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Update on the Management Commentary project

Issues Paper

Objective

- 1 The objectives of the session are to seek for members' views on the following topics:
 - (a) applying the notion of narrative coherence; and
 - (b) identifying and reporting matters that could affect the entity's long-term success, including intangible resources and relationships.

Background

- 2 In November 2017 the Board added to its agenda a project to update the Management Commentary Practice Statement (MCPS). The IASB expects to publish an Exposure Draft in the first half of 2020.
- 3 To support the work on updating the Practice Statement, the IASB established the Management Commentary Consultative Group (MCCG).
 - (a) September 28, 2018: the meeting focused on overall approach of the project and the status of a revised MCPS, the objective; application of materiality and principles for preparing the Management Commentary (MC), focusing on completeness, neutrality and comparability.
 - (b) January 11, 2019: the meeting addressed the overall approach to reporting performance, position and progress; the analysis of the financial statements; and matters that could affect the entity's future development.
 - (c) April 3, 2019: the meeting addressed the overall revised MCPS architecture; business model, strategy, operating environment and risks.
 - (d) A final wrap-up meeting is scheduled in December 2019 to tackle any unaddressed issues.
- 4 EFRAG TEG and EFRAG CFSS:
 - (a) Received a first update on the project at the November 2018 joint meeting and discussed the application of materiality and the principles for preparing the MC. ([here](#)).
 - (b) Received a second update at its March 2019 meeting and discussed a number of issues raised by the MCCG joint meeting: namely, the use of cross-reference, the tension between the concept 'through the eyes of management' with neutrality and decision useful information, the inclusion of forecast information and the need additional disclosure on the sustainability of effective tax rates. ([here](#))

- 5 EFRAG TEG also received an update on the project at the April 2019 meeting and provided their initial views and comments on the IASB's proposals to revise the MCPS. Members were generally supportive of the initiative but some expressed concerns about overlaps with other projects (such as the Primary Financial Statements project) and the lack of clarity, at this stage, of the objectives and boundary of the project. Some members also questioned the use of technical language and references in IFRS Standards as a basis for developing guidance for the MCCPS. These members suggested that the IASB considers clarity and conciseness of the Practice Statement. (EFRAG TEG issues paper [here](#)).
- 6 The following paragraphs describe the issues that will be covered at the July MCCG meeting with the EFRAG Secretariat initial comments.

Applying the notion of narrative coherence

IASB Staff proposed approach

- 7 The IASB is proposing to **introduce the notion of narrative coherence** to help management identify relevant information about reportable matters for inclusion in a MC. This information should have the potential to be material. However, more judgement could be needed for MC than for financial statements.
- 8 For that reason, the IASB proposes a **guidance** on applying narrative coherence and emphasise that the proposed guidance relates to disclosures that should be *considered* by management, rather than disclosures that must be made as not all of them would be material.
- 9 When management identified information about a reportable matter that is required in one part of MC, management would need to consider whether information about the matter is also required in relation to other content elements.
- 10 The IASB proposed guidance on applying narrative coherence in relation to the entity's:
 - (a) business model;
 - (b) strategy;
 - (c) performance, position and progress; and
 - (d) operating environment and risks.

Management Commentary Consultative Group comments

- 11 MCCG members generally agreed with the IASB proposed approach to reporting business model, strategy, operating environment and risks and introduce narrative coherence linking these topics. However, some MCCG members expressed the view that the reference to 'future net cash inflow' could be too restrictive and lead to the omission of material non-financial information. Some members suggested to refer, instead, to concept on 'value creation' as the basis for narrative coherence, instead, which would encompass a broader set of information.
- 12 MCCG members generally agree with the consideration of an enhanced description of the business model and strategy as a backbone for the MC. There was also a view expressed that the business model should be anchored to value creation rather to purpose which is often too broad.
- 13 Some MCCG members expressed the view that the revised guidance needed to also cover opportunities rather than just risks, so that MC include a balanced discussion of both risks and opportunities. It was also noted that opportunities could be more difficult to quantify than risks, but even qualitative information about opportunities would still be useful.

EFRAG Staff initial views and comments

- 14 The EFRAG Secretariat supports discussing the principle of narrative coherence in the revised MCPS as this has the potential to enhance the connection between financial statements and wider corporate reporting and to ensure inclusion of useful information required to assess position, performance, progress and impacts of a reporting entity.
- 15 The EFRAG Secretariat considers that the explanation of the principle of narrative coherence and accompanying illustrative examples are helpful. Nonetheless, narrative coherence is a relatively new term that could, at face value, result in multiple interpretations and be potentially confusing. With the reference to coherence, this principle may, at face value, be interpreted as being the same as the idea of linkage that entails the presentation or disclosure of interrelationships and dependencies between different types of information. However, as articulated by the IASB staff, the narrative coherence principle seems to focus on preparers' ensuring the completeness or inclusion of all material information within the MC - without necessarily there being a linkage or connectivity in presentation or disclosure of any interrelated information. Hence, it may be helpful to break down narrative coherence into two different principles; one that is focused on completeness and inclusion of all material information (narrative completeness) and another that informs on the linkage and connectivity (narrative coherence).
- 16 Furthermore, the EFRAG Secretariat considers that focusing only on impacts on 'net future cash inflow' to anchor the content and narrative coherence of the MC may not necessarily capture indirect but material economic impacts to the business. Paragraph 27 below further explains the potential limitations of a focus on net future cash flows.

Questions for EFRAG TEG-CFSS

- 17 Do EFRAG TEG-CFSS members agree that the proposed guidance would support the provision of relevant information to primary users?
- 18 Do EFRAG TEG-CFSS members think that any additional guidance should be provided, or that any aspects of the proposed guidance are not necessary?

Identifying and reporting matters that could affect the entity's long-term success

IASB Staff proposed approach

- 19 The IASB propose guidance on identifying and reporting in MC matters that could affect the entity's long-term success. This would include guidance on:
 - (a) reporting in the business model description;
 - (i) resources and relationships (including intangibles) that the entity depends on for its long-term success; and
 - (ii) impacts of the entity's business activities on those resources and relationships.
 - (b) describing the entity's strategy that is anchored in the entity's long-term purpose;
 - (c) describing trends and factors in the operating environment as well as risks that could affect the entity's long-term success; and
 - (d) explaining progress in managing the features of the entity's business model that the entity depends on for its long-term success.
- 20 Please refer to ASAF agenda paper 13 – 02 ASAF 02 Management Commentary Practice Statement ([here](#)) for more detail.

Management Commentary Consultative Group comments

- 21 MCCG members agreed with the IASB proposed approach mentioned before. However, some MCCG members noted that an explicit discussion of long-term value creation was needed to help users understand an entity's business model and strategy, as well as risks arising from the operation of the entity's business model.
- 22 MCCG members agreed with IASB proposed approach to reporting the entity's strategy for the long, medium and short term by discussing the entity's purpose, objectives and plans. However, a few members suggested that the guidance should specifically address the intended time frames, and that it should emphasise the focus on the long term.

EFRAG Staff initial views and comments

- 23 The EFRAG Secretariat support the proposed guidance on identifying and reporting in MC matters that could affect the entity's long-term. However, we also support guidance that enhances the discussion by management about the short-term, medium-term and long-term value created by the business.
- 24 This, in our view leads to a discussion of intangible resources and relationships, which is a key topic and driver of value creation for many entities operating in the modern economy. We consider that the importance of and unique role of intangibles is not emphasized enough in the proposals.
- 25 We also have several observations on the expressed objective of re-orienting preparers towards providing information with a longer-term focus than is currently the case. Our observations are on the following:
- (a) A potentially narrow focus on informing on net future cash flows;
 - (b) Consequent to considering an entity's impacts on resources and relationship, there is need for guidance to ensure the appropriate application of double materiality principles; and
 - (c) Need for explicit principles or illustrative examples to encourage entities to clearly distinguish and clarify the difference between short, medium and long-term horizons.
- 26 The below paragraphs further explain the above observations.
- 27 *Focus on net future cash flows is narrow:* The focus on considering long-term value creation with reference to the amount, timing and uncertainty of an entity's net future cashflows has the merit of being consistent with the revised Conceptual Framework for Financial Reporting (Conceptual Framework). It is also the approach to considering the decision-usefulness and relevance of the information within financial statements. However, a focus on net future cashflows (even when including cashflows into perpetuity) could inadvertently contribute to the short-term focus that the revised MCPS intends to overcome and could end up being too narrow a focus. These could occur due to the following reasons:
- (a) In considering net future cash flows, preparers may be primarily inclined to focus on factors that impact on realisable and easier to measure future cash flows. In contrast, they may be inclined to exclude indirect, second-order effects (e.g. long-term customer satisfaction) or factors that are difficult to quantify and translate to future cash flows or those that are subject to significant measurement uncertainty due to their potential crystallisation being too far out in time (e.g. climate change risk¹);

¹A November 2018 CDSB report based on a detailed review of 80 EU companies found that 83% describe their business model and only 44% do so with any reference to the climate or environment. The CDSB review

- (b) However, negative externalities on society and environment can affect reputation, license to operate and cost of capital, of reporting entities in a manner that cannot be readily quantified and thus often have only indirect effects on future cash flows. Nevertheless, users could be interested in such externalities as part of their understanding of the risk profile of reporting entities.
- (c) In the valuation of an entity, the uncertainty of potential future cash flows could either be reflected through the risk-adjusted net future cash flows or through the discount rate/expected return. It is not clear whether the net future cash flow as described by the IASB staff always captures the risk premium element that could sometimes be reflected through the discount rate.
- 28 For these reasons, EFRAG Secretariat would recommend the focus of MC be on informing on economic value creation rather than net future cash flows. Similar to a focus on net cash flows, a focus on economic value creation would also clarify that the intended audience of MC information are the current and potential providers of financial capital.
- 29 *Guidance related to double materiality:* The IASB Staff proposes inclusion of information on the entity's business activities on the resources and relationships. Such information can inform users about the sustainability of the business model and on how external impact (e.g. an entity contributing to water scarcity with its operations in a water stressed region) could also impact an entity's net future cash flows. Nonetheless, there is a difference² between the application of financial materiality (i.e. impact on business) and materiality of impacts which considers the perspective of a wider audience than investors. Hence, if information on an entity's impacts were to be included within the MC, entities will have to apply the "double materiality" concept and some additional guidance around the determination of materiality of such impacts would be useful. Such guidance should outline the differences and similarities between the two different types of materiality.
- 30 *Guidance on time horizons:* The EFRAG Secretariat acknowledges that it is not meaningful to be prescriptive on how entities ought to distinguish between short, medium and long term horizons because such a distinction will depend on the business model. Nonetheless, the failure³ by many reporting entities to clearly distinguish time horizon is a contributing factor to their inadequate focus on the long-term. Hence, there could be a need for the IASB to further develop principles or illustrative examples to encourage and help entities to clearly distinguish and clarify the difference between short, medium and long-term horizons.

Questions for EFRAG TEG-CFSS

- 31 Do EFRAG TEG-CFSS members have comment that the proposed guidance would promote providing a long-term view in management commentary?
- 32 Do EFRAG TEG-CFSS members think that any additional guidance should be provided, or that any aspects of the proposed guidance are not necessary?

also had a less detailed and high-level review of another 500 EU companies (smaller than the 80) and found that only three companies identify climate change as a principal risk.

https://www.cdsb.net/sites/default/files/cdsb_nfrd_first_steps_2018.pdf

² A [2017 WBCSD report](#) highlights that there is a significant discrepancy between the way in which companies identify material risks in their sustainability and mainstream filings respectively.

³ The CDSB in-depth review of 80 EU companies found that only 10 organisations state the expected time horizon and only two companies specifically disclose the definitions of short, medium and long term.

