



BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

Via e-mail: CommentLetters@iasb.org

Mr Alan Teixeira
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Discussion Paper “Management Commentary”

Dear Mr Teixeira

The Basel Committee on Banking Supervision¹ (Committee) welcomes the opportunity to comment on the Discussion Paper regarding Management Commentary (MC), published by the International Accounting Standards Board (IASB) in October 2005.

From the perspective of the Committee, the publication of MC is a useful management tool that provides information to the market as a complement to audited financial statements. MC is currently required by law or recommended for voluntary disclosure in several national jurisdictions. This commentary has the potential to enhance the level of transparency of corporate entities and to improve market discipline. Improved market discipline can contribute to more reliable financial market data leading to more realistic expectations of market participants, which can result in a higher degree of financial stability, both for the market as a whole and for supervised institutions under the scope of the Committee. Transparency and market discipline are of considerable interest to the Committee and are a significant part of its new Basel II Capital Framework (“International Convergence of Capital Measurement and Capital Standards, a Revised Framework”, June 2004).

Since financial reporting based on sound standards, such as International Financial Reporting Standards, is a prerequisite for transparency and market discipline, the Committee has a keen interest in the IASB’s efforts to improve the content and quality of its standards. The due process of the IASB in standard setting allows for an extensive exchange of views between the IASB and interested parties, including the Committee and other regulatory authorities. Examples of previous valuable exchanges include discussions regarding IAS 39

¹ The Basel Committee on Banking Supervision is a committee of banking supervisory authorities, which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.

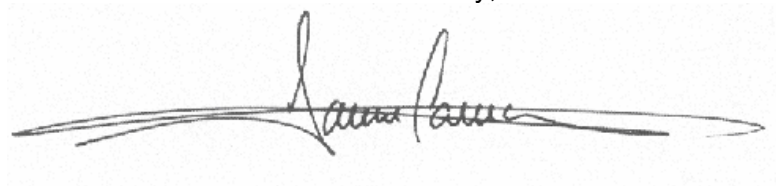
and IFRS 7, which contains guidance for disclosures about risk exposures that is similar to the approach taken by the Committee in its Pillar 3 of the Basel II Capital Framework. The Committee considers MC an essential part of management's financial reporting, which contributes to the banking supervisors' objectives for market discipline.

While the Committee broadly supports this project and the suggested content of the proposed MC in the Discussion Paper, the Committee believes that MC should not be a compulsory requirement for entities using IFRS in order to be able to assert compliance with IFRSs. In some national jurisdictions, authorities other than accounting standard setters establish corporate governance standards and issue commentary requirements. As you know, guidance for this type of commentary is currently outside of the IASB framework. One potential way to influence the MC process without establishing inconsistencies with national requirements would be for the IASB to describe MC best practices and issue MC guidance for voluntary application. The Committee believes that at least banks which are significant market participants, as entities of public interest, should provide MC in a manner that is fully transparent and valuable to investors and other users of financial information. This goal could be reached through an evolutionary process, by markets rewarding organisations with the best disclosure practices, which would include high quality MC.

Please find our detailed responses to the questions posed within the Discussion Paper in the attached appendix. These comments have been prepared by the Committee's Accounting Task Force, chaired by Prof Arnold Schilder, Executive Director of the Netherlands Bank, and approved by the Committee. The Committee trusts that you will find its comments useful and constructive.

If you have any questions regarding our comments, please feel free to contact Prof Schilder (+31 20 524 3360), Mr Karl-Heinz Hillen, who chairs the MC Discussion Paper Subgroup within the Accounting Task Force (+49 69 9566 8379), or Ms Linda Ditchkus at the Basel Committee Secretariat (+41 61 280 8007).

Yours sincerely,

A handwritten signature in dark ink, appearing to read 'Jaime Caruana', with a long horizontal flourish extending to the left.

Jaime Caruana



Appendix One

Discussion Paper on Management Commentary (MC) by the MC Project Team of IASB

The Committee would like to provide the following detailed comments to address specific questions included within the invitation to comment.

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

The importance of MC for the enhancement of transparency and the improvement of market discipline is fully recognised. It would give investors additional information not included in the financial statements, especially about the opinions of management regarding its objectives for the company and possible future developments. Through comparisons among the MCs of different companies, investors could develop more informed opinions about the quality of management.

In the view of the Committee, MC should not be part of the financial statements (ie primary financial statements and notes) nor be subject to the same level of audit assurance as the financial statements. The objective of MC is to provide information regarding processes, positions, risk exposures and prospects through the eyes of management. The performance of complete audit procedures on this information would be difficult and potentially inappropriate. This is consistent with the views of the Committee on disclosures made under Pillar 3 of its new Basel II Capital Framework, where no external audit procedure is required (see paragraph 816 of the Framework).

The Committee believes that there should not be mandatory requirements for MC either in the form of a distinct standard or a new rule integrated into IAS 1, Presentation of Financial Statements. However, the IASB may wish to work through alternative channels to influence the content of MC. One potential way to do so without establishing inconsistencies with potential existing national requirements would be for the IASB to describe MC best practices and issue MC guidance for voluntary application.

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?

The Committee fully recognises the importance of MC for the enhancement of transparency and improved market discipline. The results reached so far by the IASB and its project team

on MC are much appreciated, and the Committee is broadly supportive of further work on this issue. Considering the current full agenda of major issues facing the IASB, this question regarding priority should be assessed carefully. In any case, MC should be kept on the Board's agenda, but this project's priority should be weighed against the importance of other existing and forthcoming projects.

Regarding the implementation strategy for MC, the Committee believes that MC should not be a compulsory requirement for entities using IFRS in order to be able to assert compliance with IFRSs. As mentioned in the cover letter, some countries establish corporate governance standards and issue commentary requirements through authorities other than accounting standard setters. As you know, guidance for this type of commentary is currently outside of the IASB framework. Non-mandatory guidance, would allow for a more flexible implementation approach for different national jurisdictions and corporate entities. Such flexibility is especially warranted because the regulation of MC and its equivalents in national jurisdictions is diverse. The adoption of IFRSs and any future MC guidance will apply to many different national jurisdictions. At present, some jurisdictions do not have existing MC regulations, some have a long history of national MC requirements incorporated in their accounting standards (eg Germany), and others include MC within other supervisory guidance but not within accounting standards (eg the MD&A in the United States as required by the Securities and Exchange Commission).

The application of future IASB guidance on MC should be predominantly recommended for public interest entities, ie companies with publicly traded shares or debt securities, and at least all financial organisations that are significant market participants regardless of the listing of their financial instruments. This recommendation is consistent with other processes that improve market discipline. Financial organisations, in their special role as financial intermediaries and deposit takers, should be encouraged to ensure increased levels of transparency to provide informative MC to investors and creditors.

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.

Please, also refer to our remarks for question 2.

To the extent that non-mandatory IASB-guidance on MC is implemented, MC would not be an integral part of the financial statements for companies using IFRSs. The publication of MC would also not be a requirement for the IFRS-assertion. Notwithstanding, if there is a voluntary publication of MC according to IASB guidance, either on a corporate basis or because a national jurisdiction has chosen to adopt the guidance as mandatory, MC accompanying financial statements would be part of the financial reports.

Any consideration of an audit requirement in these cases should draw upon the experience of jurisdictions that already mandate the preparation of MCs. Since the MC discloses the assessments and opinions of management and is also future-oriented it cannot be audited to the same level of high assurance as the financial statements, but to principles such as consistency, understandability, and fair presentation (see paragraph 189 of the discussion paper). Should an audit requirement be imposed, the resulting additional audit burden should be kept reasonably low and guidance should specify that the level of audit assurance provided is significantly lower than for the primary financial statements and accompanying notes.

The Committee shares the view of the discussion paper, that issues remain open with respect to audit and assurance aspects of MC (paragraph 193 and 194). Therefore, close cooperation with the IAASB is essential. One possible solution may be to apply the International Standard on Auditing No 720 (ISA 720; Other Information in Documents Containing Audited Financial Statements)² or a similar standard. ISA 720 asks auditors to identify material inconsistencies between MC-type information and the audited financial statements and to recognise material misstatements of fact. Detected deficiencies should be discussed with management of the entity. If management is uncooperative in addressing issues, auditors should consider taking further appropriate action.

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?

The Committee agrees with the objective of MC described in paragraph 34 of the Discussion Paper. The IASB should consider clarifying that MC does not only relate to the past period described in the financial statements, but it should also be future-oriented as described in the principles formulated in paragraph 39.

While the needs of investors must be considered when setting standards, we believe the focus on the sole needs of investors is not necessarily appropriate, as it narrows the definition of potential users of financial statements. The Committee believes that the definition of users within the IASB framework is relevant for MC and should be relied upon for MC guidance. The framework lists seven different groups of users and states, that information should be useful “to a wide range of users making economic decisions” (paragraphs 9 and 12).

Regarding the potential users and qualitative characteristics of MC (see following question), the Committee recognises that the IASB framework will be subject to major changes in the medium term, since the Financial Accounting Standards Board (FASB) and the IASB are working on a joint project that will produce a future common conceptual framework for both standard-setters.

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 one suggested by the project team would you change?

The Committee agrees with the principles of MC formulated in paragraphs 41-57 of the Discussion Paper.

² Refers to other financial and non-financial information included, either by law or by custom, in the annual report as an addendum to the financial statement.

The Committee has two recommendations with respect to the qualitative characteristics (paragraphs 58-95), which would support enhanced conformity of MC rules and the IASB framework.

First, the Committee supports maintaining consistency with the IASB framework when defining the characteristics of MC. This recommendation would necessitate reinstituting the concepts of “supportability” and “balance” under the term “reliability.” Implementation of this suggestion should be straightforward, since the two new terms include the concepts of faithful representation and objectivity, which are consistent with being “free from bias” and are already parts of “reliability” according to the framework. The definition “free from material error” of the framework’s reliability characteristic can also be used in relation to MC, since none of its statements should be intentionally or unintentionally false or untrue, despite representing the management’s assessments and opinions.

Second, the Committee suggests using the characteristic of “comparability” instead of “comparability over time”. This would add to comparability over time the concept of entity-to-entity comparability. We understand that one-to-one comparisons between MCs of different corporate entities would be unlikely, since there will not (and should not) be a standardisation of MC. However, some inter-corporate comparisons will be made by investors and comparability or consistency among common elements, as defined by the IASB in IAS 1 and the application guidance, may be expected.

Consistent with our comment regarding the definition of users, the Committee also questions whether there is a need to create a distinct set of qualitative characteristics for MC. The Committee believes that the definitions within the IASB framework are well founded and that MC will be a part of the overall IFRS-environment. If some qualitative characteristics are clearly not applicable to MC, these could be explicitly excluded from the MC. Therefore, the Committee believes that the qualitative characteristics within the IASB framework are relevant for MC and recommends that they be relied upon for MC guidance.

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?

The Committee generally agrees with the content elements formulated in paragraph 100 of the paper. It would expect MC generally to include comments on all the contents mentioned. The specific amount of information to be disclosed for each content element should not be described in too much detail in order to allow a necessary degree of flexibility. The structure of the content indicated in paragraph 100 of the Discussion Paper should not be mandatory. Instead, management should be able to structure the content of MC consistent with the profile of their individual company, under the provision that no content element can be omitted. The Committee believes that an overly strict standardisation of MC content could result in a tendency to publish boilerplate statements as an expeditious way to fulfil requirements.

Regarding management comments about strategies (see paragraphs 119-121), the Committee believes companies should have the possibility to balance the need for providing valuable information to investors with the need to maintain confidentiality of certain strategic decisions, ie to avoid endangering competitiveness. In past practice, there has been a tendency towards creating boilerplate statements, which do not harm the competitive position of the company but neither provide information of high value for investors.

The Committee agrees that MC should include comments about future prospects (paragraphs 132-136). These comments could be enhanced by requiring the discussion of future prospects to identify specific time horizons. This additional information would assist investors in assessing the value, relevance, and consequences of future prospects. The length of the time horizons should be left up to management, because prescribed time requirements may not be equally relevant to all companies or business segments.

Performance measures or indicators (paragraphs 137-143) should be chosen by management, because different industries rely upon a variety of indicators, which could be relevant only to specific industries. However, the guidance should include general principles for the selection and use of measures or indicators. The Committee has two suggestions. First, performance measures should allow a high degree of comparability over time. Definitions of measures and indicators should generally remain consistent to allow investors to understand trends. Second, computations for measures and indicators should be transparent and the use of data contained in the IFRS financial statements should be strongly encouraged. Departures from this principle should be only made if there are sound reasons for it. The use of non-IFRS numbers should be accompanied by statements explaining these reasons and the differences from IFRS data. Both of these suggested principles could increase transparency and detract from the ability to bias MC.

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 best achieved?

The Committee concurs that decisions regarding the amount of published information should be left primarily within management's field of responsibility (paragraph 67). There should not be detailed MC requirements curtailing the breadth and depth of information, since limits may not be suitable for every type of organisation. The MC guidance should remain principles-based, and the principle of "relevance" should guide the length of MC and assist in avoiding redundancy. Furthermore, industry practice should assist in establishing appropriate amounts of information, since investors are generally not interested in or tolerant of irrelevant and superfluous information.

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.

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?

If the IASB maintains the current separation between MC and the financial statements, the Committee believes a change in placement of information may not be warranted. A large-scale redistribution of information between MC and the notes could result in substantial changes to respective IFRSs, and the anticipated gains in clarity may not be worth this considerable effort.

The Committee feels strongly that the disclosures required under IFRS 7 should remain within the notes to financial statements and not be moved to MC. IFRS 7 was recently issued and requires disclosure of risk exposures arising from financial instruments either within the notes or outside the financial statements with a cross-reference within the notes (paragraph BC46). This standard also includes requirements for disclosure of financial risk exposures, which can be reliably calculated for specific previous dates and since they are not subjective or speculative they can, in most cases, be audited with a high level of assurance.

Before engaging in a strategy to change the placement of information within financial reports, the IASB should ensure that currently required disclosures are not lost. For example, if information from the notes is moved into MC and MC elements or the whole MC become discretionary, there could be a significant loss of comparability between the elements of the financial reports of different entities. Furthermore, redistribution of information between the notes and MC would change the level of audit assurance for information that is currently required by IFRSs because MC would be subject to a lower level of assurance than the notes, which are currently part of the financial statements (see question 3).