

Management Commentary

Accounting Standards Advisory Forum meeting
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ASAF agenda paper 5

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Purpose of the session

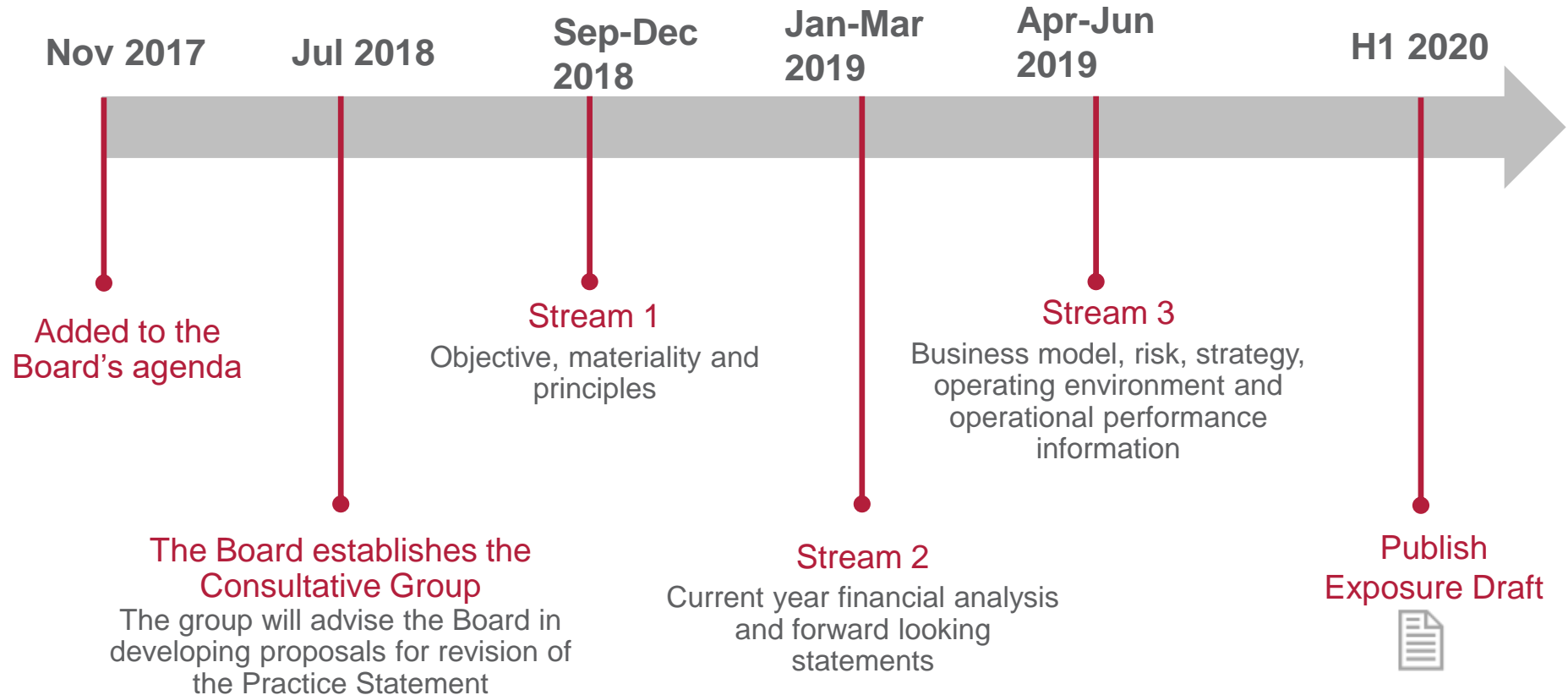
- To provide an update on the Management Commentary project
- To receive feedback on:
 - Applying materiality in preparing management commentary
 - Principles for preparing management commentary

Contents of the paper

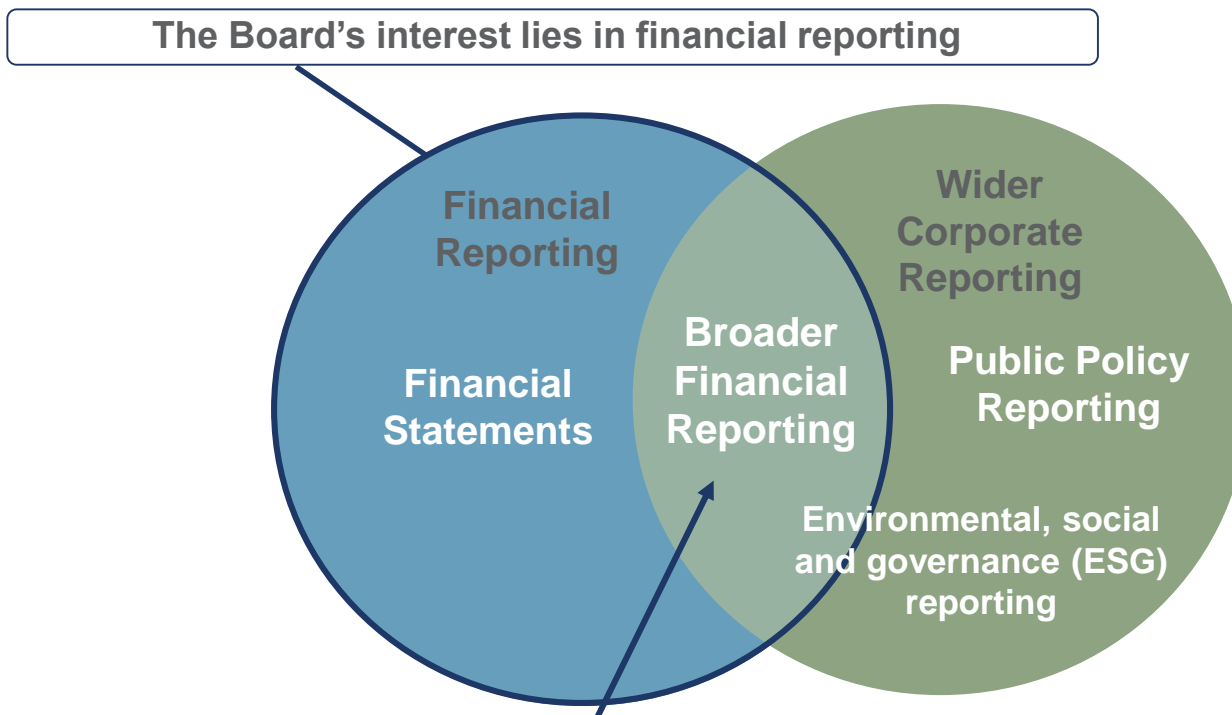
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Project update

Project timeline



Scope of Management Commentary project



Management commentary is a narrative report aimed at **primary users** of financial reports that provides context for and additional insight into an entity's financial statements.

The **primary users** of financial reports are defined in the *Conceptual Framework for Financial Reporting* as **existing and potential investors, lenders and other creditors**.

Objective of management commentary

Staff's approach on what to include in Practice Statement	Consultative Group feedback	CMAC feedback	GPF feedback
<ul style="list-style-type: none"> • Reflect the objective of financial reporting as per the revised <i>Conceptual Framework</i> • Emphasise that primary users need information for their assessments of prospects of future net cash inflows and of stewardship of the entity's economic resources • Retain the concept of 'management's view' from the existing Practice Statement • Include guidance supporting the objective 	<ul style="list-style-type: none"> • Emphasise primary users' needs and what is important in running the business, as well as link to entity's purpose • Management commentary should provide context for the financial statements and include additional insights on the entity's prospects • Wording on future cash flows could be misinterpreted as a need to disclose forecasts • Include reference to cash flow variability 	<ul style="list-style-type: none"> • Concern that use of 'whole life cash flows' implies that management knows how long the entity's life would be • Wording on future cash flows could be misinterpreted as a need to disclose forecasts • Management commentary should include reference to external trends, including information on the competitive environment, to the extent they are applicable to the entity's business • Include explicit reference to 'returns', capital structure and dividend policy, and the assumptions made by management in relation to risks 	<ul style="list-style-type: none"> • Some of the guidance is too prescriptive • Concerns on providing forward looking information (from a litigation risk perspective), which could result in less uptake of the Practice Statement • Clarify that the reference to 'future cash flows' or 'whole life cashflows' is not a requirement to disclose forecasts • 'Negative guidance', ie what management commentary is <i>not</i> expected to provide, would be helpful • Reference to risks is vague and requires a definition in the Practice Statement or by management

The Board will be asked for a decision on the objective of management commentary at its November meeting. An oral update will be provided on its decision. Further detail on the approach and the illustrative drafting presented to the Board can be found in the appendix (pages 28-37).

For input from ASAF: Applying materiality

Where we are now and why revision is needed

Where we are now

- The existing Practice Statement refers to materiality as a principle to be applied in preparing management commentary. However, it provides no guidance on *how* that principle should be applied.
- The IFRS Practice Statement 2 *Making Materiality Judgements* (the “Materiality Practice Statement”) provides application guidance on applying materiality in preparing general purpose financial statements.
- The *Conceptual Framework* defines materiality as an entity-specific aspect of relevance that could influence primary users’ decisions.

Why revision is needed

- **Difficulties in applying materiality to narrative:** The staff are aware that some preparers find the application of materiality to management commentary challenging.
- **Need for application guidance:** The existing Practice Statement does not include sufficient application guidance to address these challenges. The staff think that reiterating and adapting what is included in the *Conceptual Framework* and the Materiality Practice Statement in the revised Practice Statement will support preparers in assessing what is material for their management commentary.

Extracts from existing Practice Statement and *Conceptual Framework* on materiality

Existing Practice Statement §21: Materiality

Management should include information that is material to the entity in management commentary. Materiality will be different for each entity. Materiality is an ‘entity-specific aspect of relevance’; thus information that is relevant for an entity will also be material.

Definition of Materiality in the *Conceptual Framework*:

Information is material if omitting, misstating it or obscuring it could reasonably be expected to* influence decisions that the primary users of general purpose financial reports make on the basis of those reports, which provide financial information about a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity’s financial report. Consequently, the Board cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.

**The clarification ‘reasonably be expected to’ and the reference to ‘obscuring’ information were added to the definition of ‘material’ in October 2018 by amendments to IAS 1 Presentation of Financial Statements and IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, as well as to the Conceptual Framework.*

Extract from the Materiality Practice Statement

IFRS Practice Statement 2 *Making Materiality Judgements* §33:

The steps identified as a possible approach to the assessment of materiality in the preparation of the financial statements are, in summary:

Step 1—identify. Identify information that has the potential to be material.

Step 2—assess. Assess whether the information identified in Step 1 is, in fact, material.

Step 3—organise. Organise the information within the draft financial statements in a way that communicates the information clearly and concisely to primary users.

Step 4—review. Review the draft financial statements to determine whether all material information has been identified and materiality considered from a wide perspective and in aggregate, on the basis of the complete set of financial statements

The staff's proposed approach

Suggested approach to revisions to the Practice Statement:

Example:

Distinguish between **matters** and **information about those matters**. Management will first need to consider whether a matter is important to the entity's current and future cash flows, and then considers what information in relation to that matter is material.

Matter – the entity's brewery in a desert region may have to close

Clarify that information is material to the management commentary if it could reasonably be expected to influence a user's decisions based on the user's assessment of the amount, timing, or uncertainty of the entity's cash flows or the user's assessment of management's stewardship of the entity's economic resources.

Information on that matter – water usage in that brewery has decreased compared to last year

Provide clear and practical guidance for preparers on making materiality judgements by building on the *Conceptual Framework* and the Materiality Practice Statement.

In summary – materiality

Staff's approach on what to include in Practice Statement	Consultative Group feedback	CMAC feedback	GPF feedback
<ul style="list-style-type: none"> Emphasise that materiality is applied in the context of user assessments of cash flow prospects and stewardship Introduce a two-stage approach to identifying material information: <ul style="list-style-type: none"> (i) identification of business matters on which information is needed; (ii) identification of the information users need to assess those matters Add guidance specific to management commentary, based on IFRS Practice Statement 2 <i>Making Materiality Judgements</i> 	<ul style="list-style-type: none"> Some explicitly agreed on separate consideration of matters and information Materiality assessment for management commentary should be combined with that for the financial statements What is discussed by an entity's board should be considered material for management commentary 	<ul style="list-style-type: none"> Most agreed with approach in principle but some felt the definition of material in the <i>Conceptual Framework</i> is sufficient The Practice Statement should note that what is material changes over time 	<ul style="list-style-type: none"> Disagreed with considering what is discussed by an entity's board as material, due to sensitivity of matters Qualitative materiality for management commentary is more important than quantitative Some uncertainty on two-stage approach

Questions for ASAF members

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Question 1

Do you agree with discussing in the revised Practice Statement the proposed distinction between matters that need to be addressed in management commentary and material information about those matters?

Question 2

Should we include any other considerations for materiality assessments in the revised Practice Statement?

For input from ASAF: Principles

Principles for preparing management commentary

The need for narrative coherence in preparing management commentary

Neutrality in management commentary

Comparability of management commentary

Although there are other principles, we have focused on coherence (in relation to completeness) and neutrality due to their necessity for faithful presentation. We also discuss comparability since this enhancing qualitative characteristic features regularly in discussions on management commentary.

Coherence, neutrality and comparability: Where we are now and why revision is needed

Where we are now

- The existing Practice Statement states that management commentary should provide management's view of the entity's performance, position and progress; and supplement and complement the financial statements.
- It states that management commentary should include forward looking information and information that possesses the **qualitative characteristics** of useful financial information as described in the *Conceptual Framework*, ie:
 - relevance; and
 - faithful representation that encompasses completeness, neutrality and freedom from error.

Why revision is needed

- **Clarify how applying Practice Statement relates to information objectives:** The existing Practice Statement does not elaborate on how to ensure that management commentary possesses the qualitative characteristics (except for reference to including both positive and negative circumstances, which addresses neutrality in part).
- **Address concerns about quality of narrative:** Concerns have been raised about narrative coherence, neutrality and comparability in management commentary.
- **Introducing application guidance would help:** Staff think that application guidance needs to be included in the revised Practice Statement to promote disclosures which possess the qualitative characteristics more fully.

The staff's proposed approach – Coherence (1/3)

Linkage approach

- We suggest that the revised Practice Statement will state a requirement for coherent narrative, which is referred to as “linkage” in this slide deck.
- The essence of the linkage approach is requiring an entity to build the content of a management commentary in a methodical manner that **supports the characteristic of completeness**. This approach is illustrated opposite, and further described on the next page.
- The linkage approach is built around management’s view of **what is important to the future of the business** and provides a test for whether the report leaves unanswered questions.
- The staff think this approach will support rigorous discussion of the most important matters, with less focus on less important ones.

Illustrative examples of the linkage approach

Risks:

An entity identifies loss of its reputation for quality as a key risk



Operational Performance:

The entity provides trend information on product failure rates

Strategy

An entity identifies expansion in a new region as a key part of its growth strategy



Business model

The entity describes the key features / differences in business model for the region even though it is currently small

Business model

An entity identifies its R&D capability as a key competitive advantage



Strategy

The entity explains how it is managing R&D staff retention and development

Financial performance

An entity reports declining revenues in a segment

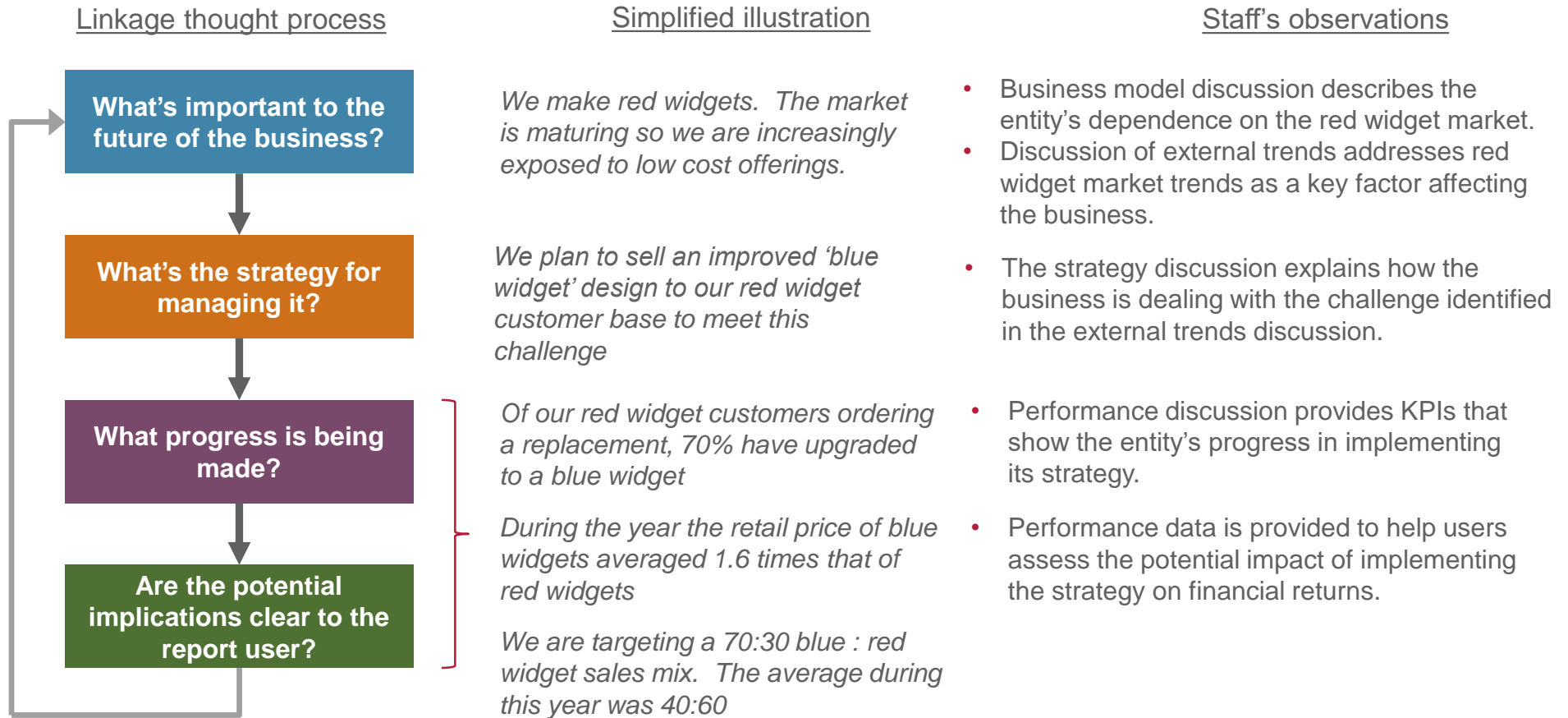


Strategy

The entity explains its strategy for addressing the trend

The staff's proposed approach – Coherence (2/3)

Applying the linkage approach across the content elements in management commentary:



The staff's proposed approach – Coherence (3/3)

Further guidance to support narrative coherence in management commentary

Internal information

- The entity considers information used internally in setting strategy and monitoring the financial and operational performance of the business—eg management information packs; operating reviews.
- This perspective is consistent with the approach of reporting 'through the eyes of management'.

External factors

- The entity considers factors it is aware of in the external environment or from its routine engagement with stakeholders.
- It is not suggested that the entity should undertake additional engagement with stakeholders in order to support the preparation of the management commentary.

Capital markets communication

- The entity considers information it has or intends to communicate directly to capital markets participants (eg investor presentations)
- Information provided through investor relations channels will ordinarily be relevant to users' decision making. In practice this information is typically much richer than that provided in a management commentary and incorporates, for example, additional analysis of strategy, disaggregated information about performance, and operational measures that relate to the entity's strategy.

The staff's proposed approach – Neutrality

The staff propose that the revised Practice Statement will describe how management could apply the following aspects of neutrality that could alter a user's assessments. Specific guidance for content elements may be provided.

Key aspects	Proposed approach	Illustrative problems it could address
Overall tone & content	Entity considers whether the management commentary as a whole provides a balanced view to support an assessment of the entity's prospects for future net cash inflows and management's stewardship of its economic resources	<i>Positive language that is not representative of overall performance / outlook</i>
Prominence, obscurity, or omission of matters	Entity considers whether undue emphasis, obscurity, or omission of discussion of a matter might affect a user's interpretation of information in management commentary.	<i>Significant drop in order book, not yet reflected in the financials</i>
Selection & presentation of information	Entity considers whether choice and form of information presented on each matter (including level of aggregation) could be expected to cause a user to take an unjustified view of the matter	<i>Aggregate water usage reported, but key water stressed site not identified</i>
Range of potential outcomes discussed	Entity considers whether an unduly wide or narrow range of potential outcomes discussed in relation to a matter might influence a user's view of the matter	<i>Initial indications suggest reserves could be as much as...</i>
Consistency	Entity considers whether changes in the basis of presentation or calculation of information might unduly influence a user's view of the matter	<i>Change in definition of same store sales</i>

The staff's proposed approach – Comparability

The staff do not propose to prescribe specific disclosures or to define subject-based performance measures as this would not be consistent with a principles-based approach. However, the Practice Statement could include principles-based guidance aligned with the *Conceptual Framework* that could support better comparability of information in relation to:

Other information published by the entity (whether within or outside the management commentary and financial statements)

Estimates, forecasts and targets previously provided by the entity

Measures and methodologies common to the industry

Furthermore, the staff propose that:

- To help users assess limitations of comparative analysis, entities should provide explanations of scope and basis of preparation for information presented in the management commentary and the assumptions underlying the information provided
- Entities should provide an explanation on the rationale and methodology where their calculations or presentation of metrics differ from a prevalent industry practice
- If trend information is useful for users' analysis, entities should consider the appropriate period over which to present it (eg in some cases 5 years)

In summary – principles

Staff’s approach on what to include in Practice Statement	Consultative Group feedback	CMAC feedback	GPF feedback
<ul style="list-style-type: none"> • <i>Completeness:</i> <ul style="list-style-type: none"> ▪ an approach to completeness based on ensuring a coherent narrative across the content elements for each business issue raised, referred to as the linkage approach; ▪ include practical considerations for assessing completeness – information used for other capital market communications or internal decisions and knowledge of external factors and insights from other stakeholders 	<ul style="list-style-type: none"> • Different views on what “coherence” means, so clear language in the Practice Statement is needed • Specific reference to how management remuneration links with purpose and performance metrics • Overlap of guidance between completeness and materiality 	<ul style="list-style-type: none"> • No disagreement was expressed on the approach 	<ul style="list-style-type: none"> • Agree with concept of a coherent narrative, but concerned about using internal metrics and decisions as guidelines for completeness

In summary – principles (cont'd)

Staff's approach on what to include in Practice Statement	Consultative Group feedback	CMAC feedback	GPF feedback
<ul style="list-style-type: none"> • <i>Neutrality</i>: to include guidance on various aspects contributing to a neutral or balanced management commentary <ul style="list-style-type: none"> - Overall tone & content - Prominence, obscurity, or omission of matters - Selection & presentation of information - Range of potential outcomes discussed - Consistency • <i>Comparability</i>: to include guidance on information published outside the annual report, previous forecasts and industry metrics 	<ul style="list-style-type: none"> • Align segmental information in the notes and management commentary • Preparer concerns on sensitive information and comparability with peers • Verifiability should be emphasised as a principle for management commentary 	<ul style="list-style-type: none"> • Neutral information may not always be possible or useful because reporting on negative matters could result in self-fulfilling prophecies, but overall, neutrality should be emphasised as a principle • Expect difficulty in relation to comparability with industry metrics – guidance on this is needed for preparers • Consistency of information was suggested as another principle 	<ul style="list-style-type: none"> • Would not expect principles other than those already in the <i>Conceptual Framework</i> • If a management commentary is complete, then it should also be neutral • Concerns on comparability of metrics with those of industry peers • Verifiability is only possible for current year results and historical information (not for forward looking information); verifiability is also seen to imply a requirement for assurance

Questions for ASAF members

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Question 3

Do you agree with the proposed linkage approach to support a coherent narrative?

Question 4

Do you agree with the five aspects of neutrality that management needs to consider in preparing management commentary?

Question 5

Do you agree with the staff's approach to comparability?

Question 6

The Consultative Group highlighted “verifiability” as an important principle. Do you agree and are there any other principles which you think should be prominent in the revised Practice Statement?

Next steps

Next steps

December 2018 – January 2019	The staff will consider feedback from the Consultative Group and other advisory groups in preparing Board Papers on the application of materiality and principles for preparing management commentary. (<i>Note:</i> The objective of management commentary was discussed at the November Board meeting.)
January 2019	2 nd Consultative Group meeting.
January – April 2019	The staff will consider feedback from the Consultative Group and other advisory groups as it drafts proposals on the detailed content elements of management commentary for discussion at subsequent Consultative Group meetings and presentation to the Board.

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Appendix

Approach and illustrative drafting on the *objective* of management commentary

Where we are now and why revision is needed

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Where we are now

- IFRS Practice Statement 1 *Management Commentary**, published in 2010, emphasises **context** for financial statements **through the eyes of management** as the objective. Its principles describe how management commentary can **help users** in their understanding of financial reports.
- The *Conceptual Framework for Financial Reporting*, revised in 2018, clarifies the objective of general purpose financial reporting and discusses the information that users need and the assessments that users make on the basis of that information. See next page.

Why revision is needed

Need for more detailed guidance:

- The objective in the existing Practice Statement is set at a high level and only limited supporting guidance is provided.
- The staff think there is a case for expanding the guidance to support consistent application of the Practice Statement in the light of:
 - user calls for better management commentary information that aligns with their decision making
 - concerns over the perceived narrow focus of management commentaries with calls for improvement related to:
 - implications of external trends
 - key resources and relationships
 - strategic challenges

*See page 32 for extracts from existing Practice Statement

The objective of financial reporting as per the *Conceptual Framework*

Provide financial information useful to **primary users** of financial reports in making decisions about providing resources to the entity:

Decisions to buy, hold or sell

Decisions to provide or settle loans

Decisions to vote and influence management

Decisions depend on **expected returns**:

Expectations about returns depend on assessment of the prospects for **future net cash inflows**

Expectations about returns depend on assessment of **management's stewardship** of the entity's economic resources

To make those assessments users need information about:

economic resources, claims and changes in them

how efficiently/effectively management discharges its responsibilities

The staff consider that the explicit reference to the **assessments of prospects for future net cash inflows** and **of stewardship** included in the *Conceptual Framework* needs to be reflected in the revised Practice Statement.

Extract from the *Conceptual Framework* in relation to the objective of financial reporting

1.2 The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity. Those decisions involve decisions about:

- (a) buying, selling or holding equity and debt instruments;
- (b) providing or settling loans and other forms of credit; or
- (c) exercising rights to vote on, or otherwise influence, management's actions that affect the use of the entity's economic resources.

1.3 The decisions described in paragraph 1.2 depend on the returns that existing and potential investors, lenders and other creditors expect, for example, dividends, principal and interest payments or market price increases. Investors', lenders' and other creditors' expectations about returns depend on their assessment of the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity and on their assessment of management's stewardship of the entity's economic resources. Existing and potential investors, lenders and other creditors need information to help them make those assessments.

1.4 To make the assessments described in paragraph 1.3, existing and potential investors, lenders and other creditors need information about:

- (a) the economic resources of the entity, claims against the entity and changes in those resources and claims (see paragraphs 1.12–1.21); and
- (b) how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's economic resources (see paragraphs 1.22–1.23).

Extracts from the existing Practice Statement related to the objective of management commentary

Paragraph 9

Management commentary should provide users of financial statements with integrated information that provides a context for the related financial statements. Such information explains management's view not only about what has happened, including both positive and negative circumstances, but also why it has happened and what the implications are for the entity's future.

Paragraph 14

Management commentary should provide information to help users of the financial reports to assess the performance of the entity and the actions of its management relative to stated strategies and plans for progress. That type of commentary will help users of the financial reports to understand, for example:

- (a) the entity's risk exposures, its strategies for managing risks and the effectiveness of those strategies;
- (b) how resources that are not presented in the financial statements could affect the entity's operations; and
- (c) how non-financial factors have influenced the information presented in the financial statements.

The staff's proposed approach

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The objective and application guidance: suggested revisions

Objective

Retain the reference to management commentary providing primary users with context for the financial statements and insights about the entity's prospects, but update the objective to reflect revisions to the Conceptual Framework.

Users' assessments of prospects and stewardship

Introduce explicit references to the assessments of prospects for future net cash inflows and of stewardship of the entity's economic resources, and provide guidance setting out information that users need to make such assessments.

'Management's view'

Retain the concept of 'management's view' in the existing Practice Statement and provide additional guidance to help preparers identify information to be included in management commentary about what matters to the entity's success.

How features of existing statements on *objective* are covered in the proposed approach

Feature	How it is addressed in the proposed approach
Context for the financial statements	Included in the objective of the management commentary
Management perspective	Included in the guidance supporting the objective, requiring coverage of matters that management considers could reasonably be expected to influence decisions by the primary users
Development, performance, position	Included in the guidance supporting the objective, which includes identification of trends and factors affecting the entity's financial and operational performance for the reporting period and its position at the end of the reporting period; also covered in the detailed content elements of the Practice Statement [part of stream 2]
Prospects	Included in the objective of management commentary: 'assessing the prospects for the entity's future net cash inflows'
Quality of earnings	Covered by the guidance supporting the objective, which includes identification of trends and factors affecting the entity's financial and operational performance for the reporting period and its position at the end of the reporting period; additionally, it is anticipated that quality of earnings considerations will feature in the detailed content elements of the Practice Statement
Strategy and risks	Included in the guidance on objective, which includes information on the entity's strategy and progress in relation to its strategy, and the risks the entity is exposed to
Resource stewardship	Included in the objective of management commentary by specifying the need for information useful to the assessment of stewardship
Impacts	Covered by supporting guidance on discussion of resources, relationships, and impacts that affecting the entity's long-term success
Value creation	No specific reference to value creation, but guidance supporting the objective includes reference to the entity's ability to develop and sustain its cash flows in the long term

Illustrative draft wording

The objective of management commentary

1. The objective of management commentary is to give context for the financial statements by providing primary users of the management commentary with the historical financial and operational information and analysis that is useful in assessing the prospects for the entity's future net cash inflows, and management's stewardship of the entity's economic resources.
2. The primary users of management commentary are the same as the primary users of financial statements, that is existing and potential investors, lenders and other creditors, as defined in the *Conceptual Framework for Financial Reporting*.
3. The management commentary addresses those matters that management considers could reasonably be expected to influence assessments by primary users of the amount, timing and uncertainty of the entity's future net cash inflows, and their assessments of management's stewardship of economic resources, including:
 - (a) the trends and factors that affected the entity's financial and operational performance for the reporting period and its position at the end of the reporting period;
 - (b) the trends and factors that could affect the future development of the entity's financial and operational performance;
 - (c) the features of the entity's business model that it depends on for future success, including:
 - (i) the tangible and intangible economic resources needed to achieve the entity's purpose and strategy, irrespective of whether it is appropriate to recognise them in the entity's financial statements;
 - (ii) the relationships that affect the entity's ability to achieve its purpose and strategy, together with the impact of the entity's activities on those relationships; and
 - (d) the opportunities and risks in relation to the matters identified in (a)-(c).

Illustrative draft wording (continued)

4. To meet its objective, management commentary sets out management's strategy for the developing and sustaining of the entity's future net cash inflows in the context of the matters identified in paragraph 3, the entity's progress in implementing that strategy; and the potential implications for the entity's prospects of future net cash inflows.
5. The decision on what information to include in management commentary takes account of the primary users' need to assess the uncertainty of the entity's net cash inflows, its ability to develop and sustain them in the long term, and management's stewardship of the entity's economic resources to support this.
6. Although management commentary includes information that could be reasonably be expected to be capable of influencing users' assessment of the amount, timing and uncertainty of (the prospects for) the entity's future net cash inflows, compliance with the Practice Statement does not require management to prepare forecast or projected performance information for inclusion in the management commentary.

Comparison of statements of objective

Objective of general purpose financial reporting as per the Conceptual Framework	Objective of financial statements as per the Conceptual Framework	Recommended objective of management commentary in the revised Practice Statement
<p>1.2 The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity. Those decisions (...)</p> <p>1.3 (...) depend on the returns that existing and potential investors, lenders and other creditors expect, for example, dividends, principal and interest payments or market price increases. Investors', lenders' and other creditors' expectations about returns depend on their assessment of the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity and on their assessment of management's stewardship of the entity's economic resources. Existing and potential investors, lenders and other creditors need information to help them make those assessments.</p> <p>1.4 To make the assessments described in paragraph 1.3, existing and potential investors, lenders and other creditors need information about:</p> <p>(a) the economic resources of the entity, claims against the entity and changes in those resources and claims; and</p> <p>(b) how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's economic resources.</p>	<p>3.2 The objective of financial statements is to provide financial information about the reporting entity's assets, liabilities, equity, income and expenses that is useful to users of financial statements in assessing the prospects for future net cash inflows to the reporting entity and in assessing management's stewardship of the entity's economic resources.</p>	<p>1. The objective of management commentary is to give context for the financial statements by providing primary users of the management commentary with historical financial and operational information and analysis that is useful in assessing the prospects for the entity's future net cash inflows, and management's stewardship of the entity's economic resources.</p>

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