

Management Commentary

Accounting Standards Advisory Forum meeting
July 2019
ASAF Agenda Paper 2

The views expressed in this presentation are those of the presenter, not necessarily those of the International Accounting Standards Board or the IFRS Foundation.

- The objective of the session is to ask for ASAF members' views on whether the staff's proposals include sufficient guidance on:
 1. applying the notion of narrative coherence (slides 10–20); and
 2. identifying and reporting matters that could affect the entity's long-term success, including intangible resources and relationships that the entity depends on for its long-term success (slides 21–32).
- Background information on the Management Commentary project is provided on slides 5–9. Further details can also be found at <https://www.ifrs.org/projects/work-plan/management-commentary/>

Question 1

Narrative coherence

The staff are proposing to introduce the notion of narrative coherence to help management identify relevant information about reportable matters for inclusion in a management commentary. An outline of the proposed guidance to help management apply the notion of narrative coherence is set out on slides 14–20.

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

The following background information is provided to support the discussion:

- Identifying information for management commentary (slide 12)
- The role of narrative coherence in identifying information that has the potential to be material (slide 13)
- The staff's proposed guidance on narrative coherence (slides 14–20)

Question 2

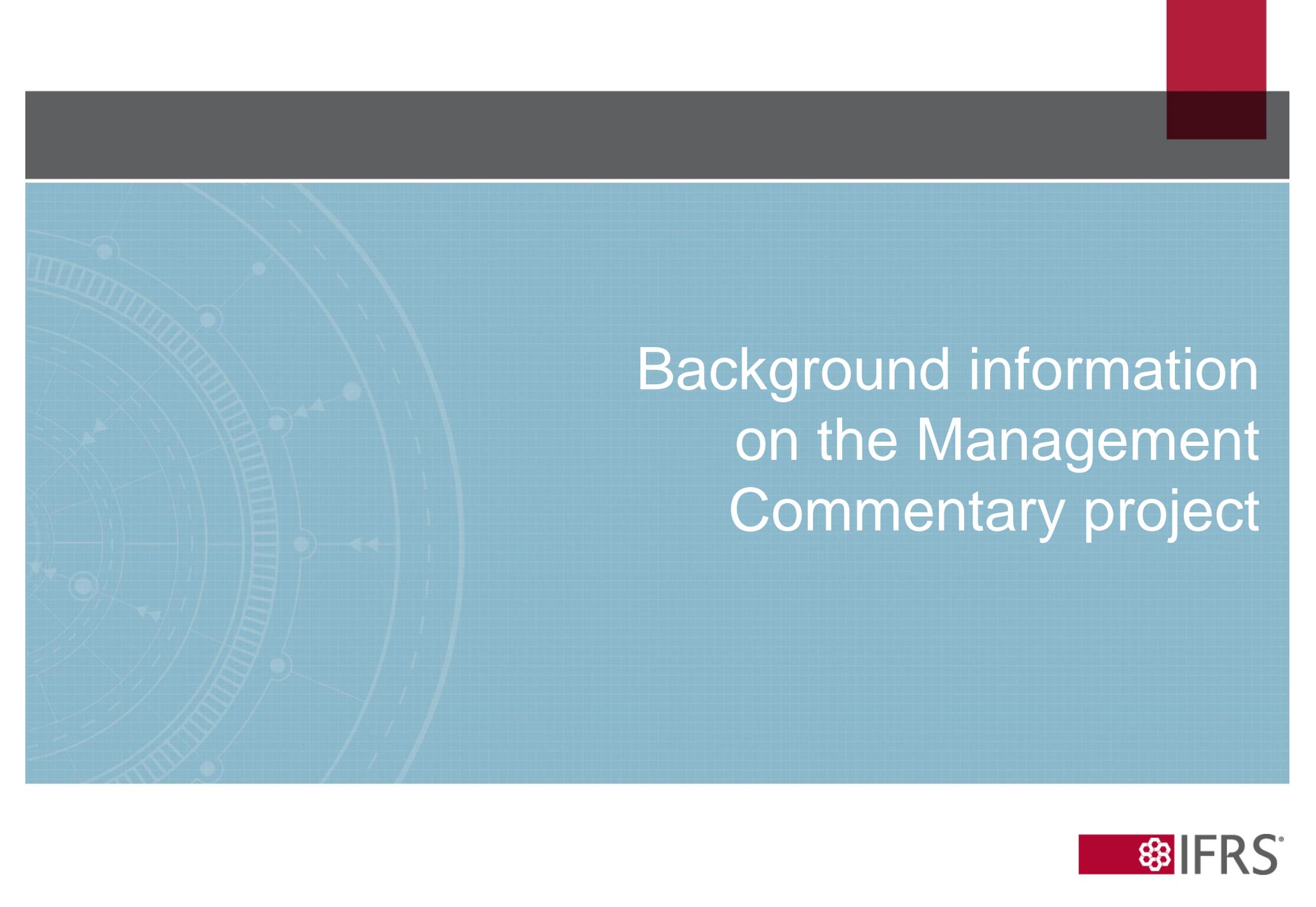
Identifying and reporting matters that could affect the entity's long-term success

The staff propose to provide guidance to promote the consideration in management commentary of matters that could affect the entity's long-term success (slides 24–32).

- Do you agree that the proposed guidance would promote providing a long-term view in management commentary?
- Do you think that any additional guidance should be provided, or that any aspects of the proposed guidance are not necessary?

The following background information is provided to support the discussion:

- Long-term view in a management commentary (slide 23)
- Overview of the staff's proposed guidance (slide 24)
- The staff's proposed guidance on identifying and reporting matters that could affect the entity's long-term success (slides 25–32)

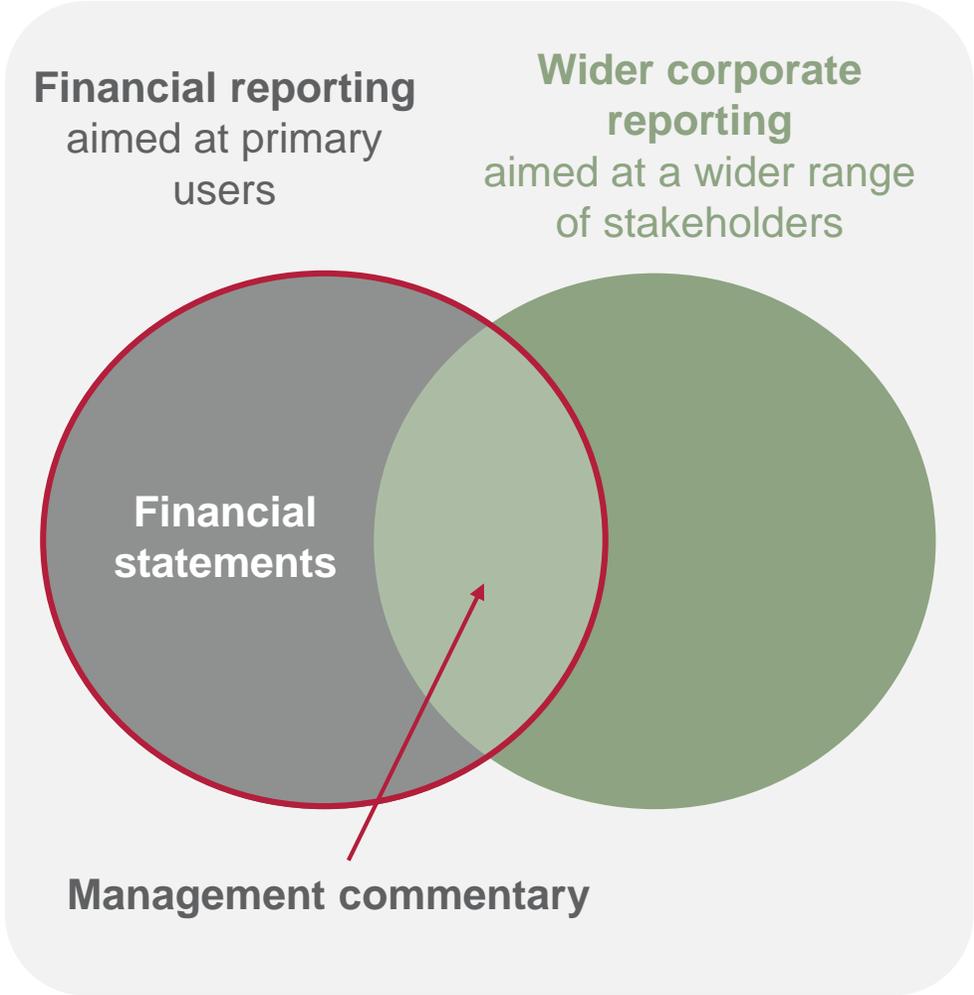


Background information on the Management Commentary project

What is management commentary?

- A narrative report that gives context for the financial statements and additional insight into the entity's long-term prospects
- Sits within the boundaries of financial reporting and is aimed at primary users of financial reports—existing and potential investors, lenders and other creditors*

Environmental, social and governance (ESG) matters—normally part of wider corporate reporting—are discussed in management commentary if necessary for primary users to make economic decisions



*Referred to as 'primary users' in this paper.

Why revise?

Focus of revision

Developments in narrative reporting



Gaps in current reporting practice



Increasing need for additional information



Meet primary users' information needs

Retain a principles-based approach but expand the guidance to:

- consolidate innovations
- address gaps in reporting
- support rigorous application

Particular emphasis on:

- company-specific matters
- intangibles and ESG matters
- matters that underpin long-term success
- coherent discussion linked to strategy

Intended to be compatible with jurisdictional requirements and subject-matter frameworks, e.g. Task Force on Climate-related Financial Disclosures (TCFD) and Sustainability Accounting Standards Board (SASB)

Topics for revision

- The revision of the guidance on management commentary will cover:

Objective of management commentary, principles and cross-cutting issues

Content elements

Business model

Strategy

Operating environment
and risks

Performance, position
and progress

- **The term ‘content element’ is used to refer to the *type of content that is expected to be included in management commentary.*** The revised guidance on content elements should not prescribe what is important to the entity and is not intended to prescribe a rigid structure for management commentary. Instead, the goal is to provide principles-based guidance that can be rigorously applied in the entity’s unique circumstances in determining what matters to address and what information about those matters to include in a management commentary.
- More information on the topics for revision, as well as the reasons for revision and its focus, can be found in May 2019 Board [Agenda Paper 15](#) *Overview of the staff’s approach to revision*.
- ASAF already discussed applying materiality in management commentary, principles for preparing it, particular cross-cutting issues (cross-referencing) and topics related to guidance on performance, position and progress.
- The staff will consider input from ASAF members in developing recommendations for the revised guidance on management commentary.

Timeline





Applying the notion of narrative coherence

Question 1

Narrative coherence

The staff are proposing to introduce the notion of narrative coherence to help management identify relevant information about reportable matters for inclusion in a management commentary. An outline of the proposed guidance to help management apply the notion of narrative coherence is set out on slides 14–20.

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

The following background information is provided to support the discussion:

- Identifying information for management commentary
- The role of narrative coherence in identifying information that has the potential to be material
- The staff's proposed guidance on narrative coherence

The staff think that in identifying information that has the potential to be material, more judgement could be needed for management commentary than for financial statements. This is because:

- a) IFRS Standards deal mainly with a relatively narrow and well-defined set of financial information and thus identify explicitly a large proportion of the information that entities need to consider including in financial statements. On the other hand, management commentary deals with a much broader and less defined set of information. Thus, the revised guidance could identify explicitly only a much smaller proportion of the information that entities need to consider including in management commentary.
- b) by its nature, management commentary is more explanatory than financial statements. Management need to exercise judgement when determining what information to include to explain the entity's performance, position and progress reported in financial statements and to provide insights into the entity's long-term prospects.

The staff think that because of the broader scope of management commentary, to identify information that has the potential to be material, management would need to identify both:

- a) **matters**—information about which is capable of being useful to primary users (referred to as 'potentially reportable matters' in this paper); and
- b) **relevant information** about those matters.

Management does not necessarily need to think about matters and information about them separately (and indeed, at the December 2018 ASAF discussion, some members commented that in some cases it can be difficult to separate the two). However, focusing on matters first and then considering which information about them is relevant, could be more efficient and effective in identifying information for reporting in a management commentary.

It would also be consistent with the description in the *Conceptual Framework for Financial Reporting* of the process of applying the fundamental qualitative characteristics of useful financial information, which suggests:

- (i) first identifying an economic phenomenon, information about which is capable of being useful to primary users; and
- (ii) then identifying the type of information about that phenomenon that would be most relevant.

The role of narrative coherence in identifying information that has the potential to be material

In developing proposals for the revised guidance on identifying potentially reportable matters, and identifying relevant information about those matters, the staff do not intend to make assumptions about what is important to each entity's success or to prescribe specific disclosures. This is because both potentially reportable matters and relevant information about those matters would depend on the entity's specific circumstances.

The staff are also concerned that prescribing specific areas for disclosure could result in preparers taking a checklist approach rather than applying the principles in the revised Practice Statement to determine what information would be useful to primary users.

Instead, the staff propose providing the following guidance on identifying information that has the potential to be material:

- a) state that in identifying both potentially reportable matters and relevant information about those matters, management needs to consider primary users' information needs.

- b) explain what sources management can use to identify potentially reportable matters. Those sources include: internal information used by management to manage the business; the entity's capital market communications; and engagement with other stakeholders such as suppliers, customers or employees.
- c) introduce the notion of 'narrative coherence' to help management identify relevant information about potentially reportable matters.

At today's meeting, the staff seek ASAF members' input in relation to point (c)—narrative coherence.

The staff's proposed guidance on narrative coherence

In December 2018, ASAF members discussed the proposed introduction of the notion of narrative coherence in the revised Practice Statement, with many members agreeing on the importance of coherence in management commentary.

Since then, in addition to a general explanation of the notion of narrative coherence (see panel opposite), the staff have developed proposals for guidance on applying narrative coherence. The guidance on narrative coherence is intended to be used by management to identify **relevant** information about potentially reportable matters so that primary users are not left with unanswered questions about a reportable matter.

At today's meeting, the staff seek ASAF members' views on the staff's proposed guidance on applying narrative coherence (slides 15–20).

The staff emphasise that the proposed guidance relates to disclosures that should be *considered* by management, rather than disclosures that must be made. This is because not all of those disclosures would be material for each entity.

For example, many entities might recognise that their future success depends on their employees, but primary users would only need information on this matter if employee matters (such as scarcity of a particular skill-set) would impact their assessment of the prospects for the future net cash inflows to the entity or of management's stewardship of the entity's economic resources.

Narrative coherence

The notion of narrative coherence would prompt management to consider which information about a potentially reportable matter to provide throughout management commentary. Specifically, management would need to consider discussing:

- a) the strategy for managing the matter;
- b) the progress in executing that strategy; and
- c) the potential implications of that progress.

If management has identified information about a reportable matter that is required in one part of the management commentary, management would need to consider whether information about the matter is also required in relation to other content elements.

For example, if the management commentary includes information on a particular trend affecting the entity, management would need to consider whether the descriptions of the entity's business model, strategy and operating environment contain sufficient information to help primary users assess the implications of that trend for the entity's prospects.

Narrative coherence in relation to business model

The table below summarises the staff's proposed guidance on applying narrative coherence in relation to the entity's business model.

If management identifies a feature of the entity's business model that primary users need information on, it should consider whether primary users would also need information on the following areas:

Area	Guidance on information that may need to be reported	Illustration
Business model – impacts	Provide information about the impacts of the entity's business activities* on that feature of the entity's business model, which may be a resource or relationship, if these impacts affect the prospects for future net cash inflows to the entity	<i>A branded goods manufacturer emphasises in its business model description the importance of maintaining an 'ethical brand' reputation. It reports on the impacts of its supply chain on this reputation.</i>
Operating environment	Describe trends and factors in the operating environment that could affect the operation of that feature of the entity's business model	<i>A pharmaceuticals business emphasises in its business model description the importance of payer relationships. The description of its operating environment explains the trends in payers' procurement policies.</i>
Risks	Identify and describe risks arising from the operation of that feature of the entity's business model	<i>An extractives business states in its business model description that its expertise lies in the development of challenging assets. Its risk disclosures address the management of safety and environmental risk.</i>
Progress	Analyse and explain progress in managing that feature of the entity's business model	<i>A retail bank relies on lifetime customer relationships. It reports customer retention statistics and the proportion of the active customer base having a five-year plus relationship.</i>

* In the staff's proposals, discussed with the Consultative Group, the term 'the entity's business activities' was used to cover inputs, processes, outputs and impacts.

Narrative coherence in relation to strategy (1/2)

The table below summarises the staff's proposed guidance on applying narrative coherence in relation to the entity's strategy.

If management identifies a feature of the entity's strategy that primary users need information on, it should consider whether primary users would also need information on the following areas:

<i>Area</i>	<i>Guidance on information that may need to be reported</i>	<i>Illustration</i>
Business model	Provide information about the scale of business activity that is potentially affected by the strategy	<i>A manufacturer's growth strategy in one major region relies on a resale partner. The business model description explains that 80% of sales for that region are made through a resale partner.</i>
	Provide information about the potential effect of the strategy on the business model	<i>An entity is implementing a major restructuring programme to support an efficiency objective. It identifies the categories of customer that it will no longer be able to serve as a result of the programme.</i>
	Describe plans to develop the business model in accordance with the strategy, including the resources and relationships affected	<i>A retailer is in turnaround, and has set an objective of delivering the leading in-store experience. It identifies the importance of having knowledgeable and engaged staff on the floor to deliver this, therefore it provides an overview of the major staff training programme that supports this.</i>
	Provide qualitative and quantitative information about features of the entity's business model to help primary users understand matters that could affect the prospects for future net cash inflows to the entity by affecting the entity's ability to pursue its stated strategy	<i>A software business announces a strategy to migrate business users to a service contract model. It reports the current proportion of revenues attributable to business users and describes the key features of the new contract model.</i>
Operating environment	Describe trends and factors in the operating environment that could affect the execution of the strategy	<i>A telco has an objective to maintain network quality leadership in its chosen markets. The entity explains how the outcome of next-generation spectrum auctions could affect the achievement of this objective.</i>

Narrative coherence in relation to strategy (2/2)

If management identifies a feature of the entity's strategy that primary users need information on, it should consider whether primary users would also need information on the following areas:

<i>Area</i>	<i>Guidance on information that may need to be reported</i>	<i>Illustration</i>
Risks	Describe risks arising from the selection and execution of the entity's strategy	<i>A utilities business's growth strategy is dependent on re-selling additional third party services to its customer base. The entity explains the risk involved in building its re-sale business.</i>
Performance, position and progress	Describe how management measures progress in executing the entity's purpose, objectives and plans and link to discussion of current performance	<i>A manufacturer has acquired a support services business to enable it to generate service revenues from its manufactured products. It monitors, analyses and explains the proportion of product customers that have also taken a service contract.</i>
	Include analysis and explanations of progress in implementing the entity's purpose	<i>A vehicle manufacturer describes its purpose in terms of producing the safest possible cars. Management monitors and reports current statistics for serious injuries arising from incidents involving its vehicles.</i>
	Link description of objectives to information that helps primary users evaluate progress made in achieving the objectives	<i>A vehicle manufacturer has an objective of halving average carbon emissions of its cars over five years. It reports average carbon economy per vehicle sold.</i>
	Link description of plans to information that helps primary users evaluate progress made in achieving the plans	<i>A business operates a major water-stressed site and is targeting a 50% reduction in water consumption in the next 12 months in order to maintain the viability of the site. The business reports the site's water consumption and the percentage reduction already achieved.</i>

Narrative coherence in relation to performance, position and progress

The table below summarises the staff’s proposed guidance on applying narrative coherence in relation to the entity’s performance, position and progress.

If management identifies a feature of the entity’s performance, position or progress that primary users need information on, it should consider whether primary users would also need information on the following areas:

Area	Guidance on information that may need to be reported	Illustration
Business model	Link information about that feature to information provided in other parts of the management commentary including the discussion of the entity’s business model	<i>A food retailer identifies revenue growth attributable to its convenience stores, offset by revenue declines at its out of town stores. The management commentary describes the group’s presence based on the different store types.</i>
	Include in the description of the entity’s business model information to help primary users understand the potential implications of matters affecting the entity’s performance, position or progress	<i>A telco identifies that growth in its customer base is attributable to new partnerships with resellers. Its business model description explains how its relationship with resale customers differs from that of its traditional customer base.</i>
Strategy	Link the discussion of that feature of performance, position or progress to the discussion of management’s strategy for managing those matters that affected the entity’s performance, position or progress where appropriate	<i>A retailer has identified a reduction in revenues attributable to online competition. The entity’s strategy explains how it is developing its in-store experience to differentiate it from online competitors.</i>
Operating environment	Link the discussion of that feature of performance, position or progress to the discussion of the entity’s operating environment	<i>An outsourcing business identifies a reduction in order book. Its discussion of operating environment explains the changed government procurement practices that have given rise to this.</i>
	Explain matters affecting the entity’s performance, position or progress in the context of the entity’s operating environment including the external trends and factors the entity faces	<i>An upstream oil business explains that it has reduced its exploration activity in a region in response to anticipated regulatory developments.</i>

Narrative coherence in relation to operating environment and risks (1/2)

The table below summarises the staff’s proposed guidance on applying narrative coherence in relation to the entity’s operating environment.

If management identifies a trend or factor in the entity’s operating environment that primary users need information on, it should consider whether primary users would also need information on the following areas:

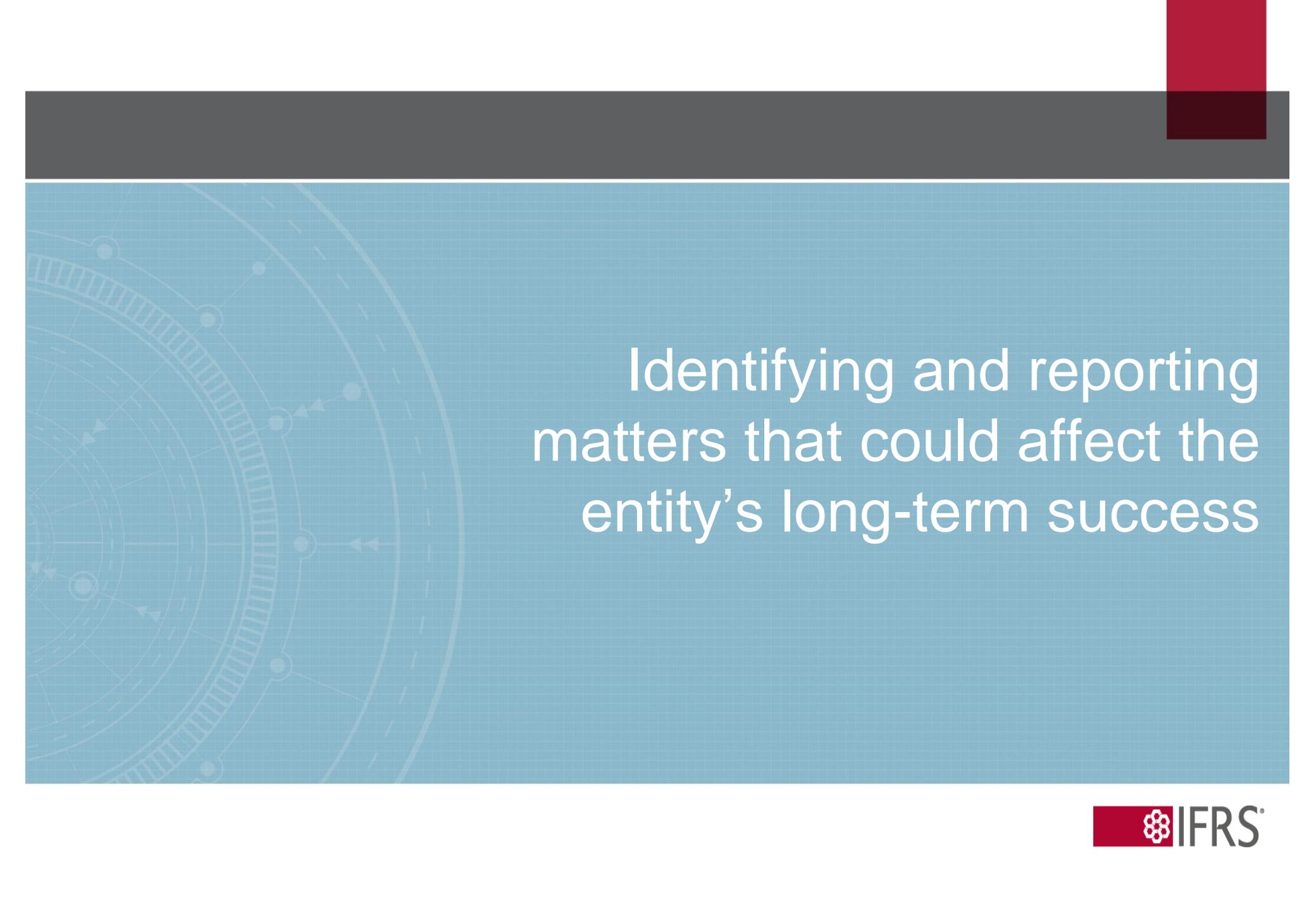
<i>Area</i>	<i>Guidance on information that may need to be reported</i>	<i>Illustration</i>
Business model	Provide overview of the business model and more detailed quantitative and qualitative information that helps primary users’ understanding of the entity’s ability to respond to that trend or factor in its operating environment	<i>An outsourcing business identifies changing patterns in local government procurement strategy. In describing the business model, management commentary reports the proportion of revenue attributable to local government contracts.</i>
Strategy	Explain how the entity plans to respond to the trend or factor in the operating environment	<i>Technology designer identifies increasing competition from clone products. Management commentary explains strategy to keep customers using its product.</i>
	Discuss funding requirements arising from that trend or factor in the operating environment	<i>An extractives business identifies external factors that are significantly increasing time from initial exploration to development. Management commentary explains how the funding strategy takes into account the longer investment funding period.</i>
Risks	Describe risks arising from that trend or factor in the operating environment	<i>Credit scoring business identifies developments in data privacy legislation. Management commentary identifies data security as a risk.</i>
Performance, position and progress	Analyse and explain progress in managing that trend or factor in the operating environment	<i>A utility business identifies that it is subject to increased levels of regulatory scrutiny. Management commentary reports on compliance with regulatory KPIs.</i>

Narrative coherence in relation to operating environment and risks (2/2)

The table below summarises the staff's proposed guidance on applying narrative coherence in relation to risks.

If management identifies a risk that primary users need information on, it should consider whether primary users would also need information on the following areas:

	<i>Guidance on information that may need to be reported</i>	<i>Illustration</i>
Business model	Provide information to help primary users evaluate the potential impact of the risk on the operation of the business model and on the prospects for future net cash inflows to the entity	<i>A food manufacturer identifies availability of palm oil as a key risk. In describing the business model, management commentary identifies the proportion of revenue attributable to palm oil based products.</i>
Strategy	Discuss the potential implication of that risk on the entity's funding strategy	<i>A manufacturer's discussion of its funding strategy explains (but does not quantify) how the strategy takes into account the interdependent risks associated with a product recall and reputational damage.</i>
Performance, position and progress	Analyse and explain progress in managing the risk including quantitative indicators used to monitor the risk	<i>A pharmaceuticals business has suffered the loss of key staff in recent years and continues to identify the risk of key staff loss affecting its longer-term R&D pipeline. The management commentary reports on R&D staff retention rates and compares them with previous year's rates.</i>



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

Question 2

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

The staff propose to provide guidance to promote the consideration in management commentary of matters that could affect the entity's long-term success (slides 24–32).

- Do you agree that the proposed guidance would promote providing a long-term view in management commentary?
- Do you think that any additional guidance should be provided, or that any aspects of the proposed guidance are not necessary?

The following background information is provided to support the discussion:

- Long-term view in a management commentary
- Overview of the staff's proposed guidance
- The staff's proposed guidance on identifying and reporting matters that could affect the entity's long-term success

The staff have identified that the most common gaps in current narrative reporting practice include:

- a) short-term focus in reporting. For example, in reporting their strategy entities often focus on the short term.
- b) lack of focus on matters that are important to the future of the business. For example, entities often provide only general descriptions of their business models and do not identify matters underpinning their long-term success.

To address these gaps, the staff are proposing to:

1. Specify an objective of management commentary that is linked to the information needed to support primary users' assessments of the entity's future net cash inflows and of management's stewardship of the entity's economic resources (see panel opposite). The staff note that the link to future net cash inflows implies the provision of information on longer-term matters as for most businesses cash flows arising in the medium and longer term (including the so called 'perpetuity' cash flows) will normally represent a substantial part of the inputs in a user's assessment of an entity's future net cash inflows.
2. Supplement the objective of management commentary with guidance that would promote a long-term view in management commentary. **These proposals are summarised on the following slides and are the focus for today's discussion.**

Staff's proposals on information needed to meet the objective of management commentary

Management commentary addresses those matters that management considers could reasonably be expected to influence assessment by primary users of the amount, timing and uncertainty of the entity's future net cash inflows, and their assessment of management's stewardship of the entity's 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 the entity depends on for its future success, including: (i) the tangible and intangible economic resources needed to pursue the entity's strategy, irrespective of whether it is appropriate to recognise them in the entity's financial statements; and (ii) the relationships that affect the entity's ability to pursue its 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).

To meet its objective, management commentary sets out management's strategy for developing and sustaining the entity's future net cash inflows in the context of the matters identified in the previous paragraph; the entity's progress in implementing that strategy; and the potential implications for the entity's prospects of future net cash inflows.

The decision on what information to include in management commentary takes into account the primary users' need to assess the uncertainty of the entity's net cash inflows; the entity's ability to develop and sustain those net cash inflows in the long term; and management's stewardship of the entity's economic resources needed to support those cash flows.

Overview of the staff's proposed guidance

The staff propose guidance on identifying and reporting in management commentary matters that could affect the entity's long-term success. The proposed guidance would include guidance on:

1. reporting in the business model description:
 - resources and relationships (including intangibles) that the entity depends on for its long-term success (slides 25–26); and
 - impacts of the entity's business activities on those resources and relationships (slide 27);
2. describing the entity's strategy that is anchored in the entity's long-term purpose (slides 28–29);
3. describing trends and factors in the operating environment as well as risks that could affect the entity's long-term success (slides 30–31); and
4. explaining progress in managing the features of the entity's business model that the entity depends on for its long-term success (slide 32).

Each aspect of the proposed guidance is described on the following slides.

Forward-looking information in a management commentary

The proposals on the following slides are intended to require provision of information available to management that supports primary users' assessments of an entity's longer-term prospects. It is **not** proposed that the revised Practice Statement would ask management to provide forecasts or otherwise make predictions of the entity's prospects either in the shorter-term or the longer-term.

Although the importance of resources and relationships was recognised in the 2010 Practice Statement, the staff think that further emphasis would be desirable to promote more focused consideration of which resources and relationships need to be described in an entity's management commentary. This would support primary users' understanding of whether the entity is managing its resources and relationships in a manner that can support the continued operation of the business model. This approach is similar to the 'capitals' concept in the International Integrated Reporting Framework, and is also applied in other frameworks, notably the FRC's *Guidance on the Strategic Report*.

To support provision of the long-term view in management commentary, the staff propose that in addition to the overview of the entity's resources and relationships, management commentary needs to **provide additional information about those resources and relationships (including intangibles) whose continued availability and strength could affect the prospects for future net cash inflows to the entity**. That would be the case, for example, if the resource or relationship provides the entity with a competitive advantage, or if there is uncertainty about the continued availability of the resource or relationship that the entity depends on for its long-term success.

To support identification of such resources and relationships the staff propose guidance on commonly held resources and relationships that management *may* need to report if information about such resources and relationships would be material.

When management identifies resources and relationships that the entity depends on for its long-term success, it would need to provide qualitative and quantitative information necessary for primary users' understanding of the nature and importance of those resources and relationships to the future operation of the business.

In particular, the staff propose that:

- a) in relation to resources, primary users need information to help them understand the rate of depletion and replenishment of the entity's resources; and
- b) in relation to relationships, primary users need information to help them evaluate the durability of the relationship, the lifecycle of the relationship, the entity's dependency on and vulnerability to the relationship; and any concentration of risk resulting from the relationship. For customer relationships, primary users would also need information about the extent of the customers' dependency on the entity.

The guidance proposed by the staff is provided overleaf.

Although the staff propose guidance on commonly held resources and relationships that the discussion in management commentary *may* need to include, the staff do not believe it is practical or desirable to provide an exhaustive list as the resources and relationships primary users need information about will be specific to the entity. For example, the staff are not proposing to explicitly identify data assets, which may be important in some businesses.

Staff's proposals for providing information on the resources the entity depends on

Management commentary provides information about resources, including intangibles, that is specific to the circumstances of the entity. Resources described in management commentary may include:

- operating sites and infrastructure;
- expertise, know-how, and other intellectual capital;
- brand and reputation;
- access to natural resources, whether licensed or unlicensed, and public goods such as roads; and
- financial resources, and access to financial resources.

If a resource is depleted as a consequence of the entity's business activities, management commentary provides information to help primary users understand the current and planned rate of replenishment of the resource relative to the rate of depletion.

Staff's proposals for information on the relationships the entity depends on

Management commentary provides information about relationships that is specific to the circumstances of the entity. Relationships described in management commentary may include:

- customer relationships, including the entity's current and target customer and end-user base, the channels and partners through which the entity distributes its products and services, a description of the entity's markets and its position in them;
- sourcing relationships, including supplier and outsourcing dependencies, and the features of the entity's supply chain;
- staffing relationships, including both those directly with employees and those indirectly with employees and contractors in the supply chain; and
- wider relationships, including those with government, regulators, and society at large to the extent that those wider relationships could affect the prospects for future net cash inflows to the entity.

Depending on the relationship, primary users may need information to help them evaluate the durability of the relationship, the lifecycle of the relationship and the entity's dependency on the relationship or its vulnerability to disruption to the relationship. In the case of customer relationships, primary users may need information about the extent of customers' dependency on the entity to meet their ongoing service needs. Management commentary also provides information about any concentration of risk resulting from a particular relationship or group of relationships.

Impacts on resources and relationships

Entities are involved not only in processes undertaken to produce the entity's outputs but also in processes undertaken to develop and maintain the entity's resources and relationships the entity depends on for its long-term success.

The staff think that **information on the impacts of the entity's business activities on its resources and relationships would help primary users evaluate the longer-term sustainability of its business model.** For example:

- on the one hand, an extractives business that is having a significant adverse impact on its local environment may be at risk of losing its licence to operate;
- on the other hand, an engineering business that is delivering a very high level of customer benefit may have significantly greater resilience in the face of competitive threats.

Therefore, the staff propose that management commentary should provide information on the impacts (whether positive or negative) of the entity's business activities on its resources and relationships.

However, given that impact reporting is sometimes approached from the perspective of a broader set of users than the primary users of financial reporting, the staff propose to emphasise that information about impacts is provided in management commentary only if these impacts affect the prospects for future net cash inflows to the entity.

Staff's proposals for describing the impacts of the entity's activities on the resources and relationships it depends on

Management commentary provides information about the impacts of the entity's business activities on the entity's resources and relationships, if these impacts affect the prospects for future net cash inflows to the entity. Impacts on the entity's resources or relationships may be positive or negative and could include, for example, impacts on relationships resulting from the entity's impacts on the environment or on staff satisfaction.

Based on research and consultations, the staff have identified that in practice many strategy discussions tend to focus on operational tactics and do not provide a long-term view of the entity's strategy.

The staff seek to promote a description of the entity's strategy that covers a range of time frames, including a long-term perspective, and provides insights into the entity's longer-term prospects.

To achieve that, the staff propose a **three-component description of strategy that is anchored in the entity's long-term purpose, or mission**, and explains how that purpose translates into the entity's medium-term objectives and short-term plans. For example, if the entity's purpose is to provide sustainable private transport, it might have an objective to halve its fleet emissions over five years, supported by plans to close its diesel engine plant. All these components of strategy would be expected to be described in management commentary with clear links of how they relate to each other.

The guidance proposed by the staff to support this is summarised on slide 29.



Entity's strategy anchored in long-term purpose (2/2)

The staff propose the following guidance on the description of an entity's strategy to promote a long-term view:

Component	Staff's proposed guidance
1) Purpose	<ul style="list-style-type: none">Anchor the strategy description around the entity's purpose that guides its strategy in order to support a longer-term view. <i>The entity's purpose can be described, for example, in terms of satisfying a market need or achieving a specified outcome for end-users.</i>
2) Objectives	<ul style="list-style-type: none">Link discussion of objectives to the entity's purpose. Objectives can, for example, relate to the enhancement or maintenance of resources and relationships that the entity depends on for its future success. <i>For example, one of an entity's objectives may be maintaining a reputation for quality or building expertise in a new field.</i>Link the description of objectives to other information in management commentary that helps primary users evaluate the entity's progress in achieving the objectives and potential implications of that progress for the prospects for future net cash inflows to the entity.Indicate quantitative or qualitative milestones by which management intends to measure progress towards achieving an objective if that objective may take a number of years to achieve.
3) Plans	<ul style="list-style-type: none">Link the discussion of plans to the entity's objectives or to trends or factors in the operating environment the plan is intended to address.Provide an overview of the features of the business model that are expected to be changed and the investment required to deliver the plan. Address positive and negative impacts on the entity's resources and relationships.Link the description of plans to other information in management commentary that helps primary users evaluate the entity's progress in achieving the plans and potential implications of that progress for the prospects for the future net cash inflows to the entity.

Trends and factors in the entity's operating environment and risks (1/2)

Some frameworks specify a list of environmental, social and governance (ESG) issues for consideration in discussing the entity's operating environment. Whilst the staff recognise that factors such as climate change regulation have the potential to affect entities' long-term prospects, the staff do not think it would be practical for the revised guidance to prescribe which specific matters that could affect the entity's long-term prospects would need to be considered in preparing management commentary.

Instead, the staff's principles-based guidance on describing the entity's operating environment would ask management to provide information about trends and factors in the operating environment:

a) that are already having an impact on the business, i.e. have affected the entity's performance, position or progress in the reporting period, and may continue to do so; and

b) that have not yet crystallised but which could affect the operation of the entity's business model, the execution of its strategy, or the entity's performance, position or progress.

In relation to trends and factors that have not yet crystallised, management should discuss both:

- a) short-term factors, i.e. those that can have an immediate effect on the prospects for the future net cash inflows to the entity (for example, currency or commodities price exposures);
- b) medium-term factors, i.e. those that are expected to crystallise in the next few years (for example, a change in political regime and trade policies in a region where the entity operates); and

c) long-term factors, i.e. those that may crystallise over a longer period (for example, the emergence of alternative technologies, or potential effects of climate change or related regulations).



Trends and factors in the entity's operating environment and risks (2/2)

The staff have identified the following gaps in practice related to reporting risks in management commentary:

- a) bias towards the identification of either just internal or just external categories of risk;
- b) bias towards smaller, shorter-term risks such as commodity price variability;
- c) failure to identify high impact but lower likelihood risks;
- d) failure to identify risks to achieving the strategy; and
- e) identification of generic rather than entity-specific risks.

Each of the above practices could affect the provision of information on the entity's longer-term risks. To address this, the staff propose to:

1. emphasise the consideration of risks specific to the entity rather than requiring management to work through general categories of risk. The guidance would include the notion of narrative coherence, which would link identification of risks to longer-term features of the entity's business model, strategy and operating environment (see table opposite).
2. emphasise that the consideration of the entity's risks should take account of systemic factors (of which climate change or regulation would be an example).

Proposed guidance on the identification of risks:

Provide information about risks arising from:

Business model risk	The operation of the entity's business model and the resources and relationships on which the entity depends for its long-term success (for example, a major manufacturing quality failure affecting the entity's reputation)
Strategy risk	The selection and pursuit of the entity's strategy, including its long-term purpose, (for example, misjudging the needs of a new market) and the operation of the entity's culture
Operating environment risk	Trends and factors in the entity's operating environment, including long-term and systemic risks such as climate change and related regulation

Progress in managing the features of the entity's business model that the entity depends on

The staff think a long-term view in reporting the entity's performance, position, and progress can be supported by drawing a distinction between:

- a) *Shorter-term*: matters affecting future development, covering aspects of performance where the entity is managing a specific opportunity or risk, for example, upgrading existing customers to a new product; and
- b) *Longer-term*: **progress in managing features of the entity's business model that the entity depends on for its long-term success**, covering aspects of performance where the entity is managing the overall health of the business, for example, retaining development expertise.

Therefore, the staff propose to make (b) an explicit consideration in the guidance on reporting the entity's performance, position and progress (see panel opposite).

Staff's proposals on reporting progress in managing the features of the entity's business model that it depends on for its long-term success

Management commentary should provide analysis and explanations of progress in managing the features of the entity's business model that the entity depends on for its long-term success, including:

- the tangible and intangible economic resources needed to pursue the entity's strategy, irrespective of whether those resources are recognised in the entity's financial statements; and
- the relationships that affect the entity's ability to pursue its strategy, together with the impact of the entity's activities on those relationships.

The analysis and explanations should address progress in managing opportunities and risks identified in the description of features of the entity's business model or the operating environment that the entity depends on for its long-term success. The information provided should be specific to the aspect of the resource or relationship for which an opportunity or risk has been identified.

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