Deutsches Rechnungslegungs Standards Committee e. V. ®
Accounting Standards
Der Standardisierungsrat

DRSC e. V. • Zimmerstr. 30 • 10969 Berlin

Telefon +49 (0)30 206412-12
Telefax +49 (0)30 206412-15
E-Mail info@drsc.de

Berlin, 14. Februar 2006

Alan Teixeira
Senior Project Manager
International Accounting Standards Board
30 Cannon Street

London EC4M 6XH
United Kingdom

XX April 2006

This draft comment letter represents ASBG's preliminary view since the discussion has not yet been finalised. ASBG is requesting for comments until 24th March 2006. ASBG will discuss your comments in the further deliberation of the comment letter.

DRAFT COMMENT LETTER – IASB Discussion Paper: Management Commentary

Dear Mr Teixeira

Re: Management Commentary – Discussion Paper

We appreciate the opportunity to comment on *Management Commentary – discussion paper prepared for the IASB by staff of its partner standard-setters and others* of October 2005. ASBG welcomes IASB's decision to publish a discussion paper that assesses the role the IASB could play in improving the quality of the management commentary that might accompany the financial statements.

We acknowledge that the IASB has discussed the recommendations of the authors at public meetings but has not developed tentative views on these issues. The Board has agreed that if it adds the project to its agenda, it will regard the discussion paper as the first stage in its due process.

In our view the discussion paper offers a useful basis for international discussion and comment. Our detailed comments on the paper are set out in the Appendix below.

We would welcome IASB's taking up the project of Management Commentary on its active agenda. The European Union decided to introduce periodic management reporting of issuers as a kind of European counterpart to the MD & A required by the SEC filing rules. We strongly support an IASB project proposal in order to avoid inconsistent developments of the European requirements and practice and that of other capital markets. This should also be the central issue of IOSCO, having issued principles on Management's Discussion and Analysis in February 2003.

Additionally, we would like to point out the following comments:

- We consider the MC to be an important part of the financial reporting package.
- We support developing a mandatory IASB standard for listed entities, and encourage issuing a non-mandatory implementation guidance, including examples on how to apply the MC standard.
- It must be ensured that the application of an IASB standard for MC exempts the reporting entity from other national MC requirements, thus the IASB should work together with the European Union and other regulators in order to enhance the acceptance of a mandatory standard.
- We broadly support the outcomes of the discussion paper, especially the proposal for a standard in Appendix A.
- Fundamentally we agree with a principle-based approach to management commentary.
- We suggest that the IASB considers consequences of the inclusion of MC in financial reports regarding the audit and assurance of MC information.

If you would like any clarification of these comments, please contact me.

Yours sincerely,

Prof. Dr. Harald Wiedmann

President

IASB Discussion Paper
Management Commentary

Requirements for MC

The project team concluded that an entity's financial report should be viewed as a package comprising the primary financial statements, accompanying notes and MC (section 1). They also concluded that the quality of MC was likely to be enhanced if the IASB issued requirements relating to MC (section 6).

Question 1: Do you agree that MC should be considered as an integral part of financial reports? If not, why not?

We consider management commentary as being an integral part of financial reports, thus we regard the financial report as a package comprising the financial statements including accompanying notes, and MC. When comparing international provisions management commentary is mainly an instrument for capital market information. Therefore integration of this information should be mandatory for public listed companies applying IFRS.

MC type information, as proposed by the research working group, is mainly derived from or linked to the financial statements and should complement and supplement the financial statements. In our view, the relationship of the different parts of financial reporting is adequately shown in figure 1.1 of the discussion paper (page 12).

Because of the close relationship of the financial statements and management commentary as well as the importance of this type of information, we propose extending the scope of the IASB Framework by other financial reporting instruments thus including MC information. Furthermore, MC covers the same users and user needs as the financial statements. This approach would be consistent with the IASCF Constitution and the IFRS Preface which cover *other financial reporting* as well. Since the Framework project for improvement and convergence is at an early stage, the MC project offers a good opportunity to discuss principles and qualitative characteristics of other financial reporting instruments. At the latest, this issue could be part of phase E of the Framework project, presentation and disclosure, including financial reporting boundaries.

We do not think that the boundaries of the financial statements should be extended in order to cover MC type information as part of the notes accompanying the financial statements. Not all information suggested to be included in a management commentary meets the Framework criteria for financial statements. This refers, for example, to forward-looking information and strategic information from a management's perspective mentioned in the MC discussion paper (see e.g. paragraph 55). Hence, not all qualitative characteristics of the financial statements as defined in the Framework can be applied to MC type information, e.g. comparability and reliability. We believe that some qualitative characteristics of the financial statements should be amended for MC purposes according to the future-oriented and subjective character of MC type information. Thus, the deliberations stated at question 5 could be a valuable input to including MC in the Framework.

Furthermore, the favoured integration of MC as part of the financial reporting package raises the question whether management commentary should be audited, and if so how to define the scope of such an audit. If an audit of the management commentary would be favoured we do not believe that such an audit could have the same level of assurance as an audit of the financial statements due to the subjective and prospective elements of MC. Some jurisdictions like the US require the auditor to read MC to identify material misstatements of fact or inconsistencies with the financial statements. In Germany and other Member States of the European Union the auditor’s assessment of the results of the audit also extends to whether the Management Report is consistent with the annual financial statements and on the whole provide a suitable understanding of the position of the company (or group). In both cases, the level of assurance is significantly less when compared to the auditor’s opinion on the financial statements. We suggest that the IASB should consider consequences of the integration of MC in financial reporting regarding audit and assurance of MC information as well. It would be helpful to keep the International Auditing and Assurance Board (IAASB) involved of the IASB’s work on MC.

Question 2: Should the development of requirements for MC be a priority for the IASB? If not, why not? If yes, what form should any requirements take?

We are strongly supportive of the project on management commentary. We regard MC as a key element of business reporting, and believe that principle based requirements are desirable on an international level. Without an international standard, entities with multi-jurisdictional MC requirements would be required to prepare multiple filings and meet different requirements regarding MC. The IASB could mitigate this proliferation by reducing the incentives for regulators to develop or expand their own MC requirements. On the other hand, it also means that the IASB and national legislators and regulators of MC like the European Union will need to work together in order to enhance the acceptance of a mandatory IASB standard.

Assuming that the IASB decides to issue MC requirements, we support developing a mandatory standard. It seems that voluntary guidance already exists in many forms around the world, thus issuing a standard is more likely to enhance and harmonise MC information. That is to say that an entity applying IFRS to prepare its financial statements would be required to prepare an MC or if it decided to do so voluntarily, it also would have to follow the IASB standard on MC.

Since management commentary is a document prepared primarily for the capital markets (e.g. Australia, Canada, United Kingdom, and United States), we propose limiting the scope of the MC standard to listed entities, in much the same way that IAS 14, Segment Reporting, is written. IAS 14 is currently under discussion, however, the scope of a MC standard could be derived from IAS 14 as well as from ED 8. The scope could be expressed as follows:

> *The MC shall be applied by entities whose equity or debt securities are publicly traded and by entities that are in the process of issuing equity or debt securities in public securities markets.*

This scope being narrower than other IFRSs leaves all other entities preparing IFRS financial statements the option to apply the requirements of the MC standard. If an entity elects to prepare MC and applies the requirements of the standard it would be entitled and required to assert compliance with it.

Furthermore, it should be discussed whether a condensed MC should be presented as part of the interim financial reporting. In this case, the information should be limited to require only that information, which represents a major change to either the information conveyed in the last annual or interim MC, i.e. important changes in the key elements of MC, which have or might have a material impact on the performance and future development of the entity. This approach would be consistent with requirements of the European Transparency Directive.

Question 3: Should entities be required to include MC in their financial report in order to assert compliance with IFRSs? Please explain why or why not.

Since we proposed a “full” IFRS with limited scope, entities being within that scope shall be required to include MC in their financial report in order to assert compliance with IFRSs. It follows from our answer to question 2 that this would include entities whose equity or debt securities are listed. Because we regard management commentary as an integral part of the financial report at least for listed entities, a comprehensive set of International Financial Reporting Standards should include a mandatory requirement to prepare a MC.

It must be ensured that the application of an IASB standard for MC exempts a reporting entity from other national requirements of MC in order to avoid a duplication of information and severe burden for preparers. In a European context, this means the adoption of an IASB MC standard by endorsement of the EU according to the IAS Regulation. At the same time the exemption from European requirements of the so-called annual or management report would be consequential if the entities prepare and present their financial reports in accordance with IFRSs. Developing a mandatory standard by the IASB facilitates the European adoption of an IASB requirement by endorsement. As mentioned above, in order to enhance acceptance of a mandatory standard the IASB and the European Union will need to work together.

Purpose of MC

The project team concluded rather than having one dominant objective, MC has three principal objectives (section 2). The project team also concluded that the primary focus of MC is to meet the information requirements of investors.

Question 4: Do you agree with the objectives suggested by the project team or, if not, how should they be changed? Is the focus on investors appropriate?

We agree with the three principal objectives of management commentary. Par. 39 concludes that MC should:

(a) supplement and complement the financial statements;

(b) provide an analysis of the entity through the eyes of the management; and

(c) have an orientation to the future.

We think that the focus on investors is appropriate and we support the approach of the working group explained in par. 24 et seq. of the discussion paper. The primary focus of management commentary should be the same as of financial statements, namely the interests of investors in publicly listed companies. Despite of setting out seven classes of users, the IASB Framework concludes that the main purpose of accounting regulations for financial statements is the focus on investors' needs "as investors are the providers of risk capital" (Framework, paragraph 10). We agree with the presumption that provisions for financial statements as well as for management commentary which meet investors' needs will also meet most of the needs of other users.

However, we recommend specifying the definition of management commentary in respect of the focus on investor information needs. The definition of management commentary information should not extend the primary target audience of shareholders and investors to other stakeholders in order to make sure that MC is directed to supplement and complement financial information. Additionally, a focus on investors underlines the objective of MC to provide useful information for taking economic decisions, and follows from including MC as an element of IFRS financial reports. Therefore, the scope of MC should not be extended to meeting special needs of a wider set of stakeholders. An MC cannot and should not replace sustainability, environmental, and corporate social responsibility reports.

This does not mean, however, to exclude all non-financial information, meaning all information not measurable in terms of monetary units, from MC. Non-financial information like environmental or sustainability issues should be included in a MC if such issues have had or could have a significant influence on the financial development or position of an entity.

Principles, qualitative characteristics and content of MC

The project team concluded that it is not appropriate to specify the precise information that must be disclosed within MC, or how it is presented. Rather, they believe that any requirements for MC should set out the principles and qualitative characteristics, as well as the essential areas of MC, necessary to make the information useful to investors. It is up to management to determine what information is required to meet these requirements, and to determine how the information is presented. The project team has also suggested that it is appropriate consider ways to limit the amount of information management is allowed to disclose, as a way of ensuring that it is the most important information which is presented to investors. (See sections 3 and 4)

Question 5: Do you agree with the principles and qualitative characteristics that the project team believes are essential in the preparation of MC? If not, what additional principles or characteristics are required, or which ones suggested by the project team would you change?

Principle based approach

Having principles and qualitative characteristics for management commentary is essential for improving the quality of such financial reporting instruments. We agree with the principle-based approach of the discussion paper as well as with the principles and characteristics as set out in the discussion paper.

While in principle agreeing with developing a principle-based standard, we recommend to develop an additional implementation guidance containing examples of how to apply the principles and qualitative characteristics. Taking into account that management commentary is mainly a narrative financial reporting instrument, illustrative examples of applying the principles would help to find a common international basis for discussion of the MC exposure draft.

Principles and qualitative characteristics of MC

Paragraphs 41-45 provide a useful explanation on what is meant by the supplementation and complementation of the financial statements.

MC should adopt a “through the eyes of the management” approach. We agree that if the information is given through the eyes of management, comparability between entities is difficult to achieve. Hence, qualitative characteristics of MC should aim at achieving comparability over time and the linkage to the financial statements. Another important issue is the supportability of the information contained in MC as proposed and explained in paragraph 75.

We concur with the proposal that MC should also have an orientation to the future. The paper establishes the forward-looking orientation as a principle (paragraph 52-57). This principle relates to communicating information through the eyes of management, meaning the *direction* the entity is taking. For example, a company should set out future strategies and goals. However, we recommend specifying the meaning of the principal objective “orientation to the future”. It seems that the proposed standard in Appendix A provides more detailed requirements than discussed in the main body of the discussion paper. For example, A18 of the Appendix refers to examples like “setting out future strategies, goals and targets”, and A46 includes “targets for key financial and non-financial measures”, while par. 56 does not mention targets.

We believe the term future orientation is subject to interpretation as to how and to which extent information are to be presented. These interpretations will depend on the regulatory and legal environment, therefore this principle and relating content requirements should be clearly defined.

It should also be clarified whether forward-looking information implies, for example, making forecasts or projections, and whether these data should be quantified or not. The paper states that the principle does not mean that forecasts or projections should be provided. It could be argued, though, that profit forecasts could provide useful information within an expected interval supported by assumptions and caveats. In our view companies should not be obliged to present quantitative forecasts or give projections but they should present information about those aspects and events for the year under review that could be relevant for assessing future prospects. Forward-looking information should focus on qualitative information.

Question 6: The DP outlines the essential content areas that MC should cover. Do you agree with these? If not, what additional areas would you recommend or which ones suggested by the project team would you change?

Principle based approach

We consent to the indication and broad guidelines approach to the content of MC. With respect to the management approach, the content requirements of MC should not be too detailed. We also generally agree with the contents formulated in par. 100 of the paper, especially with the content requirements as stated in the proposed standard (Appendix A). We would prefer the very broad content elements to be mandatory in the way that every MC has to comment on all the essential areas proposed in the discussion paper.

As already mentioned in relation to the principles and qualitative characteristics, we support developing examples of how to apply the content requirements in form of non-mandatory implementation guidance. This guidance seems to be of great benefit even in the process of developing a standard in order to interpret the content elements on a common basis, irrespective of national traditions and legal environments.

Regarding the content elements we would like to comment on the separate elements as follows:

Objectives and strategies

We agree with the requirements as stated in A33-A37. A discussion of the objectives and strategies in place provides useful information about the direction the entity is taking and management's approach taken to achieve this development.

In this context we would like to mention that the example of page 40 is not very helpful. The first half of the example seems to be a typical instance of boilerplate-language since the information provided would be suitable for almost all entities, except may be non-for-profit organisations. In our view, this content element should provide information about management's approach to the future and the key success factors of the business.

Key resources, risks and relationships

We propose to include more information about the financial and operating risk management systems of the company. It is noteworthy that reporting about the entity specific financial and operating risk management system and its processes of identifying the risks as well as risk concentrations are very important information for investors.

We concur with the comprehensive approach to risk reporting covering all risk categories, which is consistent with the German Accounting Standard 5, Risk Reporting, whereas US-GAAP and IFRSs focus on certain risks, mainly financial risks. Nevertheless, we propose to include more specific requirements relating to risk reporting, e.g. the time-frame, risk categories and the quantification of risks. This could also include reporting of opportunities of the entity. Furthermore, BC 65 of IFRS 7 states that the description of operational risks should be discussed within the MC research project.

Results and prospects

Regarding the prospects we refer to our comments on the principle "orientation to the future" (Question 5). It should be taken into account that the requirements of A43-A48 are more specific than the content elements discussed in the discussion paper itself.

Performance measures

We would like to point out that the strong linkage between the results and prospects of a company (par. 100d) and its performance measures and indicators (par. 100e) could be better incorporated in the content section of the paper. This linkage is also very important for the comparability of MC information over time. We agree that results, prospects and performance measures have to be linked over time (par. A 48).

Furthermore, we suggest including a requirement of describing the financial control systems used within the group, highlighting the measurement criteria employed within that system. This should include information about the key performance indicators used to manage the group.

In this context, we would like to mention that we strongly disagree with the findings of the research working group stated in par. 148. We do not believe that it would be helpful, not even in the future if key performance measures like return on capital employed (ROCE) were defined by financial reporting standard setting bodies. These performance measures are defined on an entity-specific level in order to support the management of the group. Standardising such measures for reporting purposes would prevent the use for entity-specific purposes and would be in contrast to the management approach of MC. We regard the requirements of par. A49-A57 in the proposed standard as being sufficient for achieving comparability with the financial statements and comparability of MC over time.

Segmentation of information provided

Regarding the segmentation of MC information we take the view that the paper should emphasise that information should be provided on a group basis. However, if the results and prospects or other content elements like risks are different for a certain segment, MC should include segment-related information. We concur with the requirement that the segmentation in MC has to be in accordance with segment information included in the financial statements in order to achieve consistency with the financial statements (par. A13 of the proposed standard).

Question 7: Do you think it is appropriate to provide guidance or requirements to limit the amount of information disclosed within MC, or at least ensure that the most important information is highlighted? If not, why not? If yes, how would you suggest this is best achieved?

The amount and the format of information published should be primarily within the management's field of responsibility, according to the management approach. The avoidance of irrelevant information is already part of the qualitative characteristics "understandable" and "relevant".

According to A19 of the proposed standard, we concur with the project team that MC information should be balanced and relevant to investors. Since to investors negative information is as important as positive information, we propose to emphasise the balance of information as a principle. This includes that MC should focus on the most relevant information to investors, highlighting those issues which are of great importance and great possible impact on the company.

Question 8: Does your jurisdiction already have requirements for some entities to provide MC? If yes, are your local requirements consistent with the model the project team has set out? If they are not consistent, what would the major areas of conflict or difference be?

As mentioned in par. 9 of the discussion paper, Germany has a very long tradition of mandatory MC requirements, at least for corporations of a certain size irrespective of a corporation being listed or not. In addition to requirements of the German commercial law, the German Accounting Standard (GAS) 15 *Management Reporting*, standardises principles, format, and content of the management report. Special principles for risk reporting in the context of management reporting can be found in GAS 5 (general principles), GAS 5-10 (principles for financial institutions and financial service institutions), and GAS 5-20 (principles for insurance institutions).

In our opinion, the existing German regulation on management reporting is not in conflict with the results reached by the IASB project team. Since the German requirements are broadly based on European requirements, we regard the European legislation as consistent with the proposed IASB model as well. However, since the German requirements are much more detailed than the principle-based model of MC, the German practice of management reporting goes beyond what the discussion paper is proposing. This relates especially to:

- reporting about opportunities of the future development of the entity;
- risk reporting and information about the risk management system;
- forward-looking information.

Nevertheless, developing an international standard on MC would be of great benefit for German listed entities applying IFRS to their financial statements, especially for those with multi-jurisdictional listings.

Placement principles

The project team concluded that it would be helpful to establish principles to guide the IASB in determining whether information it requires entities to disclose within financial reports should be placed in MC, on the face of the primary financial statements or in the notes to the financial statements. The project team has suggested some principles (section 5).

Question 9: Are the placement principles suggested by the project team helpful and, if applied, are they likely to lead to more consistent and appropriate placement of information within financial reports? If not, what is a more appropriate model?

We believe it would be premature to discuss placement criteria at this point. This discussion should be delayed to phase E of the IASB-FASB Framework project.

Having a mandatory MC standard offers the opportunity of publishing certain information in MC rather than in the notes accompanying the financial statements. However, we would like to point out that cross-references between financial statements and management commentary should be avoided for reasons of the differing scope of audit and clarity. Instead, the IASB should decide on where to disclose any information required.

Certain disclosures already required by IFRSs as part of the notes accompanying the financial statements should be shifted to the MC due to their subjective and forward-looking nature. For example, reporting on risks arising from financial instrument should be part of the MC content element “risk, resources, and relationships”. As mentioned in BC 43 of IFRS 7, Financial Instruments: Disclosures, these disclosures are future-oriented and subjective due to the management approach. However, the transfer of mandatory IFRS disclosures from the notes towards MC does only make sense if the details required are significantly reduced, because of the principles stated in par. 39 of the discussion paper.

Further comments on the discussion paper

We generally support the flexible approach of the content requirements. In order to allow the necessary degree of flexibility and to be consistent with the management approach, the structure of the content shown in the discussion paper should not be mandatory. However, we recommend including a requirement in the draft standard to structure MC by headings and to start with an index of the entity-specific content. This helps users to find specific information they are looking for and enhances comparability between different entities over time.

Furthermore, we disagree with the concept presented in paragraph 229 of the Discussion Paper. Therefore we recommend the Board not to integrate the specific disclosure requirements of MC content into different IFRSs. With the MC standard being principles-based, it is possible to define the content of MC in this standard exclusively, accompanied by an implementation guidance. We prefer not to scatter information on MC throughout different standards. In our opinion, this is a prerequisite for enhancing the quality of MC.