



**INTERNATIONAL FEDERATION
OF ACCOUNTANTS**

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Agenda Item
6

DATE: February 25, 2008
MEMO TO: Members of the IPSASB
FROM: Don Geiger
SUBJECT: Narrative Reporting (NR)
(previously called Management Discussion & Analysis MD&A)

OBJECTIVE OF THIS SESSION

To **review, discuss issues and approve** the project initiation document on a project on NR.

AGENDA MATERIAL:

Papers

- 6.1 Project Brief – project initiation document – NR
- 6.2 Issues Paper - “Narrative Reporting: Exploring the Issues for Standardization and Use in Public Sector General Purpose Financial Reporting.”

ACTION REQUIRED

The IPSASB is asked to:

- **Review** the attached project initiation document;
- **Provide** staff with comments and suggestions for improvement;
- **Discuss issues** as outlined in the draft Issues Paper – “Narrative Reporting: Exploring the Issues for Standardization and Use in Public Sector General Purpose Financial Reporting;” and
- **Approve** the project initiation document and initiation of the project.

BACKGROUND

At its meeting last March in Accra, the IPSASB selected Narrative Reporting (previously called MD&A) as a project to be on its technical agenda for 2008. Narrative Reporting has been addressed in a number of jurisdictions internationally. There are a variety of terms applied to it, including Management Discussion and Analysis (MD&A), Management Commentary (MC), Financial Statement Discussion and Analysis (FSD&A), Operating and Financial Review (OFR), rapport de gestion, and Business Report.

While the terms used for this type of reporting vary widely, all center on providing narrative explanation by management to enhance the usefulness of financial information. At this stage, staff proposes to use the term Narrative Reporting for operational purposes, with a view to determining the most appropriate title once the project has progressed.

In practice, NR is widely used in both the public and private sector within English and non-English speaking jurisdictions. The type of guidance varies from accounting standards to recommended practices to required submissions by regulators, legislatures and government agencies that specify form and content of public sector financial information to be included in NR. One of the issues in developing the project will be to determine the nature of the guidance that is most appropriate for the IPSASB.

In undertaking this project, staff will evaluate the current IASB project on MC as well as consider the work of national standard setters both in the public and private sectors.

Guidelines for Modifying IASB Documents

Because the IASB has an active project on management commentary, staff have applied the IPSASB Guidelines for Modifying IASB Documents (Rules of the Road) to help determine the approach. Below is the analysis of each of the steps and rules evaluating if there are issues that warrant departure and if it is so significant to warrant a public sector specific project. You will note, staff believes that only rule #2 on “loss of accountability to stakeholders” will result in a public sector issue that warrants departure. When this is applied in Step 2, staff concluded that it warrants a public sector specific project.

Step 1: Are there public sector issues that warrant departure?

In applying the rules in step 1 public sector issues are assessed to determine if they warrant departure in recognition or measurement or in presentation or disclosure.

Rule #1: When applying the IASB (anticipated) non-mandatory guidance on MC, would the objectives of public sector financial reporting not be met?

In addressing rule #1 we compare the IPSAS General Purpose Financial Reporting (GPFR) current objectives with the IASB MC objectives and definition of user in the MC Discussion Paper:

- **IPSAS Objectives** – The IPSAS objectives and users are defined in the current IPSAS 1 “Presentation of Financial Statements”. Users of General Purpose Financial Statements (GPFS) include taxpayers and ratepayers, members of the legislature, creditors, suppliers, the media, and employees. IPSAS 1 goes on to specifically say that the objectives of general purpose financial reporting in the public sector should be to provide information useful for decision making, and to demonstrate the accountability of the entity for resources entrusted to it by providing:
 - (a) Information about the sources, allocation and uses of financial resources;
 - (b) Information about how the entity financed its activities and met its cash requirements;
 - (c) Information that is useful in evaluating the entity’s ability to finance its activities and to meet its liabilities and commitments;
 - (d) Information about the financial condition of the entity and changes in it; and

- (e) Aggregate information useful in evaluating the entity's performance in terms of service costs, efficiency and accomplishments. (paragraph 15)

General purpose financial statements can also have a predictive or prospective role, providing information useful in predicting the level of resources required for continued operations, the resources that may be generated by continued operations, and the associated risks and uncertainties. Financial reporting may also provide users with information:

- (a) Indicating whether resources were obtained and used in accordance with the legally adopted budget; and
- (b) Indicating whether resources were obtained and used in accordance with legal and contractual requirements, including financial limits established by appropriate legislative authorities. (paragraph 16)

The IPSASB Conceptual Framework project is considering the objectives and users of GPFR and the outcome of that work will be monitored and incorporated into any guidance developed for NR. A major point of discussion relates to the enhanced need for accountability or stewardship in the public sector and how this objective is incorporated.

IASB MC Objectives - The objectives documented in the October 2005 Discussion Paper on Management Commentary are now identified as the starting point for the March 2008 active agenda for the IASB Board.

The IASB begins with a limitation on the users of MC at paragraph 24-31, stating "In our view, the information provided by MC should focus on meeting the needs of investors. It should not be expanded to fulfill the information needs of an extended range of users."

The IASB final conclusion is that the objectives of management commentary, has elements to provide information to help investors achieve their objectives. It was further decided that adapting MC to meet the needs of a wider audience would not be appropriate.

Conclusion on Rule 1: Given the focus of the IASB on investors as users of GPFRs, there is some concern as to whether material developed with the investor in mind could meet the objectives of GPFR in the public sector. Arguably, a primary focus on accountability and stewardship would not be the IASB's approach since the investor's primary concern is typically return on investment. However, the current IPSASB objectives and the IASB objectives are presented at a very high level and it would be difficult to succinctly identify that a given objective has not been met in the area of management commentary. Therefore, staff concludes that this first criterion is not a basis for a public sector specific project.

Rule #2: Applying the IASB (anticipated) non-mandatory guidance on MC would result in a loss of accountability to stakeholders?

Given the focus on investors, it is reasonable to conclude that there could be a concern about a loss of accountability to stakeholders.

It should be further noted that in our preliminary research, one national standard setter who has promulgated NR guidance, the US Federal Accounting Standards Advisory Board (FASAB), had the following to say about the users of NR:

“Several factors suggest that MD&A [NR] may be even more important for Public Sector reporting entities than for those in private sector and may need to be more extensive in scope. These factors include complexity of governmental operations, the myriad objectives they pursue, and diverse natures of the groups affected by and interested in the governments activities. Fundamentally, the government’s objective is to provide for the common defense and to promote general welfare, not to earn a profit. Therefore the reporting on performance and other matters in a way that is understandable to diverse audiences is important.”

In reviewing the IASB MC Discussion paper it is stated specifically that the emphasis should be on investors and not a wider user base. The paper indicates that it was recognized that a broader base of users, in addition to investors, rely on the MC. For example, employees also have interest in MC. The IASB also noted that beyond traditional financial statements, the information models for broader groups are less well defined. The IASB DP came to the conclusion that MC should focus on the user group of investors. Staff believes that the public sector has its own unique needs and also a less well defined model. However, while it is perhaps clear in the private sector that the information needs should focus on one user this is not clear in the public sector. In fact the current IPSASB objectives states that users of general purpose financial statements (GPFS) include taxpayers and ratepayers, members of the legislature, creditors, suppliers, the media, and employees. The Conceptual Framework project is specifically looking at this issue.

Conclusion on Rule 2 concerning loss of accountability: Initial research on the project indicates that the enhanced need for accountability information in the public sector means that the IASB MC guidance would be deficient since it does not have the same broad emphasis and focuses on the needs of investors specifically. In the public sector examples where national standard setters have issued guidance, the objectives and attributes that they have defined suggest the need not only for a citizen focus, but for content that complements and supplements the unique public sector GPFS. In these examples such content has included information on budget execution, service levels in government, performance indicators and outturn against estimates. Additionally, in the private sector there is a strong influence from the securities exchanges and their regulators which help ensure and reinforce the information needs of the investors. In the public sector there is not a comparable regulator, who participates in the process of standardizing NR, and therefore reliance on the IASB MC guidance may result in loss of accountability in the public sector.

Rule #3: Applying the IASB (anticipated) non-mandatory guidance on MC would mean the qualitative characteristics of public sector financial reporting would not be met.

The IPSASB is actively addressing qualitative characteristics in its conceptual framework project and has overall been considering this as an area where (depending upon the final outcome of IASB deliberations) it could be advantageous to, at a higher level at least, get

general agreement with the revised qualitative characteristics of the IASB. The existing IPSASB qualitative characteristics of Understandability, Relevance, Reliability, and Comparability do not seem to be an issue in the area of NR.

Conclusion on Rule 3: Staff concludes that Qualitative Characteristics is not a basis for a public sector specific project because of the broad convergence that is being advocated in the Conceptual Framework project.

Rule #4: Where the cost of applying the international accounting standards/interpretations exceeds the benefit.

In the preliminary research that has been completed in the area of NR, there has been no indication that Cost/Benefit factors are a major concern. The fact that NR is fairly widely used in the public sector is an indication that it is likely not an issue. Staff will continue to monitor the existence of cost/benefit concerns. However unlike sophisticated financial accounting systems, the development of NR does not seem to be a major challenge.

Conclusion on Rule 4: Staff concludes that Cost Benefit is not a basis for a public sector specific project.

Step 2: Are the departures so significant that a public sector specific project should be initiated?

Conclusion: Staff believes that the focus on the single users group of investors would result in a loss of accountability to shareholders. The users of government financial reports are fundamentally different and having a pervasive effect on the project as a whole. The narrow IASB focus on a primary user of the investor, in comparison to a wider user base in public sector, would cause NR not to provide a broad enhancement of the public sector users' understanding. Examples of where this may occur would be budgetary analysis, reporting of services levels, key performance indicators, fiscal sustainability reporting all of which demand a reporting models beyond the investor focus. Therefore, staff is of the view that the IPSASB should initiate a public sector specific project on NR. It should be noted however that the work of the IASB will be monitored and tracked closely in order to minimize divergences.

Step 3: Modify IASB Documents

This step has not been addressed because the IASB has just started this project.

Step 4: Issue IPSAS converged (to varying degrees) with IASB Documents

This step has not been addressed because the IASB has just started this project.

**Don Geiger
TECHNICAL MANAGER**



INTERNATIONAL PUBLIC SECTOR ACCOUNTING STANDARDS BOARD

PROJECT BRIEF AND OUTLINE

1. Subject – Narrative Reporting (NR)

This project will evaluate how a narrative explanation (termed Narrative Reporting for this project) by management should be used to enhance the usefulness of financial information provided by general purpose financial *statements* (GPFS).

2. Project Rationale and Objectives

In the private sector and in many governmental jurisdictions, it is reasonably widely accepted that NR enhances the usefulness of financial information. The focus of the project will be to identify and standardize the unique aspects of NR and how they “add value” in a public sector financial reporting context.

NR provides stakeholders with a narrative description of various matters, such as the major factors underlying the performance of the entity during the reporting period or the known factors which are likely to influence its performance in the future. This description can assist in placing aspects of the financial statements in context. NR can also enhance the value of financial information for decision making and to make assessments of the entity’s discharge of accountability.

As the appropriate scope of NR for the public sector is considered, the project will examine the current International Accounting Standards Boards (IASB) active project on Management Commentary (MC), as well as existing national standards and guidance on NR (or its equivalent) in the public and private sectors, where standards, guidance, and regulatory requirements for NR have a long history. In addition, NR approaches of other public sector bodies interested in making comparative fiscal information, such as Eurostat, IMF, World Bank and the United Nations will be considered.

a) Issues Identification

The main issues to be considered in the NR project are:

- What are the objectives of NR?
- What are the main attributes of high quality narrative explanations?
- Are there essential content elements to include in NR?
- What type of guidance is appropriate?

b) Objectives to be achieved

The objective of the project is to provide guidance for NR.

The initial objective is to produce a Consultation Paper - “Narrative Reporting: Exploring the Issues for Standardization and Use in Public Sector General Purpose Financial Reporting.” The Consultation Paper will highlight and analyze existing approaches by the IASB and in jurisdictions where NR is a feature of governmental financial management.

Preliminary research conducted that indicates NR is used by various groups to enhance GPFR in current practice. Unlike traditional financial statements, NR often includes non-financial information coupled with financial information to explain the current status and potential future financial status while introducing the idea of prospective or future looking financial data. The project will consider whether the standardization of this process will improve financial reporting within the public sector.

i. Target Audience

The definition of the users and objectives of NR should correspond closely with the Conceptual Framework work as it develops.

In considering how NR will be developed for the public sector, a consideration of those who currently define the form and content of public sector narrative explanations will be undertaken. In establishing guidance we must be cognizant of regulators and/or the equivalent government agencies that currently set the form and content (i.e. US Office of Management & Budget, European Commission, FReM) of certain types of reporting.

ii. Project Deliverables

The next step in this project would be to develop a draft Consultation Paper to be presented at the June Moscow IPSASB meeting. Once approved, this Consultation Paper would be issued for comment and eventually lead to guidance or standards as necessary.

iii. Content of IPSAS

This is not a project directly related to the general purpose financial statements. Therefore, it is not feasible or appropriate to provide definitive final outputs at the initiation stage. Dependent upon decisions following analysis of submissions on a Consultation Paper, an Exposure Draft of a Standard and/or detailed Guidance will be developed.

c) Link to IFAC/IPSASB Strategic Plans

i. Link to IPSASB Strategy

In the IPSASB Strategy and Operating Plan MD&A (NR) is listed as a potential project that is public sector specific and is identified as important. At the March 2007 meeting in Accra, the IPSASB approved the initiation of this project in 2008. The NR project was linked to the #2 IPSASB Strategic Theme of Public Sector specific project. High quality NR will enhance the quality and transparency of public sector financial reporting by providing better information for public sector financial management and decision making.

ii. Link to IFAC Strategic Plan

The alignment of the IPSASB Strategic theme concerning NR results in a direct impact on the IFAC Strategic Theme of “Recognition as the International Standard Setter” as well as a direct impact on the “Enhancement of collaborative efforts.”

3. Outline of the Project

a) Project Scope

The scope of the project is to determine how a narrative explanation by management in the public sector should be used to enhance the usefulness of financial information within general purpose financial *statements* (GPFS) and how it should be included within general purpose financial *reporting* (GPFR).

The NR guidance would apply to all public sector entities other than Government Business Enterprises.

Note that there are linkages with the Conceptual Framework, Long-Term Fiscal Sustainability and Performance Reporting projects.

b) Major Problems and Key Issues that Should be Addressed

Key Issue #1 - What are the objectives of NR?

The first issue will be to consider the objectives of narrative reporting since this will ultimately lead to developing the guidance needed to meet those objectives. The work of the IASB and national standard setters will be considered and evaluated in this context.

Key Issue #2 - What are the main attributes of high quality narrative explanations?

In establishing the main attributes that make narrative explanations useful and of high quality, the needs of the public sector GPFR user will be important. Certain definitions like “supplement and complement” will be explored. In addition, the term “through the eyes of management” will be assessed to determine if it is

appropriate in the public sector and, if so what it means. The use of prospective forward looking information will also be considered.

Key Issue #3 - Are there essential content elements to include in NR?

There are a variety of approaches to the format and elements of NR prescribed by standard setters and regulators. It will be important to consider the approach that will yield the highest quality NR that allows comparison to other entities and periods.

Key Issue #4 – What type of Guidance is appropriate?

There are a number of potential ways that guidance could be developed, including:

- Recognizing best practices;
- Issuing specific non-mandatory guidance;
- Issuing a standard that applies when certain conditions exist

(IPSAS 24, “Presentation of Budget Information in Financial Statements); and

- Issuing a standard (revised or new) that is mandatory.

While the IPSASB has primarily issued standards, as the first project addressing reporting outside of GPFS, there may be other appropriate vehicles. In considering the type of guidance, audit and assurance aspects of NR will also be addressed.

4. Describe the Implications for any Specific Persons or Groups

a) Relationship to IASB

As noted, the IASB project on MC will be followed closely for points of convergence where possible.

b) Relationship to other projects in process or planned

There are close linkages with the Conceptual Framework project, Long Term Fiscal Sustainability, and Performance Reporting.

c) Other

This project has implications for the following:

- Assurance and verifiability (IAASB/INTOSAI); and
- Budget and statistical groups involved with public sector financial statements.

5. Development Process, Project Timetable and Project Output

a) Development process

The development of outputs will be subject to the IPSASB's formal due process. The issuance of documents for public comment will be subject to the usual IPSASB voting rules. As the project progresses, regular assessments will be made to confirm the proposed path in the project timetable remains the most appropriate.

The initial output will be a Consultation Paper. Following analysis of submissions on the Consultation Paper, a decision will be made on whether to develop an Exposure Draft of Reporting Requirements and/or Guidance. An Exposure Draft and/or Guidance will also be subject to formal due process, including a consultation period of at least four months.

b) Project timetable

The project timetable should identify the major project milestones and the expected timeline for achieving the objectives.

Major Project Milestones	Expected Completion
Present Project Brief & Draft Issues Paper	March 2008
Approve Consultation Paper	October 2008 Response date March 31, 2009
Analysis & ED	October 2009 Response date March 31, 2010
Analysis of ED responses	May/June 2010
Present and Approve Final IPSAS or Guidance as required	October 2010

c) Project output

The nature of the output will depend on the results of IPSASB process.

6. Resources Required

a) Task Force

A full Task Force is unlikely to be required; however, members may need to assist the Technical Staff with a broad understanding of current practices in both English and non-English speaking countries.

This project has significant interplay with the current IASB project on Management Commentary and other projects by National Standard Setters in both the Public and Private Sectors.

The project would benefit from input from government agencies that set form and content of existing NR reports. Staff will reach out to groups like (FReM – FRAC, European Commission, US Office of Management and Budget, etc) for input.

b) Staff

One staff member will be required on this project for the period of the review (March 2008 – October 2010). It is anticipated that approximately one-third of an FTE would be needed.

c) Factors that might add to complexity or length

- Nature of Product;
- Interaction with other projects at the IPSASB (Conceptual Framework, Fiscal Sustainability, etc);
- Developments/Decisions with the IASB Management Commentary project;
- The IPSASB position of prospective forward looking information; and
- Implication to the Audit and Assurance community. Verifiability of NR.

7. Important Sources of Information that Address the Matter being Proposed

IASB MC Project:

IASB Project Page Management Commentary [Click here for MC Project Page](#)

IPSAS Standards & Projects:

IPSAS 01 Presentation of Financial Statements [Click here for IPSAS 01](#)

IPSAS 24 Presentation of Budget information in Financial Statements

[Click here for IPSAS 24](#)

Fiscal Sustainability (current project)

[Click here for FISCAL SUSTAINABILITY project page](#)

IPSAS Conceptual Framework (current project)

[Click here for CONCEPTUAL FRAMEWORK project page](#)

IPSAS 18 - Segment Reporting [Ctrl + Click here for IPSAS 18](#)

IPSAS 22 - Disclosure of Financial Information General Government Sector

[Click here for IPSAS 22](#)

IPSAS Glossary of Defined Terms (as of December 31, 2006)

[Click here for GLOSSARY](#)

Public Sector Standard Setters:

Canada PSAB http://www.cica.ca/index.cfm/ci_id/225/la_id/1.htm

FReM - Financial Reporting Manual with consultation with the Financial Reporting Advisory Board and is issued by the relevant authorities in England and Wales, Scotland and Northern Ireland <http://www.financial-reporting.gov.uk/default.htm>

French websites www.comptes-publics.gouv.fr or Conseil National de la comptabilite

USA GASB <http://www.gasb.org/>

USA FASAB <http://www.fasab.gov/>

Private Sector Standard Setters:

Prepared by _____ Date _____

(Technical Manager IPSASB)

The following should be completed after board or committee approval and after revising the project proposal form to reflect any changes by the board or committee.

Approved by _____ Date _____

(Chair IPSASB)

COMMENTS BY TECHNICAL MANAGERS

The comments of Technical Manager from each technical area are required before this Project Proposal is considered by the board or committee proposing to undertake the project.

Technical Manager to the Compliance Advisory Panel

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

Technical Manager to the DNC

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

Technical Manager to the SMPC

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

Technical Manager to the IESBA

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

Technical Manager to the IAASB

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

Technical Manager to the PAIB Committee

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

Technical Manager to the IAESB

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

Technical Manager to the Transnational Auditors Committee

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

Issues Paper

March 2008

Narrative Reporting: Exploring the Issues for Standardization
and use in Public Sector General Purpose Financial Reporting

Introduction

1. The approach to identifying the issues concerning the use of narrative reporting (NR) in public sector financial reporting will be to look at current existing pronouncements on NR. The history and status of the IASB's Management Commentary (MC) project will be reviewed, as well as the work of public sector standard setters who have promulgated guidance on NR. Lastly, private sector guidance issued at the national level will be considered. These preliminary steps are not intended to be exhaustive and further guidance from the IPSASB is sought on other approaches and areas to consider.
2. Section 2 of this document identifies the preliminary public sector issues. At this stage the point of this paper is not to reach any conclusions but simply to have a preliminary discussion of some of the issues inherent in the project and provide any feedback to staff based on experience.
3. The final outcome of the project will be to establish a definition of NR and have an approach as how this may be best introduced into a suite of IPSASB guidance.

Narrative Explanations, what are we talking about?

4. Professor Michael Granhof, in his Textbook *Government and Not-for-Profit Accounting*, describes the importance of Management Discussion and Analysis in the USA, issued by state and local governments:

“A government's fiscal health is as much dependent on the economic environment from which it draws its resources as on the resources already within its control.” He goes on to say “financial statements fail to provide sufficient information on the nature and extent of services that the government will be expected to provide in the future. Governments have long been required to include in the statistical section of the CAFR extensive data on both demographic and economic trends. This data, however are generally presented in tables. It was left to the statement users to interpret them and place them in perspective.” (Granhof, Chapter 11, page 412)

5. While the US system is advanced in the area of NR, and may not be indicative of where the IPSASB should start, Professor Granhof indicates a trend towards the importance of government officials presenting the government's fiscal condition in a way that is understandable to the average citizen.
6. A logical starting point is the IASB MC Definition:

MC is information that accompanies financial statements as part of an entity's financial reporting. It explains the main trends and factors underlying the development, performance and position of the entity's business during the period covered by the financial statements. It explains

the main trends and factors that are likely to affect the entity's future development, performance and position.

You will note that key words within the definition give an indication to some of the underlying attributes. The IASB use of the words 'development', 'performance', 'position' and 'future' are by design and carry important meaning.

7. NR can provide stakeholders with a narrative description of such matters as the major factors underlying the performance of the entity during the reporting period and the factors which are likely to influence its performance in the future. Such analysis can also assist in placing the results of operations during the reporting period and the financial position at the end of the period in context. This may enhance the value of financial information as input to decision making and to assessments of the entity's discharge of accountability.
8. Appendix C & D provide other examples of NR definitions for both public and private sectors. A condensed summary chart of existing guidance on NR (or the equivalent term) is located in Appendix A.

a) IASB Management Commentary

i. MC Summarized

9. Initiating an IPSASB NR project at this time parallels the IASB MC project, which is now on the IASB active agenda. The IASB will use the research and the primary themes of the previous discussion paper on MC as it forms the Board's position. MC is information reported that, with the financial statements, forms an entity's GPFR. MC explains the main trends and factors underlying the development, performance and position of the business during the past period, and provides information about what is likely in the future. MC gives the financial statements context to help investors interpret and assess the environment in which the entity operates and management's views on important issues and strategies. It will supplement and complement the financial statements; it is through the eyes of management and has a future oriented perspective. MC guidance is expected to identify essential content elements.

ii. Status of IASB MC Project

10. Appendix B provides an overview of the IASB Management Commentary (MC) project. The IASB commenced on a project to examine the potential for developing either a standard or guidance for management commentary as far back as October 2002. There was general acknowledgement that the preparers of financial statements were looking for guidance on this topic and so MC was officially added to the IASB research agenda. The discussion of the authority of this guidance, varied from suggestive guidance to a mandatory standard.
11. A discussion paper, "Management Commentary", was published in October 2005. The paper assessed the role the IASB could play in improving the quality of the

management commentary that accompanies financial statements. The discussion paper reviewed existing national requirements or principles on management commentary and offered recommendations on how the IASB might promote the wider adoption of best practice in the interests of investors and others who use financial reports.

12. The IASB added MC to the active agenda in December 2007 recognizing that narrative reporting accompanying the financial statements is a necessary component of the general purpose financial report. The need for this report stems from increased complexity of both the global business environment and the transactions that underpin the financial statements.
13. In March 2008 the Board will consider the project in more detail including developing principles, qualitative characteristics and essential content elements necessary to make management commentary reporting useful to investors. The current plan is that the final work product will be issued as a non-mandatory guidance document.

b) Existing Public Sector Pronouncements using NR Summarized

14. In Canada the Public Sector Accounting Board (PSAB) in June 2004 issued a Statement of Recommended Practices (SORP) on Financial Statement Discussion and Analysis (FSD&A). The FSD&A SORP provides non-mandatory guidance for the presentation of FSD&A when a government includes FSD&A in its financial report. FSD&A information includes narrative explanations and graphical illustrations of what has happened throughout the period, highlighting the key relationships that exist among the quantitative representations set out in the financial statements, as well as explanations and illustrations of variances and trends. The SORP also sets out the qualitative characteristics upon which the FSD&A information must be based, and the minimum requirements of its contents (see Appendix C for further information in the PSAB SORP 01, and a link to the PSAB website).
15. In the United States the Governmental Accounting Standards Board (GASB) in June 1999 issued a Statement on Management Discussion and Analysis (MD&A), GASB 34, for state and local governments. GASB 34 requires governments to prepare a general discussion of operating results and changes in financial condition through MD&A, similar to those prepared by publicly traded companies. The MD&A should tell the reader whether the government is better or worse off than it was in the prior year. The information presented should be confined to the topics identified in the standard and "boilerplate" discussions should be avoided. (see Appendix C for further information in the GASB Standard 34, and a link to the GASB website).
16. Additionally in the United States, the Federal Accounting Standards Advisory Board (FASAB) issued both a Statement of Federal Accounting Concept 3 and Statement of Federal Accounting Standard 15 for the US Federal Government in 1999. This concept and standard establish standards for preparing MD&A.

- MD&A is an important vehicle for (1) communicating managers' insights about the reporting entity, (2) increasing the understandability and usefulness of general purpose federal financial reports (GPFFR), and (3) providing understandable and accessible information about the entity and its operations, service levels, successes, challenges, and future (see Appendix C for further information in the FASAB Standard and Concept on MD&A as Required Supplemental Information (RSI), and a link to the FASAB website).
17. In the United Kingdom the Financial Reporting Advisory Board (FRAB) and various statutes govern public sector accounting. HM Treasury issues the Governmental Financial Reporting Manual (FReM) for central government bodies across the United Kingdom. The FReM at present relies on ASB standards with adaptations in the context of governmental accounts. The ASB has published a Reporting Statement: *Operating and Financial Review* (OFR). It is designed as a formulation and development of best practice which is intended to have persuasive rather than mandatory force. The Statement was prepared with quoted companies in mind, but it also applicable to other entities which purport to prepare OFR. The Treasury has developed guidance on producing an OFR, which indicates that when entities covered by the FReM prepare MC they need to take into consideration the OFR Reporting Statement. While the recommendations of the OFR Reporting Statement are not mandatory for the private sector, public sector organizations subject to the FReM are expected to produce MC in full. (see Appendix C for further information in the FReM guidance, and a link to the FReM website and manual).
 18. In France NR is referred to as “rapport de gestion” and examples may be found on the Ministry of Finance website or www.comptes-publics.gouv.fr. You will also find NR relating to the budget, and a detailed report, called “rapport annuel de performance.” While this practice is quite prevalent in the public sector there are no specific rules or guidance. In the private sector what is done in France does not differ from the European Union legislation.
 19. In Japan, NR is referred to as a “Business Report” and the Ministry of Internal Affairs and Communications issues guidelines on “Business Report for Independent Administrative Agencies (IAAs)” that requires disclosure of some non-financial performance information and narrative analysis on financial and non-financial information. The guidelines require that IAAs explain non-financial performance information in connection with financial data, such as comparison of each non-financial performance information and cost required to execute the project.
- c) Private Sector Pronouncements on Narrative Reporting**
20. In general, NR is well established and generally required in private companies, especially those required to file with a securities exchange. Please see appendix E for a summary used in the IASB analysis which includes requirements from the International Organization of Securities Commissions (IOSCO), Australia Corporate Law, Canadian Securities Administration (CSA), the European Union

Accounting Directives, the requirements in Germany, the New Zealand Securities Commission, the United Kingdom Corporation Act, and in the United States the Securities and Exchanges requirements for MD&A in the 10K filing.

21. Included in appendix E is a summary of the existing requirements of each of the jurisdictions mentioned above. Also included at appendix F is a cross-jurisdictional analysis of how NR is used in the private sector. It is anticipated that the IPSASB NR project will explore the private company examples more thoroughly.

So, what are the issues in narrative reporting?

Key Issue #1 – What are the Objectives of NR?

22. The IASB discussion paper on MC focuses on high level objectives that already exist in NR pronouncements. Three objectives that provide information to help investors are identified:
 - (1) To interpret and assess the related financial statements in the context of the environment in which the entity operates;
 - (2) To assess what management views as the most important issues facing the entity and how it intends to manage those issues; and
 - (3) To assess the strategies adopted by the entity and the likelihood that those strategies will be successful.
23. In a public sector context the three objectives above seem relevant. While the users in the public sector will be different, the objectives related to NR would seem to be relevant to public sector users.
24. Given that the users of public sector financial statements represent a more diverse group than what is defined in the IASB MC standard, it is believed that financial statements alone do not provide all the information that users may need to make informed decisions based on governmental financial reports. It is further noted that to help interpret and assess the financial statements that additional financial and non-financial information may be required to provide context to the financial statements
25. It is believed that traditional financial statements largely portray the financial effects of past events and do not necessarily provide non-financial information. This is especially true when you consider that the public sector user base is not just considering the profit situation of the entity but in fact may also be concerned about areas such as service delivery, fiscal sustainability, contractual obligations and other areas not typically portrayed in traditional financial statements.
26. It may there be appropriate to use these objectives as a starting point and consider whether these “work” for the public sector. A simple expression in an IPSASB

context, or to “public-sectorize” and reclassify the “users” may be all that is required. However, we may find that more extensive development of the objectives of NR could be warranted, the project will reevaluate the objectives during each phase.

Key Issue #2 – What are the main attributes of high quality narrative explanations?

27. The IASB MC (which is derived from the knowledge of other guidance) is a good starting point for a sector analysis of the main attributes underpinning NR.

The IASB DP concluded that MC should:

- (1) Supplement and complement financial statement information;
 - (2) Provide an analysis of the entity through the eyes of management; and
 - (3) Have an orientation to the future.
28. As with the previous issue, we will explore how other standard setters and regulators define attributes (although some differ in the titles given, they may call them principles or characteristics, or another term).
29. Preliminary research indicates that “an orientation to the future” could carry significant public sector connotations and this will have to be explored fully with our constituents. This project will include a consideration and decision on how and if prospective information will be used.
30. In some jurisdictions the narrative reporting or equivalent is the main mechanism by which expected future trends and changing conditions to the operational environment and the potential impact on the reporting entity are highlighted for users. Including prospective or forward looking information in GPFR, introduces a new area of concern for preparers, financial managers, internal and external auditors and ultimately what user needs are satisfied.
31. The importance of NR adding value to financial data is increasingly being recognized by preparers, and the extent and nature of analysis and commentary included in, issued with and/or intended to support financial statements continues to develop and evolve. In recognition of the potential for such analysis to enhance (or degrade, if compiled inappropriately) the value and usefulness of information included in financial reports that conform with accounting standards, the accounting standards-setters have acknowledged the merits of establishing guidance on the attributes of such analysis. As such, guidance on NR has been issued by some national standards setters in both the private and public sectors, and is making its way up the priority list of standards setters in other jurisdictions.

Key Issue #3 - Are there essential content elements to include in NR?

32. Given the assumption that narrative reporting enhances the usefulness of financial information the project will provide guidance on reporting and disclosure of information related to the public sector.
33. An existing challenge within the public sector is that the users of financial information have a different focus than investors in a private company. Inherent in many governmental financial systems is a budget process that is unique. Should the NR be used to further explain the relationship and performance against the budget to the users of governmental financial reports? An issue exists about the role of budget information in the NR and how this differs from private sector pronouncements on MD&A and MC. In the public sector a key aspect of stewardship or accountability is performance against budget. This is not the focus in private sector companies.
34. Other future IPSASB projects like “long term fiscal sustainability” and “performance reporting” may also be a factor in NR.
35. It is anticipated that NR as an integral part of financial reporting and should not be compiled as a “boiler-plating” exercise.
36. As this project develops, work and progress of the IPSASB Conceptual Framework Project, including linkages with NR and comments received from respondents from the Conceptual Framework discussion documents will be considered.
37. One of the major differences in NR in the private sector verses the public sector, is the active role the security exchanges play in the regulation of NR. Agencies like the SEC, the EU Company Law Directives, other national stock exchanges and International organization of Securities Commissions (IOSCO) play a key role in regulating and enforcing the essential content that is required in NR. A few large countries have specific governmental units that set form and content for NR. However, the standardization and reporting model in the public sector are much less developed.

Key Issue #4 - What type of Guidance is appropriate?

38. As the project progresses it will be necessary to consider the nature of the final output. As is indicated below the decision on the type of pronouncement to be issued by the IPSASB ranges from:
 - Recognizing best practices;
 - Issuing specific non-mandatory guidance;
 - Issuing a standard that applies when certain conditions exist (IPSAS 24, “Presentation of Budget Information in Financial Statements);
 - Issuing a full standard (revised or new) that is mandatory.

Figure 1- Type of Pronouncement for NR



Note * indicates non-mandatory guidance coupled with a standard

39. While the IPSASB has primarily issued full standards to date, this does not preclude a different type of guidance being developed.

Important Sources of Information

IASB MC Project:

IASB Project Page Management Commentary [Click here for MC project page](#)

IPSAS Standards & Projects:

IPSAS 01 Presentation of Financial Statements [Click here for IPSAS 01](#)

IPSAS 24 Presentation of Budget information [Click here for IPSAS 24](#)

Fiscal Sustainability [Click here for FISCAL SUSTAINABILITY project page](#)

IPSAS Conceptual Framework [Click here for CONCEPTUAL FRAMEWORK project page](#)

IPSAS 18 - Segment Reporting [Click here for IPSAS 18](#)

IPSAS 22 - Disclosure General Government Sector [Click here for IPSAS 22](#)

IPSAS Glossary of Defined Terms [Click here for GLOSSARY](#)

Public Sector Standard Setters:

Canada PSAB [Click here for PSAB Website](#)

FReM - Financial Reporting Manual with consultation with the Financial Reporting Advisory Board and is issued by the relevant authorities in England and Wales, Scotland and Northern Ireland <http://www.financial-reporting.gov.uk/default.htm>

French websites www.comptes-publics.gouv.fr or Conseil National de la comptabilite

USA GASB <http://www.gasb.org/>

USA FASAB <http://www.fasab.gov/>

Appendix A – EXISTING PRONOUNCEMENTS SUMMARIZED

	IFRS Active Project	Examples of Public Sector Guidance on NR				Example of Public Sector Guidance on NR
	IASB	Canada	GASB	FASAB	FReM	UK ASB
Title	Management Commentary (MC)	Financial Statement Discussion & Analysis (FSD&A)	Management Discussion & Analysis (MD&A)	Management Discussion & Analysis (MD&A)	Operating & Financial Review (OFR)	Operating & Financial Review (OFR)
Objectives	Investor focus Interpret & assess FS Assess mgmt views Assess Strategy	Enhance user understanding Explain & highlight FS information only Expand on & explain	Citizen focus Assess finan position improved/ deteriorated Financial & non-financial information, Objective & easily readable analysis	Diverse audience extended focus, Understanding of GPFR Operations, service levels, successes challenges & future	All user focus Reporting of key performance indicators Main trends & factors Entity's future	Member focus Development & performance Position at YE, Main trends & factors, Entity's future
Attributes	Supplement & Complement Through the eyes of Mgmt Forward Looking	Supplement & Complement Acknowledge responsibility Not-Forward Looking, FS Data Only Enhance user Understanding Accountability for resources	Supplement & Complement Financial Managers Insights Forward Looking, based on current known facts FS & Non FS Data Objective & easily understood	Supplement & Complement Reporting entity mgr Insights Forward looking FS & Non FS Data Possible future effects based on currently known facts	Supplement & Complement Through the eyes of board of director Forward looking FS & Non FS Data Good & Bad, Analysis Balanced & Comprehensive	Supplement & Complement Through the eyes of board of director Forward looking, FS & Non FS Data Comparable over time, Analysis Balanced
Essential Content	Nature of business Objectives & strategies Resources, risk & relationship Results & prospects, performance measures & indicators	Non-prescriptive Financial highlights summary Variances & trends, Identify risk & uncertainties Avoid boiler plating	Required topics prescribed Performance, Comparisons , Analysis of current year & future Improved or deteriorated Fund , budget analysis	Required topics prescribed Mission & structure, Performance goals & results System, controls, legal Future effects of currently known demands, risk, uncertainty	All of OFR plus Comparison of outturn against estimate significant variances changes, progress public service targets	Objectives & strategies Nature of business Resources, risks, uncertainties, relationships KPI & other measures
Type	Non-mandatory Guidance	Recommended Practice (SORP1)	Standard	Standard	Mandatory Guidance	Non-mandatory Guidance
Required	No (regulatory requirement)	No	Yes	Yes	Yes	
Audited		No not part of GPFS	Audited as RSI	Audited as RSI		

Appendix B – Summary of IASB Management Commentary

	IASB Discussion Paper Management Commentary ¹
Title:	Management Commentary (MC)
Definition:	MC is information that accompanies financial statements as part of an entity's financial reporting; it explains the main trends and factors underlying the <i>development</i> , <i>performance</i> and <i>position</i> of the entity's business during the period covered by the financial statements; and It explains the main trends and factors that are likely to affect the entity's <u>future</u> development, performance and position.
Objectives:	<p>The IASB MC project team has defined the objective of MC as having three elements to provide information to help investors (primary user):</p> <ol style="list-style-type: none"> 1. To interpret and assess the related financial statements in the context of the environment in which the entity operates; 2. To assess what management views as the most important issues facing the entity and how it intends to manage those issues; and 3. To assess the strategies adopted by the entity and the likelihood that those strategies will be successful.
Attributes:	<p>IASB concluded that MC is an integral part of financial reporting and should:</p> <ol style="list-style-type: none"> 1. Supplement and complement financial statement information; 2. Provide an analysis of the entity through the eyes of management; and 3. Have an orientation to the future.
Essential Content:	<p>To meet the objective of MC, an entity should disclose information on:</p> <ol style="list-style-type: none"> 1. The nature of its business; 2. Its objectives and strategies; 3. Its key resources, risks and relationships; 4. Its results and prospects; and its performance measures and indicators.
Type of Guidance:	non-mandatory guidance

¹ International Accounting Standards Boards (IASB). Discussion Paper Management Commentary, United Kingdom, 2005 <http://www.iasb.org/Current+Projects/>

Appendix C – Public Sector NSS Guidance on NR

i. Public Sector Example #1 – Canada Summarized

	Public Sector Accounting Board (PSAB) Canada
Title:	Financial Statement Discussion & Analysis (FSD&A)
Definition:	<p>The narrative format of FSD&A complements and supplements the government's financial statements, allowing government to express qualitative information, given its detailed knowledge of the transactions, events and conditions underlying the reported financial position and changes in financial position.</p> <p>For users to gain a better understanding of a government's financial position and changes in financial position, other information beyond that contained in the current financial statements is required.</p>
Objectives:	<p>To clearly explain and highlight information underlying the statements of financial position and changes in financial position as presented. To expand on and explain information contained in financial statements.</p> <p>Enhancing their understanding by highlighting information about key relationships that exist among the various pieces of information, explain why something did or did not happen, or what may happen.</p>
Attributes:	<ul style="list-style-type: none"> • Enhance users' understanding; • Enable government to demonstrate accountability for resources; • Reference Related financial statements; • Include an acknowledgment of the government's responsibility for its preparation to ensure that users are aware of who is responsible and that the government has approved the document. • Communicate information embodying the basic characteristics of understandability, relevance, reliability and validity, and comparability; • Provide a financial highlights section that summarizes the key messages that users should understand about the financial statements; and • Include a financial analysis review that examines both variances and trends for significant financial statement elements including significant risks and uncertainties related to, or inherent in, the analyses.
Essential Content:	Intended to provide a general framework for the development of FSD&A information. It is not prescriptive, but offers general guidance to encourage governments to effectively report only the most relevant information and to avoid boilerplate presentation. Not part of the financial statements, FSD&A is information that would accompany the financial statements
Type of Guidance:	Recommended Practice (SORP1) - not mandatory

ii. Public Sector Example #2 – United States – GASB Summarized

	Government Accounting Standards Board (GASB) United States
Title:	Management Discussion and Analysis (MD&A)
Definition:	GASB 34 requires state and local governments to prepare a general discussion of operating results and changes in financial condition through MD&A similar to those prepared by publicly traded companies. The MD&A should tell the reader whether the government is better or worse off than it was in the prior year. The information presented should be confined to the topics identifies and "boilerplate" discussions should be avoided. Information that does not address the required topics should not be included in the MD&A, but could be reported elsewhere, in the letter of transmittal or as supplementary information.
Objectives:	The analysis should provide users with the information they need to help them assess whether the government's financial position has improved or deteriorated as a result of the year's operation.
Attributes:	MD&A should provide an objective and easily readable analysis of the government's financial activities based on current known facts, decisions or conditions. MD&A should include comparisons of the current year to the prior year based on the government-wide information. It should provide an analysis of the government's overall financial position and results of operations to assist users in assessing whether the financial position has been improved or deteriorated. As a result of the year's activities. In addition, it should provide an analysis of significant changes that occur in funds and significant budget variances. It should also describe capital assets and long term debt activity during the year. MD&A should conclude with a description of currently known facts, decisions, or conditions that are expected to have a significant effect on financial position or results of operations.
Essential Content:	<p>The financial managers of governments are knowledgeable about the transactions, events, and conditions that are reflected in the government's financial report and of the fiscal policies that govern its operations. Financial managers are asked to share their insights in a required management's discussion and analysis by giving readers an objective and easily readable analysis of the government's <i>financial</i> performance for the year. This analysis should provide users with the information they need to help them assess whether the government's financial position has improved or deteriorated as a result of the year's operations.</p> <p>GASB 34 prescribes the type of information to be addressed in MD&A.</p>
Type of Guidance:	Required MD&A Standard - mandatory

iii. Public Sector Example #3 – United States – FASAB Summarized

	FEDERAL ACCOUNTING STANDARDS ADVISORY BOARD (FASAB) United States – Federal Government
Title:	Management Discussion and Analysis (MD&A)
Definition:	It should address the reporting entity's performance measures, financial statements, systems and controls, compliance with laws and regulations and actions taken or planned to address problems. The discussion and analysis of these subjects may be based partly on information contained on reports other than GPFFR. MD&A should also address significant events, conditions, trends and contingencies that may affect future operations.
Objectives:	MD&A is an important vehicle for (1) communicating managers' insights about the reporting entity, (2) increasing the understandability and usefulness of the general purpose federal financial report (GPFFR), and (3) providing understandable and accessible information about the entity and its operations, service levels, successes, challenges, and future.
Attributes:	Several factors suggest that MD&A may be even more important for Public Sector reporting entities than for those in private sector and may need to be more extensive in scope. These factors include complexity of governmental operations, the myriad objectives they pursue, and diverse natures of the groups affected by and interested in the governments activities. Fundamentally, the government's objective is to provide for the common defense and to promote general welfare, not to earn a profit. Therefore the reporting on performance and other matters in a way that is understandable to diverse audiences is important.
Essential Content:	<p>The standards for MD&A say that MD&A should address:</p> <ul style="list-style-type: none"> • The entity's mission and organizational structure; • The entity's performance goals and results; • The entity's financial statements; • The entity's systems, controls, and legal compliance; and • The possible future effects on the entity of existing, currently-known demands, risks, uncertainties, events, conditions and trends. <p>This discussion and analysis may be based on information in the GPFFR or based on reports separate from the GPFFR. as Required Supplemental Information (RSI)</p>
Type of Guidance:	Required Standard and Concept – Mandatory

iv. Public Sector Example #4 – United Kingdom – FReM

	GOVERNMENT FINANCIAL REPORTING MANUAL (FReM) United Kingdom - HM Treasury
Title:	Operating and Financial Review (OFR)
Definition:	The Treasury has developed Guidance on producing an OFR. When preparing the MC in the annual report, entities covered by the FReM need to take into consideration the recommendations outlined in the ASB's Reporting Statement. Whilst the recommendations of the OFR Reporting Statement are not mandatory for the private sector, public sector organizations subject to the FReM are expected to produce MC in full. Reporting of key performance indicators required by OFR are reconciled in the FReM reporting model.
Objectives:	<p>The objective of the OFR is to specify the requirements for a management commentary, which shall be a balanced and comprehensive analysis of:</p> <ul style="list-style-type: none"> • The development and performance of the business of the entity during the financial year; • The position of the entity at the end of the year; • The main trends and factors underlying the development, performance and position of the business of the entity during the financial year; and • The main trends and factors likely to affect the entity's future development, performance and position.
Attributes:	<p>OFR RS, the Management Commentary shall focus on matters that are relevant to the interests of members. In the context of the public sector, "members" shall be interpreted to be all users of the accounts.</p> <ul style="list-style-type: none"> • An analysis of the business through the eyes of the board of directors; focus on matters that are relevant to the interests of members; a forward looking orientation; • Factors should be those that have affected development, performance and position during the financial year; and those which are likely to affect future development, performance and position; • Should comment on the impact on future performance or significant events after the financial statement date; • OFR should be balanced and neutral even-handedly with both good and bad aspects.

	GOVERNMENT FINANCIAL REPORTING MANUAL (FReM) United Kingdom - HM Treasury
Essential Content:	<p>In addition to the requirements of OFR, the departments should include the following information:</p> <ul style="list-style-type: none">• A comparison of outturn against Estimate, with detailed explanations of the causes of significant variances where applicable;• Progress in relation to Public Service Agreement targets;• Where applicable, the financing implications of significant changes in the department's objectives and activities, its investment strategy and its long-term liabilities (including significant provisions and PFI and other leasing contracts) in the light of the department's spending review settlement; and• Commentary on the department's significant remote contingent liabilities (that is, those that are disclosed under Parliamentary reporting requirements and not under FRS12) to enable the reader to understand their nature and what steps the department is taking to minimize the risk of their crystallizing.
Type of Guidance:	OFR required by FReM Guidance, FReM Chapter 07

Appendix D – Private Sector Guidance on NR

	ASB ²
Title:	Operating & Financial Review (OFR)
Definition:	A narrative explanation of the main trends and factors underlying the development, performance and position of an entity during the financial year covered by the financial statements, and those that are likely to affect the entity's future development, performance and position. Fn
Objectives:	<p>OFR should be a balanced and comprehensive analysis, consistent with the size and complexity of the business, of:</p> <ol style="list-style-type: none"> Development and performance of the business of the entity during the financial year; The position of the entity at the end of the year; The main trends and factors underlying the development, performance and position of the business of the entity during the year; and The main trends and factors which are likely to affect the entity's future development, performance and position. <p>Prepares so as to assist members to assess the strategies adopted by the entity and the potential for those strategies to succeed.</p>
Attributes:	<p>-An analysis of the business through the eyes of the board of directors; - focus on matters that are relevant to the interests of members; -a forward looking orientation;</p> <p>-factors should be those that have affected development, performance and position during the financial year; -and those which are likely to affect <i>future</i> development, performance and position; -Should comment on the impact on future performance or significant events after the financial statement date;-should be balanced and neutral even-handedly with both good and bad aspects; --should complement and supplement the financial statements; be comprehensive and understandable; be balanced and neutral; and be comparable over time</p>

² Accounting Standards Board (ASB). *Reporting Statement: Operating and Financial Review*. London, 2006. www.asbpublications.com

	ASB²
Essential Content:	objectives & strategies, nature of business, development & performance (current year & future year), resources, principle risks, uncertainties, relationships that may affect entity's long term value, position of the business, Key performance indicators (KPI) and other measures, provide useful financial and non-financial information that was not reported in financial statements but which, the directors' judge, might be relevant to members' evaluation of past results and assessment of future prospects, Provide additional explanations of amounts recorded in the financial statements, Explain the conditions and events that shaped the information contained in the financial statements
Type of Guidance:	Statement of Best Practice (originally a standard)

Appendix: Existing Requirements for Management Commentary

(from appendix B of the Management Commentary discussion paper)

Existing requirements for MC

International Organization of Securities Commissions (IOSCO)

- B1 The Technical Committee of IOSCO issued a report *General Principles Regarding Disclosure of Management's Discussion and Analysis of Financial Condition and Results of Operations* in February 2003. The report summarises the objectives of MD&A, identifies principles for preparers and highlights areas where preparers should be cautious, eg avoid boiler-plate or stock language. A comparison of matters addressed in the report, and the principles suggested in this paper, is in Appendix C. [Appendix C is not included in this Board paper.]
- B2 The report states that:

The purpose of the MD&A is to provide management's explanation of factors that have affected the company's financial condition and results of operations for the historical periods covered by the financial statements, and management's assessment of factors and trends which are anticipated to have a material effect on the company's financial condition and results of operations in the future. Companies should provide the information that is necessary for an investor's understanding of the company's financial condition, changes in financial condition and results of operations.

Australia

- B3 The Corporate Law Economic Reform Program Act 2004 (CLERP 9) amended section 299A of the Corporations Act to require companies to expand their directors' report. For years beginning on or after 1 July 2004

The directors' report for a financial year for a company or disclosing entity that is a listed public company must also contain information that members of the company would reasonably require to make an informed assessment of:

- (a) the operations of the entity reported on; and
- (b) the financial position of the entity; and
- (c) the entity's business strategies and its prospects for future financial years.

- B4 The Australian Stock Exchange (ASX) has a listing rule that is based upon section 299A of the Corporations Act. ASX does not require any particular format to be followed, nor does it specify its content. However, both CLERP 9 and the ASX support the Group of 100 (G100) guidance publication *Guide to the Review of Operations and Financial Condition*. CLERP 9's explanatory memorandum states that the G100 guidance may be used for the purpose of satisfying the legislative requirement, and the ASX reproduces the guidance within its own Guidance Notes.

- B5 The G100, a group comprising Australia's major private and public business enterprises and global enterprises operating in that country, originally issued its guide in 1998 and updated it in 2003. These guides have been influenced by both the UK OFR guidance and the Canadian guidance on MD&A.

- B6 The guide states that:

The Review should provide users with an understanding of the company by providing a short-term and long-term analysis of the business as seen through the eyes of the directors. This will be facilitated by providing useful financial and non-financial information and analysis. ... A contemporary Review should include an analysis of industry-wide and company-specific and non-financial information that is relevant to an assessment of the company's performance and prospects.

Canada

- B7 In Canada the requirements for and the content of the MD&A are mandated by the provincial securities regulatory bodies, collectively known as the Canadian Securities Administrators (CSA). In December 2003, the CSA issued new MD&A requirements applicable in all securities jurisdictions in Canada, contained within National Instrument 51-102 *Continuous Disclosure Obligations*.

- B8 NI 51-102 and the related MD&A form do not refer to the CICA Guidance on MD&A issued in November 2002 (paragraph B9), but in several places appear to reflect the intent of that guidance. CSA Form 51-102FI, Part 1(a) describes MD&A as:

... a narrative explanation, through the eyes of management, of how your company performed during the period covered by the financial statements, and of your company's financial condition and future prospects.

- B9 The CICA released guidance on MD&A disclosure in November 2002 (updated in May 2004) that sets out six principles and a five-part framework of recommended disclosure practices. A comparison of the principles and framework contained in the Canadian guidance and those proposed in this paper is in Appendices C and D. [Appendices C and D are not included in this Board paper.]

- B10 The CICA as such has no mandate to issue standards for MD&A disclosure (nor to require MD&As to be issued by companies) – as explained above, that is all a regulatory responsibility and prerogative. The Guidance developed by a separate division (and volunteer board) of the CICA is used by companies on a purely voluntary basis. However, the four largest securities regulators in Canada (ie four members of the CSA) have issued explicit encouragement to companies to use the CICA Guidance, and the latest CSA MD&A requirements show signs of adopting some aspects of the CICA Guidance.

- B11 The guidance states:

... useful MD&A explains the 'why' behind both past performance and future prospects by 'connecting the dots' between otherwise separate pieces of internal and external information ... should enable readers to view the company through the eyes of management ... providing information important to an investor, acting reasonably, in making a decision to invest or continue to invest in the company ... having a forward-looking orientation ... focusing on management's strategy for generating value for investors over time.

European Union (EU)

- B12 The requirements for MC type reporting are set out in various legal instruments adopted by the EU, in particular the Fourth and Seventh Company Law Directives (the 'Accounting Directives'), as updated by the Modernisation Directive and enhanced by the Transparency Directive. The Accounting Directives state that the annual report:

... shall also give an indication of any important events after the balance sheet date, the likely future development of the entity, the activities in the field of research and development, and the risks relating to the use of financial instruments including their management.²

- B13 The Modernisation Directive, which has been implemented in all Member States, requires companies to present an annual report that provides:

... at least a fair review of the development and performance of the company's business and of its position, together with a description of the principal risks and uncertainties that it faces.

- B14 The directive states:

To the extent necessary for the understanding of the company's development, performance or position, the analysis shall include both financial and, where appropriate, non-financial key performance indicators relevant to the particular business, including information relating to environmental and employee matters. ... the annual report shall, where appropriate, include references to and additional explanations of the amounts reported in the annual accounts.

- B15 In December 2004, the EU adopted the Transparency Directive, which must be implemented by all Member States within two years. Under the directive, all security issuers will have to provide annual and half-yearly financial reports. These reports must include a management report prepared in accordance with the Accounting Directives. The half-yearly interim management report:

...shall include at least an indication of important events that have occurred during the first six months and their impact on the financial statements together with a description of the principal risks and uncertainties for the remaining six months of the financial year.

Germany

² Article 46 of the Fourth Directive and Article 36 of the Seventh Directive.

- B16 The German tradition of management reporting goes back to 1931, when all public limited companies were required to prepare a business report. Specific requirements were introduced in 1937 requiring management:
- (a) to explain the related financial statements;
 - (b) to identify material changes from the previous financial year; and
 - (c) to comment on the financial position of the company.
- B17 The requirement to prepare a business report was extended to all limited companies in 1986. This has evolved to the management reporting we see today, which is based on the legal requirements of the EU and is almost identical to the EU content mentioned previously. Additionally, a legal requirement for risk reporting was introduced in 1998, and a German accounting standard (*GAS 5 Risk Reporting*) has been in place since 2001. GAS 5 states that:
- Risk reporting ... should allow users to form an appropriate understanding of the risks affecting the future developments of the group.
- B18 The legislation was amended in December 2004 to emphasise some topics such as an extensive analysis of development and performance of the business during the year, its financial position at the year-end, reporting of financial and non-financial key performance indicators, and the likely future development of the company including its significant opportunities and risks. The objective is an improvement in management reporting.
- B19 The DRSC adopted GAS 15 *Management Reporting* in December 2004; it is based on the EU legal requirements and takes into account the SEC requirements, and the Canadian and UK guidance. GAS 15 sets out the principles, and format for content, to be followed in preparing management reporting. A comparison of those areas and the principles and essential content elements suggested in this paper is in Appendices C and D. [Appendices C and D are not included in this Board paper.]
- B20 GAS 15 states that:
- The group management report shall present a fair review of the development of the business and of the group's position. Expected developments shall be assessed and discussed together with the significant risks and opportunities. ... Management reporting is intended as a vehicle for presenting information to users from management's perspective. ... The focus should be on sustainable value creation ... The main factors which could influence changes in the value of the enterprise in the future should be disclosed and discussed. ... It is recommended that the key performance indicators used internally to manage the group are quantified.
- B21 GAS 15 also states that the intention is to reduce:
- ... the gap between the information available to users of the financial statements and that available to management.

New Zealand

- B22 The New Zealand Securities Commission is the principal regulator of securities when money has been obtained from the public. It has no specific requirements for MC. Rather, the regulator uses the financial reporting framework to manage the content of general purpose financial reports. MC is required for certain items when an entity makes an initial public offering, but those requirements do not extend to annual reports.
- B23 The New Zealand financial reporting framework is managed by the Financial Reporting Standards Board. The framework is sector-neutral, covering profit-oriented and public-benefit entities. As such, the framework covers both financial and non-financial reporting. The consequence is that the framework refers to general purpose financial reports rather than the narrower financial statements. The framework includes outputs and outcomes as elements, and the qualitative characteristics apply to this wider set. In practice, public sector entities regularly report on service performance with non-financial measures.
- B24 Notwithstanding the wider scope of the New Zealand reports, there is no specific analysis or discussion of MC within the New Zealand framework. However FRS-9 *Information to be Disclosed in Financial Statements* requires that when an entity has published prospective financial information it must present a comparison with actual performance in the period to which the forecast relates.

United Kingdom

- B25 UK legislation in early 2005 requires quoted companies to prepare an operating and financial review (OFR). The

UK Government has stated that the statutory requirement for an OFR should be supported by a 'reporting standard'. The Government specified the UK ASB as the body to issue such a standard.

B26 The OFR objective as stated in the legislation is:

... a balanced and comprehensive analysis, consistent with the size and complexity of the business, of -

- (a) the development and performance of the business of the company during the financial year,
- (b) the position of the company at the end of the year,
- (c) the main trends and factors underlying the development, performance and position of the business of the company during the financial year, and
- (d) the main trends and factors which are likely to affect the company's future development, performance and position

prepared so as to assist the members of the company to assess the strategies adopted by the company and the potential for those strategies to succeed.

B27 In May 2005, the UK ASB issued Reporting Standard (RS 1), which built on its existing statement of best practice on OFRs. RS 1 is a principle-based standard, which makes clear that the OFR must reflect the directors' view of the business. The objective is to assist members to assess the strategies adopted and the potential for those strategies to succeed. The standard also provides a basic framework for directors to apply in order to meet the requirements of the Regulations. It is for the directors to consider how best to use the framework to structure the OFR, given the particular circumstances of the entity. A comparison of both the principles and basic content framework in RS 1 with the proposals contained within this paper is in Appendices C and D. [Appendices C and D are not included in this Board paper.]

B28 RS 1 defines an OFR as:

... a narrative explanation, provided in the annual report, of the main trends and factors underlying the development, performance and position of an entity during the financial year covered by the financial statements, and which are likely to affect the entity's future development, performance and position.

B29 Although following a framework approach, the ASB has also prepared implementation guidance to accompany RS 1, as the ASB was conscious that some guidance would be useful to preparers of OFRs. The guidance sets out some illustrations and suggestions of specific content and related key performance indicators that might be included in an OFR.

United States

B30 In the US MD&A is called for by the federal Securities and Exchange Commission (SEC), the US securities regulator. The SEC is charged with administration of, and rulemaking and enforcement under, the Securities Act of 1933 and Securities Exchange Act of 1934. The Sarbanes-Oxley Act of 2002 caused the SEC to undertake significant additional rule-making. A comprehensive overview of the evolution, purpose and content of the MD&A is provided in the Interpretive Guidance released by the SEC in December 2003 (release numbers 33-8350 and 34-48960).

B31 That guidance stated:

The purpose of the MD&A is not complicated. It is to provide readers with information "necessary to an understanding of [a company's] financial condition, changes in financial condition and results of operations." The MD&A requirements are intended to satisfy three principal objectives:

- (a) to provide a narrative explanation of a company's financial statements that enables investors to see the company through the eyes of management;
- (b) to enhance the overall financial disclosure and provide the context within which financial information should be analyzed; and
- (c) to provide information about the quality of, and potential variability of, a company's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance.

B32 Furthermore:

... companies should identify and discuss key performance indicators, including non-financial performance indicators that their management uses to manage the business and that would be material to investors.

- B33 Since the collapse of Enron (late 2001), the SEC has issued several new releases, rules and proposals on topics including critical accounting policies and estimates, liquidity, capital resources, off balance sheet arrangements, aggregate contractual obligations and transactions with non-independent third parties. Some of these releases arguably call for disclosures that might otherwise be expected in notes to financial statements under US GAAP (the standards that are the responsibility of the US FASB.)
- B34 The FASB does not issue guidance about MD&A disclosure. This is left to the SEC as a regulatory matter.

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Appendix C

Principles and qualitative characteristics: a cross-jurisdictional analysis

DP proposal for IASB	IOSCO	Canada	Germany	UK	USA
Supplement and complement financial statement information.	Improves financial disclosure overall and provides the context within which financial information should be analysed.	Should complement as well as supplement financial statements.	(Not a principle as such. However, this is an underlying function of the annual report.)	Shall complement as well as supplement the financial statements.	Should not be merely a restatement of financial statement information in a narrative form.
Provide an analysis of the entity through the eyes of management.	Enable investors to see the company 'through the eyes of management'.	A company should disclose information that enables readers to view the company through the eyes of management.	Information from the perspective of management – it is management's assessment of the reported matters which is at the forefront.	Set out an analysis of the business through the eyes of the board of directors.	Enable investors to see the company through the eyes of management.
Have an orientation to the future.	Enable investors to make a better prediction about the sustainability of earnings and cash flow in the future.	A forward-looking orientation is fundamental to useful MD&A reporting.	Focus on sustainable value creation – all events, decisions and factors known that could have a significant impact on the future development of the value of the entity should be disclosed and discussed.	Shall have a forward-looking orientation.	To provide information about the quality of, and potential variability of, a company's earnings and cash, so that investors can ascertain the likelihood that past performance is indicative of future performance.
Be understandable, relevant, supportable, balanced and comparable over time.	Should be clear, concise and meaningful, and in plain language. Should highlight the most relevant information. Should be presented in a format that will enhance the comprehensibility of the issuer's financial statements to investors, as well as other users of this information, such as investment advisers and rating agencies.	Usefulness – should be written in plain language, with candour and without exaggeration, and embody the qualities of understandability, relevance, comparability and consistency over reporting periods. Completeness and materiality – to be reliable, MD&A should be complete, fair and balanced, and provide information that is material to decision making needs of users.	Reliability – plausible, free from contradiction and consistent with the financial statements. Clarity and transparency – consistency in terms of methodology and format from one year to the next. Completeness – the group should provide all information that, from the perspective of management, a knowledgeable reader requires.	Shall be balanced and neutral, dealing even-handedly with both good and bad aspects. Shall be comparable over time. Shall be comprehensive and understandable. Shall focus on matters relevant to members.	Communicate with investors in a clear and straightforward manner. Should focus on material information and eliminate immaterial information that does not promote understanding.

MANAGEMENT COMMENTARY

Appendix D

Content: a cross-jurisdictional analysis

DP proposal for IASB	Canada	Germany	UK
Although the items identified below are essential elements of MC this does not suggest that these are required headings. It is the responsibility of management to determine how best to present and structure this information.	Companies shall structure and integrate their MD&A disclosures within a broad reporting and disclosure framework. The framework is presented as an integrative reporting tool, not a template. Management should choose the best way to use the framework to organise its MD&A disclosures and place information in a meaningful context.	The management report is required to start with a table of contents.	Set out below is a framework for the disclosures to be provided by the directors in an OFR. This framework is not a template, nor should the elements be taken as headings that must be included within an OFR. Its purpose is to set out the key content elements that shall be addressed within an OFR. It is for the directors to consider how best to use the framework to structure the OFR and the precise content, including the level of detail to be disclosed, relating to the key elements, given the particular circumstances of the entity. These circumstances may include: the industry or industries in which it operates the range of products, services or processes it offers the number of markets it serves.
To meet the objective of MC, information should be provided about: Nature of the business Objectives and strategies Key resources, risks and relationships Results and prospects Performance measures and indicators.	The MD&A should communicate information that helps users understand past performance and future prospects. Five key elements of the disclosure framework to achieve this are: The company's vision, core businesses and strategies Key performance drivers Capability to deliver results Results Risks.	It is recommended that the report be subdivided, at a minimum, into the following sections. Sections of management reporting: Business and operating environment Results of operations Financial position Net assets Risk reporting Report on post-balance sheet date events Reporting on anticipated developments.	The OFR shall provide information to assist investors to assess the strategies adopted by the entity and the potential for those strategies to succeed. The key elements of the disclosure framework necessary to achieve this are: The nature of the business, including a description of the market, competitive environment in which the entity operates, and the entity's objectives and strategies. The development and performance of the business, both in the financial year under review and the future. The resources, principal risks and uncertainties and relationships that may affect the entity's long-term value. Position of the business including a description of the capital structure, treasury policies and objectives and liquidity of the entity, both in the financial year under review and the future.
	Within 'key performance drivers' section, they also need to know the measures and significant leading indicators used by management to monitor progress on these key performance drivers'.	It is recommended that the key performance indicators used internally to manage the group are quantified. (Relates to 'performance measures and indicators'!)	Within 'nature, objectives and strategies' the OFR shall include the key performance indicators, both financial and, where appropriate, non-financial, used by the directors to assess progress against their stated objectives'. 'Directors shall also consider the extent to which other performance indicators and evidence shall be included in the OFR.'