Response to EFRAG Research Paper: The role of the business model in financial statements

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INTRODUCTION

ICAS welcomes the opportunity to comment on the EFRAG Research Paper: The role of the business model in financial statements.

The ICAS Charter requires its committees to act primarily in the public interest, and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members' views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

The ICAS Accounting Standards Committee has considered the research paper and I am pleased to forward their comments.

Any enquiries should be addressed to Amy Hutchinson, Assistant Director, Technical Policy and Secretary to the Accounting Standards Committee.

General comments

The concept of the business model in corporate and financial reporting is very topical, and this paper is a timely and relevant contribution to the debate. The business model is seen by many as a key element in improving corporate reporting, as it focusses attention on the 'story' of a business, and encourages the presentation of a consistent and coherent message in corporate reports.

ICAS has consistently supported greater use of the business model concept, as we believe that it improves the relevance and understandability of financial reporting. With developments such as Integrated Reporting, and the introduction of the strategic report in the UK, there has been a shift in focus towards a complete, cohesive corporate report. The appropriate use of the business model in the financial statements will help ensure that they retain their important role within the corporate reporting package.

Question 1 – Implicit use of the business model

Chapter 2 discusses the explicit use of the term 'business model' in IFRS. The chapter also includes implicit examples of earlier use of the business model.

(a) Do you support the analysis of the implicit examples in IFRS? Please explain.
(b) Are you aware of additional implicit examples in IFRS?

Response:
Yes, we agree that EFRAG has identified the appropriate implicit examples from IFRS, and we are not aware of any additional implicit examples.

Question 2 – cash conversion cycle

Chapter 3 discusses the assumed meaning of the business model, including an analysis of the cash conversion cycle.

(a) Do you agree with the analysis of the cash conversion cycle? Please explain.
(b) Are there any other attributes to add?

Response:
While we agree with the analysis of the cash conversion cycle, we are not convinced that this level of detail is necessary in defining the business model. We believe there is a common high-level understanding of the term 'business model' and that it is not necessary to seek to define it more tightly.

Question 3.1 – Banking example

(a) Do you think the example describes different business models? Please explain.
(b) Do you support View A or View B? Please explain.
(c) If the different activities of Entity A and Entity B were both conducted in the same entity, would your answer to the above question be different? If so, why?

Response:

We think that the example describes different business models, as the way that each entity manages its loans is different, therefore this should be reflected within the financial statements. Therefore, we support view A. We agree that amortised cost is an appropriate measurement base for Entity A's loans, as it intends to hold these to maturity, so this most closely reflects the expected future cash flows. Fair value is the most appropriate basis for Entity B as it sells its loans. Our answer would not change if the different activities of Entity A and Entity B were both conducted in the same entity, as there would still be two distinct business models within the same entity.

Question 3.2 – mobile network operator example

(a) Do you think the example describes different business models? Please explain.
(b) Do you support View A or View B? Please explain.
(c) If the different sales channels of Entity A and Entity B were both conducted in the same entity, would your answer to the above question be different? If so, why?

Response:
We find this example less clear-cut than the banking example, and find that there is insufficient information to help determine whether there are two different business models. In this case the key point of difference is the commission payment to the dealers (Entity B) vs. costs of providing mobile phones (Entity A). If there is an element of the commission payments that represents Entity B reimbursing the dealer for providing a mobile phone to the customer, then it would appear appropriate that this should be accounted for in a similar way as Entity A treats the cost of the mobile phones. But at least part of the payment to the dealers is for the acquisition of a new customer – it appears appropriate that this is accounted for differently as this represents the different sales approach of Entity B. If the different sales channels were both conducted in the same entity our answer would be the same as if the activities were within separate entities.

Question 3.3 – insurance example

(a) Do you think the example describes different business models? Please explain.
(b) Do you support View A or View B? Please explain.
(c) If both insurance products of Entity A and Entity B were provided by the same entity, would your answer to the above question be different? If so, why?

Response:

We are unsure whether the example describes different business models or simply different products. In Entity B, the liability cash flows are dependent on the asset returns, therefore we believe that it is appropriate that this aspect of the business model is reflected in the accounting treatment. We agree with view A that for Entity B, the liabilities should be measured on the same basis as the assets to which they are linked. This means that measurement is based on the way that the liabilities are managed in the business, rather than being based purely on the type of liability. As in the previous examples, our answer would be the same if the insurance products of Entity A and Entity B were provided by the same entity.

Question 4 – playing a role in financial reporting
Chapter 4 discusses the conceptual debate as to whether the business model should play a role in financial statements. The Bulletin includes a tentative view that the business model should play a role in financial reporting, including financial statements, and asked whether constituents support that view.

Do you have any additional comments?

Response:
We agree that the business model should play a role in financial reporting, including financial statements, and as the discussion paper demonstrates, it already does so to a certain extent. We believe that the business model is an important element of a principles-based financial reporting system, as it helps ensure that accounting is based on economic reality, involving an element of flexibility that is crucial in ensuring that standards are capable of wide application. The notion of the business model encourages a proactive, independent mindset amongst preparers, auditors and users, as it requires them to consider how the business operates and therefore results in a more accurate depiction in the accounts.

We also believe that the incorporation of the business model into financial reporting standards is necessary to maintain the relevance and legitimacy of financial statements in the future. In the current era, there are a number of new developments in corporate reporting, with an increased focus on non-financial reporting and the complete corporate reporting package. The business model is an important focus of the 'front-end' of corporate reports, therefore this should also be reflected in the financial statements to ensure financial and non-financial information is linked.

Question 5 – criteria for use of the business model

Chapter 5 discusses the implications of the business model in IFRS and proposes criteria to be used in the Conceptual Framework to identify when the business model might be used in accounting standards. The chapter also proposes principles for identifying business models in those accounting standards.

(a) Do you agree that criteria should be included in the Framework to provide a more systematic approach for accounting standard setters to consider the business model?
(b) If so, do you agree with the suggested criteria?
(c) Are there additional criteria that should be included? Please explain.

Response:

We are comfortable with the criteria proposed to be included in the Framework. We believe that the criterion in paragraph 5.7 (a) should also refer to risk i.e. 'when it leads to accounting which better reflects the economics and risks of transactions.'

Question 6 – implications of the business model

The Bulletin proposes some implications to IFRS and asks whether constituents support the implications to the IFRS literature.

Do you have any additional comments?

Response:

We have no additional comments.