CFA INSTITUTE
Centre for Financial Market Integrity

4 April 2006

Alan Teixeira
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Re: Discussion Paper: Management Commentary, October 2005

Dear Mr. Teixeira,

The CFA Centre for Financial Market Integrity ("CFA Centre" or the "Centre")[1], in conjunction with its Capital Disclosure Policy Council (the "Council"), appreciates the opportunity to comment on the International Accounting Standards Board's ("IASB" or the "Board") *Discussion Paper: Management Commentary*, *October 2005* (the "DP"). The CFA Centre represents the views of investment professionals to standard setters, regulatory authorities, and legislative bodies worldwide on issues affecting the quality of financial reporting and disclosures provided to investors.

General Comments

The Centre's Position on Disclosures

In our recently issued paper, *A Comprehensive Business Reporting Model: Financial Reporting for Investors* (the Paper), we discuss the importance of disclosures and what information should be provided in these disclosures.[2] As noted in the Paper, we view disclosures broadly to include the accompanying notes to the financial statements, management's discussion and analysis of the company's performance and future prospects, and other required information in regulatory filings. Furthermore, we firmly believe that the principles of transparency, consistency, and completeness along with the intention to communicate clearly, using plain language, must be the basis for disclosure elements wherever they are found.

[1] The CFA Centre for Financial Market Integrity is part of CFA Institute. With headquarters in Charlottesville, VA and regional offices in New York, Hong Kong and London, CFA Institute, formerly the Association for Investment Management and Research®, is a global, non-profit professional association of more than 81,600 financial analysts, portfolio managers, and other investment professionals in more than 126 countries of which more than 67,500 are holders of the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 132 Member Societies and Chapters in 53 countries and territories.

[2] Chapter 4. Financial Statements and Disclosures, pp. 46-62.

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Generally, disclosures must provide investors with all of the additional information they need to place into context the amounts presented in the financial statements. A particular amount in the financial statement can be broken down into two parts: (1) the pure economic effect of an event or transaction on the company's operations and financial position and (2) the effect of the financial reporting policies and methods that managers have selected in measuring and recognizing the reported amount. To evaluate and understand fully, investors need to sort through those policies and methods which affect the amounts reported within financial statements that have little to no economic substance in reflecting the current operations and financial position of the company. To this end, a principal objective of disclosures must be to provide investors with the information they need to make this distinction.

As noted in the Paper, disclosure should provide information which enables investors to understand fully:

1) Managers' accounting policy choices;

2) The methods and valuation models (including assumptions, inputs, and other judgments) managers have used to implement the policy choices;

3) How these decisions have affected the recognition and measurement of individual financial statement items;

4) How they have affected the amounts and timing of items recognized in the financial statements;

5) What degree of uncertainty is associated with individual measurements;

6) How to disaggregate the reported financial statement information into components that:

   a) Exhibit different economic characteristics and trends; and that

   b) Have differential and sometimes offsetting effects on the financial statements;

7) How the company's risk exposures, including market, price, currency, and event risk, might affect the company's operations and financial position;

8) How economic assets and liabilities that are not reported in the financial statements may affect the company's operations;

9) How the nonfinancial drivers influence financial statement results;

10) The implications of the economics for the investor's forecasts of future events; and

11) How the investor's event forecasts will affect forecasts of financial statement components.

Agreement with Views Expressed in the Discussion Paper

We commend the Project Team for a thoughtful and well written paper on Management Commentary. We believe that many of the views expressed in the DP are consistent with our perspective of what disclosures (both financial and non-financial) should be and the manner in which they should be provided to investors. In particular, we strongly support the view expressed in the DP that Management Commentary should be focused on meeting the needs of investors and that it ***should not*** be expanded to fulfill the information needs of an extended range of users.

The three elements of the objective for providing Management Commentary, as noted in the DP, articulate very well the purpose of such commentary, which are:

- To interpret and assess the related financial statements in the context of the environment in which the entity operates;
- To assess what management views as the most important issues facing the entity and how it intends to manage those issues; and
- To assess the strategies adopted by the entity and the likelihood that those strategies will be successful.

Further, we concur with the characterization of Management Commentary in that it should:

- Supplement and complement financial statement information;
- Provide an analysis of the entity through the "eyes of management;" and
- Have an orientation to the future.

Finally, just as the financial statements and related note disclosures should have certain qualities or attributes (such as, relevance, understandability, balance or neutrality, supportability, and comparability) so should management's commentary on the entity's financial performance and its financial prospects for the future. In weighing these attributes, we place more emphasis on information that has economic relevance and provides a balance regardless of what the outcome is or what the prospect may be, either good or bad. We believe that without these attributes this commentary diminishes in utility, or informational value, for enabling investors to evaluate and analyze the financial statements. Additionally, irrelevant and/or biased commentary may even obfuscate and distract the user from fully understanding an entity's financial statements; thus, defeating the very reason for providing the commentary.

Concerns with Views Expressed in the Discussion Paper

In Section 3 of the DP, there is discussion about the characteristics of information that should be provided in management's commentary, in particular, as it relates to relevancy. Paragraph 70 states the following:

> *Generally, disclosure requirements in IFRSs are designed to identify the minimum information that the IASB believes should disclosed to meet the stated objective of the disclosure. <u>For MC, we believe that consideration should be</u>*

> *<u>given to ways to limit disclosure</u>. This is because one of the elements of the objective of MC is to help investors to identify and assess what management views as the most important issues facing the entity, and its approach to those issues. Allowing management to present a plethora of information about all the risks facing an organization conflicts with the objective. [Emphasis added]*

Although we agree with the overall objective to provide relevant information that enables investors to understand fully the key issues facing a company, we are concerned with the notion to arbitrarily limit disclosure. We believe that the stated consideration should be to limit ***irrelevant*** and ***meaningless*** disclosure, such as boilerplate wording and/or duplication of information already provided in the financial statements. The Management Commentary should supplement the financial statement disclosures to add company-specific data and context. To this end, it should be clearly explained in the final Standard so as to not be read as limiting the very information which is needed to fully understand the company's operations, financial performance and financial condition.

Inclusion of Management Commentary within the IASB's Conceptual Framework

The IASB's current Conceptual Framework and International Accounting Standard (IAS) 1, *Presentation of Financial Statements* state that information reported outside of the financial statements is not subject to IFRSs. As noted in Section 5 of the DP, the staff concluded that Management Commentary should provide for optional adoption by jurisdictions or entities in the short term. We understand that this conclusion is based on the fact that some jurisdictions require such commentary as part of securities regulation [e.g., U.S. Securities and Exchange Commission and Canadian provisional securities regulators] while other jurisdictions [e.g., Germany and Netherlands] do not.

As users of this information, we believe that the Management Commentary <u>should be included as part of the IFRSs</u> because the information provided in this commentary is essential for a complete and thorough evaluation and analysis of a company's financial performance and condition and in addition, its future prospects. Additionally, we believe that management's discussion and analysis should be required for both the annual and interim financial statements. Therefore, we urge the IASB to consider adding disclosures, such as Management Commentary, to the Conceptual Framework. Too often, disclosures to financial reporting standards are discussed towards the end of the development of the standard rather than as aspects of the measurement and recognition of the standard are being deliberated.

The U.S. SEC staff, in its report on off-balance-sheet items[3], recommended that disclosures be covered within the conceptual framework by the Financial Accounting Standards Board, which the Board has subsequently agreed to do in its response to the SEC staff dated 16 February 2006, as follows :

> *…[E]xplaining what factors might influence the decision as to which objectives should drive disclosure requirements in a particular standard, the addition of disclosure guidance to the FASB's conceptual framework could drive more consistent disclosures across various accounting issues, while helping users to understand why certain disclosures are included in financial statements. The Staff has suggested to the FASB that adding disclosures to its conceptual framework would be helpful.*
>
> *Of course, insights generated by the development of such a disclosure framework might also lead to recommendations from the Staff regarding the Commission's regulatory disclosure requirements. Indeed, some of the objectives noted above, each of which is evident in the disclosure requirements for notes to the financial statements in some areas, are also objectives of MD&A or other regulatory disclosure requirements. As such, the Staff would be willing to work closely with the FASB in its development of a disclosure framework, in order to consider whether complementary changes to the Commission's disclosure requirements would generate further improvement as well as to ensure that disclosure is provided in the most appropriate location, whether it be in notes to the financial statements, MD&A or in some other location.*

Other Items for Consideration

We recommend that the Board consider addressing and/or expanding the discussion of the following items in drafting the Standard for Management Commentary:

1) **Financial and Non-financial Metrics**

   Under the section titled **Comparability,** there is a discussion about management's use of non-financial and non-IFRS metrics. There is reference to SEC's guidance that indicates that a company should provide an explanation of all non-standard metrics to promote comparability across companies within the industry. We agree strongly with the SEC's guidance and would like this guidance to apply to such financial metrics as Economic Value Added (EVA), operating income, and other financial ratios for which there is no standard calculation.

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[3] *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance-Sheet Implication, Special Purpose Entities and Transparency of Filings by Issuers*; June 2005

For users to comprehend fully the relevance of metrics and how they relate to the data provided in the financial statements, they need to know how all metrics (both financial and non-financial) are calculated. To this end, we believe that future guidance will be needed to standardize non-IFRS financial performance measures and other non-financial performance measures and indicators. However, until this guidance is provided, a company should explain how it has calculated any non-IFRS metrics, indicators, or other measures for both financial and non-financial items presented in its Management Commentary. Also, we believe that the important metrics should also be provided in interim MC.

2) Linking Management Commentary to Other Documents

It is often difficult to link management's discussion and analysis of the company's operations back to other documents, such as a proxy, that disclose the company's schemes for executive compensation. We believe that management's commentary should provide the context for, or connection between, how management is compensated to how the company has performed. This linkage would enable investor to understand more fully management's incentives to engage in certain business activities or transactions and how these incentives may impact management's decisions and in turn, future operations of the company.

CDPC Response to Specific Questions in the Discussion Paper

Requirements for management commentary (MC)

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

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

Yes. As noted in our general comments, we believe that the MC (if properly done) provides necessary information about a company's financial performance and condition, and future prospects. We consider MC an integral part of a company's overall business reporting.

Question 2:
Should the development of requirements for MC be a priority for the Board? If not, why not? If yes, should the IASB develop a standard or non-mandatory guidance or both?

Yes. We believe that a MC standard could be partially addressed in some of the Board's projects currently on its active agenda as maybe as a phase or segment in the development of the conceptual framework and/or performance reporting standards.

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

Yes. As stated in our response to question 1, we believe that MC is an integral part of a company's business reporting to investors.

Purpose of MC

The project team concluded that the objective of MC has three elements (section 2). The project team also concluded that the primary focus of MC is to meet the information requirements of investors.

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

Yes. We agree that the primary objective of MC is to provide context – explanation and meaning - to the financial statements. As such, we believe that the elements of this objective noted in the DP are appropriate and focus sufficiently on the needs of investors, which are to:

- Interpret and assess the related financial statements in the context of the environment in which the entity operates;
- Assess what management views as the most important issues facing the entity and how it intends to manage those issues; and
- Assess the strategies adopted by the entity and the likelihood that those strategies will be successful.

Principles, qualitative characteristics and content of MC

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

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

Yes. We agree with the principles and qualitative characteristics outlined in the DP. However, we would put more emphasis on providing disclosures which have economic relevancy and are neutral in focus, thus providing a balanced discussion and analysis of the company's financial performance and condition.

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

Generally, yes. We agree that the following five elements of MC contents are appropriate:

- Nature of business
- Objectives and strategies
- Key resources, risks and relationships
- Results and prospects
- Performance measures and indicators

However, we are concerned with how these elements are illustrated in the DP. For instance, the example illustration of a simple description for the nature of business provides minimal information about the nature of the company's business.

> *The company is a leading provider of serviced apartments. It operates in the major cities of Europe and the Far East.* **[Too vague – should state which cities and in which countries]** *The company's presence comprises over 3,250 serviced apartments in 27 cities across 10 countries, with a further 415 apartments due to come on line over the next 12 months.* **[What is the distribution by city for both the current and expected units? What is the operating data – revenues, expenses, etc. - by grouped units? What is the investment in each city?]**

We consider the above example to be a boilerplate disclosure, leaving the reader with many unanswered questions. The disclosure is overly condensed and appears to provide quantitative or other detailed information while, in fact, provides little or nothing of substance for making an informed decision. We recommend that the final Standard for MC not include this kind of illustrative examples. Instead, the illustrative examples for the nature of business should include more useful information such as a tabular format provided later in the DP along with a narrative about –

- What is management's business model for operating these apartments?
- Why management has chosen to operate in these cities?
- How the operations of the units are financed?
- Quantitative information about the value of the apartments and expected cash flows from current contractual or lease arrangements.

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

Yes, but with qualification. As noted earlier in our general comments, we have concerns about "limiting" the amount of information. It should be quite clear in the final Standard for MC that only relevant information should be provided. Additionally, enough information should be provided to enable the user to understand fully the company's operations and how it is managed. This means that the MC should provide supplemental information to what is already provided in the financial statements and the accompanying notes. In other words, the MC should not include boilerplate disclosure which provides information of no substance and varies very little from period to period, and redundant information that is already provided in the financial statements and the accompanying notes.

Question 8:
Does your jurisdiction already have requirements for some entities to provide MC? If yes, are your local requirements consistent with the model the project team has set out? If they are not consistent, what are the major areas of conflict or difference? If you believe that any of these differences should be included in an IASB model for MC please explain why.

No comment. The CFA Centre represents an international constituency located within different jurisdictions.

Placement criteria

The project team concluded that it would be helpful to establish criteria to guide the Board in determining whether information it requires entities to disclose within financial reports should be placed in MC, or in the general purpose financial statements. The project team have suggested placement criteria (section 5).

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

As users of financial information, we find the criteria for placement of information neither helpful nor unhelpful. Generally, we view notes to the financial statements and management commentary as disclosures, which together provide context for the financial statements. And as such, the delineation between what information should be in notes to the financial statements versus management commentary is somewhat arbitrary. The understanding of a company's operations, financial performance and financial condition is greatly improved if information – explanation, discussion and analysis about a given financial item - is provided in **one** location rather than scattered throughout various disclosures which need to be pieced together to get a complete picture.

Closing Remarks

The CFA Centre for Financial Market Integrity, together with its Corporate Disclosure Policy Council, appreciates the opportunity to provide comments to the IASB on the Discussion Paper: *Management Commentary*, October 2005. To gain a full understanding of a company's operations, its current and future prospects, as well as its financial performance and financial condition, management needs to provide its insights through detailed explanations, discussion and analyses. Therefore, we view management's commentary, which presents a clear and complete representation of the company's operations and future prospects, to be unequivocally essential disclosure.

If you or your staff have questions or seek further elaboration of our views, please contact Georgene B. Palacky, by phone at +1.434.951.5326 or by e-mail at georgene.palacky@cfainstitute.org.

Sincerely,

/s/ Patricia A. McConnell | */s/ Georgene B. Palacky*

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