IASB document published to accompany

IFRS Practice Statement 1

Management Commentary
A framework for presentation

IFRS Practice Statement 1 *Management Commentary* was issued in December 2010 for application from 8 December 2010. The text of Practice Statement 1 is contained in Part B of this edition. This part presents the following accompanying document:

BASIS FOR CONCLUSIONS

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, the Practice Statement.

Introduction

BC1 This Basis for Conclusions summarises the International Accounting Standard Board's considerations in developing the IFRS Practice Statement *Management Commentary*. Individual Board members gave greater weight to some factors than to others.

BC2 The Practice Statement was approved by the Board for issue as non-binding guidance, after considering the responses to its public consultation on the discussion paper *Management Commentary* and the exposure draft *Management Commentary*.

BC3 The purpose of financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions (paragraph 9 of IAS 1 *Presentation of Financial Statements*). Financial statements prepared for that purpose meet the common needs of most users. However, financial statements do not provide all the information that users need to make economic decisions because the financial statements largely portray the financial effects of past events and do not provide non-financial measures of performance or a discussion of future prospects and plans.

BC4 Management commentary supplements and complements the financial statements. The Board's objective in issuing the Practice Statement is to improve the usefulness of the information provided in an entity's management commentary so that, when it is provided in conjunction with the financial statements, users are better able to make decisions about providing resources to the entity.

BC5 Governments, securities regulators, stock exchanges and professional accountancy bodies often require entities whose debt or equity securities are publicly traded to publish management commentary. Management commentary encompasses reporting that jurisdictions may describe as management's discussion and analysis (MD&A), operating and financial review (OFR), business review or management's report.

BC6 This Basis for Conclusions discusses the following matters:

(a) background (paragraphs BC7–BC11);

(b) objective (paragraphs BC12–BC14);

(c) scope (paragraphs BC15–BC17);

(d) identification of management commentary (paragraphs BC18–BC21);

(e) users of management commentary (paragraphs BC22–BC25);

(f) purpose of management commentary (paragraphs BC26–BC28);

(g) principles for the presentation of management commentary (paragraphs BC29–BC44);

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(h) presentation (paragraphs BC45 and BC46);

(i) elements of management commentary (paragraphs BC47–BC49); and

(j) placement of disclosure within the financial reports (paragraphs BC50–BC53).

Background

BC7 In late 2002 the Board set up a project team comprising representatives from the national standard-setters in Germany, New Zealand and the United Kingdom and from the Canadian Institute of Chartered Accountants. The project team examined the potential for issuing a standard or guidance on management commentary. In October 2005 the Board published the results of the project team's research in a discussion paper *Management Commentary*.

BC8 In the discussion paper, the project team presented its views on the users, objective and qualitative characteristics of management commentary. The project team also described essential elements (described as 'content elements' in the discussion paper) of management commentary and a possible framework for use by standard-setters in distinguishing between information that would appear in management commentary and information that would appear in the notes to the financial statements.

BC9 In 2009 the Board published an exposure draft *Management Commentary*. The exposure draft took into account the proposals contained in the discussion paper and respondents' comments on those proposals. It also reflected developments in narrative reporting at the regulatory level in a variety of jurisdictions and the Board's recent work on the *Conceptual Framework for Financial Reporting*, specifically the work on the exposure draft *An improved 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* (May 2008). Importantly, the exposure draft *Management Commentary* included a proposal to publish the proposals in the exposure draft as non-binding guidance, not as an International Financial Reporting Standard (IFRS).

BC10 Most respondents supported the Board's proposal in the exposure draft to issue guidance. In developing the Practice Statement, the Board considered responses to this proposal and on other issues such as applying the qualitative characteristics to information in management commentary, including application guidance and illustrative examples in the Practice Statement and whether forecasts must be included in management commentary as forward-looking information.

BC11 The Board observed that management commentary meets the definition of 'other financial reporting' described in paragraph 7 of the *Preface to International Financial Reporting Standards*. Thus the Board decided that management commentary is within the boundaries of financial reporting and within the scope of the *Conceptual Framework*. Consequently, management commentary is also within the scope and authority of the Board.

Objective

BC12 The Practice Statement sets out a non-binding framework to guide the presentation of management commentary. The Board's intention in issuing the Practice Statement is to foster good practice in management commentary reporting by permitting an entity's management to exercise discretion in tailoring its commentary to the entity's particular circumstances.

BC13 Although the Practice Statement is not an IFRS and is not binding, the Board believes the Statement will promote comparability across all entities that present management commentary to accompany their IFRS financial statements, thereby improving the usefulness of the financial reports to users.

BC14 The Board considered the view that a non-binding practice statement would not result in improvements in financial reporting. However, the Board decided that a practice statement would provide useful guidance for entities, and its flexible application would benefit entities in jurisdictions that have local requirements or regulations. Furthermore, the Board believes that a practice statement might encourage entities that are not accustomed to presenting management commentary to provide it for users. The existence of a practice statement might also encourage jurisdictions to adopt it as their own.

Scope

BC15 The Board believes that the Practice Statement may prove useful to entities that are not accustomed to presenting management commentary. It may also be useful for entities that are already accustomed to presenting reports setting out commentary by management because of local requirements or regulations imposed by the public exchanges on which their securities are listed, provided the Practice Statement does not contradict those requirements or regulations. Thus, the Board decided that the Practice Statement could be applied by entities that present management commentary that relates to financial statements that have been prepared in accordance with IFRSs.

BC16 The Board decided to provide guidance on the content of management commentary in the form of a non-binding practice statement, rather than an IFRS, because it believes it is up to individual jurisdictions to make their own judgements on:

(a) whether entities should be required to include management commentary in addition to their IFRS financial statements and whether inclusion is necessary to assert compliance with IFRSs;

(b) the level of assurance to which management commentary should be subjected;

(c) the necessity of 'safe harbour' provisions in relation to the inclusion of forward-looking information;[1] and

(d) the type of entity that should present management commentary.

1 A safe harbour is a provision of a statute or a regulation that reduces or eliminates a party's liability under the law, on the condition that the party performed its actions in good faith.

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BC17 The Board's decision to issue a practice statement and not an IFRS means that entities applying IFRSs are not required to comply with the Practice Statement, unless specifically required by their jurisdiction. Furthermore, non-compliance with the Practice Statement does not prevent the entity's financial statements from complying with IFRSs, if they otherwise do so. Additionally, the entity's financial statements may comply with IFRSs if an entity has not provided management commentary during a particular financial year.

Identification of management commentary

BC18 The positioning of management commentary relative to the financial statements varies among jurisdictions that require management commentary. In some jurisdictions, management commentary accompanies the annual financial statements in a printed report to shareholders. In others, management commentary is contained within separate annual regulatory filings.

BC19 The Board considered whether it would be desirable to incorporate management commentary within the financial statements, perhaps by adding textual material and other information within the notes to the financial statements. The Board rejected this idea on the ground that management commentary should supplement and complement the financial statements. Consequently, the Board concluded that management commentary should not be placed within the financial statements themselves.

BC20 The Board also decided to link management commentary to the financial statements because, as noted in paragraph BC33, management commentary is designed to supplement and complement information provided in a related set of financial statements. The Board observed that providing management commentary without (at minimum) identifying the related financial statements might be misleading for users. Consequently, the Board decided that when an entity presents management commentary that relates to IFRS financial statements, it should either make the financial statements available with the commentary or identify the financial statements to which the commentary relates. The Board noted that because the Practice Statement does not require entities to prepare management commentary, IFRS financial statements can be made available for use without a corresponding management commentary.

BC21 In the Board's view, it is important for users of the financial reports to be able to distinguish information contained in the reports using the Practice Statement from information that is prepared using IFRSs and from information that may be useful to users but is neither the subject of the Practice Statement nor the requirements in IFRSs. While the Board concluded that preparers should not be required to include a formal confirmation that they have complied with the Practice Statement, because the Statement is not binding, it did agree that it would be helpful if preparers included in management commentary an explanation of the extent to which the Practice Statement has been followed. The Board also concluded that it would be misleading if preparers were to assert compliance with the Practice Statement if they did not comply with the Practice Statement in its entirety.

Users of management commentary

BC22 In September 2010 the Board published two chapters of the *Conceptual Framework*: Chapter 1: *The objective of general purpose financial reporting* and Chapter 3: *Qualitative characteristics of useful financial information*. In the Board's view, management commentary is within the scope of the *Conceptual Framework*. The two aspects of the Practice Statement most affected by the *Conceptual Framework* are the definition of users and the qualitative characteristics (see paragraphs BC41–BC43) of management commentary.

BC23 In most jurisdictions, the requirements or guidance on management commentary specify that the information should be directed to meeting the needs of investors, or a narrower group such as existing shareholders. In some jurisdictions there has been debate about which users should be the focus of management commentary—with many constituents taking the view that management commentary should meet the needs of all stakeholders.

BC24 The Board reasoned that given that management commentary forms a part of financial reporting and is within the scope of the *Conceptual Framework*, it follows that information provided by management commentary should focus on the same users as do general purpose financial reports.

BC25 Therefore, the Board concluded that the primary users of management commentary are those identified in paragraph OB2 of Chapter 1 of the *Conceptual Framework*: 'existing and potential investors, lenders and other creditors'.

Purpose of management commentary

BC26 The Board agreed that the purpose of management commentary is to provide, from management's perspective, context for the financial statements. This is consistent with the objectives stated in regulations and guidance in many jurisdictions. For example, guidance issued by the US Securities and Exchange Commission (SEC) in December 2003 states that the purpose of Management's Discussion and Analysis (MD&A) is 'not complicated'. It is to provide users with information 'necessary to an understanding of [a company's] financial condition, changes in financial condition and results of operations' (SEC, Regulation S–K, Item 303).

BC27 The content of management commentary is not necessarily bound to the reporting period described by the financial statements to which it relates. Some information within management commentary looks to the future. The Board concluded that the inclusion of forward-looking information within management commentary helps users of the financial reports assess whether past performance is indicative of future performance and whether the progress of the entity is in line with management's stated objectives.

BC28 The Board defined the term 'progress' in the Appendix on the basis of the usage of the term 'development' in the European Union's requirement for 'at least a fair review of the development of the company's business and of its position' (Article 46 of the Fourth Council Directive on the annual accounts of certain

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types of companies (78/660/EEC)). The Board did not use the term 'development' in the Practice Statement, because it is already defined in IFRSs.

Principles for the presentation of management commentary

Management's view

BC29 The principle in paragraph 12(a) raises the issue of what is meant by 'management'. The term 'key management personnel' is defined in IAS 24 *Related Party Disclosures* to mean 'those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity' (paragraph 9 of IAS 24).

BC30 The Board noted that determining who presents and approves management commentary may not be limited to 'key management personnel' and is likely to depend on jurisdictional requirements. For example, in the United Kingdom the Companies Act 2006 requires a business review as part of the directors' report. For quoted companies, the requirements are reflected in the UK Accounting Standards Board's (ASB's) OFR Reporting Statement, which recommends that an OFR should be the analysis by the directors. Furthermore, it is the directors who are responsible for approving the business review or OFR. There are similar requirements in Canada, France and Germany. Therefore, the Board determined that referring to 'management' would enable entities to apply the principle in paragraph 12(a) given their jurisdictional requirements.

BC31 The Board observed that the principle that management commentary should describe management's view of the financial statements has its roots in regulation. For example, the first of the SEC objectives requires that MD&A:

> ... provide a narrative explanation of a company's financial statements that enables investors to see the company through the eyes of management. [SEC, Regulation S–K, Item 303]

That requirement has also been enshrined in securities regulation in Canada and in the UK ASB's OFR Reporting Statement.

BC32 The Board noted a study that suggests that, with few exceptions, the information important to management in managing the business is the same information that is important to capital providers in assessing performance and prospects. Consequently, the Board decided that management commentary should derive from the same information that is important to management.

Supplement and complement the financial statements

BC33 Paragraph BC11 points out that the Board observed that management commentary meets the definition of 'other financial reporting' in the Preface. In addition, the Board noted that the principle of providing information to supplement and complement the financial statements in effect formalises the statement in paragraph 7 of the *Preface* that:

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

BC34 To provide context for the principle of supplementing and complementing the financial statements is the example of commentary for a defined benefit pension plan that has a deficit. In this example, management could supplement and complement the disclosure in the financial statements by providing a narrative explanation of the nature of the deficit and the conditions and events that led to the deficit (eg poor returns on plan assets or the demographics of those covered by the plan). Furthermore, management could provide helpful information related to the plan that is not otherwise disclosed in the financial statements, but is important to the management of the plan (eg changing investment managers or focusing on specific investment opportunities).

Forward-looking information

BC35 The Board observed that in many jurisdictions, requirements relating to management commentary focus on information that helps users of the financial reports to assess the entity's prospects. These requirements have their roots in regulation, specifically in the MD&A requirements of the SEC. The third of the SEC objectives for MD&A reporting is:

> ... to provide information about the quality of, and potential variability of, a company's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance. [SEC, Regulation S-K, Item 303]

BC36 This US regulatory requirement for the inclusion of information that helps investors assess prospects is found in both Canadian securities regulations and the European Modernisation Directive. The Directive has in turn been transposed into legislation in EU Member States.

BC37 The Board agreed with the inclusion of forward-looking information in management commentary for the reasons specified in the SEC MD&A requirements.

BC38 Many respondents to the exposure draft were concerned about the focus on forward-looking information. However, the Board decided that forward-looking information is important. Explanations of management's perspective of the entity's direction, targets and prospects, in addition to explanations of past events, can help users of the financial reports to develop expectations about the entity from its past performance and current state. Furthermore, the Board observed that the Practice Statement allows flexibility for management in determining to what extent management commentary includes forward-looking information. In particular, the Board observed that the Practice Statement clearly indicates that the extent of forward-looking information will be influenced by the regulatory and legal environment within which the entity operates. Moreover, although disclosure of forward-looking information is encouraged in many jurisdictions, this does not necessarily mean providing forecasts or projections. The Board notes that in some jurisdictions there are safe harbour provisions to restrict liability claims or regulatory provisions, or both, for forward-looking information. However, those safe harbour provisions require cautionary statements to be included with the forward-looking information.

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BC39 The Board considered the view that forward-looking information might present an over-optimistic picture of the entity. However, the Board observes that forward-looking information must possess the qualitative characteristics, including faithful representation, and thus must be neutral. Furthermore, management must disclose its assumptions used in providing the forward-looking information, thus enabling users to evaluate the reasonableness of the assumptions.

BC40 An example of what the Board envisages as forward-looking information that does not include forecasts or projections is again the commentary that could be provided for a defined benefit pension plan that has a deficit (described in paragraph BC34). In that example, management could provide forward-looking information by explaining management's objectives and strategies for remedying the plan deficit. These strategies might include a planned future increase in contributions, changes in investment strategy or changes to the plan. Management could also provide an explanation of how general market trends or other risks might affect the deficit and the strategies of management for remedying the deficit. This disclosure could include some quantitative information, but it is not necessarily a forecast or a projection.

BC41 In developing the exposure draft, the Board considered the view that detailed application guidance or illustrative examples are necessary to put into operation the guidance around forward-looking information included in the Practice Statement. However, the Board decided not to include such detailed guidance because there is a risk that undue emphasis could be placed on the application guidance or illustrative examples. Furthermore, the Board observed that such guidance or examples could be misinterpreted and thus reduce the flexibility in applying the framework. Many respondents to the exposure draft supported the Board's decision not to include detailed application guidance or illustrative examples.

Qualitative characteristics

BC42 As a result of the Board concluding that management commentary is within the scope of the *Conceptual Framework*, the Practice Statement specifies that the appropriate qualitative characteristics are those identified in Chapter 3 of the *Conceptual Framework* (see paragraph BC22). The qualitative characteristics in Chapter 3 will therefore be applied to both financial statements and management commentary.

BC43 In discussing the application of the qualitative characteristics to management commentary, the Board considered how the concept of balance (ie the inclusion of both bad news and good news) relates to the qualitative characteristics in general and the application of the qualitative characteristic of verifiability in particular. The Board decided that balance is equivalent to neutrality, in the context described in Chapter 3 of the *Conceptual Framework*. Consequently, the Board reasoned that because neutrality is a characteristic of faithful representation, balance is subsumed within faithful representation.

BC44 Furthermore, the Board decided that information in management commentary, including forward-looking information, can possess the qualitative characteristic of verifiability as it is described in Chapter 3. Paragraph QC26 of

Chapter 3 indicates that 'verifiability means that different knowledgeable and independent observers could reach consensus'. Expressed differently, the information presented is capable of being tested, either by observation or experiment. The Board observed that for forward-looking information, the test to ensure verifiability may be one of reasonableness: do the assumptions that support the forward-looking information in financial reports make sense?

Presentation

BC45 The Board agreed that it should be management's responsibility to decide both the content of its management commentary and the best way to present that content (ie the form). The Board observed that providing flexibility in both the content and form of management commentary reduces the risk that management will adopt a boilerplate approach to the presentation of management commentary.

BC46 Because management commentary supplements and complements the financial statements, the Board decided that management commentary should be consistent with the financial statements, particularly in terms of its presentation of segment information. The Board noted that, if the financial statements include segment information, the information presented in the management commentary should reflect that segmentation. The Board observed that this information is relevant for understanding the entity as a whole.

Elements of management commentary

BC47 The Board noted that specifying disclosures for management commentary may 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 that they expect to see in management commentary rather than defining the elements themselves. The Board decided that following a similar approach would generate more meaningful disclosures, because entities can discuss those matters most relevant to their individual circumstances. Some Board members requested that the Practice Statement should include a detailed list of items (eg critical accounting estimates), even though they recognise that the elements and the framework would lead to discussion of those items. However, the Board wishes to avoid a checklist-compliance mentality, which might result from specifying a detailed list.

User needs

BC48 The Board decided to include the five elements described in paragraphs 24–40 of the Practice Statement as based upon the needs of existing and potential investors, lenders and other creditors as the primary users of management commentary information. The table below relates the five elements to the Board's assessment of the needs of the primary users of management commentary.

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Elements	User needs
Nature of the business	The knowledge of the business in which an entity is engaged and the external environment in which it operates.
Objectives and strategies	To assess the strategies adopted by the entity and the likelihood that those strategies will be successful in meeting management's stated objectives.
Resources, risks and relationships	A basis for determining the resources available to the entity as well as obligations to transfer resources to others; the ability of the entity to generate long-term, sustainable net inflows of resources; and the risks to which those resource-generating activities are exposed, both in the near term and in the long term.
Results and prospects	The ability to understand whether an entity has delivered results in line with expectations and, implicitly, how well management has understood the entity's market, executed its strategy and managed the entity's resources, risks and relationships.
Performance measures and indicators	The ability to focus on the critical performance measures and indicators that management uses to assess and manage the entity's performance against stated objectives and strategies.

BC49 The Board observed that information in management commentary will be of interest to users other than the primary users described in paragraph 8 of the Practice Statement. As a result, the Board noted that management may need to consider the extent to which commenting on issues relevant to a wider user group may be appropriate given the degree of those issues' influence on the performance of the entity and its value. The Board also noted that management commentary should not, however, be seen as a replacement for other forms of reporting addressed to a wider stakeholder group.

Placement of disclosure within the financial reports

BC50 The Board noted that neither IFRSs nor the *Conceptual Framework* include principles to guide the Board's approach for establishing disclosure requirements. Thus, it is not always clear whether information belongs in the notes to the financial statements or in management commentary.

BC51 In December 2007 the Board decided to defer its work on a framework for disclosure and instead wait for the phase *Boundaries of financial reporting, and presentation and disclosure* (phase E) of the conceptual framework project. The Board noted that phase E includes the development of disclosure principles.

Consequently, the Board views phase E of the conceptual framework as the appropriate project to resolve questions about the placement of disclosures in the financial reports.

BC52 The Board acknowledges that until phase E is completed, overlap will exist between the type of information that is disclosed in the notes to the financial statements and the type of information that is disclosed in management commentary. In the light of this overlap, the Board decided that it was important to establish management commentary as a disclosure tool, before resolving questions of placement.

BC53 The Board acknowledges that some entities already present management commentary and it has addressed this overlap in one area, which is the risk disclosures required by IFRS 7 *Financial Instruments: Disclosures*. IFRS 7 permits management to provide required risk disclosures either in the financial statements or in management commentary, if the disclosure in management commentary is cross-referenced in the financial statements and management commentary is provided at the same time and under the same terms as the financial statements. However, IFRS 7 and the Practice Statement do not address auditing matters related to the location of those disclosures.

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