ICAEW representation

ICAEW REP 20/06

MANAGEMENT COMMENTARY

Memorandum of comment submitted in April 2006 in response to the IASB discussion paper 'Management Commentary', published in October 2005

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INTRODUCTION

1. The Institute of Chartered Accountants in England & Wales ('the Institute') welcomes the opportunity to comment on the discussion paper 'Management Commentary', published for comment by the International Accounting Standards Board in October 2005. We have reviewed the proposals and set out below our responses to the questions posed in the consultation paper.

WHO WE ARE

2. The Institute is the largest accountancy body in Europe, with more than 127,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.

3. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry through the Financial Reporting Council. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy.

MAJOR POINTS

Support for the Initiative

4. Over the past decade the Institute has been a persistent champion of improvements in public reporting by listed companies. We believe that a clear commentary issued alongside the annual financial statements is a very important element in the communication process, providing a platform for subsequent dialogue between management and investors and other key stakeholders. It encourages management to take stock and convey a clear, coherent account of their strategies and objectives and their success in implementing them. The significance of management commentary in relation to unlisted companies is less clear, as discussed below.

5. We agree that in principle 'other financial reporting' is a legitimate topic for the Board to address. The Board is well-placed to establish a widely-used framework for narrative and non-financial reporting. However, as explained below, we do not believe that management commentary should be regarded as a priority for the Board, and do not support the development of a mandatory standard.

6. Recent debate and developments in the UK have highlighted the risk that well-intentioned initiatives may result in bland narrative reports, produced at a significant cost to companies and without any significant benefit to investors. We elaborate on some of these risks below.

<u>Costs and Benefits</u>

7. If the Board decides - contrary to our advice - to develop a mandatory standard, it should first undertake a more rigorous assessment of costs and benefits than that included in Section 6 of the discussion paper. We believe that the assumption that marginal preparation costs will be low may be unrealistic. We would encourage the Board to undertake its own assessments rather than rely only on those undertaken in the UK in relation to listed companies. It is also important to note that the legislation implementing a mandatory OFR in the UK was repealed before it took effect.

8. For SMEs in particular, the benefits are very unlikely to outweigh the costs of preparation. In our view, the application of rigorous cost: benefit analysis, a proper identification of the users of SME general purpose financial statements and an understanding of the needs of those users would confirm that most SMEs should not be required to publish management commentary. Whatever course of action is adopted by the Board, it should not involve imposing new mandatory requirements in this area on all companies that apply IFRS.

<u>RESPONSES TO SPECIFIC QUESTIONS</u>

Question 1

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

9. As discussed above, we believe that a clear commentary issued alongside the annual financial statements is a very important element of the corporate reporting process. The degree to which it might be regarded as *integral* is, in our view, dependent on the nature of the reporting entity. In any case, the qualities and objectives of management commentary and the financial statements are distinct, and the boundary between them should remain firmly in place. We recognise that the current review of the *Framework* should encompass consideration of whether it should cover ‘other financial reporting’, which is referred to in both the IASC Foundation Constitution and the *Preface to International Financial Reporting Standards*.

Question 2

Should the development of requirements for MC be a priority for the Board? If not, why not? If yes, should the IASB develop a standard or non-mandatory guidance or both?

A priority for the Board?

10. As discussed above, we agree that it is appropriate to encourage companies to provide management commentary alongside their financial statements, subject to cost:benefit considerations and an assessment of user needs. However, we

do not believe that the topic should be added to the Board's active agenda. The Board has many pressing demands on its time, and should not divert resources from more urgent projects, in particular the development of simplified accounting standards for SMEs.

11. The Board should instead arrange for the project team to finalise their recommendations on management commentary - which we generally support - at an early date. They should then be published as a new type of document (see paragraph 13 below) in recognition of the fundamental differences in the characteristics of information suitable for disclosure in the management commentary and the financial statements.

A standard or non-mandatory guidance?

12. In our experience, the market is generally the most effective arbiter of the quality of a company's reporting practices. Investors recognise and reward transparent reporting practices. We consider, furthermore, that any attempt to introduce mandatory requirements on a global scale would be unsuccessful. Practice and market expectations around the world differ markedly in this area, as does the legal environment. In particular, as discussed in paragraph 17 below, the availability of defences in law for directors making forward-looking statements - which has a major impact on the quality of management commentary - varies between jurisdictions.

13. We therefore recommend that the Board publishes an optional standard or statement of good practice on management commentary. A non-mandatory document would permit regulators of management commentary to align their recommendations or requirements over time with an agreed global benchmark. It would also encourage the development of good practice in jurisdictions unfamiliar with the notion of providing the market with balanced and transparent narrative information. The Board should keep the guidance under review as practice develops in this area around the world.

Question 3

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

14. No. As discussed above, we do not believe that management commentary should be mandated by the Board. However, assuming the Board publishes non-mandatory guidance, companies that publish management commentary with their IFRS accounts should be encouraged to explain the extent to which they have complied with that guidance.

Question 4

Do you agree with the objective suggested by the project team or, if not, how should it be changed? Is the focus on the needs of investors appropriate?

15. We broadly agree with the objective suggested on page 19 of the discussion paper. However, we suggest that particular emphasis is placed on the third

element of the objective - *to help investors to assess the strategies adopted by the entity and the likelihood that those strategies will be successful* (paragraph 34).

16. We agree that, although high quality management commentary will be of interest to a variety of users of financial statements, its focus should not extend beyond investors. The more specific information needs of other stakeholders should be met through separate reporting processes, including corporate responsibility and sustainability reports, although such issues may well be relevant to investors seeking to assess the financial performance and prospects of the reporting entity.

17. Recent experience in the UK indicates that where directors consider that their potential legal duty of care extends beyond members as a body to all investors, perhaps to all prospective investors, the outcome is likely to be anodyne disclosures and a rigid approach by boards to management commentary. If an element of compulsion was introduced, the Board is therefore likely to face calls for the focus of its guidance on management commentary to be restricted to the current shareholders of the parent company. This would introduce a significant inconsistency with the *Framework*, and in our view reinforces the case for issuing only a voluntary statement on management commentary.

Question 5

Do you agree with the principles and qualitative characteristics that the project team concluded are essential to apply 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?

18. We broadly support the principles identified for management commentary: *supplement and complement financial statement information*; *through the eyes of management*; and *an orientation to the future*. However, the Board should not underestimate the challenges involved in encouraging companies to publish more forward-looking information. Indeed, in some jurisdictions there may be legal impediments to the disclosure of such information, as is recognised in paragraph 57 of the discussion paper.

19. We suggest that before publishing final guidance - and certainly before mandating this type of reporting - the Board should evaluate in detail practical experience in the European Union regarding the implementation of the new requirement for publication of an enhanced Business Review, which must include some information with an orientation to the future; and in the UK in relation to the voluntary Reporting Statement on the OFR, which has a clear focus on the disclosure of forward-looking information.

20. We also broadly support the qualitative characteristics elaborated - *understandability*, *relevance*, *reliability*, *supportability*, *balance*, and *comparability over time*. We welcome in particular the emphasis on the importance of an even-handed approach to this type of reporting. This requirement that favourable and unfavourable aspects of performance and prospects should be disclosed with equal prominence is fundamental to the

success of a management commentary standard. We also welcome the recognition that, as management commentary should reflect the information used by directors to manage the business, in comparison with accounting standards, the guidance will give rise to a lower level of comparability *between* reporting entities.

Question 6

Do you agree with the essential content elements that the project team concluded that MC should cover? If not, what additional areas would you recommend or which ones suggested by the project team would you change?

21. We broadly support the discussion in Section 4 of the essential content elements for management commentary, although we would restructure the disclosure categories listed as (a) to (e) in paragraph 100 to clarify that the purpose of the other disclosures is to assist in an effective assessment of the company's strategies (referred to in category (b)).

22. We also believe that the draft standard set out in Appendix A to the discussion paper is generally well-structured and principles-based. In particular, we welcome the references to segmental information (although these might be strengthened) and strongly support the decision not to require disclosure of any particular measures or indicators or any minimum number. Nonetheless, we have concerns regarding the level of detail in the draft standard.

23. In our view, the clear attempt of the project team to limit the degree of prescription in the draft standard - which we applaud - may not have gone far enough. There is a risk that the language used and level of detail will discourage innovative reporting if any element of compulsion is introduced. For example, the list of items that should be included in a description of the business in paragraph A31 and the examples of key relationships in paragraph A42 may encourage a 'checklist mentality'. The outcome may be a tendency for some directors to focus on compliance with the standard's detailed requirements - or what come in practice to be regarded as requirements, rather than recommendations or illustrations - rather than developing useful company-specific and sector-specific types of disclosure that enable shareholders and other users to truly view the business 'through the eyes of management'.

24. We encourage the Board to develop high level guidance that is as succinct as possible, incorporating key principles, qualitative characteristics, and clear and concise guidance on contents that is non-prescriptive in tone - 'may' or 'might' rather than 'should'.

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?

25. We agree that management commentary should be a clear and concise aide to users of financial reports, avoiding clutter. However, whilst some clear guidance on this principle might be provided, we do not think introducing requirements aimed at limiting disclosures would be desirable or effective.

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 are the major areas of conflict or difference? If you believe that any of these differences should be included in an IASB model for MC please explain why.

26. As referred to above, the law requiring listed UK companies to prepare an OFR was repealed in January 2006. Companies in the UK remain subject to the high level requirements of the EC Accounts Modernisation Directive, which reflect – albeit more succinctly – many of the key features of the proposed standard on management commentary. However, these requirements, and the decision to abolish the statutory OFR, are at present subject to a process of consultation and review. The UK Accounting Standards Board has withdrawn its Reporting Standard on the OFR and reissued it without significant changes as non-mandatory guidance. Listed companies have been encouraged by the Financial Reporting Council to continue to improve their narrative reporting on a voluntary basis.

Question 9

Are the placement criteria 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?

27. The discussion of placement criteria in section 5 of the discussion paper represents a useful preliminary assessment of the underlying issues. However, we are not convinced that the criteria proposed on page 53 are sufficiently clear and robust. This topic should be addressed and tested comprehensively as part of the conceptual framework project.

28. We have some concerns regarding the discussion of assurance in this section of the discussion paper (paragraphs 186-194). We recognise that auditor involvement enhances the confidence of users in the information provided by management. However, a requirement for an audit may encourage a rigid and excessively-cautious approach to management commentary. There are also major cost implications for business. Once there is agreement on the key characteristics of guidance on management commentary, the Board should encourage consideration by regulators and the profession of the level of assurance that would be appropriate.

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