EFRAG

European Financial Reporting Advisory Group

EFRAG TEG meeting
17 April 2019
Paper 07-01
EFRAG Secretariat: MCPS Team

Management Commentary Practice Statement Project Update

Objective

1 To provide an update on the Management Commentary Practice Statement project and seek members' views on a number of issues discussed by the Management Commentary Consultative Group at its April meeting.

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 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 (Meeting notes are available here).

(c) April 3, 2019: the meeting addressed the overall revised MCPS architecture; business model, strategy, operating environment and risks.

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 Management Commentary (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 The following paragraphs provide a high-level overview of the IASB staff's proposals to date as presented to the MCCG and focuses on a number of issues covered at the April 2019 MCCG meeting.

6 It has however to be noted that none of proposals have been approved by the IASB and no complete drafting of the proposals is available at this stage.

7 No decisions are expected form EFRAG TEG at this stage.

What is not expected to change in the Management Commentary

8 The revised MCPS is expected to retain the following core principles:

(a) A non-mandatory framework applying only to management commentary relating to financial statements prepared applying IFRS Standards.

(b) 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 (no consideration of the needs of a broader set of stakeholders).

(c) Principle-based framework that does not prescribe the content of the Management Commentary or detailed industry or issue-specific disclosures.

(d) Provides management's view of the entity's performance, position and progress.

(e) Includes forward looking information but does not require the provision of forecasts or previsions.

What is expected to change

Business model and Strategy to provide a focus for building the report:

9 The Management Commentary must give insight into the company's strategy for creating value over time, its progress in implementing it, and the potential impact on future financial performance not yet captured by the financial statements.

(a) Emphasis the concept of 'linkage' (or 'narrative coherence') of information across the report and beyond.

(b) More focus on resources and relationships including intangible assets whose continued availability and strength could affect the prospects for future net cash inflows'; and management remuneration policies.

10 The Management Commentary will specify three components to the 'strategy description' corresponding to three time horizons: purpose (long term), objectives (medium term) and plans (short term) and require to describe:

(a) The entity's current strategy and changes and adjustments to the strategy since the last reporting date.

(b) The assumptions relating to the entity's operating environment on which the strategy has been based;

(c) Identify and describe both management's aspirations and the challenges management anticipates in executing the strategy; distinguishing clearly between statements of fact, predictions, and aspirations.

(d) Specific information about financing position and requirements: describe funding strategy, including any leverage and credit rating objectives (see paragraphs 41 and following .

(e) The role of culture and values (explain how the entity's culture supports the execution of the strategy).

Forward-looking information:

11 A greater focus on explaining future prospects, including the factors trends and impacts that may affect the prospects for future net cash inflows to the entity.

12 Requirement to provide comparisons of the entity's actual performance to past forecasts and targets to those forecasts and targets that were previously published by the entity outside of the management commentary.

Disclosure on risks

13 Entities will be required to disclose (i) how risk is managed, (ii) the progress in monitoring and managing the risk, (iii) mitigating actions if the risk crystallises; and (iv) information to help users evaluate potential impact of risk on the prospects for future net cash inflows to the entity .

14 Identify separately other risks (other than those that affect the prospects for future net cash inflows e.g. disclosures required by law or regulation).

15 Further discussion on this matter is included in paragraphs 32 and following.

Comparative information

16 The revised Management Commentary will specify that:

(a) The overview of the entity's performance, position and progress based on amounts in the financial statements should cover <u>at least</u> all periods for which financial statements provide comparative information.

(b) In determining comparative periods, management also considers the period over which identified longer-terms trends relating to a matter may emerge (indication that could extend 'over 3 to 5 years' or more).

Unusual and infrequent items

17 The revised Management is expected to require to provide information that helps users evaluate the extent to which 'current period financial performance is indicative of the entity's ability to generate cash flows in the future'; that is to identify:

(a) Unusual and infrequent items,

(b) Transactions that may not be 'inferred' from the Business Model; or

(c) Effects of changes in accounting policies.

Use of adjusted performance measures

18 If adjusted performance measures (such as APMs) are used, the IASB staff proposes a guidance that it considers to be aligned with the current thinking and decisions of IASB's *Primary Financial Statements project* i.e.:

(a) Adjusted measures are not reported with greater prominence than their unadjusted equivalents;

(b) Labelling should be appropriate and not misleading;

(c) Reconcile adjusted performance measures to their unadjusted equivalents in the financial statements; and

(d) Explain the basis of its calculation (and any change thereto), why the measure provides management's view of performance.

19 In addition, the revised Practice Statement would provide that:

(a) The management commentary should not use descriptions such as 'non-recurring' or 'non-underlying' when items of a similar nature may be expected to arise over the entity's business cycle.

(b) Particular care is needed when reporting adjusted measures that cause ratios to cross a key threshold; and

(c) Where ratios are presented, the nature and scope of the numerator and denominator and any related adjustments must be consistent with each other.

Issues discussed by the MCCG (April 2019)

20 The following paragraphs describe a selection of topics discussed by the MCCG at its 3 April meeting, upon which the early views of EFRAG TEG would be welcome.

Business Model

21 The IASB staff suggests to specify two components of the business model on which information is required the structure and the business activities:

Structure

(a) Provide an overview of the entity's operating structure, including descriptions of how different parts of the entity interact, of the common resources and relationships they depend on; and

(b) Explain how operating and legal structure relate to each other.

Business activities

(a) Provide a description of the business activities undertaken by the entity, including an overview of the business activities and more detailed qualitative and quantitative information about features of business activities necessary for users' understanding of (a) trends reflected in the financial statements and (b) matters identified in other parts of management commentary that could affect the prospects for future net cash inflows to the entity.

(b) The description of business activities needs to cover the entity's inputs, processes, and outputs and impacts. These elements are suggested for consistency with the definition of a business in IFRS 3 *Business Combinations* (except for identification of 'impacts').

MCCG comments

22 MCCG members generally agree with the consideration of an enhanced description of the business model and strategy as a backbone for the management Commentary. Some questioned whether the starting point for building the MC should be the business model (as suggested by the IASB staff) or whether it flows from the purpose and strategy of the entity (the business model being the way the entity operationalise its strategy.). There was also a view expressed that the business model should be anchored to value creation rather to purpose which is often too broad.

23 Some members did not consider that expressing the business model in terms of its components (i.e. 'input, including resources and relationships, processes and output and impacts') would be helpful. They had rather express it in terms of actions or verbs.

24 A member expressed the view that there should be consistency in the description of business model within management commentary and the application of the term within recognition and measurement requirements (e.g. IFRS 9). The business model described in management commentary should inform on the business activities considered for recognition and measurement purposes.

EFRAG Secretariat initial views

25 The EFRAG Secretariat observes that references to business model or business activities already exist in IFRS Standard with sometimes different meanings:

(a) The Conceptual Framework uses the term ‘business activities’ instead of ‘business model’ and explains (BC0.33) that it does so because 'business model' is ‘used with a range of different meanings by various organisations, for example, the International Integrated Reporting Council, the Enhanced Disclosure Task Force of the Financial Stability Board and various regulators’. Adopting the term 'business model' in the 2018 Conceptual Framework could have led to confusion with those definitions'.

(b) Conversely, IFRS 9 *Financial Instruments* used the term ‘business model’ with a narrower meaning to refer to how an entity manages its financial assets in order to generate cash flows (‘hold to collect’, ‘hold to collect and sell’ and ‘other’).

26 Since the assigned role for the management commentary is to supplement and provide context for the financial statements, we consider that using inconsistent concepts is problematic. Agree that the business model described in management commentary should also inform on the business activities considered for recognition and measurement purposes.

Boundaries of information about resources and relationships, trends and risks and opportunities

27 In various instances, the IASB staff suggests to consider the effects on ‘future net cash inflows’ as the determinant to identify which information to include in the Management Commentary. This is the case, in particular for:

(a) Information about resources and relationships is focused on these ‘which continued availability and strength could affect the prospects for **future net cash inflows**’.

(b) Information on trends and factors in the entity’s operating environment must include ‘factors that can have effect on the prospects for the future **net cash inflows’**.

(c) Information about risks (and opportunities) must identify those risks ‘affecting prospects for **future net cash inflows** to the entity, taking into account likelihood and magnitude of impact of risks on entity’s future net cash inflows’.

MCCG comments

28 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. For instance information about staff or client satisfaction may be important but may not have a readily identifiable cash-flow impact in the foreseeable future. There was also a concern that a focus on future net cash inflow may contribute to a short term orientation as it is easier for reporting entities to anticipate future cash flows in the short term. However, the IASB staff clarified that future net cash inflows ought to be considered into perpetuity and across all time horizons.

29 Some members suggested to refer, instead, to concept on ‘value creation’ instead, which would encompass a broader set of information.

EFRAG Secretariat initial views

30 The EFRAG Secretariat considers that focusing only on impacts on ‘net future cash inflow’ may not necessarily capture what is material to the business. 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.

31 Furthermore, economic value encompasses both realisable future cash flows and their associated risk premium. But, it is also not clear whether a focus on the net future cash inflow always considers the risk premium associated with these cash flows.

Disclosures about risks

32 The IASB staff suggested approach requires to:

(a) Identify material risks affecting prospects for future net cash inflows to the entity, taking into account likelihood and magnitude of impact of risks on entity's future net cash inflows.

(b) Identify risks arising from (i) operation of business model; (ii) selection and execution of strategy and the operation of the entity's culture; and (iii) trends or factors in the operating environment.

(c) Provide information on (i) how risk is managed, (ii) the progress in monitoring and managing the risk, (iii) mitigating actions if the risk crystallises; and (iv) information to help users evaluate potential impact of risk on the prospects for future net cash inflows to the entity.

(d) Identify separately information about risks required by law or regulation (that does not meet the criteria in (a)).

MCCG comments

33 Members generally supported the approach suggested by the IASB staff. However, some members considered that the Management commentary should place equal emphasis on both risks and opportunities.

34 So members considered that further consideration should be given to the fact that risks are dynamic not static; and therefore information on changes in the risk environment is paramount.

35 Some members also considered that it was unclear whether risks ought to be disclosed 'gross' or 'net' for each identified categories of risks (i.e. before risk mitigation factors or just the residual risk) and called for clarifications on the matter. It was noted that in some countries (e.g. Germany) there was an option for gross or net presentation.

36 Some members suggested that to illustrate the risks and opportunities associated with trends in the operating environment, there could be a review of how reporting entities are implementing the Task Force on Climate-related Financial Disclosures (TCFD) recommendations.

37 It was also noted that some of the information on risks (e.g. litigations) could be sensitive and basing the identification on the 'magnitude and likelihood' could have prejudicial consequences. Some members considered that these were situations where the 'comply of explain' approach could be envisaged (see discussion, above, on sensitive information).

EFRAG Secretariat initial views

38 The EFRAG Secretariat takes no issue with the proposed approach but agrees that more emphasis should be place on 'opportunities'.

39 Consideration should also be given to the interactions with the existing requirements in IFRS Standards about risks (in particular IAS 1 *Presentation of Financial Statements*, IFRS 7 *Financial Instruments: Disclosures*; IAS 37 *Provisions, Contingent Liabilities and Contingent Asset*s).

40 We observe that IFRS Standards focus on risks to which the entity is exposed during the period and at the end of the reporting period, whereas the management commentary also considers risks to which the entity may be exposed in the future

as a consequence of its business model or strategy. However, it may be useful in some circumstances to consider a holistic discussion on risks in one place and then use cross-references in other reports when needed.

Information about financing position and requirements

41 The IASB staff suggests that the Management Commentary should include information to help users assess the entity's ongoing financing requirements as follows

(a) Explanation of working capital changes during the period if the entity's working capital position at the end of the period is unrepresentative of the entity's working capital during the period;

(b) Analysis of performance measures and ratios that help users understand the entity's compliance with its financing covenants;

(c) Analysis of the terms and conditions of guarantees, lease, option and other financing agreements to the extent that they could give rise to early repayment obligations; and

(d) Discussion of the entity's financing requirements both for the next period and beyond, including explanations of the impact of the entity's stated strategy on its financing requirements.

42 However the IASB staff made it clear that it stayed away from suggesting any 'viability report'. In particular it does not require stress testing on funding strategies nor any explicit statement as to whether funding are sufficient and quantification of the risks.

MCCG comments

43 MCCG members generally welcome the provision of information to help users assess the entity's ongoing financing requirements. However some members suggested that the discussion should cover both funding and liquidity. A member expressed a view that funding, liquidity and capital management disclosures made in financial statements due to IFRS 7 and IAS 1 requirements should be considered and cross-reference requirements applied.

EFRAG Secretariat initial views

44 The EFRAG Secretariat first notes that the IASB staff enumerate a specific and prescriptive list of disclosure rather than develop objective-based disclosures.

45 We also observe that IFRS Standards already require information on the entity's capital position, strategy and liquidity (e.g. IAS 1 *Presentation of Financial Statements*) and interactions with the proposed disclosures in the Management Commentary will need to be considered to avoid duplication. Some may consider preferable to have a holistic discussion about funding strategy and capital management in one place and then use cross-references from and to other documents when needed. However the placement choice may also be guided by consideration of the level of assurance attached to different reports.

Commercially sensitive information

46 This was raised as one of the cross-cutting issues. Regarding the disclosure of commercially sensitive information in the Management Commentary, the IASB staff considers proposing a 'comply or explain' approach with constraints (subject to also considering feedback from the consultation of the IFRS Advisory Council on the matter- see below).

47 If Management considers that the disclosure of detailed information about impending developments or matters in the course of negotiation would be 'seriously prejudicial to the interests of the entity', it would be required to:

(a) Provide summarised information about the developments or matters that is as detailed as possible but without being seriously prejudicial to the interests of the entity;

(b) Consider whether information in the management commentary may be misleading without the context of the excluded information, and if so, management adapts the content and tone of the management commentary accordingly; and

(c) Describes the process undertaken to determine that it was appropriate to exclude material information from the management commentary.

48 The exclusion of material information would be :

(a) Applicable only if permitted by the entity's legal and regulatory environment; and

(b) Limited to situations when providing that information would cause serious prejudice to the entity's interests in impending developments or in ongoing negotiations which are not in the public domain, for example when the entity is in negotiations to acquire another entity.

MCCG comments

49 Many MCCG members expressed support for the comply or explain approach. Some however suggested to emphasise that this would apply in very rare circumstances such as information embargos prescribed by regulations. Some, however, suggested that the situation of confidentiality agreements should also be considered.

IFRS Advisory Council

50 On 19-20 March, the IFRS Advisory Council responded to the request for advice from the IASB staff and discussed in breakout sessions, balancing the needs of investors and other users of financial statements with those of preparers in the disclosure of corporate sensitive information.

51 Mixed views were mixed views on what constitutes sensitive information; with the different perspectives of preparers, investors and regulators highly visible. However:

(a) There was a general recognition by members of the importance of trust and transparency in financial statements and most were therefore supportive of the disclosure of sensitive information while acknowledging that in rare circumstances this may not be appropriate.

(b) For those cases, Advisory Council members supported the view that there should be a requirement to explain why disclosure was not appropriate. Advisory Council members noted that by doing this it would appropriately send a "red flag" to the users of the financial statements.

EFRAG Secretariat initial views

52 The EFRAG Secretariat first notes possible interactions of the proposals with European regulations:

(a) EU's Regulation No 596/2014 on market abuse allows issuers to 'delay, under its own responsibility, the public disclosure of inside information such as not to prejudice its legitimate interests provided that such omission is not likely to mislead the public and the issuer is able to ensure the confidentiality of the information'.

(b) EU's NFI directive 2014/95/EU on non-financial reporting also allows a "comply or explain" approach for NFI disclosures (which can be placed in the Management Commentary or a separate report).

53 The EFRAG Secretariat is of the view that exceptions undermine principle-based frameworks such as the Management Commentary and should apply only in rare circumstances with a high hurdle. A good illustration of this would be IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* which allows exceptions to provide information on litigations in 'rare cases ' and in presence of 'serious prejudice' to the position of the company.

54 Furthermore exceptions should only be allowed based on a proper costs and benefits assessment when developing or revising guidance considering in particular the effect on the usefulness of the information for users.

Questions for EFRAG TEG

55 Does EFRAG TEG have comment on the update provide by the EFRAG Secretariat?

56 What are EFRAG TEG's initial views on the issues listed in paragraphs 20 to 54?