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EFRAG

European Financial Reporting Advisory Group

DRAFT COMMENT LETTER

Comments should be sent to commentletter@efrag.org by 10 February 2010

XX February 2010

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir/ Madam

IASB ED *Management Commentary*

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the IASB Exposure Draft *Management Commentary*, which was issued in June 2009 ('the ED'). This letter is submitted in EFRAG's capacity of contributing to the IASB's due process and does not necessarily indicate the conclusions that would have been reached in its capacity of advising the European Commission on endorsement, were the ED to result in material falling within the scope of the EU's IAS Regulation.

The ED describes at a high-level and in a principles-based way a framework for the preparation and presentation of Management Commentary ('MC') and the content of a decision-useful MC. The proposal is that this material will represent non-mandatory guidance on MC.

Our detailed comments on the ED are set out in the appendices. (Appendix 1 contains our responses to the questions asked in the ED, whilst appendix 2 contains some additional observations related to the objective, users and qualitative characteristics of MC and on placement principles). To summarise our comments made in these appendices:

- we support the IASB's decision to develop high-level, principle-based, non-mandatory guidance on MC;
- we broadly support the detailed proposals, except that:
    - we have some concerns about the desirable qualitative characteristics it is proposed that MC should have;
    - we do not support the IASB's decision to defer the development of placement principles until Phase E of the Conceptual Framework project. We think that some

sort of placement principles are necessary to increase the effectiveness of financial reporting where MC is prepared.

We hope that you find the comments helpful. If you wish to discuss them further, please do not hesitate to contact Mark Abela or me.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix 1
EFRAG's response to the questions asked in the ED

Question 1: The IASB's approach to the subject of MC—Do you agree with the Board's decision to develop a guidance document for the preparation and presentation of management commentary instead of an IFRS? If not, why?

Notes for EFRAG's constituents

1 *At the beginning of this project, the IASB considered whether to carry out an active project on Management Commentary (MC) and, if it was to carry out a project on the subject, whether the objective should be to develop a mandatory standard or non-mandatory guidance. In the light of feedback received from respondents to an earlier discussion paper prepared for the IASB, the IASB decided to undertake a project designed to result in non-mandatory guidance. In reaching this decision, it noted that both the Committee of European Securities Regulators (CESR) and the International Organization of Securities Commissions (IOSCO) support the publication of a guidance document on MC rather than a mandatory standard.*

2 *The IASB believes that issuing non-mandatory guidance rather than a mandatory standard will permit an entity's management to exercise discretion in tailoring its commentary to the entity's particular circumstances and will enable individual jurisdictions to make their own judgments on:*

- *(a) whether entities should be required to include MC in their financial reports to assert compliance with IFRS financial statements;*
- *(b) the level of assurance to which MC should be subjected;*
- *(c) the necessity for 'safe harbour' provisions in relation to the inclusion of forward–looking information; and*
- *(d) the type of entity that should prepare MC.*

EFRAG's response

EFRAG's view

- EFRAG supports the IASB in carrying out work on MC.
- EFRAG agrees that at this stage it is non-mandatory guidance rather than a mandatory standard that the IASB should be developing.

3 EFRAG supports the IASB's decision to carry out an active project on MC. In our view, the MC is a very important part of the annual reporting package, and the annual reporting package is a fundamentally important element of business reporting. Even though some jurisdictions already have well-developed requirements and guidance on MC, an IASB project on the subject ought to assist:

- (a) with the global convergence of MC reporting requirements; and

(b) jurisdictions that do not have MC reporting requirements and as a result improve the quality of financial reporting in those jurisdictions.

4 EFRAG carefully considered the advantages and disadvantages of either a mandatory standard or non-mandatory guidance. We, for example, acknowledge that a standard is more likely to guarantee a consistent application of MC requirements. In addition, Europe has a long tradition of requiring MC information (for example as laid out in the Fourth and Seventh Company Law Directives). Having said that, we are also concerned about the difficulty of developing a standard that is sufficiently detailed to have an impact on existing practice without creating inconsistencies with those existing requirements. Having weighed these arguments, we—like the IASB—have concluded that developing non-mandatory guidance would be the most appropriate approach at this time. We are, therefore, supportive of the IASB developing and issuing non-mandatory guidance on the subject.

5 We in particular do not agree with the three IASB dissenters, who have argued that non-mandatory guidance will not result in improvements in financial reporting. In our view, global guidance on the subject could make a difference. In some jurisdictions it will provide impetus and direction to the jurisdictional authorities to develop material (including requirements and best practice material on the subject), and in some other jurisdictions it will provide impetus and direction to the entities themselves. We accept though that there might be some jurisdictions that take little notice of non-mandatory guidance, but do not believe that this should be the IASB's concern at this stage.

Question 2: Content elements—Do you agree that the content elements described in paragraphs 24 – 39 are necessary for the preparation of a decision–useful management commentary? If not, how should those content elements be changed to provide decision-useful information to users of financial reports?

Notes for EFRAG's constituents

6 The IASB has chosen to adopt a high-level principles-based approach to MC. Therefore, having described a high-level framework for the preparation and presentation of MC, it describes, again at a high-level, the content of MC. In particular, it suggests that, to meet the objective of MC, an entity should disclose information on:

(a) the nature of the business;

(b) management's objectives and strategies for meeting those objectives;

(c) the entity's most significant resources, risks and relationships;

(d) the results of operations and prospects; and

(e) the critical performance measures and indicators that management uses to evaluate the entity's performance against stated objectives.

These five content elements are further described in paragraphs 25 – 39 of the ED.

7 The IASB explains this approach by pointing out that specifying disclosures for management commentary can be more difficult than specifying information to be disclosed in the notes to the financial statements. The types of activities that are critical to an entity *are specific to that entity. As a consequence, regulators have tended to identify the elements that reflect the type of content they expect to see in management commentary rather than defining the elements themselves. Furthermore, by not specifying a detailed list of contents, the IASB hopes to discourage a checklist compliance mentality.*

EFRAG's response

EFRAG's view

- EFRAG supports the high-level, principles-based approach that the Board is proposing to adopt.
- EFRAG is broadly supportive of the specific things the ED says on content.

8 We support the high-level principles-based approach towards the content of MC that the IASB has chosen to adopt. We think anything other than a high-level approach would have created a risk of inconsistencies between the IASB material and the guidance and requirements that already exist in many jurisdictions. And we favour principle-based material over rules.

9 We are also broadly supportive of the specific things the ED says on content. We support the direction the IASB has taken in avoiding a checklist approach to the list of essential content information in paragraph 24 of the ED. However, we think it would be preferable were this paragraph to focus more of the information objectives and the need to develop the MC with care and less on a list of information to be provided.

Question 3: Application guidance and illustrative examples—Do you agree with the Board's decision not to include detailed application guidance and illustrative examples in the final management commentary guidance document? If not, what specific guidance would you include and why?

Notes for EFRAG's constituents

10 Although the MC discussion paper contained both application guidance and illustrative examples that were included to demonstrate the principles underpinning the MC framework, the IASB has decided not to include such material in its guidance. There are two reasons for that decision. First, the IASB was concerned at the risk that its application guidance or illustrative examples would be interpreted as either a floor (minimum requirements) or a ceiling (the only disclosures for inclusion in MC) and it concluded that the risk of undue emphasis being placed on the application guidance and illustrative examples outweighs their utility. Second, the IASB decided that the development of application guidance or illustrative examples to help entities apply the framework for the preparation and presentation of management commentary is best left to other organisations.

EFRAG's response

11 EFRAG supports the IASB's approach.

Appendix 2
Some additional observations

1 The questions asked by the IASB in the Invitation to Comment part of the MC ED do not cover all the proposals in the ED. In particular, they do not cover the proposals on the framework for the preparation and presentation of management commentary that are described in paragraphs 8 – 23 of the ED. Set out below are EFRAG's comments on the proposals.

OBJECTIVE, USERS AND QUALITATIVE CHARACTERISTICS OF MC

Notes for EFRAG's constituents

2 Paragraph 9 of the ED states that the primary users of MC are existing and potential capital providers, and that, the needs of those users are paramount when management considers what information to include in MC.

3 The ED also explains that the objective of MC is the same as the objective of all other general purpose financial reports: to provide decision-useful information for existing and potential capital providers in their role as capital providers.

4 The ED explains that the desirable qualitative characteristics of MC are the same as the desirable qualitative characteristics of all other general purpose financial reports. In other words:

(a) *the fundamental qualitative characteristics of MC are relevance and faithful representation; and*

(b) *the enhancing qualitative characteristics of MC are comparability (over time and between entities), verifiability, timeliness and understandability.*

5 The MC ED goes on to set out high-level principles for the preparation and presentation of MC. To summarise:

(a) *MC should explain the main trends and factors that are likely to affect the entity's future performance, position and development. It should also communicate information about an entity's economic resources, claims on those resources and the transactions and other events and circumstances that change them. Consequently, MC is not only about the present, but also the past and the future.*

(b) *MC should provide existing and potential capital providers with information that helps them place the related financial statements in context. MC that fulfils that purpose explains management's view on not only what has happened, but also why management believes it has happened and what management believes the implications are for the entity's future.*

(c) *MC should help users assess the performance of the entity and the actions of its management relative to stated strategies and plans for development.*

(d) *MC should provide management's view of the entity's performance, position and development; supplement and complement information presented in the financial statements; and have an orientation to the future.*

6 On presentation, the ED explains that:

(a) *The form of MC may vary from entity to entity.*

(b) *MC should be clear and straight-forward.*

(c) *Repetition of financial statement information without analysis and boilerplate discussion with no insight do not result in useful MC.*

(d) *The presentation should focus on the most important information.*

(e) *MC should be consistent with the financial statements.*

(f) *Management should avoid duplicating in its MC the disclosures made in the notes to its financial statements.*

(g) *Generic disclosures not relating to the practices and circumstances of the entity should be avoided.*

EFRAG's response

EFRAG's view

- EFRAG agrees with the proposed objective and users of MC.
- We do not agree that the desirable qualitative characteristics of MC are those set out in the May 2008 Framework ED.
- We think the meaning of paragraph 23(b) is unclear.

7 In May 2008, the IASB published an ED *Conceptual Framework for Financial Reporting: Chapter 1-The Objective of Financial Reporting and Chapter 2-Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information*. That ED proposed inter alia that the objective of general purpose financial reports was to provide financial information about the reporting entity that is useful to the primary user group (ie present and potential equity investors, lenders, and other creditors) in making decisions in their capacity as capital providers. The MC ED notes that MC is an example of a general purpose financial report and it reaffirms that the objective set out in that May 2008 Framework ED applies equally to MC.

8 When EFRAG commented on the May 2008 Framework ED, it agreed that in principle the Framework should apply to all types of general purpose financial reports, not just to general purpose financial statements. However, we also made it clear that we were not convinced that everything that was said in that ED could be applied to all types of general purpose financial reports.

Objective of MC

9 Against that background, we agree that the information objective of MC is the same as the information objective of general purpose financial reports as set out in the Framework ED: to provide decision-useful information to the primary user group.

10 Having said that, we do not think that the description in paragraph 10 of the ED fully reflects what we see as the essence of MC. In our view the objective of MC is to put the information provided by the general purpose financial statements in context. For that reason we agree with the second sentence of paragraph 10's reference to explaining the main trends are factors that are likely to affect the entity's future performance, position and development. But we think the first sentence misses the point in describing MC in terms that apply equally to general purpose financial statements. We think the sentence should be omitted.

The users of MC

11 We also agree that the users of MC are the same as the users of general purpose financial reports as described in the Framework ED, because we think it reasonable to suppose that the various parts of the annual report package have the same primary users. It follows that we believe that MC should focus primarily on the needs of existing and potential capital providers, but also take into account the information needs of other groups of users. We therefore agree with the wider notion of users set out in paragraph 9 of the ED. Accordingly, it also follows that we do not believe general purpose financial reports (such as MC) should focus exclusively on the information needs of existing and potential capital providers and that therefore we do not think that the notion used in paragraph 11 of the ED, which limits the focus of MC to existing and potential capital providers, is appropriate. In our view, it would be more consistent and appropriate if the IASB used the reference in paragraph 9 of the ED when referring to users in the MC guidance.

12 We suggest that the easiest way of addressing this concern is to use the term 'users' throughout the ED and to make it clear, probably in paragraph 9 of the ED, that the term is intended to refer to users as described in that paragraph.

Desirable qualitative characteristics of MC

13 We do not agree that the desirable qualitative characteristics of MC are those set out in the May 2008 Framework ED. That Framework ED proposed that the fundamental qualitative characteristics of general purpose financial reports are relevance and faithful representation and the enhancing qualitative characteristics are comparability (over time and between entities), verifiability, timeliness and understandability.

14 We agree that desirable qualitative characteristics of MC are relevance, comparability over time, timeliness and understandability. However, we do not believe it reasonable to expect all MC to be comparable between entities, neutral and verifiable.

(a) We do not believe that it is realistic to expect MC to be both comparable between entities and also able to show the entity's activities, position and prospects from the management's perspective and the circumstances of the entity, with an emphasis on what management views as important. 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.

(b) Faithful representation is attained when the depiction of an economic phenomenon is complete, neutral, and free from material error. Financial information that faithfully represents an economic phenomenon depicts the economic substance of the underlying transaction, event or circumstances, which is not always the same as its legal form. In our view, MC should aspire to be complete, free from material error, and depicting the economic substance of transactions, events and circumstances. However, we do not think it is reasonable to expect MC to be neutral, because it represents, by definition, management's view of the entity. To that extent we agree with the comments made by the three dissenting IASB Board members in paragraph AV3. We wonder whether it might be preferable to use the notion of 'balance', which would involve dealing even-handedly with both the good and bad aspects of an event etc.

(c) We are not convinced that the verifiability notion could be applied effectively to MC. Future-oriented information, for example forecasts and projections, cannot be verified. We wonder whether it might be preferable to use a notion of 'reasonableness', that is to say, do the assumptions that support the future-oriented information in financial reports make sense? Perhaps this could be supported by a 'supportability' notion, where information is deemed to be supportable if it faithfully represents factually-based strategies, plans and risk analysis.

15 We note that the ED's Basis for Conclusions states that questions about the applicability of the qualitative characteristics to MC "will be resolved during the finalisation of Chapter 1 of the Conceptual Framework for Financial Reporting". That chapter had not been published at the time we were preparing this draft letter so it has not so far been possible for us to assess whether our concerns about the applicability of the Framework's qualitative characteristics to MC—concerns that we have raised previously both within the context of the MC project and within the context of the Framework project—have been addressed in finalising that chapter.

16 EFRAG is in agreement with the rest of paragraphs 8 - 23, although we think the meaning of paragraph 23(b) ("Management should avoid duplicating in its MC the disclosures made in the notes to its financial statements. Doing so may create an obstacle for users to identify and understand the most significant matters facing the entity") is not entirely clear and therefore should probably be clarified.

PLACEMENT PRINCIPLES

Notes for EFRAG's constituents

17 The MC DP included proposals for a framework to guide the IASB in determining whether information it requires entities to disclose within general purpose financial reports should be placed in MC or in the general purpose financial statements ('placement principles'). The placement principles the DP suggested were 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.

18 The MC ED does not contain any placement criteria because the IASB believes that Phase E of its conceptual framework project (which deals with the boundaries of financial reporting, presentation and disclosure) is the appropriate project to resolve questions about the placement of disclosures in the financial reports. Until this phase is complete the IASB acknowledges that overlap will exist between the type of information that is disclosed in the notes to the financial statements and that which is disclosed in MC. In the light of that overlap, the Board determined it was more important to establish management commentary as a disclosure tool within IFRSs than it was to immediately resolve questions of placement for that information.

EFRAG's response

Summary of EFRAG's view:

- EFRAG does not support the IASB's decision to defer development of placement principles until Phase E of the conceptual Framework is completed. We think that, in the interim period, the IASB should develop placement criteria.

19 In its reply to the MC DP, EFRAG argued that placement principles were needed because otherwise each time the IASB requires a new disclosure it would need to take an ad hoc decision as to whether that new disclosure should be presented in MC or in the notes to the financial statements. We continue to be supportive that criteria are needed to determine whether a piece of information should be provided in the MC rather than the financial statements and vice versa. It is widely accepted that it would be inappropriate to include in MC information that should be provided in the general purpose financial statements, and we think it can sometimes also be inappropriate to include MC information in the general purpose financial statements.

20 At present nonetheless, the IASB specifies requirements for disclosures in the financial statements that would rather belong to the MC. Placement criteria would help the IASB specify in each standard which disclosures should always be presented in the notes to the financial statements and which disclosures should be presented in the MC, should a MC need to be prepared in accordance with the local compliance framework. All disclosure requirements would be mandatory in all circumstances, despite the non-mandatory feature of the MC guidance. Where a MC is prepared, financial reporting would hence, in our view, be more cohesive and effective.

21 Accordingly, we do not support the IASB's decision to defer the development of placement principles to Phase E of the conceptual framework. It is our understanding that Phase E will not be completed for some years and we think that, if the financial reporting is to be effective, some principles are needed to distinguish between information that should be disclosed in the notes and that which should or could be disclosed in the MC.