4 May 2006

Alan Teixeira
Senior Project Manager
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Mr Teixeira

Re: Management Commentary – Discussion Paper

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the paper *Management Commentary – discussion paper prepared for the IASB by staff of its partner standard-setters and others* of October 2005 ('the Discussion Paper').

EFRAG welcomes the publication of the Discussion Paper. We consider the management commentary (MC) to be an important part of the financial reporting package and we welcome within reason initiatives that are designed to improve the quality of MCs and/or to achieve greater convergence in existing MC practice. As we see a need for harmonisation in this area we suggest developing principle based guidance which could be seen as benchmark in the short term. We believe that that it would not be practicable to develop a mandatory standard on MC because in many jurisdictions it might conflict with existing requirements of those bodies who deal with MC information already. Therefore, given the current workload and time frames of the active agenda projects we recommend the IASB not to regard MC a top priority project.

We agree that it could be useful to develop placement criteria but have some concerns about the criteria proposed in the paper.

We do not comment on the audit issues raised in the paper because such issues are not within our area of responsibility.

We hope that you find the comments helpful. If you wish to discuss them further, please do not hesitate to contact Knut Tonne or me.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

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 regard management commentary (MC) information as an integral part of financial reports.

The financial statements as currently covered by the IFRS should be seen as a kind of stand-alone package for accounting purposes. An additional MC should complement and supplement the financial statements as part of the financial reporting package of companies. In our opinion figure 1.1 of the discussion paper (see page 12) adequately illustrates the relationship of the different financial reporting instruments. We do not think that the boundaries of the financial statements should be extended in order to include MC information.

Almost all companies that apply IFRS provide some additional statements to meet the information needs of investors and often an even wider group of stakeholders. Since the information proposed to be included in MC is derived from or linked to financial statements—for example, information about research and development of a pharmaceutical company—it should form part of the financial reporting package together with the financial statements.

Indeed, the MC is so important, and the links between it and the financial statements so great, that we believe the IASB's Framework document should be extended to cover the MC. We note in this context that the Framework is currently under examination for improvement. Since this project is still at a fairly early stage it appears to be a great opportunity to discuss a possible extension of the scope of the Framework to other financial reporting, and thereby bringing it more into line with the wording of the IASCF Constitution and the IFRS Preface. This issue could be part of phase E of the project, presentation and disclosure, including financial reporting boundaries. Such material would help ensure that a consistent approach is adopted to the subject and that conflicts between otherwise separate projects are avoided.

We think that the material that we comment on under 'Question 5' below would be a good starting point for the Framework discussion of the 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 generally supportive of the project on MC, because we see MC as a key element of business reporting. However we have concerns that taking the project on MC on to the IASB's agenda would delay its current active agenda projects. We also believe that it is not practicable for this project to result in a mandatory standard as it might conflict with requirements of some of the bodies dealing with this subject in their jurisdiction. Therefore we believe the IASB should, when time and other priorities allow, develop and issue principle-based high-level guidance on the subject, because we think such an approach has the potential to be of benefit internationally.

Please note that EFRAG carefully considered the advantages and disadvantages of either a mandatory standard or non-mandatory guidance. We for example acknowledge that a standard is more likely to guarantee a consistent application of MC requirements. In addition, Europe has a long tradition of requiring MC information (e.g. as laid out in the 4. and 7. Company Law Directive), to which the suggestions of the MC discussion paper are not in opposition. EFRAG also acknowledges the need for MC as an additional reporting instrument. Nevertheless, after having weighed these arguments against the potential area of conflict with those bodies currently requiring MC information we concluded that developing principle based guidance would be the more reasonable approach.

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.

As we do not support a mandatory standard on MC (see answer to question two above), the inclusion of non-mandatory disclosures is in consequence not a compliance issue.

Purpose of MC

The project team concluded that, 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 MC.

We think that the focus on investors is appropriate. We note in this context that the IASB has tentatively decided to revise what its Framework says about the primary users of financial statements; at the moment the Framework states that investors are the primary users, but the IASB has tentatively decided to extend this to include creditors. As we see the MC as a document prepared primarily for the capital markets, our view is that, even if the IASB implements its tentative decision, the focus of MC should remain on investors. It might be useful to include in the definition of MC a reference to this focus on investor information needs.

We also agree that the scope of MC should not be extended to meeting special needs of a wider set of stakeholders. As mentioned in paragraph 30 of the discussion paper, MC should not be a replacement of sustainability and corporate social responsibility reports prepared by many companies nowadays. Nevertheless, this kind of environmental issues, social responsibility issues as well as issues of sustainability should be included in management commentary if such issues have had or are expected to have significant influence on the financial development or position of an entity. Even investors concerned principally with financial returns will be interested in a company's environmental and social policies to the extent that they might have an impact on risks and future financial returns. Such impacts can cause, for example reduced revenues, if customers react to a company's environmental policy, or significantly increase costs because of accidents due to poor safety standards.

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?

Having qualitative characteristics for management commentary is essential for improving the quality of such financial reports. We agree with the characteristics as set out in the discussion paper.

We regard the three proposed principles of MC (set out in paragraph 39) as appropriate. We recognise that, if the information is given through the eyes of management, comparability between entities is difficult to achieve, but agree that the qualitative characteristics of MC should focus on achieving comparability over time. Another important issue is the supportability of the information contained in MC as proposed and explained in paragraph 75.

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?

We agree with the principles-based high-level approach adopted to the content of MC. We are also broadly supportive of the specific things the paper says on content, although we have the following observations:

- We do not consider paragraph 100 to be a comprehensive list and would suggest that this is made clear in the text.

- We think there ought to be strong linkage between the information provided about the objectives and strategies of a company (paragraph 100b) and the information provided on its results and prospects (paragraph 100d). This linkage is very important for the comparability of management commentary information over time.

- Although the paper refers to segmental information, we think it should emphasise that MC information should generally be provided on a segment basis. We recognise that not all information contained in MC can be or should be segmented, e.g. information about the cash flow management. We think best practice is to segment the key MC content information unless impracticable or irrelevant to do so and to use the same segmentation in MC as that used in the financial statements (A13 of the proposed standard).

- We think the "key resources, risks and relationships" (paragraph 100c) should include more information about the risk management of the company. Reporting about the entity specific risk management system and its processes of identifying the risks as well as the ongoing improvement effort of the management system respectively are very important information for investors.

- We believe the illustrative standard provided in appendix A is when taken as a whole too prescriptive and too far away from the principles detailed and explained in the core paper. Although A43 seems to be in line with the core paper A46 contains much more detailed requirements for example.

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?

We agree with the approach of the discussion paper—it is important that the MC does not get cluttered up and its message obscured. For that reason we suggest that any guidance should emphasise that:

- MC should focus on issues relevant to investors and should be presented in a way that highlights those issues of greatest importance to investors.

- the information included in the MC should be balanced and the presentation of the information should also be balanced. For example, negative information that is important to investors should be given the same prominence as positive information that is as important to investors.

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?

The Fourth and Seventh EU Company Law Directives already require the preparation and presentation of an annual report which is very similar to the management commentary as proposed by the working group. Additionally, the annual report will become a mandatory and essential part of the annual and half-yearly financial reports of security issuers listed on regulated markets in the EU from 2007 onwards. Further details of the EU legislation are set out in Appendix B12-B15 of the discussion paper. So far we are not aware of any major areas of conflict or differences.

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?

The DP's discussion of placement and placement criteria in paragraphs 153-185 is a good discussion that is worth studying carefully. We are supportive of the suggestion that criteria are needed to determine whether a piece of information should be provided in the management commentary rather than the financial statements and vice versa. However, we suggest reconsidering and specifying the placement principles. In particular, although the criteria described in paragraph 169 b) for including information in the notes to the primary financial statements is derived from the current IASB Framework, the term "…essential to an *understanding* of the primary financial statements and its elements…" might not be suitable to define the boundary between the information within the financial statements on the one side and MC information on the other side. MC information might also be necessary for an understanding of the results and outcomes of the financial statements by providing contextual and strategic information, e.g. a report on the developments of the financial year under report. Even though we believe that development of guidance on MC should not be a priority for the time being for the IASB, we believe nonetheless that it would be useful for the Board to develop placement criteria. Such criteria could then be used in developing new or amended standards, to identify those disclosures which can be incorporated in the notes by cross-reference to a management commentary (whenever a management commentary is made available to users on the same terms as the financial statements-in the same spirit as is mentioned in IFRS 7.B6 and BC46).