



Accounting Standards Board

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Dear Amy

Exposure Draft 'Management Commentary (MC)'

This letter sets out the comments of the UK Accounting Standards Board (ASB) on the above Exposure Draft (ED).

The ASB broadly supports the proposals in the ED. The ASB has long believed that the publication of a narrative explanation of a company's development, performance, position and prospects should be regarded as an important element of best practice in corporate reporting. In our response to the Management Commentary discussion paper (DP) published in October 2005, the ASB supported the development of a standard on management commentary, but – at least initially – we accepted that it should not be mandatory to assert compliance with IFRS financial statements. In light of the responses to the discussion paper, the ASB supports the IASB's decision (as referred to in paragraph BC8 of the ED) to develop a guidance document rather than an IFRS.

The ASB supports the flexible 'framework' approach in the DP, however we find it confusing that paragraph 26 (e) refers to an entity's 'economic model', when the concept of an entity's 'business model' has already been introduced in other IASB literature, namely IFRS 9 *Financial Instruments*. Accordingly, we recommend that the reference to an entity's 'economic model' is removed, and a specific reference to the disclosure of the entity's business model should be made. The component parts of a business model are already addressed in the items noted in paragraphs 26(a) to (e). However, understanding an entity's business model requires more than just describing the matters set out in paragraph 26 (a) to (e) in isolation – instead it requires communication of how these matters fit together to make the entity distinctive and create value. Accordingly, we recommend that a new paragraph is added following paragraph 26 (e). Suggested wording is provided in Appendix 1.

Evidence of the need for an explicit requirement for the disclosure of an entity's business model is provided in the ASB published report 'Rising to the Challenge'. Published in October 2009, this report sets out the conclusions of the ASB's review of narrative reporting by UK listed companies¹. That report highlights that few UK companies provide a full disclosure of their business model, although most provide some description of their business. The report goes on to note that 'Some of the best reporters in the sample included a business model disclosure, which led to our conclusion that this can help drive better disclosures in other areas.' While this is not an explicit legal requirement in the UK, the credit crisis has made clear the importance of the disclosure of business models.

The case for a more explicit recommendation relating to the disclosure of an entity's business model has been picked up by our parent body, the UK Financial Reporting Council (FRC). In its current consultation on the Revised UK Corporate Governance Code², the FRC is proposing a new Code Provision (C.1.2) that the annual report should include an explanation of the company's business model and overall financial strategy. This builds on the view expressed by the UK House of Commons Treasury Committee³ that "a short description of the business model and overall financial strategy, linked to the disclosure on risks and uncertainties in the Business Review, would help shareholders and potential investors have a better understanding of what those risks and uncertainties threaten".

While largely supporting the proposals, the ASB does have two major concerns. First, we are concerned at the IASB's decision to defer its work on the placement principles for disclosure to Phase E of the conceptual framework project, which may not be completed for some years. However, while we consider that the conceptual issue of the boundary of financial reporting is important and should be addressed, this work should not delay the implementation of the management commentary proposals.

Second, the ASB does not agree that the desirable qualitative characteristics of management commentary (as set out in paragraph 20 of the ED) are all the same as those that apply to the financial statements. We agree that the qualitative characteristics of management commentary should be relevance, timeliness and understandability. We also agree that management commentary should be comparable, but only over time and not as between entities, given that the purpose of management commentary is explain management's view of the entity. But we have concerns that management commentary can possess the qualitative characteristics of faithful representation, in particular the requirement for information to be 'neutral'. We would prefer that management commentary should possess the characteristic of 'balance', as suggested in the October 2005 DP. We also have concerns that verifiability can be applied to management commentary and again we prefer the characteristic of 'supportability' suggested in the DP.

¹ Available at: <http://www.frc.org.uk/asb/press/pub2148.html>.

² Available at: <http://www.frc.org.uk/publications/pub2177.html>.

³ As expressed in the UK House of Commons Treasury Committee report (May 2009) *Banking Crisis: reforming corporate governance and pay in the City* <http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/956/95602.htm>.

We have answered the specific questions highlighted in the ED in the attached Appendix.

If you would like to discuss these comments, please contact Peter Godsall (020 7492 2426, p.godsall@frc-asb.org.uk) or me.

Yours sincerely

A handwritten signature in black ink, appearing to read "Ian Mackintosh". The signature is written in a cursive style with a large initial "I".

Ian Mackintosh

Chairman

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Appendix 1 – ASB’s response to the questions asked in the Exposure Draft

Status of the Final Work Product: Question 1

Do you agree with the Board’s decision to develop a guidance document for the preparation and presentation of management commentary instead of an IFRS? If not, why?

ASB Response:

Yes, the ASB supports the IASB’s decision to develop a guidance document for the preparation and presentation of management commentary to ensure that management commentary will form an integral part of future financial reporting.

The ASB does not agree with the Alternative View expressed in the ED, which states that the non-authoritative guidance will not improve financial reporting. The ASB has since 1993 a Statement on the Operating and Financial Review (the latest version of which is referred to as a Reporting Statement), which we consider has contributed to improvements in reporting.

Content elements of a decision-useful management commentary: Question 2

Do you agree that the content elements described in paragraphs 24–39 are necessary for the preparation of a decision-useful management commentary?

If not, how should those content elements be changed to provide decision-useful information to users of financial reports?

ASB Response:

The ASB agrees that the content elements described in paragraphs 24-39 are necessary for the preparation of a decision useful management commentary. However, as set out in the covering letter, we think that the reference to an entity’s economic model in paragraph 26 (e) should be removed. Instead, to be consistent with other IASB literature, reference should be to an entity’s business model. The current list of matters that may be included in MC to provide a description of the nature of the business are, in our view, those that are needed to describe a business model. However, understanding an entity’s business model requires that the entity brings the communication of all these matters together within MC, in order to explain what makes the entity distinctive from its competitors and also how it creates value. Accordingly, we recommend that a new paragraph is added following paragraph 26(e).

In summary, our suggested changes are as follows:

In paragraph 26 (e) remove the reference to ‘and its economic model.’

(e) the entity’s structure ~~and its economic model~~.

Add a new paragraph 27 after 26 (e):

Management should communicate the entity's business model by explaining how these matters fit together and make the entity distinctive, thereby enabling it to create value.

In relation to the discussion of risk in paragraph 30 of the ED, the ASB considers that it is also important to provide context for each risk – is it increasing or decreasing? This level of information, along with risk management strategies, 'helps users to evaluate the entity's risks as well as its expected outcomes'.

Application guidance and illustrative examples: Question 3

Do you agree with the Board's decision not to include detailed application guidance and illustrative examples in the final management commentary guidance document? If not, what specific guidance would you include and why?

ASB Response:
Yes.

Other Issue:

The ASB is concerned over the proposal in paragraph 6 of the ED to prohibit an entity from issuing its management commentary separately from the financial statements to which it referred. The ASB recommends that the ED should instead make the point that before issuing the management commentary without the financial statements, entities should consider carefully the implications of issuing this in isolation and whether this made it misleading.