear in mind the three principles of MC. For example, for the illustrations above, alignment with the principles can be demonstrated as follows:

| **Principle** | **How the principle is illustrated in the example** |
|---|---|
| Supplement and complement the financial statement information | Supplements the financial statements by providing non-financial information about property, plant and equipment recognised and disclosed in the primary financial statements and the accompanying notes—the number of serviced apartments by geography and location.<br>Complements the financial statements by providing information relating to GDP and foreign investment. |
| Through the eyes of management | Sets out the key factors affecting market growth for the entity's market as determined by management. |
| Orientation to the future | Provides information on the number of serviced apartments opening in the next 12 months.<br>Provides expected GDP and foreign investment figures for the next two years as published by an external party. |

118 Although we do not demonstrate the alignment to the principles of MC for each example, the exercise would be a good test for any MC disclosure.

### *Objectives and strategies*

119 Another of the elements of the objective of MC is to provide information to assist investors in 'to assess the strategies adopted by the entity and the likelihood that those strategies will be successful'. Clear and explicit communication of the entity's objectives and strategies is fundamental if investors are to be able to make this assessment.

120 Management could discuss the financial and non-financial objectives of the business, the time frame for achieving them and how they relate to the creation or preservation of value over the longer term. The illustration that follows is for a property company.

| |
|---|
| The company's objective is to be recognised by stakeholders and peers as being within the top quartile of the world's property companies. Our strategies for achieving this objective are:<br>• to maximise the returns from our investment portfolio;<br>• to complete and let our development properties;<br>• to focus on our customers with products that meet their needs;<br>• to build and retain the best team in the property industry; and<br>• to focus on generating the maximum earnings from the capital invested in order to drive total returns, thereby creating value for our shareholders.<br>A new strategy for future years will be to grow our property and outsourcing business by winning new contracts and expanding existing ones. |
| Property development is a long-term activity and performance should generally be assessed over a period of three to five years. Disappointing results in any one year do not necessarily reflect a failure of the programme. Furthermore, given the long-term nature of the business, treasury activities are central to our business. Our financial policy is primarily based on an unsecured funding strategy, which management and the board believe offers the right balance between debt capacity, flexibility and cost. This translates into the following financial goals:<br>• a credit rating in the single A range;<br>• net gearing no greater than 60-70%; and<br>• interest cover above 2.0 times. |

121 Management might also present information about targets and achieved measures for return on capital employed for each property, occupancy rates, customer satisfaction levels, employee retention rates and overall return against weighted average cost of capital.

### *Key resources, risks and relationships*

122 MC should set out and discuss the key resources, risks and relationships, relating to the entity, that will assist in the pursuit of its objectives. In complementing the financial statements, the key resources, risks and relationships addressed will largely relate to non-financial aspects of the business. Examples cited in paragraph A40 include human and intellectual capital, processes, systems, distribution networks, rights to natural resources and reputation.

 

123 In supplementing the financial statements, MC could contain management's explanation of how it intends to address particular matters within the financial statements. Suppose an entity has significant foreign currency exposure risk. The accounting policies, and the related impacts of foreign currency movements on the current year, will be reflected in the financial statements. In supplementing the financial statements in this case, MC could explain how management manages this risk and the conditions and trends within the relevant foreign exchange markets.[48]

124 Reporting on the key risks and uncertainties facing an entity, together with a commentary on managements' approach to them, is a critical aspect of MC. Risks might arise from the external environment, dependencies on others or the management of resources, both financial and non-financial. The risks facing an entity will reflect its particular circumstances.

125 For example, some entities have greater employee-related risks than others. Some entities have high concentrations of intellectual capital embedded in key employees and others expose employees to high physical risks, while others have minimal employee-related risk. Identification of key risks is important.

126 We do not want the MC to present all known risks, since this obscures information. In the following example the fact that management differentiates between key and subsidiary risks is described first.

> The Board has identified over thirty risks, which are re-evaluated formally at least once a year to assess whether they are considered 'key' risks or subsidiary risks. Subsidiary risks are allocated to senior managers for day-to-day management purposes.
>
> 'Key' risks are monitored by the Board on a monthly basis, being those risks that the Board has determined are fundamental to the success of the company's business, namely related to:
>
> - food safety;
> - our customers;
> - our consumers;
> - our people; and
> - continuing investment to allow for future growth.

[48] An example is shown in paragraphs E3-E5.

127 We note, however, that this introduction tells us very little. It could be considered a boiler-plate statement that any entity in the food sector could use. The value of MC is in explaining which of the risks management views as being key, and how it is managing those risks.

128 Continuing the example, we have set out how management might explain risks related to customers.

> **Our customers -** The retail food market is highly concentrated, with the top five retailers having nearly 70% share and the top three over 50%. In the freshly prepared food sector in which we operate, this is even more concentrated. The top five retailers have over 80% and the top three over 60% share.
>
> Our sales reflect these market positions with our top three customers in freshly prepared foods representing over two-thirds of our sales and the top five over 90%. With such a concentrated market place we need to trade with all the main retailers and, more importantly, meet both their and our expectations.
>
> The main features of how we manage these relationships are:
>
> - we operate a decentralised structure with teams being responsible for running the day-to-day business and looking at the longer-term strategic development for their customers.
> - around one-third of our business units are dedicated to individual retailers – although there is no hard and fast rule about this. However, where volumes are larger or where there may be competitive sensitivities, we usually pursue the option of dedicated sites.
> - we rarely have written contracts with our customers, as in practice it would take too long to draw up meaningful contracts. Notwithstanding this, retailers are relatively loyal to suppliers in our market. At present, we are in a very competitive era in fresh food retailing. Despite this, in the current year, only around 5% of our sales turnover moved to and from other suppliers.
> - in order to ensure enough of the right product is on the supermarket shelf we operate a planning and scheduling system to match our customers' just-in-time delivery demands. We aim to achieve a service level into retailer depot of better than 99% each day.

129 The narrative relating to customers in this example also includes a high level overview of the competitive environment. It is by providing this contextual information that a user of MC can have an understanding of why customers are such a risk area for the entity. As shown in this example, the onus is on management to identify and explain which risks are the most important to the entity.

130 Other examples of key resources, risks and relationships include assessment of matters such as reputation risks and their impact on the short- and long-term performance of the entity. This includes issues such as customer or employee satisfaction levels. Entities will need to determine the extent to which such areas need to be reported in MC to assist investors in assessing the strategies adopted by the entity and the potential for successfully achieving them.

131 Some may see it as better to consider this sort of matter within the domain of 'corporate social responsibility'. We acknowledge that perceived social obligations can affect the value of the entity. The suggestion that such information is useful to investors is not intended to expand the set of stakeholders to which an entity must report. Rather, it acknowledges that how an entity interacts with its customers, employees, the community in which it operates and the environment, can have a significant impact on its short- and long-term financial well-being. And, again, the relative importance of this information to investors will depend on the circumstances of each entity.

### *Results and prospects*

132 Within MC, management should provide users with a clear understanding of the financial and non-financial performance achieved and the extent to which this performance is indicative of future results and management's assessment of future prospects.

133 SEC guidance suggests that MC should explain if 'events and transactions reported in the financial statements reflect material unusual or non-recurring items, aberrations, or other significant fluctuations …'[49] There is evidence that investors are interested in how management adjusts earnings for one-off or unusual items to reveal what it perceives to be core earnings.[50] Such information is often conveyed in MC.

134 Furthermore, management should include an assessment of the main trends and factors in the development and performance of the business and their relationship to the objectives and strategies of the entity. These factors will often relate to risk factors or key operating factors. For example, an entity operating in the chemical business might be affected significantly by increases in the price of oil. An analysis of past

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49 SEC Interpretation MD&A, III B 4.

50 See Brown and Sivakumar (2001), Bradshaw and Sloan (2002) and Ciccone (2002).

 

oil price trends, the effect of changes in oil prices on the entity and what management expects the future trends to be could assist investors in understanding how oil prices have affected current results and are likely to affect future prospects.

135 A retail bank might assess operating performance through customer-focused measures, such as loyalty, satisfaction and penetration (number of products purchased by customer).

136 As has been shown in the examples earlier in this section, it is difficult to illustrate just one essential element of content envisaged for MC, and it is even more difficult with results and prospects. Results and prospects will necessarily involve the quantification of both financial and non-financial performance and position of the entity, which will be communicated through the use of performance measures and indicators. Accordingly, the detailed illustration relating to results and prospects is provided in the next section.

### *Performance measures and indicators*

137 Within MC, management should provide the key measures and indicators that it uses to assess and manage performance against stated objectives and strategies. These indicators will also provide evidence on how well the entity is managing its key resources, risks and relationships.

138 We concluded that any IASB standard or guidance on MC should not specify the performance measures or indicators that entities should disclose.[51] Nor should it specify the minimum or ideal number of performance measures or indicators to be reported. The optimal level of disclosure and measures will be specific to an entity. This conclusion is consistent with the views reached in the German GAS 15 and UK RS 1, and reflects the principle that MC should be 'through the eyes of management'. The onus is on management to determine which performance measures and indicators, and how many, reflect best what is required for an understanding of the business.

[51] 'Performance measures and indicators' are referred to in various jurisdictions as measures, indicators, performance measures, or key performance indicators (KPIs).

139 For example, the serviced apartment company featured in our earlier examples might measure the success of its strategy and performance via occupancy and rental rates, as well as gross operating profit. The producer of freshly prepared food might measure the percentage of production failing food safety tests, consumer satisfaction and the percentage of revenue retained with the top five retailers to assess performance.

140 Although the number and particular performance measures and indicators disclosed in MC will be specific to each entity, it is important that information should be disclosed to enable investors to see how measures have been defined and calculated. Paragraphs A52-A57 identify information that should be disclosed for each performance measure and indicator.

141 Take, for example, a consumer products company that has an objective of being number one or two in the markets it serves. One of the strategies for achieving this objective might be to provide innovative products to its customers. Management might use the measure 'percentage of revenue from new products' to assess how well it is both managing its intellectual capital and achieving its stated strategy, as illustrated below.

> In order to continue to grow in the fast paced market of consumer products, the company needs to ensure that it is continually renewing its product portfolio. We monitor our success by measuring the percentage of revenue from new products. Our objective is to achieve 35% of revenue from new products.
>
> In addition, we also measure and monitor patent applications and patent rights, as these are lead indicators of our future products. Patent applications are defined as the number of applications accepted in any one year with the national patent authority, whilst patent rights is a cumulative measure of the number of products subject to existing patent. We aim to increase both of these indicators by 10% per year.
>
> Percentage of revenue from new products is measured as revenue from those products launched in the past two years divided by total revenue for the year.

142 This could be accompanied by a graph showing the percentage of revenue from new products for the past five years, plus the target for an appropriate time frame.

 

143 The examples featured in this section are clearly not exhaustive. Many further trends and factors, as well as performance indicators, exist and could be equally valid information featured within MC. As noted earlier, the selection of appropriate information for an entity's MC will relate to both the industries in which it operates and to the strategies it has adopted.

## Future guidance or standards

144 We have taken only the first steps in the developments that might be necessary in this area, by proposing an MC standard (see Appendix A) along with some ideas about what MC would look like in practice.

145 One of the essential content elements for MC relates to performance measures. We believe that future guidance is likely to be required to provide more definitive guidance to standardise various non-IFRS financial performance measures and other non-financial performance measures and indicators. Specifically, it would be beneficial to define particular measures in the same way that accounting policies are, in some circumstances, defined.

146 To illustrate, in a survey of the wireless industry PwC notes that there are differences in the way entities measure both the numerator and denominator in reporting customer churn rates.[52] There are several other examples in the survey, including a wide variation in the costs included in the numerator used when calculating the cost of adding each new user (cost per gross addition) and the different types of revenue reported in the measure of average revenue per user.[53]

147 Similarly, entities that have significant environmental risks may set objectives and adopt strategies to address them. Standardising the way some environmental impact outputs are measured, such as carbon dioxide emissions, may assist users in the cross-sectional comparison of entity performance. Of course, for some entities the management of environmental risks will affect their reputation but would not be regarded as a key performance measure.

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52 PwC *Wireless Industry Survey*, page 26.

53 Ibid., page 34 for the cost per gross addition example and page 74 for average revenue per user.

 

148 Guidance or standards would not necessarily be limited to non-financial measures. For example, there is no consensus on how to measure *return on capital employed*. At some future point it may be helpful if these terms were defined for the purpose of facilitating comparison between entities.

149 Developing guidance or standards on how items should be measured does not compel an entity to report that measure, but would lead to greater consistency in reporting by entities that regard that measure as important.

150 Other parties may also have an interest in defining key measures and indicators. Industry sector groups already have some standardisation and the development of IASB guidance would not prevent this continuing.

## Section 5 Implementation

151 At the heart of our proposals is the idea that the IASB should view the financial report as a whole and use MC as a place in which information might be required to be disclosed. This concept is not without its challenges. We are aware that some constituents are concerned that moving information out of the financial statements and into MC might affect its perceived reliability, because MC is not subject to the same level of assurance as financial statements.[54] And, because MC sits outside the information covered by the IFRS assertion, it is difficult for the IASB to use MC as a disclosure vehicle when it develops IFRSs.

152 There is also the matter of how the IASB should determine whether information, identified as important for investors, should be disclosed in MC or the financial statements.

### Placement criteria

153 Although it is often easy to distinguish information that would appear in MC from information that would appear in the financial statements, this is not always the case. It is also apparent that some constituents have clear, and differing, views about how to delineate the information placed in MC from information placed in the financial statements. Suggestions included placing all 'unauditable' or 'non-financial' information into MC. As our analysis has demonstrated, some non-financial information that is indisputably part of MC is easy to verify—such as retail square footage. Similarly, MC often contains financial information—such as return on capital.

154 During its discussions of drafts of this paper the IASB asked us to suggest the additional criteria that would be necessary for determining where, in the financial report, information should be placed—a placement framework.[55]

155 The IASB and the FASB are undertaking a joint project on the conceptual framework. There is a risk that our thoughts on what any placement criteria could look like might not align with the views that emerge from that project. On the other hand, having an idea of what we think the

54 See paragraph 186.

55 There are, arguably, two dimensions to disclosure—what and where. The 'what' relates to identifying the type of, or specific, information that should be disclosed. The 'where' relates to where this information should be presented within a financial report. Placement is concerned with 'where', not 'what'.

criteria might look like should assist readers in understanding our view of how MC aligns with financial statements within an integrated financial report. On balance, we believe that timely feedback on this issue from this project outweighs the additional benefit that might be gained from waiting for information from the framework project. It might also provide helpful feedback for that project.

156 Accordingly, the criteria described here are simply a first step. We hope the expression of these criteria and the feedback that is received from this paper will serve to inform those that continue the development of placement criteria.

157 Nothing in our discussion on placement implies anything about *what* should be disclosed. It is only when an entity, or a standard-setter, has decided that some information is important enough to be disclosed that a placement framework assists in determining *where* it might be best to disclose that information.

### Background

158 In the previous sections we identified what we believe are the most appropriate principles, characteristics and essential content elements of MC. In developing the model we have viewed the financial report as a package comprising the financial statements and MC.

159 We also suggested that it might be more appropriate to present some disclosures required by IFRSs in MC and others in the financial statements. Even without placement criteria, the characteristics of MC developed in this paper suggest that there are clear candidates in existing IFRSs that appear to have the characteristics of MC. For example, IAS 32 *Financial Instruments: Disclosure and Presentation* required risk management policies to be disclosed in the financial statements. Risk management information is, in our view, more appropriately viewed as MC information. The IASB and some of those who submitted comments on the exposure draft of the standard concur with this view, as the Basis for Conclusions on IFRS 7 *Financial Instruments: Disclosures* notes (see paragraph 172).

160 The opposite is also true. To illustrate, the SEC requires disclosure in the MD&A of operating lease obligations in the next year, two to three years ahead, three to five years ahead and beyond five years. Yet similar, more detailed, disclosures are also required within the financial statements by the US SFAS 13 *Accounting for Leases*. It is not always clear why some

 

disclosures are driven by regulation and some by accounting standards. It appears, however, that perceived deficiencies in national GAAP or IFRSs can lead to requirements for MC disclosures that are, arguably, better treated as financial statement disclosures. Conversely, the absence of requirements for MC gives standard-setters little choice when mandating disclosures.

161 We have no evidence on whether placing information in MC rather than explanatory notes to the financial statements affects the way users incorporate that information in their decision processes.

162 Some empirical studies indicate that footnote disclosures are incorporated in share prices, while other studies suggest that prices do not fully reflect footnote disclosures.[56] Experimental studies indicate that some information disclosed as supplementary notes is given less weight in the decision-making processes of the users than information recognised in the financial statements.[57] However, there is an important caveat. The extant literature on recognition versus disclosure is generally concerned with alternative ways to measure accounting numbers such as including or excluding pension liabilities or measuring financial assets at fair value. In contrast, the MC we describe is concerned with describing aspects of performance and position once those measurements have been made. It could be that placing MC content in a section preceding the financial statements or included in the explanatory notes to the financial statements is less sensitive to the recognition versus disclosure issue. We simply do not have sufficient evidence to reach defensible conclusions.

163 Our interest in placement is not isolated. In April 2005 the US Government Accounting Standards Board (GASB) released Concepts Statement No. 3, addressing communication methods in the general purpose external financial reports of government. Although the Statement does not address MC directly, it considers what determines whether information required to be disclosed should be placed in the explanatory notes to the financial statements or placed in 'required supplementary information'. The latter could be defined to include a governmental equivalent of MC.

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56 See Harris and Ohlson (1998), and Barth (1994) for examples of the former. Landsman and Ohlson (1990) is an example of the latter.

57 See Sami and Schwartz (1992), for example.

164 The GASB's conclusion was that information 'integral to financial statements' and a user's understanding of them should be in the explanatory notes. Information 'essential for placing basic financial statements and notes to basic financial statements in an appropriate operational, economic or historical context' would be required supplementary information. This delineation is consistent with the objective of financial statements and the objective of MC we are recommending.

165 A recent staff paper from the SEC noted that its staff were:

> ... willing to work closely with the FASB in its development of a disclosure framework, in order to consider whether complementary changes to the Commission's disclosure requirements would generate further improvement as well as to ensure that disclosure is provided in the most appropriate location, whether it be in notes to the financial statements, MD&A or in some other location.[58]

### Financial statements

166 Financial statements are a structured representation of the financial position and financial performance of an entity.[59] Many of the transactions and activities to which entities are a party enter the financial reporting system. An item is recognised within financial statements when:

(a) it meets the definition of an element;

(b) it is probable that any future economic benefit associated with the item will flow to or from the entity; and

(c) it has a cost or value (expressed in units of currency) that can be measured with reliability.

167 Items that are recognised in the financial statements will either be disclosed on the face of the primary financial statements or in the notes that accompany them, or not at all.[60]

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58 SEC *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers*.

59 IAS 1, paragraph 7.

60 Information that is not material to investors is not disclosed separately, because to do so would obfuscate material information.

168 IAS 1 *Presentation of Financial Statements* specifies the assets and liabilities that the IASB has decided must be disclosed on the face of the primary financial statements. IAS 1 also requires additional line items, headings and subtotals to be presented on the face of the primary financial statements 'when such presentation is relevant to an understanding' of the entity's financial performance or position.[61]

### The criteria

169 MC and the notes accompanying the primary financial statements both elaborate on information provided in the primary financial statements.[62] Although we have described the principles and qualitative characteristics of MC, the examples that follow demonstrate that these principles and characteristics are not always sufficient to direct a preparer or a standard-setter on where to disclose some information. Information presented by management on its perspective of the key issues and strategies of the entity, that is to say the second and third elements of our MC objective, clearly belongs in MC. It is more difficult to delineate between information that meets the first element of our MC objective and the notes. Criteria to assist with this delineation could be that:

> Information would be disclosed:
>
> (a) in MC if it provides an investor with information that puts the financial statements into the context of the entity and its operating environment;
>
> (b) in the notes if it is essential to an understanding of the primary financial statements and its elements, whether recognised or not.

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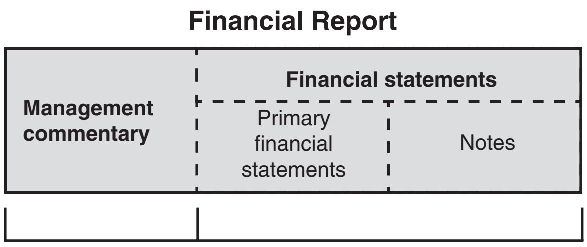
61 IAS 1, paragraphs 69 and 83.

62 Primary financial statements comprise a balance sheet, an income statement, a statement of changes in equity and a cash flow statement.




**Placement criteria**
MC provides an investor with information that puts the financial statements into the context of the entity and its operating environment.

The notes accompanying the financial statements provide an investor with information that is essential to an understanding of the primary financial statements and their elements, whether recognised or not.

Figure 5.1 Placement criteria

170 We offer the criteria as a starting point, to stimulate discussion. And to help in this regard the next sections provide examples of how the criteria could be applied.[63]

## Application of placement criteria

171 We have already discussed MC and provided examples of the type of information we expect to see in it. As we noted in paragraph 159 our criteria would result in some information being disclosed in MC rather than the notes to the financial statements. The *Framework* states that the notes '... may include disclosures about the risks and uncertainties affecting the entity ...'[64] Under our placement criteria much of the information about the 'risks and uncertainties affecting the entity' would be disclosed within MC rather than in the notes. The IASB appears to acknowledge a role for MC and raised the matter of placement during the development of IFRS 7 *Financial Instruments: Disclosures*.

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[63] See also Appendix E.

[64] *Framework*, paragraph 21.

 

172 The Basis for Conclusions on IFRS 7 states:

> The Board also noted that some entities might prefer to present the information required by the IFRS together with material such as a management commentary or risk report that is not part of the financial statements. Some entities might be required by regulatory authorities to provide in a separate report information similar to that required by the IFRS. Accordingly, the Board decided these disclosures should be given in the financial statements or incorporated by cross-reference from the financial statements to some other statement that is available to users of the financial statements on the same terms as the financial statements and at the same time.[65]

173 Appendix E provides some additional examples of how we would apply the placement criteria, including elements of MC. Equally informative is what we do not expect to see in MC. That is what we discuss next.

174 As we have explained, MC complements and supplements the financial statements. In many ways the notes accompanying the statements also supplement the primary financial statements. For example, information that disaggregates or expands on the elements presented in the primary financial statements or explains how the information has been defined or measured is, in our view, the province of the notes.

175 MC and the notes obviously serve different purposes. We would not expect MC to include information that is essential to an understanding of the primary financial statements. To illustrate, the notes are the obvious place to disaggregate information that appears in the primary financial statements, when disaggregation is considered by management or standard-setters to be important. For example, IAS 16 *Property, Plant and Equipment* requires the disclosure of, among other things, gross carrying amount and accumulated depreciation, an analysis explaining the change in the carrying amount since the end of the prior period including depreciation expense and impairment losses for each class of property, plant and equipment.[66]

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65 IFRS 7, paragraph BC46.

66 IAS 1 requires the disclosure of information on the face of the primary financial statements if this is 'relevant to an understanding' of the entity's financial performance or position. In some circumstances, therefore, some of this information might be disclosed in the primary financial statements.

 

176 Determining how to measure information recognised in the financial statements requires the exercise of judgement by management. However, information about the accounting policies used to measure financial statement elements, or the judgements made in making estimates, was not what we had in mind when we stated in paragraph 42 that:

> In supplementing the financial statements, MC includes additional explanations of amounts reported in the financial statements and explains the conditions and events that shaped the information in the financial statements.

177 We believe that the notes are the most appropriate place to present information about how an entity has measured the amounts it has presented in the financial statements. The requirement in most IFRSs to disclose accounting policies is consistent with this view.

178 There are several aspects to determining the carrying amount of an element (such as an asset or liability) that can involve the exercise of judgement. Measuring each element generally follows a process similar to the following:

(a) define a unit of physical measurement—such as motor vehicle, oilfield, trees, or forest plantation;

(b) establish a measurement attribute—such as cost or fair value; and

(c) apply the measurement attribute to the unit of account.

179 In most cases the resulting measure provides information that is sufficient for investors, because the measures used are well known and uncontroversial. In other cases even defining the physical measure can be difficult.

180 For some elements it may be helpful for investors to have more information about the element quantity or the valuation base. This concept appears to be acknowledged in IFRSs. For example, if an entity revalues property, plant and equipment it must disclose the methods and significant assumptions applied in estimating the items' fair values.[67] If management believes that information on measurement estimates,

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[67] IAS 16, paragraph 77(c).

 

assumptions or uncertainties is material to investors we do not envisage that this would be disclosed in the MC.[68] In our view the notes to the financial statements would be the appropriate place to present this information.

181 As we have indicated, information about the physical measures could be important in some circumstances. In most cases there is little or no uncertainty about, for example, the quantity of an asset. It is therefore not surprising that very little information on the physical aspects of assets tends to be disclosed. There are exceptions, the most obvious example being the disclosure of oil and gas reserves.[69] We also observe that some property investment entities disclose information about individual investment properties. The more unique characteristics an asset has, the more likely it is that there is incremental information in the disclosure of those characteristics. Information about those unique characteristics (which could include legal or contractual restrictions on an asset) is not what we had in mind for MC. We believe that it is more appropriate to disclose this sort of information in the notes. It also illustrates the inappropriateness of delineating information on the basis of whether it is non-financial or financial.

182 When standards permit a choice of measurement base, standard-setters or management may decide that it is appropriate to disclose information about an alternative measurement base. If, for example, an entity recognises a class of property, plant and equipment at revalued amounts, as it is entitled to do under IAS 16, the entity must also disclose the carrying amount that would have been recognised had the assets been carried under the cost model. Again, we do not believe this disclosure is appropriate for the MC.

183 In some circumstances a measurement base is not regarded as reliable enough to allow an element to be recognised in the financial statements. Examples include self-generated brands and customer lists as well as some oil reserves. Disclosing information about quantities of these assets

[68] This is consistent with the requirement in IAS 1 to disclose information about measurement uncertainty.

[69] This information is often disclosed in the MC even though paragraph 21 of the *Framework* suggests that 'mineral reserves' is an example of information that may be included in the notes.

 

or their fair values, for example, within the notes to the financial statements, is consistent with the placement criteria we have described; this is because brands and oil reserves meet the definition of an asset but do not always meet the recognition criteria.

### Consistency with the *Framework*

184 The placement criteria described above are consistent with the *Framework* in that they:

(a) acknowledge the view that financial statements are part of financial reporting, and that notes are 'an integral part of the financial statements';[70]

(b) incorporate the criteria for recognising the elements within financial statements;[71] and

(c) reflect the notion that 'financial statements do not provide all the information that users may need to make economic decisions since they largely portray the financial effects of past events and do not necessarily provide non-financial information.'[72]

185 It is important to remember that what we are describing is a set of criteria. There will be information for which judgement will be required in deciding where it might best be disclosed. But entities, or the standard-setters, will already have made a judgement that the information is material to investors. If the IASB takes forward a project on MC and takes the view that MC is an appropriate place to disclose information, the impact of suboptimal placement of information is reduced.

## Assurance and perceived reliability

186 As we noted earlier, we are aware that some constituents would be concerned if information was shifted from the financial statement notes to MC. However, these concerns imply that MC is not, or could not be, subjected to an audit of some sort. Neither assertion is true.

70 *Framework*, paragraph 7.

71 Ibid, paragraphs 82 and 83.

72 Ibid, paragraph 13.

 

187 Some jurisdictions require the auditor to read MC to identify material misstatements of fact or inconsistencies with the financial statements. This is the case, for example, for an audit performed in accordance with International Standards on Auditing if the MC is to be published in the same document as the audited financial statements.[73] It should be noted, however, that the level of assurance attaching to the MC is significantly less under this scenario than would be the case if the information in it were itself audited or reviewed and, as a consequence, the auditor does not express any opinion on MC. Some other jurisdictions require the statutory auditor to express an opinion on the MC itself. For example, the EU requires an opinion concerning the consistency or otherwise of the annual report (or consolidated annual report) with the annual or consolidated accounts for the same financial year.[74] Still others require positive opinion over the MC.

188 The UK requirements are that the auditors must state in their report:

> ... whether in their opinion the information given in the operating and financial review ... is consistent with those accounts and whether any matters have come to their attention, in the performance of their functions as auditors of the company, which in their opinion are inconsistent with the information given in the operating and financial review.

189 Germany requires an audit of MC. The auditor must state whether the management report is consistent with the financial statements and with any additional knowledge obtained by the auditor in the course of the audit.[75] The auditor's opinion must also assert whether the management report as a whole provides a suitable understanding of the position of the entity and whether the risks and opportunities of its future development are suitably presented. Accordingly, the opinion has to include an assessment of the comprehensiveness of disclosures required.

190 Prospective financial information has many of the characteristics of MC in terms of uncertainty and focus. Although prospective financial information is narrower than the content envisaged in MC it is forward-looking in nature and reflects management's view. Several jurisdictions have assurance standards addressing prospective information.

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73 ISA 720. This is also a requirement in Canada and the US.

74 Article 51 of the Fourth Directive and Article 37 of the Seventh Directive.

75 For further details on the scope of audit and on audit procedures required see IDW Auditing Standard No. 350.

 

191 Despite the existence of auditing standards and guidance relating to MC and forward-looking information there appears to be limited demand for separate opinions on MC. In the US, for example, Ernst & Young in its submission to the SEC on the proposed 'Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies' stated that the firm had been requested to attest to only one MC report between 1996 and 2002.

192 We believe that the lack of observed assurance regarding MC, separate from the financial statements, is more likely to be associated with the absence of requests for auditors to undertake this type of work rather than technical or conceptual hurdles to performing it. In some jurisdictions the regulators are now creating requirements for this type of work to be performed.

193 During the development of this paper we were made aware that although the assurance aspects are not insurmountable, there are challenges. It was suggested to us that:

(a) there are issues of timeliness and the balance between benefit and cost—to get a meaningful level of assurance may result in prohibitive costs.

(b) there is a need for suitable criteria. The *International Framework for Assurance Engagements* describes criteria as 'the benchmarks used to evaluate or measure the subject matter including, where relevant, benchmarks for presentation and disclosure'. At present no such criteria are believed to exist.

(c) there are difficulties of attribution, where the commentary seeks to explain the causes for results. Evidence may be available as to events and results, but causality is not directly observable, presenting a difficult assurance challenge.

194 We suggest that the IASB should keep the International Auditing and Assurance Standards Board (IAASB) informed of its work on MC to allow the IAASB to address the attestation of MC.

 

## Section 6 IASB requirements

195 Our analysis highlights the growing trend for standard-setters, regulators and corporate interest groups to issue guidance or mandatory requirements relating to the form and content, and regulation of, MC.[76] Our view is that without the IASB's active involvement, working alongside other interested global organisations such as IOSCO, it is unlikely that a single set of global standards or guidance relating to MC will emerge within the near term, given the proliferation of guidance and regulations.

196 The first objective of the IASB calls for 'a single set of high quality, understandable' global standards. This is reinforced by the third objective of the IASB, which is:

> to work actively with national standard-setters to bring about *convergence* of national accounting standards and IFRSs to high quality solutions.[77] (emphasis added)

The emphasis on convergence will be important when we discuss the role of the IASB in developing requirements for MC.

197 Without global standards or guidance, entities with multi-jurisdictional MC requirements would be required to prepare multiple filings. This is the very concern that motivated international convergence of financial reporting standards. The IASB can mitigate this proliferation by reducing the incentives for regulators to develop their own MC requirements. Whether IASB requirements would reduce existing regulated MC requirements is a separate matter, and one that is outside the control of the IASB.

### Benefits and costs of MC requirements

198 It would be inappropriate to develop a standard or guidance that imposes reporting obligations on an entity without assessing first whether the benefits of doing so exceed the costs. It is obviously not possible for us to undertake a formal analysis, but we can make some observations about likely benefits and costs.

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[76] Within this paper the term 'regulation' is intended to have a wide meaning, and includes pronouncements and guidance from standard-setters, such as the CICA and DRSC, and regulators such as the SEC and members of IOSCO.

[77] *Preface*, paragraph 6(c).

 

### Benefits

199 It is generally accepted that investors value information that is incrementally informative over that provided in financial statements. The core question, however, is whether there are marginal benefits associated with the development of requirements for MC by the IASB. We identified at least three major benefits.

200 First, it would assist jurisdictions that do not have MC reporting requirements and improve the quality of financial reporting in those jurisdictions. MC requirements could improve the quality of MC information reported by increasing comparability of an entity's MC over time, and between entities, and help ensure that the information is consistent, or reconciled, with the IFRS financial information. There is also a perception that some narrative reporting has a positive bias. MC requirements would impose a discipline to report in a more balanced way.

201 Secondly, it may assist with the global convergence of MC reporting requirements by improving the consistency and cross-entity comparability of financial reports. Having IASB requirements may encourage regulators to adopt those rather than develop their own. For those entities listed in multiple jurisdictions, following one international standard for MC rather than having to prepare MC in accordance with multiple requirements would reduce preparation costs.

202 Thirdly, it would increase the legitimacy of MC as an appropriate place to disclose information. This would allow the IASB to specify MC information disclosures. Without this legitimisation we will continue to observe IFRSs that require some financial statement disclosures that we suggest have the characteristics and qualities of MC information.[78] We note that the IASB, in developing both IFRS 7 and the proposed changes to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets,* acknowledged the potential role of MC as an appropriate place to disclose information. In the case of IAS 37 the IASB has proposed that entities should not be required to disclose contingencies in their financial

78 See paragraph 153 for a more extensive discussion of whether information is more appropriately placed in MC or in the financial statements.

 

statements, because this information is more appropriately disclosed in MC.[79] In IFRS 7 the IASB has a requirement to disclose information in the financial statements about risks, but notes that it might have been more appropriate to disclose this information in MC.

203 The level of benefits associated with any disclosure requirements will also be a function of the range of users for whom the information is relevant. Meeting the needs of users with a direct financial interest in an entity, such as those holding listed equity or debt, may also benefit other users. Smaller entities with a narrow ownership base and operating activities are likely to have fewer users to benefit from financial reporting disclosure requirements. The IASB SME project also acknowledges that the level of benefits can vary: to illustrate, the SME project currently uses public accountability as a proxy for determining the threshold for when the marginal benefit of full IFRS reporting is likely to exceed the marginal costs of such reporting.

### Costs

204 There are costs associated with introducing MC requirements. For example, a requirement to present MC could increase the size of financial reports. There is a risk that some preparers could respond to an MC requirement by disclosing a plethora of MC data rather than meaningful MC information. It is arguable that some US companies take that approach when preparing SEC MD&A information, even though the objectives of the SEC requirements are clear that the SEC wants information that is *important* to investors to be disclosed. The SEC provides guidance which states that 'the effectiveness of (MC) decreases with the accumulation of unnecessary detail or duplicative or uninformative disclosure that obscures material information.'[80]

205 Among the costs generally associated with a requirement to disclose information externally are preparation costs and proprietary costs. If the perceived marginal preparation and proprietary costs exceed the perceived marginal benefits of the requirements entities may seek ways to avoid them. This might include delisting, and sourcing capital from private sources, or moving to alternative markets.

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79 Exposure Draft of Proposed Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IAS 19 *Employee Benefits*, Basis for Conclusions, paragraph BC32.

80 SEC Interpretation MD&A, III B 2.

 

206 The marginal costs of compliance are also likely to vary across jurisdictions. In our view relevance and balance are equivalent to the EU Modernisation Directive requirement that MC should be comprehensive and balanced. Furthermore, the Directive also requires the content of MC to include a description of the principal risks and uncertainties facing the entity and, when appropriate to an understanding of the business, its key performance indicators.[81] Similar mandatory requirements exist in other jurisdictions. When an IASB MC requirement replicates an existing reporting obligation the marginal cost of an IASB pronouncement will be lower than in a jurisdiction where the requirement does not exist.

### The adoption hurdle

207 Discussions with constituents during the development of this paper highlighted a concern that, although the marginal benefits of MC requirements might exceed the marginal costs, such requirements could raise the gross compliance costs. Increasing gross costs can create what we call an 'adoption hurdle'. In other words, there is a perception that the costs of complying with IFRSs will increase if MC is part of IFRSs, which could discourage jurisdictions or entities from adopting IFRSs. This is most likely to occur if:

(a) a country had not yet adopted IFRSs and the addition of a mandatory MC standard might prove to be too onerous initially for some countries; or

(b) there are significant differences between a jurisdiction's requirements for MC and the requirements set out in an IASB MC standard.

### Benefits and cost assessment

208 Although we considered these factors generally, we concluded that a detailed assessment of the costs was unnecessary in the context of the model we are recommending in this paper. Our model assumes that the marginal preparation costs are relatively low because management is required to present information in MC that is drawn from the information it uses to manage the business. The model also places the onus on management to determine the actual information disclosed on

81 Article 46 of the Fourth Directive and Article 36 of the Seventh Directive.

 

the basis of its assessment of what is necessary and sufficient to meet the objective of MC. This leaves management to assess the benefits and costs trade-off, including its own assessment of the proprietary costs of disclosure versus the benefits of reducing informational asymmetries.

209 The benefits of MC requirements are more likely to exceed the associated costs for entities with a wide range and quantity of users. As the number of users reduces the potential level of benefits is likely to fall. We note that the benefit to cost relationship is, however, likely to vary between jurisdictions because of differences in the regulatory environments.

210 Many regulators are required to assess formally the benefits and costs of regulatory requirements. We take comfort that, in developing the legal requirements for the OFR in Great Britain, the UK Government completed a regulatory impact assessment on the proposal. The UK Government concluded that the benefits of introducing a statutory OFR for quoted companies justified the costs.

211 We concluded that the marginal benefits of the IASB developing requirements on MC are likely to exceed the marginal costs. Any IASB requirements would need to sit alongside the requirements in a given jurisdiction. The potential for conflict between IASB requirements and local requirements is clearly greater in those jurisdictions with extensive regulatory or legal requirements currently in place for MC.

## A standard or non-mandatory guidance

212 Assuming that the IASB decided to issue MC requirements, we considered whether these requirements should be presented in the form of a standard or guidance.

213 Some jurisdictions have had voluntary guidance relating to MC for many years. For example, in the UK the ASB issued its first non-mandatory statement on the OFR in July 1993. This was subsequently updated in January 2003. However, despite its existence for over a decade, in 2002 'only 61% (68% in 2000) of listed companies produced either a formal OFR or clearly adopted the broad recommendations on OFR statements ... and ... only 25% of companies identify and discuss the principal risks facing the business (29% in 2000, 17% in 1996).'[82] Furthermore, 'the Company

[82] Deloitte & Touche *Carrots to sticks*.

Law Review found that the content and rigour of reporting varies widely, and a significant proportion of large companies fall well short of meeting the ASB's recommended practice.'[83] We see little benefit in encouraging compliance with IASB MC guidance.

214 Accordingly, we concluded that a standard was more likely to enhance MC and was to be preferred to non-mandatory guidance. As set out in section 3, any such standard should be principle-based. Additionally, the standard should define MC, and identify and explain the characteristics and essential content of MC.

215 Some may question how a standard that contains principles and qualitative characteristics can be enforced. We already have this type of requirement in IFRSs. The concept of materiality, for example, is expressed as a principle and judgement is regularly applied in using this concept. And the disclosure requirements about risk in IAS 32 *Financial Instruments: Presentation* are similar to the type of disclosure we would expect to see in MC. Building the concepts we have described into a standard would force preparers to consider and apply these principles when preparing MC.

## What sort of standard?

216 We considered four ways an MC standard could be developed, being:

(a) requirements within an existing IFRS, specifically IAS 1;

(b) a standard with defined scope that is narrower than other IFRSs, in much the same way that IAS 14 *Segment Reporting* is written;

(c) a standard that sits outside the 'core' set of IFRSs, but is available for adoption if a jurisdiction elects to make it mandatory or an entity elects to adopt it, in a similar way to how the scope of IAS 34 *Interim Financial Reporting* is written; or

(d) a separate strand of standards aimed at MC, with a unique numbering system to distinguish them from IFRSs, in much the same way that the UK ASB has established a separate series for OFR.

83 Department of Trade and Industry *Draft Regulations on the OFR: A consultative document*.

 

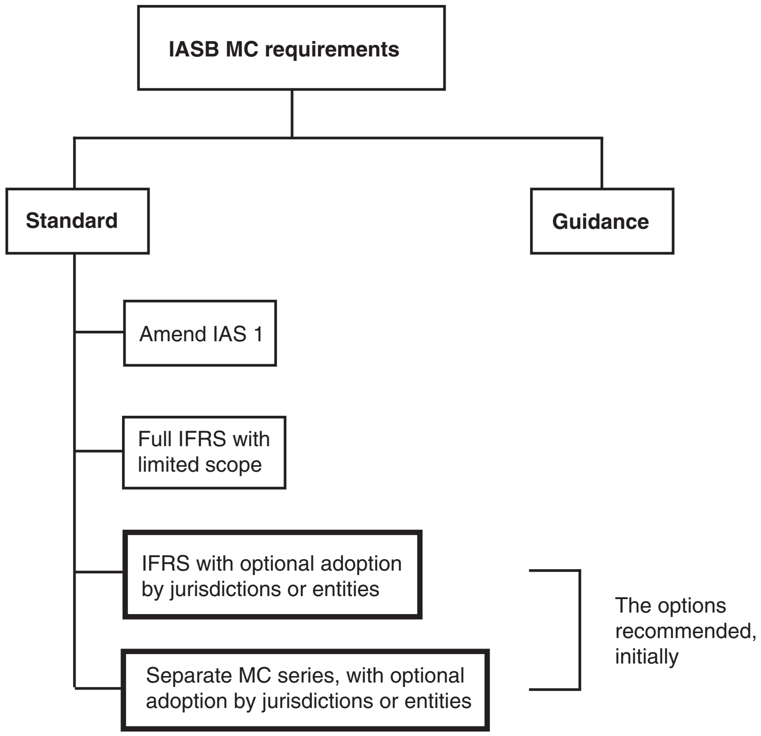


Figure 6.1 Alternative approaches to an MC standard

### Incorporate MC requirements within IAS 1

217 The meeting of the IASB with partner standard-setters in September 2002 recommended that IAS 1 *Presentation of Financial Statements* should be amended to require the presentation of MC.

218 We considered and dismissed this approach for two reasons. First, amending IAS 1 would impose a requirement on entities to present MC in order to be able to assert compliance with IFRSs. This would raise the adoption hurdle, as discussed in paragraph 207. Secondly, placing

MC inside the financial statements, as an IAS 1 amendment would do, is at odds with the fundamental purpose of MC, which is to enhance the reporting process by supplementing and complementing the financial statements.

### An IFRS with limited scope

219 An MC standard could have a narrow scope, akin to IAS 14, ie 'entities whose equity or debt securities are publicly traded ...' An entity falling within its scope would be required to comply with this standard to be able to assert compliance with IFRSs.

220 However, this option still exposes a potential MC standard to the problems associated with the adoption hurdle. Accordingly, we rejected this option as well, in the short term.

### An IFRS that sits outside the requirements for IFRS assertion

221 An IFRS on MC would have the credibility associated with the IASB. The scope of the standard could be defined in a way that does not mandate either the preparation of MC or compliance with that standard. If, however, an entity elects to prepare MC and complies with the standard it would be entitled and required to assert compliance with it. Furthermore, a body responsible in a particular jurisdiction for regulating MC, such as a securities regulator, government, stock exchange or accountancy body, could choose to make the MC standard mandatory for entities within its jurisdiction.

222 Because of its flexible scope, this approach to developing an MC standard would not create an 'adoption hurdle' and avoids uncertainties about the status of a separate series of MC standards issued by the IASB (see paragraphs 226 and 227). In countries or for stock exchanges in which no MC is required, such a standard would not prevent entities from describing their financial statements as complying with IFRSs.

223 Although this approach would be a positive step toward international convergence of MC reporting, it would reduce the feasibility of the IASB using MC as a disclosure vehicle when it develops IFRSs. If the IASB elected not to make MC mandatory, the IASB would not be able to require an entity to place disclosures in MC and still be covered by the IFRS assertion. Or, if the scope of an MC standard was limited, it would be difficult for the IASB to mandate the disclosure of information in MC for an IFRS that had wider scope than the MC standard.

 

224 There are work-arounds. For example, an IFRS could require information to be disclosed in MC (prepared in accordance with the MC standard) unless the entity is not required to prepare MC. In such cases the information would be required to be disclosed in the explanatory notes to the financial statements. The point is that any scope limitation on an IFRS has consequences.

225 If this option is preferred, it would be necessary to amend IAS 1, which states that information presented outside the financial statements is outside the scope of IFRSs.

### A separate series aimed at MC

226 The UK has recently issued its standard on operating and financial reviews as a 'reporting standard', which the law distinguishes from an accounting standard.

227 This option has the same benefits and disadvantages associated with the previous option. An added advantage is that, given differences in the nature of information disclosed in MC relative to the financial statements, some believe that a separate series allows for greater clarity in defining its principles, characteristics and requirements. On the other hand, a separate series could give the impression that MC requirements are not integral to meeting the objectives of financial reporting. A separate series for MC might cause uncertainties about the status of such pronouncements because, as we have already noted, the *Preface* refers to other financial reporting as well. The UK ASB did not discuss this distinction because it was required by legislation to take this approach.

### Summary

228 As stated earlier, we believe that MC is an integral part of financial reporting and, accordingly, the ultimate goal is for MC presentation to be a prerequisite for assertion of compliance with IFRSs. We acknowledge the initial barriers to this. Accordingly, we concluded that an MC standard should provide for optional adoption by jurisdictions or entities in the short term. This could be either through an IFRS or in a separate MC series of standards. Figure 6.2 summarises the conflicts we have attempted to address.

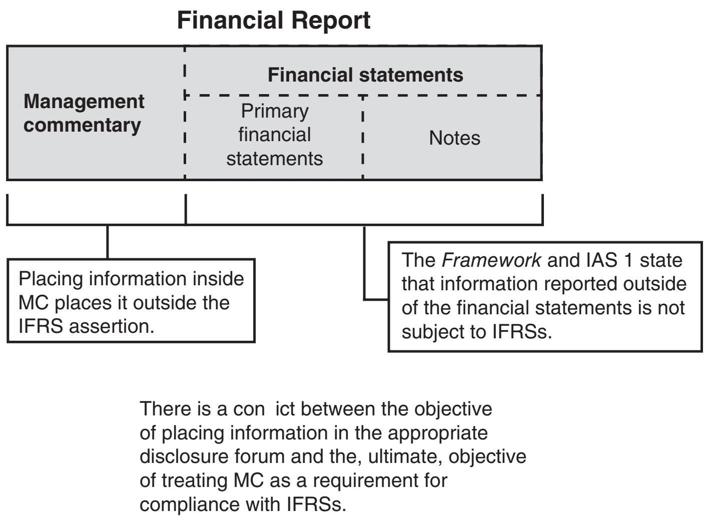


Figure 6.2 Asserting compliance with IFRSs

229 If our recommendations are followed the IASB will consider MC disclosures when it reviews existing IFRSs or issues new ones. This means MC disclosure requirements would be integrated into IFRSs. Accordingly, the MC standard would be limited to a standard containing the principles and qualitative characteristics, essential content elements of MC, and any subsequent standards that define the measurement of non-IFRS financial information and non-financial information.[84] If the review of the *Framework* being undertaken jointly with the FASB broadens the scope of the *Framework* to cover financial reports, including MC, it is possible that the qualitative characteristics of MC will be included in that framework, limiting the role of a separate MC standard to discussing the principles and the essential content.

84 Even measurement requirements could be integrated into an IFRS that addresses both the IFRS and MC requirements.

 

## Application of an MC standard

230 We recognise that principle-based standards demand more judgement from management than prescriptive rule-based standards. There is a danger that, faced with interpretative uncertainty, management will err on the side of disclosing larger quantities of data rather than exercising the judgement required to present the information necessary to meet investors' needs. This can be a particular problem in jurisdictions where the regulatory and civil legal environments penalise management for failure to disclose. The resulting failure to discriminate between key and other information can result in MC that is of little value to investors.

231 We concluded that implementation guidance has an important role to play in ensuring that MC reflects the principles contained in a standard. Section 4 provides discussion and examples that could be included in future implementation guidance issued by the IASB. We envisage that any implementation guidance would include suggestions and illustrations to demonstrate essential content elements of MC that comply with the proposed standard.

232 Even with implementation guidance, there is a limit to how far we will observe cross-jurisdictional consistency of application. The legal and regulatory environments affect the incentives and behaviour of management. We are already observing differences between jurisdictions about the extent to which guidance and interpretation from the IASB is necessary for IFRS compliance. Nevertheless, achieving convergence of the core MC requirements should, by definition, narrow the observed variation in application from existing practice.

233 The presentation form of MC can be influenced by local regulation, and special labels are sometimes required by local regulation. We believe it would be helpful to users if the financial statements:

(a) include a statement that they are accompanied by MC;

(b) indicate how that MC can be identified (by title or page references for example); and

(c) state the basis on which it has been prepared.

234 For example, is the MC prepared in accordance with the IASB's requirements or the requirements of a specific jurisdiction? This would necessitate an amendment to IAS 1 and could be implemented even if IASB MC requirements are not developed.

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# Appendix A
# Proposals for an MC standard

## Introduction

A1 The conclusion reached in paragraph 214 is that the IASB should issue a standard for MC. This Appendix sets out our preliminary view of what should be included in such a standard. It is not intended to constitute a complete draft, but to identify the core components from which a standard could be developed. The components of the proposed standard are set out in paragraphs A3-A60.

A2 Because the proposals reflected in this section are intended to be read as components of a standard, some of the material repeats conclusions reached, and explained, in sections 3 and 4.

## Definitions

### Management commentary

**A3 Management commentary (MC) is information that accompanies financial statements as part of an entity's financial reporting. It explains the main trends and factors underlying the development, performance and position of the entity's business during the period covered by the financial statements. It also explains the main trends and factors that are likely to affect the entity's future development, performance and position.**

A4 In some jurisdictions MC is referred to as operating and financial review (OFR), management discussion and analysis (MD&A) or management reporting. The definition of MC is intended to encompass the information provided by those statements.

A5 The information that is intended to be included within an entity's MC should be defined as such by the use of appropriate headings so that it is clearly distinguishable from the financial statements and from other published information.

### Management

**A6 In the context of MC the term 'management' means those responsible for the decision making and oversight reflected in the MC, who may include executive employees and members of a governing body.**

 

## The objective of MC

**A7 The purpose of MC is to provide information to help investors:**

> **to interpret and assess the related financial statements in the context of the environment in which the entity operates;**
>
> **to assess what management views as the most important issues facing the entity and how it intends to manage those issues; and**
>
> **to assess the strategies adopted by the entity and the likelihood that those strategies will be successful.**

## Principles and qualitative characteristics

A8 Any information included in the identified MC that is required to meet the objective of MC must be prepared and presented in accordance with the principles and qualitative characteristics identified here.

**A9 MC should supplement and complement information in the financial statements.**

A10 In supplementing the financial statements, MC includes additional explanations of amounts reported in the financial statements and explains the conditions and events that shaped the information in those statements.

A11 In complementing the financial statements, MC includes financial and non-financial information about the business and its performance that is not reported in those statements.

A12 MC should not repeat information given in the financial statements, unless the information is essential to place the MC in context.

A13 An entity's MC should be consistent with its financial statements. Where the financial statements include segment information, the information presented in the MC should reflect that segmentation. When information from the financial statements has been adjusted for inclusion in MC that fact should be highlighted, and a reconciliation provided.

**A14 MC should provide an analysis through the eyes of management.**

A15 MC should reflect management's view of the business, disclosing appropriate elements of information used, and assessments made, in managing the entity. This will help align better the information used internally with the information disclosed to investors.

**A16 MC should have an orientation to the future.**

A17 Orientation to the future requires identification of those trends and factors relevant to an investor's assessment of the current and future performance of the entity and its progress towards the achievement of long-term strategies and objectives. This also requires an explanation of past events, decisions, circumstances and performance in the context of whether they are reasonably likely to be indicative of, and have a material impact on, future prospects.

A18 Orientation to the future is about communicating, through management's eyes, the direction the entity is taking, by, for example, setting out future strategies, goals and targets.

**A19 MC should be understandable, relevant, supportable, balanced and comparable over time.**

A20 MC should be written in plain language, using graphics and tables when these are likely to assist investors.

A21 It is the responsibility of management to consider what information should be included in MC, and whether the omission of any information is likely to have an impact on the decisions investors make.

A22 MC should provide sufficient information to meet the needs of investors rather than all information about an entity. The objective is quality rather than quantity of MC content.

A23 MC should be underpinned by an entity's business plans, strategies and risk analysis. When relevant, management should explain the source of the information and when MC information is less certain this should be clear from the information presented.

A24 MC should be free from bias, dealing even-handedly with good and bad aspects of the performance and prospects of the entity.

A25 An entity's MC should be comparable over time. If an entity changes its MC in such a way that comparability is impaired, it should explain and justify those changes.

## Content

A26 To meet the objective of MC identified in paragraph A7, information should be provided about:

(a) the nature of the business

(b) objectives and strategies

(c) key resources, risks and relationships

(d) results and prospects

(e) performance measures and indicators.

A27 MC should be viewed as a whole. Although the items identified in paragraph A26 are essential elements of MC they are not required headings. It is the responsibility of management to determine how best to present and structure this information.

A28 These elements are related and should not be presented in isolation. It is essential that management demonstrates and communicates how these elements interrelate. A content map may help readers understand the structure of the MC and the location of elements within it.

A29 Management is in the best position to determine the most appropriate content, including the level of detail, given the particular circumstances of the entity.

### Nature of the business

**A30 MC should provide readers with a clear description of the nature of the business and the external environment in which it operates.**

A31 A description of the business is essential for an investor to gain an understanding of the industries and markets in which the entity operates. This includes its segments, products and services, business model and processes, distribution methods, the business structure including the main operating facilities and their location.

A32 MC should discuss matters such as the entity's competitive position within the markets in which it operates and the significant features of the regulatory, legal, macro-economic and social environment that affects the business.

### Objectives and strategies

A33 **MC should provide readers with a clear description of the entity's objectives and the strategies in place to achieve them.**

A34 Management should discuss the financial and non-financial objectives of the business, the time frame for achieving them and how they relate to the creation or preservation of value over the longer term.

A35 A discussion of the strategies in place is necessary for investors to be able to assess the ability of the business to achieve its objectives in the context of the entity's key resources, risks and relationships.

A36 The objectives and strategies should be related to the entity's business cycle. Management should explain significant changes from the prior period in the objectives and strategies adopted, or planned.

A37 A statement of the vision and values of the business and how they relate to the objectives and strategies might also be helpful.

### Key resources, risks and relationships

A38 **MC should provide readers with a clear description of the key resources, risks and relationships that management believes may affect the entity's long-term value and how those key resources, risks and relationships are managed.**

A39 Management should set out the key financial and non-financial resources available to the entity and discuss their adequacy in meeting its objectives. The discussion of financial resources should supplement the financial statements by including an analysis of the adequacy of the capital structure, financial arrangements (whether on or off balance sheet), liquidity and cash flows of the business, and plans to address any identified inadequacies or surplus resources.

A40 Non-financial resources comprise both tangible and intangible items, including those not reflected in the financial statements. Examples of the latter include human and intellectual capital, processes, systems, distribution networks, rights to natural resources and reputation.

A41 Management should consider the full range of risks the entity faces and identify the key external and internal risks and opportunities that may affect the ability of the business to achieve its objectives. Management should explain the potential impact of the identified risks and how they are being managed. When the risks perceived to be important to the entity or the way risks are being managed changes, management should identify and explain these changes.

A42 Management should include information about key relationships the business has in place, how they are likely to affect the performance and value of the business and how they are managed. Examples can include customers, employees, suppliers, business partners, regulators, communities and providers of finance.

### Results and prospects

**A43 MC should provide readers with a clear description of the financial and non-financial performance achieved, the extent to which this performance is indicative of future results and management's assessment of future prospects.**

A44 Management should supplement the financial statements by explaining the development and performance of the entity during the period under review and its position at the end of that period. This explanation should focus on those business segments that are relevant to an understanding of the entity as a whole. MC should explain and discuss significant changes in financial position, liquidity, and results compared with those of the previous period(s), and the extent to which past results are indicative of future results.

A45 Management should include an assessment of the main trends and factors in the development and performance of the business and their relationship to the objectives and strategies of the entity.

A46 Management should provide an analysis of the future prospects of the entity including targets for key financial and non-financial measures.

A47 When future prospects are quantified management should explain the risks and assumptions necessary to assess the likelihood of achieving stated targets. Management should alert investors to the uncertainty inherent in the information about future prospects.

A48 When an entity has previously reported quantified targets it should report actual performance, and analyse and explain significant variances.

### Performance measures and indicators

**A49 MC should provide readers with a clear description of the key measures and indicators that management uses to assess and manage performance against the stated objectives.**

A50 Management should set out the key financial and non-financial measures that it uses to measure and assess progress towards the objectives of the entity. In this context, the measures are quantified measurements that reflect the critical success factors of an entity.

A51 Management should set out the key financial and non-financial indicators that it uses to monitor progress towards the objectives of the entity when it is difficult to measure performance directly. Indicators could be narrative evidence describing how the business is managed or quantified measures that provide indirect evidence of performance. In addition, management should set out those indicators it uses to monitor external trends and factors it does not control.

A52 Management should provide information that enables investors to understand how each measure, or quantified indicator, reported in MC has been defined and calculated.

A53 Corresponding amounts for the prior period should be provided for each measure and indicator. When there have been changes in the quantified measures or indicators reported, or the definition or calculation method, that fact should be identified and explained.

A54 The purpose of each reported measure should be disclosed.

A55 MC should include information to assist investors in assessing the extent of uncertainty surrounding the performance measures and indicators to enable them to make a judgement regarding the extent to which they will rely on that information.

A56 MC should include a cautionary note to ensure that users are made aware of areas of uncertainty and the source of the underlying data.

A57 To ensure comparability with the financial statements, information derived from, or referenced to, the financial statements should be consistent with those statements, or reconciled if it has been adjusted.

## Form

A58 The form of MC will vary between entities, reflecting the nature of their business, the strategies adopted and the regulatory environment in which they operate.

## Assertions

A59 An entity must clearly identify what it is presenting as MC.

A60 An entity shall make an explicit and unreserved statement that it has complied with all the requirements of the MC standard, when those requirements have been met.

# Appendix B
# Existing requirements for MC

### International Organization of Securities Commissions (IOSCO)

B1 The Technical Committee of IOSCO issued a report *General Principles Regarding Disclosure of Management's Discussion and Analysis of Financial Condition and Results of Operations* in February 2003. The report summarises the objectives of MD&A, identifies principles for preparers and highlights areas where preparers should be cautious, eg avoid boiler-plate or stock language. A comparison of matters addressed in the report, and the principles suggested in this paper, is in Appendix C.

B2 The report states that:

> The purpose of the MD&A is to provide management's explanation of factors that have affected the company's financial condition and results of operations for the historical periods covered by the financial statements, and management's assessment of factors and trends which are anticipated to have a material effect on the company's financial condition and results of operations in the future. Companies should provide the information that is necessary for an investor's understanding of the company's financial condition, changes in financial condition and results of operations.

### Australia

B3 The Corporate Law Economic Reform Program Act 2004 (CLERP 9) amended section 299A of the Corporations Act to require companies to expand their directors' report. For years beginning on or after 1 July 2004

> The directors' report for a financial year for a company or disclosing entity that is a listed public company must also contain information that members of the company would reasonably require to make an informed assessment of:
>
> (a) the operations of the entity reported on; and
>
> (b) the financial position of the entity; and
>
> (c) the entity's business strategies and its prospects for future financial years.

B4 The Australian Stock Exchange (ASX) has a listing rule that is based upon section 299A of the Corporations Act. ASX does not require any particular format to be followed, nor does it specify its content. However, both CLERP 9 and the ASX support the Group of 100 (G100) guidance publication *Guide to the Review of Operations and Financial Condition.* CLERP 9's explanatory memorandum states that the G100 guidance may be used for the purpose of satisfying the legislative requirement, and the ASX reproduces the guidance within its own Guidance Notes.

B5 The G100, a group comprising Australia's major private and public business enterprises and global enterprises operating in that country, originally issued its guide in 1998 and updated it in 2003. These guides have been influenced by both the UK OFR guidance and the Canadian guidance on MD&A.

B6 The guide states that:

> The Review should provide users with an understanding of the company by providing a short-term and long-term analysis of the business as seen through the eyes of the directors. This will be facilitated by providing useful financial and non-financial information and analysis. ... A contemporary Review should include an analysis of industry-wide and company-specific and non-financial information that is relevant to an assessment of the company's performance and prospects.

## Canada

B7 In Canada the requirements for and the content of the MD&A are mandated by the provincial securities regulatory bodies, collectively known as the Canadian Securities Administrators (CSA). In December 2003, the CSA issued new MD&A requirements applicable in all securities jurisdictions in Canada, contained within National Instrument 51-102 *Continuous Disclosure Obligations.*

B8 NI 51-102 and the related MD&A form do not refer to the CICA Guidance on MD&A issued in November 2002 (paragraph B9), but in several places appear to reflect the intent of that guidance. CSA Form 51-102FI, Part 1(a) describes MD&A as:

> ... a narrative explanation, through the eyes of management, of how your company performed during the period covered by the financial statements, and of your company's financial condition and future prospects.

 

B9 The CICA released guidance on MD&A disclosure in November 2002 (updated in May 2004) that sets out six principles and a five-part framework of recommended disclosure practices. A comparison of the principles and framework contained in the Canadian guidance and those proposed in this paper is in Appendices C and D.

B10 The CICA as such has no mandate to issue standards for MD&A disclosure (nor to require MD&As to be issued by companies) – as explained above, that is all a regulatory responsibility and prerogative. The Guidance developed by a separate division (and volunteer board) of the CICA is used by companies on a purely voluntary basis. However, the four largest securities regulators in Canada (ie four members of the CSA) have issued explicit encouragement to companies to use the CICA Guidance, and the latest CSA MD&A requirements show signs of adopting some aspects of the CICA Guidance.

B11 The guidance states:

> … useful MD&A explains the 'why' behind both past performance and future prospects by 'connecting the dots' between otherwise separate pieces of internal and external information … should enable readers to view the company through the eyes of management … providing information important to an investor, acting reasonably, in making a decision to invest or continue to invest in the company … having a forward-looking orientation … focusing on management's strategy for generating value for investors over time.

### European Union (EU)

B12 The requirements for MC type reporting are set out in various legal instruments adopted by the EU, in particular the Fourth and Seventh Company Law Directives (the 'Accounting Directives'), as updated by the Modernisation Directive and enhanced by the Transparency Directive. The Accounting Directives state that the annual report:

> … shall also give an indication of any important events after the balance sheet date, the likely future development of the entity, the activities in the field of research and development, and the risks relating to the use of financial instruments including their management.[85]

[85] Article 46 of the Fourth Directive and Article 36 of the Seventh Directive.

B13 The Modernisation Directive, which has been implemented in all Member States, requires companies to present an annual report that provides:

> ... at least a fair review of the development and performance of the company's business and of its position, together with a description of the principal risks and uncertainties that it faces.

B14 The directive states:

> To the extent necessary for the understanding of the company's development, performance or position, the analysis shall include both financial and, where appropriate, non-financial key performance indicators relevant to the particular business, including information relating to environmental and employee matters. ... the annual report shall, where appropriate, include references to and additional explanations of the amounts reported in the annual accounts.

B15 In December 2004, the EU adopted the Transparency Directive, which must be implemented by all Member States within two years. Under the directive, all security issuers will have to provide annual and half-yearly financial reports. These reports must include a management report prepared in accordance with the Accounting Directives. The half-yearly interim management report:

> ...shall include at least an indication of important events that have occurred during the first six months and their impact on the financial statements together with a description of the principal risks and uncertainties for the remaining six months of the financial year.

### Germany

B16 The German tradition of management reporting goes back to 1931, when all public limited companies were required to prepare a business report. Specific requirements were introduced in 1937 requiring management:

(a) to explain the related financial statements;

(b) to identify material changes from the previous financial year; and

(c) to comment on the financial position of the company.

 

B17 The requirement to prepare a business report was extended to all limited companies in 1986. This has evolved to the management reporting we see today, which is based on the legal requirements of the EU and is almost identical to the EU content mentioned previously. Additionally, a legal requirement for risk reporting was introduced in 1998, and a German accounting standard (GAS 5 *Risk Reporting*) has been in place since 2001. GAS 5 states that:

> Risk reporting ... should allow users to form an appropriate understanding of the risks affecting the future developments of the group.

B18 The legislation was amended in December 2004 to emphasise some topics such as an extensive analysis of development and performance of the business during the year, its financial position at the year-end, reporting of financial and non-financial key performance indicators, and the likely future development of the company including its significant opportunities and risks. The objective is an improvement in management reporting.

B19 The DRSC adopted GAS 15 *Management Reporting* in December 2004; it is based on the EU legal requirements and takes into account the SEC requirements, and the Canadian and UK guidance. GAS 15 sets out the principles, and format for content, to be followed in preparing management reporting. A comparison of those areas and the principles and essential content elements suggested in this paper is in Appendices C and D.

B20 GAS 15 states that:

> The group management report shall present a fair review of the development of the business and of the group's position. Expected developments shall be assessed and discussed together with the significant risks and opportunities. ... Management reporting is intended as a vehicle for presenting information to users from management's perspective. ... The focus should be on sustainable value creation ... The main factors which could influence changes in the value of the enterprise in the future should be disclosed and discussed. ... It is recommended that the key performance indicators used internally to manage the group are quantified.

B21 GAS 15 also states that the intention is to reduce:

> ... the gap between the information available to users of the financial statements and that available to management.

### New Zealand

B22 The New Zealand Securities Commission is the principal regulator of securities when money has been obtained from the public. It has no specific requirements for MC. Rather, the regulator uses the financial reporting framework to manage the content of general purpose financial reports. MC is required for certain items when an entity makes an initial public offering, but those requirements do not extend to annual reports.

B23 The New Zealand financial reporting framework is managed by the Financial Reporting Standards Board. The framework is sector-neutral, covering profit-oriented and public-benefit entities. As such, the framework covers both financial and non-financial reporting. The consequence is that the framework refers to general purpose financial reports rather than the narrower financial statements. The framework includes outputs and outcomes as elements, and the qualitative characteristics apply to this wider set. In practice, public sector entities regularly report on service performance with non-financial measures.

B24 Notwithstanding the wider scope of the New Zealand reports, there is no specific analysis or discussion of MC within the New Zealand framework. However FRS-9 *Information to be Disclosed in Financial Statements* requires that when an entity has published prospective financial information it must present a comparison with actual performance in the period to which the forecast relates.

### United Kingdom

B25 UK legislation in early 2005 requires quoted companies to prepare an operating and financial review (OFR). The UK Government has stated that the statutory requirement for an OFR should be supported by a 'reporting standard'. The Government specified the UK ASB as the body to issue such a standard.

B26 The OFR objective as stated in the legislation is:

> ... a balanced and comprehensive analysis, consistent with the size and complexity of the business, of -
>
> (a) the development and performance of the business of the company during the financial year,
>
> (b) the position of the company at the end of the year,

 

(c) the main trends and factors underlying the development, performance and position of the business of the company during the financial year, and

(d) the main trends and factors which are likely to affect the company's future development, performance and position

prepared so as to assist the members of the company to assess the strategies adopted by the company and the potential for those strategies to succeed.

B27 In May 2005, the UK ASB issued Reporting Standard (RS 1), which built on its existing statement of best practice on OFRs. RS 1 is a principle-based standard, which makes clear that the OFR must reflect the directors' view of the business. The objective is to assist members to assess the strategies adopted and the potential for those strategies to succeed. The standard also provides a basic framework for directors to apply in order to meet the requirements of the Regulations. It is for the directors to consider how best to use the framework to structure the OFR, given the particular circumstances of the entity. A comparison of both the principles and basic content framework in RS 1 with the proposals contained within this paper is in Appendices C and D.

B28 RS 1 defines an OFR as:

> ... a narrative explanation, provided in the annual report, of the main trends and factors underlying the development, performance and position of an entity during the financial year covered by the financial statements, and which are likely to affect the entity's future development, performance and position.

B29 Although following a framework approach, the ASB has also prepared implementation guidance to accompany RS 1, as the ASB was conscious that some guidance would be useful to preparers of OFRs. The guidance sets out some illustrations and suggestions of specific content and related key performance indicators that might be included in an OFR.

## United States

B30 In the US MD&A is called for by the federal Securities and Exchange Commission (SEC), the US securities regulator. The SEC is charged with administration of, and rulemaking and enforcement under, the Securities Act of 1933 and Securities Exchange Act of 1934. The Sarbanes-Oxley Act of 2002 caused the SEC to undertake significant additional rule-making. A comprehensive overview of the evolution, purpose and content of the MD&A is provided in the Interpretive Guidance released by the SEC in December 2003 (release numbers 33-8350 and 34-48960).

B31 That guidance stated:

> The purpose of the MD&A is not complicated. It is to provide readers with information "necessary to an understanding of [a company's] financial condition, changes in financial condition and results of operations." The MD&A requirements are intended to satisfy three principal objectives:
>
> (a) to provide a narrative explanation of a company's financial statements that enables investors to see the company through the eyes of management;
>
> (b) to enhance the overall financial disclosure and provide the context within which financial information should be analyzed; and
>
> (c) to provide information about the quality of, and potential variability of, a company's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance.

B32 Furthermore:

> ... companies should identify and discuss key performance indicators, including non-financial performance indicators that their management uses to manage the business and that would be material to investors.

B33 Since the collapse of Enron (late 2001), the SEC has issued several new releases, rules and proposals on topics including critical accounting policies and estimates, liquidity, capital resources, off balance sheet arrangements, aggregate contractual obligations and transactions with non-independent third parties. Some of these releases arguably call for disclosures that might otherwise be expected in notes to financial statements under US GAAP (the standards that are the responsibility of the US FASB.)

B34 The FASB does not issue guidance about MD&A disclosure. This is left to the SEC as a regulatory matter.

 

# Appendix C
# Principles and qualitative characteristics: a cross-jurisdictional analysis

| DP proposal for IASB | IOSCO | Canada | Germany | UK | USA |
|---|---|---|---|---|---|
| Supplement and complement financial statement information. | Improves financial disclosure overall and provides the context within which financial information should be analysed. | Should complement as well as supplement financial statements. | (Not a principle as such. However, this is an underlying function of the annual report.fl | Shall complement as well as supplement the financial statements. | Should not be merely a restatement of financial statement information in a narrative form. |
| Provide an analysis of the entity through the eyes of management. | Enable investors to see the company 'through the eyes of management'. | A company should disclose information that enables readers to view the company through the eyes of management. | Information from the perspective of management – it is management's assessment of the reported matters which is at the forefront. | Set out an analysis of the business through the eyes of the board of directors. | Enable investors to see the company through the eyes of management. |
| Have an orientation to the future. | Enable investors to make a better prediction about the sustainability of earnings and cash ow in the future. | A forward-looking orientation is fundamental to useful MD&A reporting. | Focus on sustainable value creation – all events, decisions and factors known that could have a significant in uence on the future development of the value of the entity should be disclosed and discussed. | Shall have a forward-looking orientation. | To provide information about the quality of, and potential variability of, a company's earnings and cash, so that investors can ascertain the likelihood that past performance is indicative of future performance. |
| Be understandable, relevant, supportable, balanced and comparable over time. | Should be clear, concise and meaningful, and in plain language.<br>Should highlight the most relevant information.<br>Should be presented in a format that will enhance comprehensibility of the issuer's financial statements to investors, as well as other users of this information, such as investment advisers and rating agencies. | Usefulness – should be written in plain language, with candour and without exaggeration, and embody the qualities of understandability, relevance, comparability and consistency over reporting periods.<br>Completeness and materiality – to be reliable, MD&A should be complete, fair and balanced, and provide information that is material to decision making needs of users. | Reliability – plausible, free from contradiction and consistent with the financial statements.<br>Clarity and transparency – consistency in terms of methodology and format from one year to the next.<br>Completeness – the group should provide all information that, from the perspective of management, a knowledgeable reader requires. | Shall be balanced and neutral, dealing even-handedly with both good and bad aspects.<br>Shall be comparable over time.<br>Shall be comprehensive and understandable.<br>Shall focus on matters relevant to members. | Communicate with investors in a clear and straightforward manner.<br>Should focus on material information and eliminate immaterial information that does not promote understanding. |

# Appendix D
# Content: a cross-jurisdictional analysis

| DP proposal for IASB | Canada | Germany | UK |
|---|---|---|---|
| Although the items identified below are essential elements of MC this does not suggest that these are required headings. It is the responsibility of management of determine how best to present and structure this information. | Companies shall structure and integrate their MD&A disclosures within a broad reporting and disclosure framework.<br>The framework is presented as an integrative reporting tool, not a template. Management should choose the best way to use the framework to organise its MD&A disclosures and place information in a meaningful context. | The management report is required to start with a table of contents. | Set out below is a framework for the disclosures to be provided by the directors in an OFR. This framework is not a template, nor should the elements be taken as headings that must be included within an OFR. Its purpose is to set out the key content elements that shall be addressed within an OFR. It is for the directors to consider how best to use the framework to structure the OFR and the precise content, including the level of detail to be disclosed, relating to the key elements, given the particular circumstances of the entity.<br>These circumstances may include:<br>the industry or industries in which it operates<br>the range of products, services or processes it offers<br>the number of markets it serves. |
| To meet the objective of MC, information should be provided about:<br>Nature of the business<br>Objectives and strategies<br>Key resources, risks and relationships<br>Results and prospects<br>Performance measures and indicators. | The MD&A should communicate information that helps users understand past performance and future prospects. Five key elements of the disclosure framework to achieve this are:<br>The company's vision, core businesses and strategies<br>Key performance drivers<br>Capability to deliver results<br>Results<br>Risks. | It is recommended that the report be subdivided, at a minimum, into the following sections.<br>Sections of management reporting:<br>Business and operating environment<br>Results of operations<br>Financial position<br>Net assets<br>Risk reporting<br>Report on post-balance sheet date events<br>Reporting on anticipated developments. | The OFR shall provide information to assist investors to assess the strategies adopted by the entity and the potential for those strategies to succeed. The key elements of the disclosure framework necessary to achieve this are:<br>The nature of the business, including a description of the market, competitive environment in which the entity operates, and the entity's objectives and strategies.<br>The development and performance of the business, both in the financial year under review and the future.<br>The resources, principal risks and uncertainties and relationships that may affect the entity's long-term value.<br>Position of the business including a description of the capital structure, treasury policies and objectives and liquidity of the entity, both in the financial year under review and the future. |
| | Within 'key performance drivers' section, 'they also need to know the measures and significant leading indicators used by management to monitor progress on these key performance drivers'. | It is recommended that the key performance indicators used internally to manage the group are quantified. (Relates to 'performance measures and indicators'fl | Within 'nature, objectives and strategies' the 'OFR shall include the key performance indicators, both financial and, where appropriate, non-financial, used by the directors to assess progress against their stated objectives'. 'Directors shall also consider the extent to which other performance indicators and evidence shall be included in the OFR.' |

# Appendix E
# Placement criteria examples

E1 To help readers envisage how the placement criteria described in section 5 would work, we offer a few examples.

E2 The purpose of the examples is to demonstrate *where* information would be disclosed and not *what* would be disclosed. All of the examples assume that either the standard-setter or management has decided that the information being presented is material to investors.

## Foreign currency transactions

E3 An entity transacts in currencies other than its functional currency. It recognises gains and losses on foreign currency transactions.

E4 The financial statements and notes might include:

(a) foreign currency gains or losses.

(b) the accounting policy with regard to the translation of foreign currency transactions during the year, and at the year-end.

(c) the functional currency and the rationale for selecting it.

(d) foreign currency gains and losses, if they have not been disclosed on the face of the primary financial statements.

E5 If foreign currency risks are a key risk for the entity, MC might include:

(a) information about market risk, which includes foreign currency risk, and how this risk is managed by the entity.

(b) the impact changes in currency rates have on the entity.

(c) historical trends of foreign currency exchange rates and what management expects the future trends to be.

(d) objectives and strategies for managing foreign currency risks.

(e) measures used by management to assess and manage performance in relation to foreign currency risks, eg percentage of foreign currency transactions effectively hedged (if the entity's policy is to hedge such transactions).

## Mineral exploration costs and reserves

E6 An entity's right to extract mineral reserves is an asset. However, the ability to value those rights in financial terms can be difficult because of the need to estimate several factors, such as the quantity of reserves associated with each specific right, the cost of extracting the reserves and the price that will be achieved in selling the reserves.

E7 Different accounting treatments have been advocated for exploration activities by standard-setters around the world. A common approach is to recognise within the financial statements what management believes to be the recoverable portion of mineral exploration costs.

E8 The financial statements and notes might include:

(a) exploration expenses or the recognised carrying amount of reserves.

(b) the accounting policy for deferring mineral exploration costs.

(c) disaggregation of mineral exploration costs by site.

(d) information relevant to determining the recoverable amount of deferred mineral exploration costs, such as 'proven and probable' reserves measured by volume (eg tonnes), estimated costs to extract per measure of volume, estimated selling price by volume.

(e) any recognised expenses or carrying amount that were not disclosed on the face of the primary financial statements.

E9 If management regards mineral reserves as a key resource of the entity, MC might contain:

(a) historical and expected future trends of metal prices, supply and demand for the minerals themselves, and economic indicators that are lead indicators. For example, if the mineral is a key component in white goods, GDP growth in the main markets in which the entity's customers operate might be a lead indicator.

(b) strategies and objectives for reserve replacement.

(c) measures used by management to assess and manage performance against reserves replacement strategies, eg historical success rates, historical cost per unit mined along with targets for the future.

 

## Internally generated brands

E10 A brand meets the definition of an asset. However, although the value of externally acquired brands can be measured reliably, IAS 38 *Intangible Assets* states that internally generated brands cannot. Accordingly, any internally generated brand will be valued at nil within the financial statements.

E11 The following information might be included in the notes to the financial statements:

(a) accounting policies for brands, eg those purchased externally are measured at cost on acquisition and then amortised, and internally generated brands are measured at nil.

(b) the value of internally generated brands.

(c) information about the important estimates in valuing those brands.

E12 If management regards brands as a key resource/risk of the entity, MC might contain:

(a) trends of growth rates for the markets (eg both market and geography) in which the branded products are sold, any lead economic indicators relating to market growth (eg demographics if particular brands appeal to any one age or socio-economic group), both historical and forward-looking.

(b) objectives and strategies for brand acquisition, development and maintenance.

(c) measures used by management to assess and manage performance against brand replacement strategies, eg historical market position, volume of units sold, brand awareness ratings, as well as future targets for the same measures.

## Employee workforce

E13 Under the IASB's proposal for a revised IFRS 3 *Business Combinations* an entity's employee workforce must not be recognised as an asset. Accordingly, an employee workforce will not be recognised in the financial statements whether the employees were recruited by the entity itself or 'acquired' through the acquisition of a business.

E14 Even though the employee workforce is not recognised in the financial statements, disclosure in the notes of the number of employees is consistent with the placement principles set out in section 5.

E15 If management regards the employee workforce as a key resource/risk or relationship of the entity, MC might contain:

(a) information about trends that affect the employee workforce, eg demographics, level of training/education in the general workforce and unemployment rates, both on a historical basis and on a forward-looking basis.

(b) strategies and objectives for employee recruitment, retention and training.

(c) measures used by management to assess and manage performance against employee workforce strategies, such as acceptance levels against offers, training levels relating to key employee groups, employee morale ratings, training measures and leaving rates.