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The role of the business model in financial statements

RESEARCH PAPER

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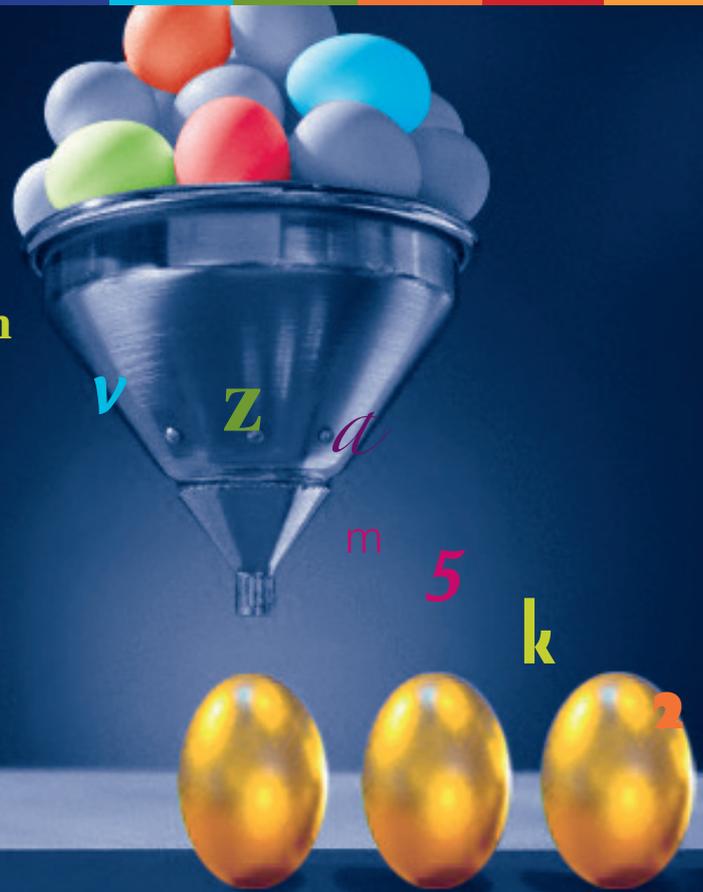
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This Research Paper is issued by the European Financial Reporting Advisory Group (EFRAG), the French Autorité des Normes Comptables (ANC) and the UK Financial Reporting Council (FRC).

The following standard setters in Europe also support the issue of this Research Paper:

Belgium, CNC/CBN – Commission des Normes Comptables/Commissie voor Boekhoudkundige Normen

Cyprus, ICPAC – The Institute of Certified Public Accountants of Cyprus

Denmark, FSR – Danske revisorer

Germany, DRSC (ASCG) – Accounting Standards Committee of Germany

Italy, OIC – Organismo Italiano di Contabilità

Luxembourg, CNC – Commission des normes comptables

Malta, MIA – The Malta Institute of Accountants

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Norway, NRS – Norsk RegnskapsStiftelse

Poland, KSR – Polish Accounting Standards Committee

Slovenia, Slovenski Institut za Revizijo

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These bodies, while encouraging debate on the issues presented in the paper, do not express any opinion on those matters at this stage.

Copies of the Research Paper are available from the websites of those bodies issuing it. A limited number of copies of the Research Paper will also be made available in printed form, and can be obtained from EFRAG.

The paper invites comment on its proposals via the 'Questions for Respondents' at the end of each section (which are summarised in the Invitation to Comment). Such comments should be sent by email to:

commentletters@efrag.org or by post to:

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so as to arrive no later than 31 May 2014.

All comments will be placed on the public record unless confidentiality is requested.

EFRAG's Proactive Work in Europe

It is important to set the project within the broader context of our Proactive Work. EFRAG aims to influence future standard-setting developments by engaging with European constituents and providing timely and effective input to early phases of the IASB's work. This proactive work is carried out in partnership with National Standard Setters in Europe to ensure resources are used efficiently and to promote stronger coordination at the European level. Four strategic aims underpin proactive work:

- Engaging with European constituents to ensure we understand their issues and how financial reporting affects them;
- Influencing the development of global financial reporting standards;
- Providing thought leadership in developing the principles and practices that underpin financial reporting; and
- Promoting solutions that improve the quality of information, are practical, and enhance transparency and accountability.

More detailed information about our proactive work and current projects is available on the EFRAG website.

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Preamble



Although the term ‘business model’ appeared in the IFRS literature for the first time in 2009, when IFRS 9 *Financial Instruments* was issued, this paper shows that the notion had previously been an implicit part of IAS/IFRS for a long time. The business model does not, however, play a role or is discussed in the present IASB *Conceptual Framework*. As a result, if the notion is used, it is not always clear why this is the case or why it is ignored, and there is no consistency from standard to standard.

This paper argues that it is time for a change: the business model should play a role in financial reporting and be part of the revised *Conceptual Framework*. The business model introduces the notion of the ‘cash conversion cycle’, which is able to provide insight into how value is captured and net cash flows are generated through income in the normal course of a business. All standards must, therefore, be capable of representing faithfully the business model, and, where applicable, the business model should explicitly be incorporated on a standard-by-standard basis. On this level, its consequences for recognition, measurement, and presentation and disclosures should be assessed, and decisions should be taken whether and how the business model should affect financial reporting.

Various recent discussions show that EFRAG, the ANC and the FRC are not alone in their view of the importance of the business model notion in financial reporting. For instance, as explained later in this paper, EFRAG, the ANC and the FRC were joined by the standard setters of Germany and Italy when they jointly issued a Bulletin on the topic, as part of a series to promote discussion on topics related to the *Conceptual Framework*. This Bulletin was based on the research presented in this paper, and is included as the next section.

In our view, it is now time to open the debate among a wider audience. This is the purpose of the paper, and it therefore asks a number of specific questions to the constituents. EFRAG, the ANC and the FRC are interested in your views.



BULLETIN Getting a Better Framework: The Role of the Business Model in Financial Reporting

On 8 July 2013, EFRAG and the national standard setters of France, Germany, Italy, and the United Kingdom published a Bulletin on the role of the business model in financial reporting. The Bulletin was based on the work done to develop this Research Paper. The following is the text of that Bulletin, including the Bulletin's questions to constituents. The intent of including a reprint of those questions is to provide background to the reader. This Research Paper includes additional questions to constituents.



INTRODUCTION AND BACKGROUND

- B.1 The term 'Business Model' was used for the first time in an accounting standard issued by the IASB when it was explicitly introduced in 2009's IFRS 9 *Financial Instruments*. A reference to the business model was also included in the 2008 Exposure Draft of the *Conceptual Framework*, but not maintained in the final version.
- B.2 However, the notion of the business model has already been implicit in IFRS a long time in, for example, IAS 2 *Inventories* (issued in 1975), under which the use of the assets defines whether or not they are considered as inventory, or IAS 40 *Investment property* (issued in 2000) which differentiates between real estate assets depending on the economic purpose pursued in holding the asset.
- B.3 Whether or not the business model should play a role in financial reporting has been controversial for some time, with many commentators arguing that referring to the business model would enhance relevance, while others oppose the idea claiming that it introduces bias that would be detrimental to transparency and comparability of financial reporting.
- B.4 EFRAG, the ANC and the FRC have been working on a proactive project researching this topic. They intend to publish the results of their work later in 2013 in the form of a Research Paper. Given the relevance of the issue to the *Conceptual Framework* project of the IASB, and the tentative view of EFRAG, the ANC, the ASCG, the OIC and the UK FRC that the business model should have a role in financial reporting, this Bulletin has been prepared in advance of the Research Paper. It is one in a series the five partners are issuing to stimulate the debate in Europe on the *Conceptual Framework*.
- B.5 This Bulletin presents our assumed meaning of the term 'business model', which is, at the moment, an undefined term in the IFRS literature. The document also provides a conceptual discussion as to whether financial statements based on the business model meet the qualitative characteristics in the IASB *Conceptual Framework*. Our tentative view is that this is the case. The following section discusses the distinction between the business model and management intent, presenting our view that a valid distinction exists. The Bulletin concludes by considering the implications of the business model for financial reporting under IFRS.

- B.6 The following example puts the discussion in a practical context.
- B.7 Suppose an entity purchases a quantity of cotton for CU100. It still owns the cotton at the reporting date, when it is worth CU120 (and the entity could readily sell it at that price). If the entity is a shirt manufacturer and will use the cotton in its operations, current practice would be simply to report the cotton as ‘inventory’ at its cost of CU100. But if the entity is a commodity trader that seeks to make profit from short-term price movements, that accounting may not reflect fairly the entity’s financial position or financial performance: current practice reflects this view by stating the asset at its current selling price of CU120, with the gain of CU20 included in profit. However, there might be other ways in which the business model might impact the financial statement: if the transaction is a non-recurring speculation that is outside the normal activities of the entity, it would probably have to be separately presented, whatever the accounting treatment. Thus the nature of an entity’s business may affect the measurement of assets, the reporting of profit and presentation.

AN ASSUMED MEANING OF THE TERM FOR FINANCIAL REPORTING PURPOSES

- B.8 Whilst there is no universal defined meaning of the term ‘business model’, academic literature evidences that the term is increasingly referred to in corporate reporting to describe an entity’s activities, its asset configuration (for example, capital intensive or heavy reliance on R&D), and its customers, products and services.¹
- B.9 The literature also shows that there is no universal view on the relationship and distinction between business purpose, strategy, management actions, management intent, and similar notions.
- B.10 It could be difficult to arrive at a universally acceptable definition of the term that could be consistently applied by those who prepare financial information and adequately understood by those that use financial information. For example, there is no agreement as to whether there are two business models such as a trading and a holding model, or if there are more business models that reflect how each entity tries to differentiate itself from its competitors.
- B.11 For the purpose of this Bulletin, we have adopted an assumed meaning of the term for financial reporting purposes. Financial reporting is meant to provide the basis for assessing the financial position and performance of an entity. It assesses and understands how the entity is ‘making money’, how it provides capital providers with appropriate returns on the resources invested in the entity, and how it is exposed to risks and organised to mitigate those risks.

¹ An overview of the relevant academic literature and background information on our assumed meaning will be presented in the Research Paper.

B.12 Our assumed meaning of the term ‘business model’ focuses on the value creation process of an entity, i.e. how the entity generates cash flows. In case of non-financial institutions, it represents the end-to-end value creation process or processes of an entity within the business and geographical markets it operates.

THE CONCEPTUAL DISCUSSION

B.13 To assess whether the business model could, or even should, play a role in financial reporting, the following paragraphs look at whether such role is essential for, or enhances the response to, the key characteristics in the IASB *Conceptual Framework*.

B.14 The 2010 *Conceptual Framework* includes two fundamental qualitative characteristics: relevance and faithful representation. It also includes four enhancing qualitative characteristics: comparability, verifiability, timeliness and understandability.² The timeliness characteristic is not relevant in the debate raised in this Bulletin. Verifiability is important, but is, in our view, a precondition to be met when the conclusion would be that there is a role for the business model in financial reporting, and is therefore not further considered here. For these reasons, the discussion below focuses on the remaining four qualitative characteristics.

Does financial reporting based on the business model notion provide relevant information?

B.15 According to the *Conceptual Framework*, financial information is relevant if it is capable of making a difference to those who use the financial information in making decisions (QC6). It subsequently explains that to do that, the financial information must have predictive or confirmatory value or both (QC7).

B.16 Providing information reflecting events that are not likely to occur, or using valuations that do not reflect the most likely way an entity will realise its cash flows does not help users in assessing future cash flows. For instance, including the gain of CU20 in profit in the case of the shirt manufacturer in the example presented above does not reflect how the asset is used and how he makes money. However, giving prominence to the most likely scenario – the one that would depict how the entity is generating cash flows, i.e. reflecting the entity’s business model – would be more in line with the *Conceptual Framework* requiring that the expectation of future economic benefits must be sufficiently certain to meet the required probability criterion (4.5). As a consequence, recognising the gain in profit would make sense for the commodity trader.

B.17 Having the business model play a role in financial reporting would presume that investors have an understanding of the business model prior to assessing an entity’s financial position and performance.

² Until 2010, there were four key characteristics: relevance, reliability, comparability, and understandability. Whether or not the changes are substantive or only semantics, is discussed in the Bulletin Reliability of financial information, published in April 2013.

- B.18 Academic research shows that this is indeed the case in practice, in particular for long-term investors.³ Long-term investors who buy or hold a share in an entity will generally first consider who the main players in this type of business are, whether their strategy is conducive of sustainable market shares in the sector and how they have organised themselves to make money. In other words, what their business models are. Only after they have done so, they start comparing and selecting in which of those players they want to invest.
- B.19 The need to understand an entity's business model is further increased by development of integrated reporting, which suggests that investors need to rely on a cohesive set of information, encompassing more than only financial statements.⁴ One of the elements to be disclosed under the proposed framework is the business model.⁵ If financial reporting is not consistent with an entity's business model, the required level of cohesiveness in integrated reporting would not be achieved.⁶
- B.20 Academic evidence also suggests that many investors rely on the income statement as a first basis for predicting future operating results. Some argue that if results are reported independently of how the entity generates its actual cash flows, such results reflect what the entity would have gained or lost if it had used the same assets and liabilities differently (i.e., an alternative use or hypothetical approach), but not how the entity has created or destroyed value. Again, the example of the cotton explains this: what relevant information would be provided in the financial statements of a shirt manufacturer if they show the gain of CU20 in profit while the material is still part of inventory?
- B.21 Whilst the *Conceptual Framework* contains no reference to an entity's business model, it highlights that some resources (assets) do not generate cash flows on a standalone basis but may be combined with others in order to do so (4.10(a)). This means that, in those cases, the analysis in isolation of the nature of the resources concerned is not sufficient to assess the prospects of future cash flows. Users will need to have information on all interactions between the different resources used in combination by the entity to produce goods or provide services. Some consider that understanding how business models work and how different resources interact with one another will be of great help in this respect. In their view, the role that various resources play in cash conversion cycles is relevant to financial reporting: the way items are used in the context of a business model has an unavoidable impact on the timing and amount of cash flows that will be generated and on the exposure to risks.

³ The academic evidence is based on a study, performed at the joint request of EFRAG and ICAS as part of the proactive activities. The results of the study will be published later in 2013.

⁴ "Integrated Reporting is an approach to corporate reporting that demonstrates the linkages between an organisation's strategy, governance and financial performance and the social, environmental and economic context within which it operates." (International Integrated Reporting Council, *Consultation Draft of the International <IR> Framework*, 2013).

⁵ International Integrated Reporting Council (2013), paragraph 1.20.

⁶ It should be noted that these references to the Integrated Reporting publication does not represent any views of the partners on the contents of this paper.

- B.22 Some take this position one step further and argue that ignoring the business model in financial reporting would reflect changes in value that are irrelevant to the financial position and performance of the entity, or delay the recognition of elements. This would result in accounts that are established on what is considered a theoretical basis and produce information that is not based on economic reality. In their view, this results in non-compliance with the *Conceptual Framework*, and is therefore not acceptable. At the same time, they do acknowledge that financial statements should also reflect the impact of transactions executed and events occurred outside the business model, for instance when loans held to collect the cash flows until maturity are sold during this period. But in their view, this deals more with presentation and disclosures than anything else.⁷
- B.23 Some argue that having an understanding of how different business models combine assets, or assets and liabilities, in order to create value for shareholders, suggests that the business model may be a helpful notion in selecting a relevant unit of account for financial reporting purposes.
- B.24 In their view, this could help to address some of the existing inconsistencies in present IFRS on this topic. They observe that where the unit of account is defined, it sometimes seems to be based on a business model notion, and sometimes not. They note that examples of the first can be found in the hedge accounting requirements in IAS 39 *Financial Instruments: Recognition and Measurement*, where qualifying hedge items can be a group of assets or liabilities, next to individual items. The notion of the business model is, in their view, also observable in the recent IASB deliberations on the unit of account in the *Insurance Contracts* project, where it is defined on the level of portfolios, i.e. a group of contracts that are, among others, managed together as a single pool. An example where the business model notion is, in their view, ignored is in defining the unit of account in IAS 16 *Property, Plant and Equipment*, which allows an accounting policy choice, but the elected policy has to be applied to an entire class of assets, irrespective of their use by the entity.
- B.25 Many also note that a change in the entity's business model is a significant event, because it implies a change in how assets and liabilities are used in the cash flow generation process, i.e., when and how gains and losses are recognised and reported. Therefore, it is necessary to inform users of this change and the impact on future cash flows. Presenting assets and liabilities as if nothing happened deprives users from information that is directly relevant to how they should assess future cash flows. Assessing the impact of management's decision to change business models is also useful from a stewardship perspective.

⁷ The discussion on presentation and disclosures will be included in a future Bulletin on Performance reporting.

B.26 However, others argue that accounting standards that allow different methods of accounting based on the business model do not lead to better predictive or confirmatory value. To them, this introduces increased subjectivity, which harms the ability of investors to predict future cash flows and to assess stewardship. For example, measuring assets and liabilities based on the business model instead of on objective external information results, in their view, in biased information. Such a bias, they claim, fails to capture the cash flow potential that has been created or destroyed by the entity, in designing its business model. Therefore, no financial performance can be reliably depicted.

B.27 At the same time, they do not deny that proper understanding of a business model and its impact on future cash flows has relevance. But, in their view, entities have the ability to explain or provide supplemental disclosures, if they believe that reported financial results do not reflect their business model. The primary financial statements should, however, not be based on entity-specific information such as the business model.

Does financial reporting based on the business model notion provide faithful representation of economic phenomena?

B.28 The second fundamental qualitative characteristic in the *Conceptual Framework* is faithful representation. The requirement is that financial information must faithfully represent the phenomena that it purports to represent. To be a perfectly faithful representation, a depiction needs to be complete, neutral, and free from error (QC12). In applying these characteristics most efficiently and effectively, relevance is assessed first and faithful representation second (QC18). This is also the sequence of our analysis.

B.29 Those who oppose the view that the information presented in financial statements needs to reflect and respond to the business model consider that this brings bias in financial reporting and is therefore undermining neutrality in financial statements. In other words, it creates a conflict with faithful representation. In their view, accounting standards should focus on contractual and economic terms of each individual resource in order to determine the rights and obligations of the entity involved in it. The focus on rights and obligations associated with the resource would provide, they claim, a more objective and neutral manner to assess future cash flows.

B.30 In contrast, those who promote the relevance of the business model notion believe that reflecting the business model of an entity is enhancing faithful representation of economic phenomena. Where the business model has an influence on an entity's cash flow generation from assets and liabilities, this business model is part of an entity's economic reality. Reflecting financial information on a basis that is not aligned with the entity's business model is failing to be faithfully representative, as it portrays the assets and liabilities, income and expense, as if they were held and generated in an entity different from the reporting entity. They strongly believe that financial information should be prepared from the perspective of the entity, and that ignoring the accounting consequences of the business model is not providing a faithful representation.



Does financial reporting based on the business model notion provide information that is comparable?

- B.31 Comparability enables users to identify and understand similarities in, and differences between, items (QC21). Introducing different bases for the recognition, measurement and presentation of assets, liabilities, income, and expenses, based on the business model, raises the question of whether such approach could lead to financial reporting that lacks the necessary level of comparability.
- B.32 The dividing line between proponents of, and opponents to, the business model being reflected in the primary financial statements seems to be drawn by a different understanding of comparability.
- B.33 As highlighted before, those who oppose the business model and the use of entity-specific information believe that this introduces bias in the way the financial position and performance of an entity are reported, and therefore make comparisons between entities difficult. The desirable level of comparability is reached, they believe, if financial reporting requirements mandate that potential economic benefits that can be derived from rights or sacrificed from obligations are shown, irrespective of the entity that holds them. Assessing whether the business model an entity has adopted makes it more or less profitable than it would be if it had adopted another model, is part, they contend, of the analysis investors want to undertake themselves. In addition, they believe that, as there is no clear definition of the business model and it can be understood differently by different stakeholders, this makes it even more difficult to understand the financial information based on such model.
- B.34 Supporters of the business model hold the view that such approach to comparability is more akin to calling for uniformity, rather than comparability. Comparability is also about accounting differently for dissimilar activities and events, not just dissimilar transactions. Ignoring the effects of the business model is, in their view, misleading to users as it makes investors expect that future economic benefits will arise or be sacrificed as they are reflected in the primary financial statements, although there is observable evidence and knowledge that the pattern of economic benefits will behave quite differently.
- B.35 Their support for the business model is therefore not based on a trade-off between relevance and comparability, where relevance would be given priority at the cost of a loss of comparability. On the contrary, they believe that reflecting the business model enhances comparability, as the way assets and liabilities are used in the value creation process is one of their economic features. Ignoring that feature is misleading as it presents the deployment of assets and liabilities as quasi-similar although, in reality, they will generate quite different streams of cash flows or be subject to different risk exposures.
- B.36 Finally, proponents of the business model point out that its application makes financial statements of entities with similar business models more comparable, assisting in, for instance, comparisons between companies within certain industries.

Does financial reporting based on the business model notion provide information that is understandable?

- B.37 Understandability deals with the clear and concise classification, characterisation and presentation of information on economic phenomena (QC30). In that sense, it is clearly linked to the qualitative characteristics discussed before: information that is relevant, faithfully represents economic phenomena, and enables comparison should also be understandable. Because of this linkage, much of the discussions presented above in favour of, or against, the use of the business model in financial statements is applicable to the qualitative characteristic understandability as well and are not repeated.
- B.38 Some argue that it is difficult to imagine how a dialogue between investors and management on the financial statements could be fruitful, if it did not have a primary focus on the results of the business model. To take part in such a dialogue, users need to understand the business, how the business has performed, and how this performance has been affected by various factors (both those within and outside the control of management). In other words, they need to know the business model. Only with this information can meaningful discussions take place on whether management has effectively implemented the business model in the past, on the options for the future, and how the entity could or should respond to new opportunities and challenges.
- B.39 Others argue that, while agreeing with the need for users to know the business model, this does not, automatically, mean that this notion should play a role in the financial statements themselves. Often companies present such information outside the financial statements, such as in the management commentary. They state that, to understand the financial statements, users also need to look (and do look) at the other parts of financial reporting.
- B.40 While acknowledging the fact that information about the business model is often presented outside the financial statements, another group of commentators argue that non-incorporation of the business model in the financial statements stimulates the use of non-GAAP measures to communicate with investors. This refers to those key performance indicators which are not easily derived from financial statements or which cover different sets of data. They argue that such measures also include performance indicators that reflect an entity's business model, i.e. which are relevant to the context in which the entity operates and result in understandable information. For example, if net income reflects gains and losses that will not materialise in an entity's cash flow generation in the ordinary course of business, management would need to set up its own performance indicator to eliminate those gains and losses in its communication to investors, a sign that the information contained in the financial statements is not easily understandable. In other words, ignoring the role that the business model should play in the financial statements harms understandability.



Our tentative view

B.41 In our view, the business model should play a role in financial reporting, including the financial statements. Not doing so results in less relevant information, does not lead to a faithful representation of economic reality, harms comparability, and makes the financial statements less understandable. For this reason, the business model notion should be incorporated in the IASB literature. Some implications of this view are presented hereafter.



BUSINESS MODEL VERSUS MANAGEMENT INTENT

B.42 However, before discussing the implications, we discuss the similarities and differences between the business model and management intent, an issue which has been debated extensively in the academic literature.

B.43 An important similarity between the two notions is that they are both entity-specific, i.e., the financial statements reflecting the business model and management intent both present what actually happened and how the entity made or lost money. In other words, the financial statements provide information that is useful for an assessment of management's accountability, or stewardship.⁸ The resulting information therefore meets the relevance criterion, since it has the predictive value discussed in paragraph B15.

B.44 Both business model and management intent are also verifiable, if they are documented on the necessary level of detail.

B.45 Some take these similarities one step further and argue that the business model is the same as management intent, or that the two notions are connected, at least for purposes of financial reporting.

B.46 In their view, IFRS 9 demonstrates that the idea of a business model is intended to capture the idea of management intent. That is, management has goals and objectives and would take actions to achieve them. Second, the logic of profit-seeking behaviour dictates a link between management's intent for a given item and actions taken with regard to that item to generate profits. They also note that financial reporting is applied at the level of individual items or arrangements, so it is the intention of management with individual assets and liabilities that needs to be reflected in the financial statements.

B.47 Others challenge these views. They believe an important distinction is that a business model can be observed by the users of the financial statements in terms of cash flow generating and by assessing past and current transactions, which, in their view, is not, the case for management intent.

⁸ Accountability/stewardship is discussed in the Bulletin *Accountability and the objective of financial reporting*, issued in September 2013.

B.48 They also point out that management intent relates to future actions that cannot be observed. Furthermore, they argue that management intent relates to the actions of individuals, and is more relevant at a transactional, asset or liability level. It is more volatile, since management intent can be changed from one day to another. In contrast, business models are more predictable, do not change frequently, and, if it occurs, the consequences are presented and explained as a major event.

B.49 For this reason, they conclude, financial reporting under the business model results in more reliable information.

Our tentative view

B.50 In this Bulletin, we take the tentative view that there is a distinction between business model and management intent. Both notions provide relevant information, but business models tend to focus on the larger picture, are, generally, more stable, and usually require much less documentation to make them verifiable.

B.51 We also think that financial reporting should portray the business model in order to faithfully represent the economic reality of the reporting entity, since it focuses on the actual past and current transactions and events. Therefore, once the business model is identified and observed, the accounting treatment related to a business model should be derived from the business model.

IMPLICATIONS OF THE BUSINESS MODEL NOTION FOR FINANCIAL REPORTING UNDER IFRS

Playing a role in the Conceptual Framework

B.52 As indicated above, EFRAG, the ANC, the ASCG, the OIC and the UK FRC hold the tentative view that the business model should play a role in financial reporting. We are not convinced by the arguments of those who oppose that view, as we believe that financial statements that are consistent with other parts of corporate financial reporting are likely to support the most effective communication between management and investors and provide more useful information.

B.53 We do not believe, however, that the current status quo, i.e. the business model being referred to in financial reporting requirements only on an ad hoc basis, explicitly or implicitly, at standards level should be maintained. As a consequence, we support the development of a proper rationale as part of the *Conceptual Framework*, with appropriate guidance for standard-setting purposes.

B.54 Such guidance would help identify whether and when the business model of an entity should be taken into account on individual standards level. The *Conceptual Framework* should also require that the business model be based on observable and verifiable evidence.

B.55 If the business model approach is applied, its meaning would need to be described in the *Conceptual Framework* and in individual accounting standards that use the term.

B.56 Furthermore, all standards must be capable of representing faithfully the business model or models. Where applicable, the business model may need to be explicitly incorporated on a standard-by-standard basis, to operationalise the concept in a specific situation.

B.57 Additionally, the *Conceptual Framework* should highlight and illustrate how the business model can play a role in recognition, measurement, and presentation and disclosures at standard level. Some suggestions are presented hereafter.

Playing a role in recognition

B.58 If the business model plays a role in recognition, an item could be an asset for some entities and not recognised by others. An example can be found in IAS 39, paragraph 5, which states that the standards should be applied to “contracts to buy or sell a non-financial items that can be settled net in cash ... with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity’s expected purchase, sale or usage requirements.” This means that a contract to receive an amount of coal is a non-recognised executory contract for an energy producer, but a recognised financial instrument for a commodities trader.

Playing a role in measurement

B.59 Measurement (and the related accounting policy choice) is an obvious place where the business model can play a role, because current IFRS require, or permit, different measurement requirements depending on how an asset or a liability, or a group of assets or liabilities, contribute to the entity’s cash generation. This is illustrated by the ‘cotton’ example, presented before: under one business model, cost is used as the measurement basis, and under another model fair value accounting is applied with immediate recognition of the gain in profit.

Playing a role in presentation and disclosures

B.60 The discussion above has emphasised the relevance to investors of how assets and liabilities are combined and used in an entity’s activities. This requires a disclosure of the entity’s business model(s), although such disclosure would often be presented outside the financial statements. Measuring, but also presenting assets, liabilities, income and expenses in such a way that investors can understand how they contribute to the entity’s cash flow generation can in itself be a way of representing the entity’s business model. Segregating assets and liabilities which play a different economic role in the entity, for example helping provide optimum daily cash management versus creating liquidity for acquisitions and capital expenditures, would provide users with both a better basis for looking at currently reported financial results and forming expectations of future financial results.

B.61 To a certain extent, this was the approach presented in the IASB-FASB joint project on *Financial Statements Presentation*, which proposed that separation be made into operating, investing and financing activities, based on the nature of the assets and liabilities but also on the economic role they played in the activities of the entity. These underlying principles were widely welcomed (although constituents active in the financial services industry commented that such distinction was not always easy to make), and such a presentation was supportive of more meaningful sub-totals and performance indicators, such as operating profit.

B.62 The business model could also play a role in distinguishing between net income and other items of comprehensive income. This was considered in EFRAG and ICAC *PAAinE paper on Performance Reporting* in March 2009, and is discussed in a future Bulletin on Performance Reporting.

We would welcome views on any of the points addressed in this Bulletin.

In particular:

- (i) Do you think that our assumed meaning makes sense from a financial reporting perspective?
- (ii) Do you support the tentative view that management intent and business model are distinct?
- (iii) Do you support the tentative view that the business model should play a role in financial reporting?
- (iv) Do you support the proposed implications for the IFRS literature?
- (v) Do you have any other comments on this Bulletin?

Comments should be addressed to: commentletters@efrag.org, so as to be received before 30 September 2013.

Questions to constituents

The Bulletin invited comments on certain questions related to the role of the business model in financial reporting. We are not asking again for comments to those questions; however, this Research Paper includes some additional questions.

EFRAG, the ANC and the FRC invite comments on all matters in this Research Paper, particularly in relation to the questions set out below. Comments are more helpful if they:

- a) Address the question as stated;
- b) Indicate the specific paragraph reference, to which the comments relate; and/or
- c) Describe any alternative approaches EFRAG, the ANC and the FRC should consider.

All comments should be received by 31 May 2014.

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?

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?

Chapter 3 also includes examples of business models and raises recognition and measurement issues for each example with alternative views.

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?

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?

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?

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?

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.

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?

Chapter 1 – Background

WHY ARE WE UNDERTAKING THIS PROJECT?

- 1.1 EFRAG, the French and the UK accounting standard setters have undertaken this project in partnership to examine the role of the business model in financial reporting. There is increasing attention and discussion about the role an entity's business model should play in financial reporting. Divergent views exist about whether financial reporting should reflect an entity's business model and how this should influence the development of future accounting standards and the selection of accounting policies adopted by entities.
- 1.2 The primary focus of this project is within the context of IFRS, but this debate could be wider and apply to all accounting standard setters. Since this project aims at influencing the thinking of accounting standard setters, it was agreed that its scope should be only the financial statements, i.e. the primary financial statements and notes to the financial statements, and not the whole of financial reporting. The IASB's remit is generally limited to financial statements where IFRS is required and information in other parts of financial reports is often mandated by national authorities.
- 1.3 EFRAG and the standard setters from France, Germany, Italy and the United Kingdom recently issued a Bulletin titled *The Role of the Business Model in Financial Reporting*, presented in the beginning of this paper. The Bulletin was part of a series to promote discussion on topics related to the IFRS *Conceptual Framework* debate. It was prepared on the basis of a draft of this Research Paper, includes tentative views, and served to provide early input to the IASB discussions on a new *Conceptual Framework*, for instance at the first meeting of the Accounting Standards Advisory Forum (ASAF) in April 2013. This Research Paper provides further context, background, and details underlying and complementing the contents of the Bulletin. The paper has, however, been written as a standalone document and does not include tentative views. It does include several parts of the Bulletin. It also includes some additional questions to constituents.
- 1.4 With increasing frequency, Exposure Drafts and Discussion Papers are criticised on the grounds that the proposals do not reflect an entity's business model. Some of those comments are provided later in this Research Paper. It is important to understand those criticisms, and therefore to understand what is meant by those who use the term 'business model'.
- 1.5 The term 'business model' was explicitly introduced in 2009 in IFRS 9 *Financial Instruments* but that standard did not specifically define the term. That was the first time the term was used in an accounting standard issued by the IASB.⁹ The term was used a second time by the IASB when it issued amendments to IAS 12 *Deferred Tax: Recovery of Underlying Assets* in late 2010 in reference to investment properties. Some also suggest the business model has been implicit in several earlier standards.

⁹ All existing IFRS (including the *Conceptual Framework*) are included in IASB (2012b).

- 1.6 There are many notions of what a business model could be but there is no universal understanding. It seems clear that the term ‘business model’ is a vague and ambiguous notion to some. Therefore, it is important to be precise as to what is meant by the term when it is used. This Research Paper does not aim to define the term but rather look at how the term has been used and identify some common characteristics that could then be used to further explore the role the business model plays in financial statements.
- 1.7 Some contend that the business model should determine recognition and measurement in certain situations. They believe that the same transaction should be treated differently depending on the entity’s business model. They believe the linking of recognition and measurement to the business model provides better information to users and improves financial reporting. Others believe the same transaction should always be recognised and measured the same way regardless of an entity’s business model. Some have concerns that comparability will be lost if entities account for transactions, assets and liabilities differently because of their business models.
- 1.8 According to the IASB’s *Conceptual Framework* (the ‘Framework’) comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items. Comparability is not uniformity, but like things must look alike and different things must look different. Some are concerned that comparability could be compromised if the business model is used to determine an accounting treatment. Others argue that an increased role of the business model in financial reporting could enhance comparability.
- 1.9 Under current practice, entities use different accounting for similar transactions. For example, suppose an entity purchases a quantity of cotton for €100. It still owns the cotton at the reporting date, when it is worth €120 (and the entity could readily sell it at that price). If the entity is a shirt manufacturer and will use the cotton in its operations, current practice would be simply to report the cotton as ‘inventory’ at its cost of €100. But if the entity is a commodity trader that seeks to make profit from short-term price movements, that accounting may not reflect fairly the entity’s asset or financial performance: current practice reflects this view by stating the asset at its current value of €120, with the gain of €20 included in profit. There are further possibilities: if the transaction is a non-recurring speculation that is outside the normal activities of the company, it would probably have to be separately presented, whatever the accounting treatment. Thus, the nature of an entity’s business may affect the measurement of assets, the reporting of profit and presentation.

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- 1.10 Many respondents to various IASB proposals believe that the objective of a proposed standard is also to contribute to the faithful presentation of the performance of entities. Hence, they believe that financial results need to be presented and measured in a way that predicts the performance of an entity and its ability to generate future cash flows. Most of those commentators believe that it is of paramount importance for the IASB and other standard-setting bodies to start a proper debate on fundamental issues related to financial statements such as (i) the notion of performance and its relationship with business models, (ii) the content of performance statement(s), (iii) the principles that would underpin other comprehensive income, and (iv) recycling. As part of this debate, they believe that thorough research should be carried out to determine what information is most important as a basis for meaningful communication to users and what information is needed for an analysis of an entity's performance.
- 1.11 Some believe that the Framework has given primacy to the definitions of the notions of assets and liabilities by using a balance sheet approach. They think that such an approach reduces the relevance and understandability of the income statement on which most users continue to rely on, and that the income statement should be given primacy. They further point out the Framework lacks an autonomous definition of income and expense. Financial statements of course include more than just the balance sheet. The income statement and statement of cash flows need to have an equal position for both accounting standard setters and users of financial statements.¹⁰
- 1.12 In this paper, we explore whether the concept of the business model is a relevant consideration for financial reporting. We discuss a number of areas later in this Research Paper where that seems to be the case. There will, of course be other factors beside the business model that need to be considered in achieving an accounting solution: the intent is to draw attention to possible implications of taking the business model into account. The question we seek to explore is whether assisting users to assess the performance of the business model will assist them to have a better understanding of an entity and its performance and how the business model could be used by accounting standard setters.
- 1.13 We do not claim that presenting information about the business model should be the sole aim of financial reporting. Entities often have assets and liabilities, enter into transactions and are affected by economic events that do not relate to the business model, but which nonetheless need to be reported in financial statements if they are to give a complete account of the entity's financial performance and position.
- 1.14 Nevertheless, financial reporting is intended to reflect economic performance and the economic position of entities. The business model is a notion that arguably deals with economic phenomena and so it needs to be explored, which is the intention of this paper.

¹⁰ In September 2013, EFRAG and its partners issued another Bulletin: *The Asset/Liability Approach*.

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- 1.15 In the next chapter, we discuss the objective of financial reporting in the context of the existing Framework. We look at the explicit emergence of the term in IFRS 9 and at some of the comment letters received by the IASB that referenced the business model in order to better understand the existing criticisms of IFRS. Later in the chapter, we consider whether there was an implicit use of the notion in earlier standards.
- 1.16 In chapter 3 of this paper, we propose to focus on value creation and cash flow generation as an assumed meaning of the business model and explore some examples of business models both inside and outside the financial industry. We discuss the potential financial reporting implications of those business models with respect to recognition and measurement, particularly exploring whether the same transaction could be accounted for differently based on the business model.
- 1.17 In chapter 4, with the assumed meaning of chapter 3, we present the arguments both supporting and opposing to the use of the business model in IFRS.
- 1.18 In chapter 5, we consider the broader implications the business model could have on financial reporting, including the Framework. We also discuss certain implications for specific accounting treatments.

Chapter 2 – The Business Model in IFRS

In this chapter, we look at how the term ‘business model’ has emerged in recent IFRS and consider whether the notion was also implicitly used in earlier accounting standards. Before doing this, we first discuss the objective of financial reporting in the Framework in order to highlight some of the important aspects of the debate about the notion’s role in financial statements. We come back to the Framework later in chapter 4 as the implications of the business model for financial statements are debated.

OBJECTIVE OF FINANCIAL REPORTING

- 2.1 The Framework specifies that the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity (OB2). The decision makers on which the Framework focuses cannot require reporting entities to provide information directly to them and must rely on general-purpose financial reports for much of the financial information they need. These primary users need information to help them assess the prospects for future net cash inflows to an entity, which is the (quantitative) basis for their expectations about their returns on their investments.
- 2.2 To assess an entity’s prospects for future cash inflows, existing and potential investors, lenders and other creditors need information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity’s management and governing board have discharged their responsibilities to use the entity’s resources. Many accounting standards use a balance sheet approach and some argue the balance sheet approach diverts attention away from operations. They believe it implies that changes in asset and liability values are more important than results of operations. In contrast, they believe the income statement approach to financial reporting is, by its nature, more aligned with operations. Often an entity might focus more on profits and the generation of cash flows than on the balance sheet. Generally, when entities prepare budgets and forecasts they usually prepare projected income and cash flow statements, but might be less likely to forecast a balance sheet. Perhaps some calls for using the business model are attempts to bridge the difference in focus between both approaches to financial reporting.
- 2.3 It is clear that the Framework has a ‘decision-usefulness for capital providers’ focus. The term stewardship is not used in the Framework. Instead, there is a description of what stewardship captures. Accordingly, the objective of financial reporting acknowledges that users make resource allocation decisions as well as decisions as to whether management has made efficient and effective use of the resources provided.

- 2.4 That objective by itself leaves a great deal to judgement and provides little guidance on how to exercise that judgement. The Framework describes the first step in making the judgements needed to apply that objective. It identifies and describes the qualitative characteristics that financial information should have if it is to meet the objective of financial reporting. It also discusses cost, which is a pervasive constraint on financial reporting.
- 2.5 The IASB and the FASB completed the first phase of their joint project to develop an improved Framework for IFRS and US generally accepted accounting practices in 2010. The 2008 Exposure Draft of the improved Framework contained a reference to the business model (OB 23): ‘Capital providers use information about cash flows to help them understand an entity’s business model and operations, evaluate its financing and investing activities, assess its liquidity or solvency, or interpret information provided about financial performance.’¹¹ However, the reference to an entity’s business model was not included in the final version.
- 2.6 The IASB’s recent Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* records that the IASB’s preliminary view is that financial statements can be made more relevant if the IASB considers, when it develops or revises particular standards, how an entity conducts its business activities (9.32).¹² It provides some examples where that is relevant to the issues addressed in the Discussion Paper. However, it does not propose that the business model should be explicitly reflected in the Framework.
- 2.7 An important aspect of the debate about the business model is whether the same transaction should be accounted for differently because of the business model. In connection with the Framework, most support a Framework that provides a principles-based set of accounting standards. One side of the debate might argue that accounting for the same transaction similarly is always more principles-based whilst others might argue that accounting for differences based on a business model is also consistent with a principles-based notion.



THE EXPLICIT EMERGENCE OF THE TERM IN IFRS 9 AND OTHER ACCOUNTING REFERENCES

- 2.8 The term ‘business model’ was explicitly introduced in IFRS in 2009 when the IASB issued IFRS 9 *Financial Instruments*. IFRS 9 requires classification and measurement of financial assets based on an entity’s business model. Paragraph 4.1.1 of IFRS 9 states:

‘Unless paragraph 4.1.5 applies, an entity shall classify financial assets as subsequently measured at either amortised cost or fair value on the basis of both:

- (a) The entity’s business model for managing the financial assets and
- (b) The contractual cash flow characteristics of the financial asset.’

¹¹ IASB (2008b).

¹² IASB (2013).

2.9 Paragraph 4.1.2 states:

- ‘A financial asset shall be measured at amortised cost if both of the following conditions are met:
- (a) The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.
 - (b) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.’

2.10 Although IFRS 9 does not contain a definition of the term ‘business model’, it does contain some implicit assumptions about its meaning. For example, in BC4.15 of IFRS 9, the IASB states:

‘The Board concluded that an entity’s business model affects the predictive quality of contractual cash flows—i.e. whether the likely actual cash flows will result primarily from the collection of contractual cash flows. Accordingly, the exposure draft published in 2009 proposed that a financial asset should be measured at amortised cost only if it is ‘managed on a contractual yield basis’. This condition was intended to ensure that the measurement of a financial asset provides information that is useful to users of financial statements in predicting likely actual cash flows.’

2.11 The above implies that the IASB views the business model based upon how assets (liabilities) are managed. Then the IASB goes on to say in BC4.19:

- ‘...the Board clarified the condition by requiring an entity to measure a financial asset at amortised cost only if the objective of the entity’s business model is to hold the financial asset to collect the contractual cash flows. The Board also clarified in the application guidance that:
- (a) It is expected that an entity may sell some financial assets that it holds with an objective of collecting the contractual cash flows. Very few business models entail holding all instruments until maturity. However, frequent buying and selling of financial assets is not consistent with a business model of holding financial assets to collect contractual cash flows.
 - (b) An entity needs to use judgement to determine at what level this condition should be applied. That determination is made on the basis of how an entity manages its business. It is not made at the level of an individual financial asset.’

2.12 Later in BC4.20 and BC4.21 the IASB states:

‘The Board noted that an entity’s business model does not relate to a choice (i.e., it is not a voluntary designation) but rather it is a matter of fact that can be observed by the way an entity is managed and information is provided to its management. For example, if an investment bank uses a trading business model, it could not easily become a savings bank that uses an ‘originate and hold’ business model. Therefore, a business model is very different from ‘management intentions’, which can relate to a single instrument. The Board concluded that sales or transfers of financial instruments before maturity would not be inconsistent with a business model with an objective of collecting contractual cash flows, as long as such transactions were consistent with that business model, rather than with a business model that has the objective of realising changes in fair values.’

- 2.13 IFRS 9 is of course about financial instruments. This Research Paper looks at the business model not just in terms of financial instruments or a single industry but more broadly. In the discussion in BC4.20 and BC4.21 above, some may suggest that a business model might be similar in some respects to a segment. An operating segment is defined very differently in IFRS 8 *Operating Segments* (Appendix A) than IFRS 9's description of the business model. However, in looking at the example in BC4.21, if an entity owned and operated both an investment bank and a savings bank under two different business models the entity might also disclose two segments for financial reporting.
- 2.14 The November 2012 Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9* (4.1.2A) also contains the business model assessment and introduces the 'fair value through other comprehensive income' measurement category for financial assets that contain contractual cash flows that are solely payments of principal and interest.¹³ The Exposure Draft also proposes application guidance on how to determine whether the business model is to manage assets both to collect contractual cash flows and to sell.
- 2.15 The term 'business model' has also been used in other standards that go beyond financial instruments. Amendments to IAS 12 *Income Taxes* that were issued in 2010 also included the term 'business model'. It is stated in paragraph 51C:
- 'If a deferred tax liability or asset arises from investment property that is measured using the fair value model in IAS 40, there is a rebuttable presumption that the carrying amount of the investment property will be recovered through sale. Accordingly, unless the presumption is rebutted, the measurement of the deferred tax liability or deferred tax asset shall reflect the tax consequences of recovering the carrying amount of the investment property entirely through sale. This presumption is rebutted if the investment property is depreciable and is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the investment property over time, rather than through sale.'

¹³ IASB (2012a).

2.16 The IASB explained its use of the term in BC23:

‘After considering the responses to the exposure draft, the Board reworded the rebuttable presumption so that clear evidence would not be required to rebut it. Instead, the presumption is rebutted if an asset is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the investment property over time, rather than through sale. Many respondents were concerned that, because clear evidence is an ambiguous term, the requirement to gather clear evidence would have been onerous for entities that have no problem applying the existing principle in IAS 12, and could have led to abuse by entities that choose whether to gather clear evidence to achieve a favourable result. The Board chose to use the term ‘business model’ because it is already used in IFRS 9 *Financial Instruments* and would not depend on management’s intentions for an individual asset. Many respondents were concerned that the presumption would lead to inappropriate results in some cases because it would not be rebutted if a minor scrap value would be recovered through sale. The Board also reworded the rebuttable presumption in order to respond to those concerns. The Board also made it clear that the presumption of recovery through sale cannot be rebutted if the asset is non-depreciable because that fact implies that no part of the carrying amount of the asset would be consumed through use (see paragraph BC6).’

2.17 It should be pointed out that the term was used in IAS 12 in reference to an area of accounting that has industry-specific accounting requirements rather than a broad application.

2.18 The term business model has also been used in the Basis for Conclusions of other Exposure Drafts issued by the IASB as justification of some of their proposals. In the Exposure Draft *Insurance Contracts* (November 2010) the term was used in the Basis for Conclusions.¹⁴ In BC 109 (a) of that Exposure Draft, the IASB argued that the resulting measurement of its proposal would:

‘convey useful information to users about the amount of risk associated with the insurer’s insurance contracts because the management of risk is integral to the insurance business model.’

2.19 The IASB also included the term in the 2011 Exposure Draft *Revenue from Contracts with Customers* (BC 65 and BC 263).¹⁵

2.20 The IASB did not define the term in any of the Exposure Drafts and the implicit meaning sometimes seems to depend on the context in which the term is used. In the case of IFRS 9, the implied meaning is based on how (financial) assets and liabilities are managed. There is also a constraint placed in IFRS 9, such as the ‘solely payment of principal and interest’ test. For other Exposure Drafts that use the term ‘business model’ it is not clear whether the term means the same thing.

¹⁴ IASB (2010).

¹⁵ IASB (2011b).



COMMENT LETTERS TO THE IASB

2.21 Respondents to the recent IASB proposals often refer to the ‘business model’ concept. The references are made either to welcome the consideration by the IASB of the business model when new proposals are developed, or criticise the IASB when respondents believe that the Board had not considered the business model in the proposals. It is often not clear what meaning respondents imply when they use the term business model. In other cases, they identified and described distinct models in order to show how the business model should play a role when the IASB is considering the various accounting proposals.

2.22 While many respondents often welcomed the introduction of the term to accounting proposals, some expressed concern about using such a term in accounting standards. For example, the CFA Institute responded to the IASB’s proposal that led to IFRS 9 by stating:

‘A possible unintended consequence of designating instruments as being managed on a contractual yield basis is that the business model definition may be influenced by the accounting requirements. We maintain that the accounting should simply reflect the underlying business performance. The Board appears to have formally developed a business model rationale that exists for reporting purposes rather than a business model that is a rational outcome of economic verities.’

2.23 This of course is at the heart of the debate about the role of the business model has in financial reporting. As already mentioned, some are concerned about comparability in financial reporting if the business model is used in IFRS. Others argue that the use of the business model in IFRS will enhance IFRS by better aligning financial reporting with the business.

2.24 KPMG in responding to the IASB proposal on financial instruments pointed out the need for clarity when using terms that can have more than one meaning:

‘We support the underlying rationale in the ED that amortised cost measurement is decision-useful when the instrument is a loan that pays only principal and interest and the entity’s business model primarily involves holding the instrument to pay or receive those cash flows. However, we believe that these principles require clearer expression and refinement in order to be capable of reasonable and consistent application.’

- 2.25 The term has been used with increasing frequency in debates about accounting proposals on a variety of topics. Even where the term ‘business model’ is not used in an accounting proposal, some constituents of the IASB are increasingly using the term in their responses to the IASB to either criticise or support a position. For example, in the August 2011 Exposure Draft *Investment Entities* the IASB did not use the term.¹⁶ The Exposure Draft proposed that an investment entity should be required to measure investments in entities that it controls at fair value through profit or loss in accordance with IFRS 9 rather than to consolidate such investments. Thus, the Exposure Draft proposed to create an exception to the principle of consolidation in IFRS 10 *Consolidated Financial Statements* and thereby responded to the long-standing concern raised by many, including users of financial statements, that the consolidation of investments in controlled entities by investment entities does not provide information as useful as the information that would be provided by measuring the investments at fair value through profit or loss. Those proposals were in October 2012 confirmed by the IASB by issuing the document *Investment Entities (Amendments to IFRS 10, IFRS 12 and IAS 27)*.
- 2.26 Some respondents to that proposal used the term in their comment letters and stated that it is important that financial information be consistent with the business model. However, it was not always clear what those respondents meant when they used the term. In some cases, it was difficult to understand the comments because the rationale provided in some comment letters was that a certain outcome reflects the business model without further explanation.
- 2.27 Others use the term business model in their comment letters and do include a certain context as to what they mean by the business model. These meanings may vary from one entity to the next and from one accounting issue to the next. The term business model was eventually included in the final version of IFRS 9.
- 2.28 The accounting debate about the business model notion is more challenging to follow without a clear understanding of the meaning of the term and the specific reasons or logic as to why one alternative better reflects a business model. Some argue that the term business model is being used as a substitute in debates for more reasoned arguments of why one measurement attribute is preferable over another. In any case, the debate on business models is closely linked to the debate on recognition and measurement bases.
- 2.29 The term business model has now been injected into several debates related to accounting proposals that deal with contentious measurement issues such as when fair value should be used. Some could argue that using the business model enhances that debate. Others argue that use of the term business model hinders the debate in part because of the vagueness surrounding the term.

¹⁶ IASB (2011a).

THE BUSINESS MODEL NOTION IMPLICITLY USED IN IFRS?

2.30 The business model is already implicitly used in IAS and IFRS that pre-date IFRS 9. Although the term ‘business model’ was not used at the time when these accounting standards were issued, there are several provisions in specific standards that suggest that accounting standard setters had implicitly felt that it was necessary to take the notion into account. Perhaps the most noteworthy of these standards is IFRS 8.

IFRS 8 Operating Segments

2.31 IFRS 8 defines an operating segment as a ‘component of an entity that engages in business activities from which it can earn revenue and incur expenses.’ It further requires that discrete financial information is available about the operating segment and that the results of the operating segment are regularly reviewed by the chief operating decision maker to make resource allocation decisions.

2.32 A segment is often not at the same level as the entity as many reporting entities have multiple segments. An entity with more than one business model is likely to have them in different segments. Reporting entities discuss operating segments narratively within their annual reports and financial information about operating segments is included in the notes to the financial statements. Some reporting entities base their discussion on the geographic distinctions of their operating segments. Other reporting entities discuss their operating segments based on the products and services of that component of the entity. Some entities discuss their operating segments based on both.

2.33 It is difficult to find any reporting entity that explicitly described business models in their IFRS 8 segment disclosures. However, the logic is that if an entity has a business model, the chief operating decision maker that allocates resources would want to know if the business model is performing as intended. It seems that if an entity had a business model it would have internal reporting information and processes designed to measure the performance of the business model. This raises the question as to whether a business model could be linked to or based on a similar or the same notion as a reporting segment.

Interaction between accounting standards

2.34 There are other ways in which the business model could be implicitly used currently in IFRS. IFRS in some cases provides a choice to the reporting entity in which standard applies to a transaction. The choice that is likely the most common is when entities acquire non-financial tangible assets. In certain situations, the accounting for tangible asset would be determined by IAS 2 *Inventories*, in other situations it would be determined by IAS 16 *Property, Plant and Equipment*.



Specific standards

2.35 Another way the business model could be implicit in IFRS is based on choices contained in some standards. There are several standards in IFRS that provide measurement choices for reporting entities. These choices could be viewed as dependent on the business model of the entity. We describe some of these standards below for illustrative purposes to show how a standard may have implicitly used the business model notion.

IAS 2 Inventories

2.36 One example where the business model could have been implicit in a standard can be found in IAS 2 related to inventories, which was first issued in 1975. IAS 2 generally requires inventories to be measured at the lower of cost and net realisable value. However, IAS 2 includes an exception to this general requirement that allows commodity broker-traders to measure their inventories at fair value less cost of sale with changes in fair value less cost to sell recognised in profit or loss.

2.37 The standard justifies the different treatment for broker-trader inventories because those inventories are principally acquired with the purpose of selling in the near future and generating a profit from fluctuation in prices and trade margins. This example is similar to the one applying to financial instruments that are actively traded, which would therefore justify a similar accounting treatment. The benefit in terms of relevant representation of the performance and expected future cash flows is also the same.

IAS 17 Leases

2.38 IAS 17 was first introduced in 1982 to address leasing transactions. Under that standard, a lease is classified as either an operating lease or a finance lease by the lessor based on whether sufficient risks and rewards of the leased asset are retained by the lessor or transferred to the lessee. The accounting by the lessor varies significantly depending on whether the lease is a finance lease or an operating lease.

2.39 It could be argued that the business models of leasing entities are implicitly reflected in IAS 17. Some of these leasing entities are in substance selling assets and providing financing to the buyer with the leased asset as collateral for the financing. Other leasing entities may have a business model that allows them to lease short-term and retain the benefits of the leased asset for further rentals.

IAS 39 *Financial Instruments: Recognition and Measurement*

2.40 Another example of an accounting treatment that could be viewed as linked to a specific business model is IAS 39 prior to the issuance of IFRS 9. That standard was first issued in 1998 and addressed financial instruments that are actively traded. It described a trading asset as the one which:

‘...is acquired or incurred principally for the purpose of selling or repurchasing it in the near term’ or ‘...is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking...’

Although there is no specific reference to a business model notion in IAS 39, active trading is considered by many as a business model.

2.41 The accounting treatment applied to actively traded financial instruments – measured at fair value through profit and loss – has been considered by many as the most relevant accounting treatment. They believe this treatment better reflects the performance of this kind of business as the expected cash flows to be generated are closely linked to changes in market prices of these instruments. This treatment provides the best information to users in order to help them to assess the economic performance of trading activities.

2.42 The explicit introduction of the business model notion in IFRS 9 that provides for certain financial assets to be accounted for at amortised cost when ‘the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows’ could be seen as a clarification of what was already implicit in IAS 39 when the same accounting treatment was applied to financial instruments classified as ‘loans and receivables’ or as ‘held-to-maturity’.

IAS 40 *Investment Property*

2.43 IAS 40 was issued in 2000 in order to distinguish a property that is held by entities for investment purposes from the one that is intended to be occupied by the owner. Investment property is generally held for capital appreciation, rentals, or both. An investment property differs from an owner-occupied property because the investment property generates cash flows largely independently of the other assets held by an entity. Non-investment properties are generally part of a production or supply process to generate goods or services or used for administrative purposes by the entity.

2.44 IAS 40 defines two (or even three) different uses of property. These different uses may implicitly be corresponding to different business models. The standard highlights in particular that an owner-occupied property’s generation of cash flows is intrinsically linked with those of other assets used in a production process that should be considered as a whole with the contribution of the property to this process. The standard concludes that an owner-occupied property should be measured at depreciated cost less any impairment loss, which can be seen as the appropriate way of reflecting the use of the property.

2.45 Investment property is instead measured at either fair value with fair value changes recognised in the income statement, or on the same cost basis as for an owner-occupied property. These different accounting treatments between owner-occupied property and investment property have been considered by most constituents as relevant to reflect the different ways of using these assets in different types of activities. Two adjacent office buildings that are identical in every respect except that one is an owner-occupied building and the second is an investment property could be measured differently under the standard.

IFRIC 13 Customer Loyalty Programmes

2.46 IFRIC 13 was issued in 2007 and requires different revenue recognition treatments based on different circumstances. The interpretation identifies situations where an entity supplies customers with incentives to buy their products or services.

2.47 Entities can manage their own programme or participate in a programme operated by a third party. If the entity supplies the awards itself, it recognises the consideration allocated to award credits as revenue when award credits are redeemed and it fulfils its obligations to supply awards. If a third party supplies the award the entity either measures its revenue as the gross consideration allocated to the award credits and recognise the revenue when it fulfils its obligations or measures commission income based on the difference between the consideration allocated to the incentive and the amount payable to the third party supplying the incentive. The different accounting treatment depends on whether the consideration is for the entity's own account or whether it is acting as an agent for the third party.

2.48 It could be argued that the different accounting treatments are the reflection of different business models, which have a different impact on the timing and generation of cash flows.

Other standard development issues

2.49 We pointed out some existing standards where the business model could have been implicitly used. Below are several examples where some believe a standard that could have benefited from the use of the business model when the standard was first developed.

IAS 36 Impairment of Assets

2.50 The first example where a problem may have been avoided if the business model was considered when a standard was developed is IAS 36 on impairment, originally issued in 1998. A loss is recognised when the carrying amount of an asset or cash-generating unit exceeds its recoverable amount. The recoverable amount is defined as the higher of its fair value less costs to sell and its value in use.

- 2.51 Some consider that the requirement to use the higher of the two alternative values does not provide the right amount for the impairment because the standard does not consider the way the asset is used in the business model to which the asset relates. They suggest that the standard could be improved if it referred to either the fair value less cost to sell or to the value in use depending on the business model applied resulting in the asset being held for sale or for use. Others consider that the standard correctly identifies the amount recoverable from the asset, and that if the entity chooses to use the asset in a manner that recovers less, then that will correctly be reflected at the time that use is made.

IAS 41 Agriculture

- 2.52 A second example of a standard that could have benefited from the use of the business model in its development is IAS 41 on agriculture, approved in December 2000. Under IAS 41, fair value changes on biological assets are recognised in the income statement in the period in which they arise. This accounting treatment applies whether or not the biological asset has a long life process or a short process being subject to harvest.

- 2.53 Some countries that have recently adopted IFRS have raised the issue of the appropriate accounting treatment to apply to long-living biological assets. Some have argued that many biological assets are more like production tools than final products. Requests have been made to treat these assets using IAS 16 in order to better reflect the amount and timing of cash flows collected from them in the normal activity cycle of the related agricultural production.

IFRS 4 Insurance Contracts

- 2.54 Some believe there is an issue when a standard focuses on assets and liabilities in isolation without taking into account possible interactions between them in the framework of a business model. One example of this relates to assets and liabilities of insurance companies. Whilst liabilities that relate to insurance contracts are dealt with in IFRS 4 (issued in March 2004), the associated financial assets acquired by insurance companies to satisfy their insurance commitments are subject to IAS 39. IAS 39 does not take into account the way these financial assets are managed nor is it consistent with the way liabilities are treated in IFRS 4. Some believe this could result in an accounting mismatch between the two sides of an insurance entity's balance sheet that may prevent them from representing their business activity in a consistent manner.

2.55 In this example, some believe the disconnection between the way the business is managed and the accounting presentation has caused confusion and misunderstanding among users of financial statements. The IASB has developed short-term solutions to the problem and is currently undertaking a fundamental review of the related accounting provisions in order to improve the information provided. It has reopened phase 1 of IFRS 9 especially for addressing the insurance companies' issues. This raises the question as to whether the problem could have been avoided in the first place if the business model had been considered when these standards were first developed.

Questions to constituents

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

Chapter 3 – Assumed Meaning and Examples of Business Models

The prior chapter has made it clear that the business model is already playing a role in IFRS. Before we begin discussing what role the business model could have in financial reporting we try to gain a better understanding of what is meant by those that use the term ‘business model’. Depending on the meaning attached to the term, views may vary significantly as to the role it could have.

There are other terms related to a business, which also have meanings that can vary by those that use them. Often it could depend on the context in which these terms are used. Examples of such terms are ‘business strategy’ or ‘business purpose’. Like the term business model, there is no universal agreement as to its meaning of these terms. Some think that a business model and business strategy are the same thing and use those terms interchangeably. Others view the meanings of those terms as very different.

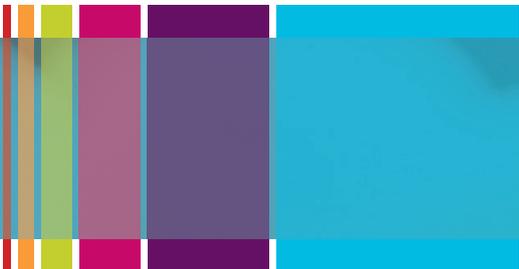
Some could think of a business model as something that operates at a very high level and reflects a broad notion of how entities within industries conduct business or add value. Others think a business model is at a lower level, such as at a cash-generating unit. A business model notion using the higher-level view could result in very similar business models between competitors in the same industry.

There are also many differences from one business to the next even within the same industry. Although nearly every business aims to add value for their owners, many of these businesses attempt to create a competitive advantage to distinguish themselves from their competitors. Based on these differences, some think of the business model as a much more specific notion of how one entity differentiates itself from its competitors.

The aim of this Research Paper is not to define the meaning of the term, but instead consider what could be some of the important underlying characteristics of a business model in order to look at its role in financial statements. There are many similarities between businesses. Nearly every business aims to add value for their shareholders or stakeholders mainly by providing products or services to customers. Users of financial statements want financial reporting to assist them in determining and understanding how successful the business has been at adding value for investors during the course of the reporting period. The first question is whether financial reporting does a good job in fulfilling this demand or whether the use of the business model in IFRS could enhance this type of information.

We reviewed academic papers on the topic in an attempt to gain a better understanding of the term. By taking a closer look at the academic literature, we found that the term has become popular only recently in the 1990s with the advent of the internet and the related interest in technology companies. Our research found that academics have not developed a widely accepted meaning of the term. A summary of this research is included in Appendix 1.

In this chapter, we also consider the role of management intent and examine some of the key characteristics of alternative meanings of the term.



ROLE OF MANAGEMENT INTENT

- 3.1 Some think that management intent plays a significant role in the business model. There is precedent in the accounting standards that support the use of management intent in certain cases. Over an extended period of time, all business activities could be viewed as determined by management intent. Most think of management intent in the context of short-term transactions or holdings of financial instruments. The intent of these transactions and holdings has already influenced standard-setting, particularly related to financial instruments. Examples include hedging transactions or whether financial instruments are entered into with the intent of trading or the intent to hold the instrument for a period of time.
- 3.2 Some mention management intent as a notion that is the substance of the business model or that it is somehow connected with business model. In fact, a 2012 paper 'Business model (intent)-based accounting' by Leisenring et al. is based upon the premise that the business model is the same thing as management intent and was written in response to the IFRS 9.¹⁷ Their paper begins with the same observation that we found in the academic literature in that there appears to be no agreed-on definition of the 'business model' in financial reporting. The paper includes an example from IFRS 9, which states that an entity would measure a financial asset at amortised cost 'only if the objective of the entity's business model is to hold the financial asset to collect the contractual cash flows.' They argue that based on this statement, it would seem that the idea of a business model is intended to capture the idea of management's intent.
- 3.3 The paper later notes that IFRS 9 attempts to differentiate management intent from an entity's business model. It concludes that the business model and management intent capture the same idea, at least for purposes of financial reporting, based on the following reasoning. First, it seems impracticable for an entity to have a business model that management does not intend to follow, and does not follow. That is, management has goals and objectives and would, by the natural operation of commercial necessity and governance practices, take actions to achieve those goals and objectives. Second, the logic of profit-seeking behaviour dictates a link between management's intent for a given item and actions taken with regard to that item to generate profits.

¹⁷ Leisenring et al. (2012).

- 3.4 In our view, one issue that underlies the business model as it relates to the debate in the financial instrument context is the lack of difference in actions or activities of the entity. A financial instrument can generally be purchased or sold like other assets. In the case of a financial instrument, it is not an asset that is physically used in the business. However, as long as the entity owns the financial instrument it can generally only do one thing with it, i.e. holds the financial instrument. When acquiring a financial instrument, the intention could be to hold the financial instrument to collect the cash flows, i.e. dividends or principal and interest. This is very different from selling or physically using an asset. In contrast, two entities purchase a similar truck. One entity uses the truck to generate revenues by providing transportation services to customers. The second entity is a retailer of trucks and holds the truck in inventory for resale. The actions or activities connected with a truck are completely different – in the first case, the truck is used, i.e. driven to provide transportation services, while in the second case it is not directly used, but just parked in the showroom.
- 3.5 Many challenge the view that the business model is the same thing as management intent. They believe that business models can be observed in terms of cash flow generation and by assessing past and current actions that are both observable and verifiable. They point out that management intent relates to future actions that cannot be observed.
- 3.6 IFRS 9 notes that ‘The entity’s business model does not depend on management’s intentions for an individual instrument’ (B4.1.2). It also notes that an entity’s business model is ‘a matter of fact that can be observed by the way an entity is managed and information is provided to its management’ (BC 4.20).
- 3.7 Verifiability and observability are important considerations. Should the notion of the business model be used for accounting standard-setting, it could focus on the consequences of the application of the business model that could be observed in terms of past and current cash flows and resources used in combination for undertaking the related activities, generally with the requirement of a historical pattern of application. Once the business model is identified and observed, the accounting treatment related to a business model might not be at the choice of management.

- 3.8 This paper does not accept the premise that a business model is the same thing as management intent. As mentioned earlier, we do think that management intent is inherent in the context of all business activities. However, we think the business model is more than just a substitute for management intent. There is evidence that the business model is a broader and more complex notion than simply a substitute term for management intent. For example, there have been regulatory requirements introduced in the UK that address disclosure of the business model within the management commentary of annual filings. The UK Governance Code began requiring listed companies in their 2011 annual reports to explain their business models along with the nature and risks that the entity is willing to take. Moreover, in entity descriptions of their own business models there is generally no evidence that management intent is a primary consideration. In the UK Governance Code, the business model is not described as an intent-based notion and instead described as how the entity generates or preserves value over the longer term.

Note to constituents

The Bulletin includes a question asking whether management intent and the business model are distinct.

SOME KEY CHARACTERISTICS OF THE BUSINESS MODEL

- 3.9 If the business model is not about management intent, then it needs to be determined what the term is about. As mentioned earlier, the aim of this Research Paper is not to define the meaning of the term business model. However, in order to discuss the role that the business model could play in financial reporting there needs to be some common understanding in order to assess any assertions made in the debate.
- 3.10 To arrive at some common understanding of the business model, this Research Paper identifies some key characteristics that are common to most businesses. One could try to create a very exhaustive list of characteristics about a business, but it could be impossible to identify all of the potential characteristics that could be part of a business model for all businesses in this paper. This Research Paper identifies some of the key characteristics that we believe are the most significant.
- 3.11 Several notions of a business model seem to provide an answer to a central question about the business itself. These questions include:
- a) What are the activities of the business?
 - b) How does the business generate cash flows and create value?
 - c) Why are assets of the business configured the way they are?
 - d) Who are the customers and what are their needs for the products or services of the business?

- 3.12 We think these questions could provide insight into the key characteristics of the business model as they each relate to the key characteristics of the business itself. Perhaps a business model is a response to one or more of these questions.
- 3.13 Many also think of risk as being an important aspect of the business model. We discuss the role of risk later in this chapter as it is linked to other characteristics, particularly value creation as it is often viewed as the reward or the opposite of risk.
- 3.14 We attempt to describe below a simple business model with an activity notion, a value creation notion, an asset configuration notion and a customer notion. For each alternative, we include some very basic descriptions of the business model.

Activities of the business

- 3.15 The term business model is often used to simply describe the business itself. Very often, the business is described in terms of the activities the business is engaged in. An entity is generally engaged in activities to conduct its business whether it is making a product or providing a service.
- 3.16 For example, a pharmaceutical entity could describe its business model in terms of the activities it undertakes. There are often many different activities that need to be undertaken before a new drug is sold. The first set relates to the research for new drugs. This could begin with clinical research, which could or could not lead to the discovery of a successful new drug. For promising newly discovered drugs, the entity needs go through development activities, activities involved in clinical trials and getting new drugs approved by regulators. Once new drugs are approved, the entity then conducts manufacturing and marketing activities in order to sell the new drug to customers.
- 3.17 An oil entity could be another example of a business model described in terms of its activities. Such entity will conduct exploration activities in efforts to find new oil deposits. Once the entity finds them, it must develop those deposits in order to produce the oil by installing production wells and pipelines to produce and transport the oil. The entity then performs other activities to refine the oil into various petroleum products and marketing activities to sell those products to customers.
- 3.18 Every business needs to engage in some set of activities. Understanding the significant activities that each business engages in would seem to be central and important to users to understand the business and possibly a key characteristic of the business model.



Cash flow generation and value creation

- 3.19 The reason a business exists in the first place is to create or add value for its owners. Value creation could be viewed as current earnings that can be either reinvested or paid in dividends, or future value that will be realised at a later date. Cash flows and their timing as well as related risks have a significant impact on the value creation to a business. Some view value creation or the cash flow cycle of the business as the most important aspect of the business model.
- 3.20 Value creation could be viewed to include realised and unrealised cash flows. Assets that have appreciated in value reflect unrealised potential future cash flows. Some argue that the cash flow cycle is important to the business model as it links the inputs of the business with the outputs. Cash flows and their timing or cycle together with related risks have always been a fundamental feature of value.
- 3.21 Value creation could also be viewed as earning a return on investment that exceeds the cost of capital. However, for purposes of this paper, we focus on adding value and cash flow generation since this is more observable in the financial statements.
- 3.22 An example of a business model that is described in terms of value creation could be a food processing entity. Such entity will procure basic food ingredients from agricultural producers. From those ingredients, the entity will then prepare more valuable food products, package and finally market those products to consumers. The entity captures the incremental added value of the manufactured final food product over the cost of purchasing and processing ingredients, marketing and distribution.
- 3.23 Another example of a business model focused on value creation could be that of a chemical entity. Such entity will purchase inputs or raw materials. The entity processes those inputs through various units in their chemical plant. Inputs are converted by a variety of methods in chemical reactions to create more valuable chemicals. The entity adds value by converting the lower cost chemical inputs into either higher valued commodity or specialty chemical products. If the added value of the conversion is greater than the conversion costs, the entity adds value.
- 3.24 All businesses focus or should focus on creating or adding value for their investors so it would seem reasonable that an entity's value proposition is a key characteristic of its business model. Every business attempts to add value for their investors and can describe how they intend to add that value. A financial institution, such as a retail bank, could describe their business in terms of value creation as earning a higher return on their investments including loans, than the cost the bank incurs on deposits. This of course is a very simplified description but understanding how an entity tries to add value for its investors is something that would seem vital to all users.

Configuration of assets

- 3.25 Another way to view a business model is by the configuration of an entity's assets. The configuration of an entity's assets is often critical to the success of many entities as it could play a significant role in both the markets served by the business and the cost structure of the business.
- 3.26 An example of where the configuration of assets could be the key characteristic of a business model can be found in many logistic type companies. An airline, for instance, could structure its flight routes using certain 'hub' airports to optimise its passenger or cargo traffic. By routing passengers through certain hub airports, it can combine local and connecting passengers from multiple locations in order to offer more frequent flights and more destinations. The configuration of these routes also impacts the cost structure of the entity.
- 3.27 A railroad entity often could depend on the rail lines it owns or has access to. Access to certain lines could allow such entity to optimise its operations and attract business of shippers that want products or material moved from point A to point B or even point C. The network of lines available not only impacts the market opportunities of the entity but also impacts the entity's cost structure, as more direct routes are likely to be less costly to maintain and operate than longer indirect routes between markets.
- 3.28 It is easy to visualise the importance of asset configuration to a logistics entity. However, managing assets properly is critical to the success of most entities. Even for non-logistic industries, the configuration of assets plays an important role. A manufacturer could configure its assets based on the location of its suppliers or markets or to minimise bottlenecks in its operations. One could even view a financial institution in terms of asset configuration even though most of its assets are financial assets. A bank could configure its financial assets holdings in such a way to mitigate risks associated with its financial liabilities.

Customers of the products and services

- 3.29 Companies often place a significant emphasis on their customers and their needs. Some businesses could deliver specialised products and services to meet very specific customer needs or target niche markets. Other businesses could focus on products that have broader use and target a much wider market.
- 3.30 An example of where the customer is a key characteristic of the business model could be within the semiconductor industry. A semiconductor entity's business model could focus on creating and manufacturing semiconductors that have unique and very specific application for its customers. That type of business model could contrast with another entity that makes semiconductors that have much broader application within the industry such as those for computers and mobile phones.

- 3.31 Another example of a business model where the key characteristic is the customer is that of a luxury handbag maker. Such maker will try to distinguish its brand and its products by focusing on higher quality materials and craftsmanship than its competitors. The entity will target its marketing efforts to just a portion of the market that could be willing to spend much more than products offered by other handbag makers.
- 3.32 It could be argued that some entities do not have a direct relationship with customers because they may only interact directly with organised markets. However for most companies, building a strong brand image and maintaining relationships with customers are critical for the long-term success of the entity and as a result they place a great deal of emphasis on their customers. Some companies could focus on small 'niche' markets where they hope to earn higher margins on a lower volume by catering to a select few customers. Other companies attempt to capture larger market share.

Role of risk

- 3.33 Of course, there are other aspects of the business that are not explicitly noted above that are important if not critical to a business. For example, many note that exposure to various risks is one of the most important issues that a business needs to deal with and could argue that risk is a key characteristic of a business model. Risk could include the price risk associated with purchase and sale transactions, credit risk of receivables or loans, regulatory and compliance risk with governments, political risk, operational and other risks.
- 3.34 This Research Paper assumes that exposure to risk is implicitly part of any value creation notion of a business model. The primary purpose of a business is not to incur risk for the sake of risk itself. Many risks are generally accepted as either a trade-off for something else such as making an investment or as a cost of doing business. For example, credit risk is accepted as part of the exchange a bank makes in when it provides a loan to a customer with the expectation that the loan will be repaid with interest. A manufacturer has investment risk when it commits its capital to build a new manufacturing facility that is expected to provide additional revenues in the future. These types of risks seem integral to how a business captures value and are viewed as the opposite of the risk/reward decision process of a business. There are certainly business processes that companies employ to deal with risk, but not necessarily business models.



ASSUMED MEANING

- 3.35 All of the key characteristics discussed above that are found in most businesses could be part of a business model. One could argue that a business model might include any or all of these characteristics. All of these characteristics are linked in one way or another to each other. An entity will engage in certain activities, manage its assets and target customers all in efforts to add value for the entity's owners.
- 3.36 In order to discuss and analyse the issue of the role the business model has in financial reporting, in our opinion there is a need to have a common understanding of the notion being discussed in this Research Paper. Using an 'all of the above' approach is so broad that it would fail to remove the ambiguity and therefore make it difficult if not impossible to debate the central issue of this Research Paper. As a result, this paper will assume one key characteristic of the business model as dominant for purposes of the discussion.
- 3.37 Key characteristics of the business are generally linked to the notion of a business model having something to do with a value creation meaning of the term. In addition, a primary, if not the primary reason businesses are formed in the first place is to create and add value by earning profits for its investors. Capturing value is what the business is all about. Financial reporting is about measuring value in monetary terms and monetary measurements are used in and often linked to cash flows. Therefore, we think the generation of cash flows and the creation of value are the most relevant characteristics discussed above. For these reasons, this Research Paper will assume that the business model focuses on the value creation process of an entity, i.e. how the entity generates cash flows. In the case of non-financial institutions, it represents the end-to-end value creation process of an entity within the business and geographical markets it operates.

Note to constituents

The Bulletin includes a question asking whether the assumed meaning makes sense from a financial reporting perspective.



The cash flow conversion cycle

- 3.38 We use both adding value and cash flows in this Research Paper because we think these are similar concepts. Adding value has something to do with the generation of cash flows as well as with the timing of those cash flows. Adding value could be viewed in various ways and assessed against different kinds of benchmarks. As an example, one could look at 'cost of capital' under which insufficient returns would be viewed as destroying value although the absolute return is still positive. Cash flows are objectively measurable and analysing how cash flows are used and generated in the business could provide a more objective basis for assessing the impact of a business model in terms of adding or destroying value.

- 3.39 The cash flow conversion cycle of a business was not specifically discussed above in the key characteristics of business models. However, the concept of a cash conversion cycle, which has been analysed for accounting purposes,¹⁸ could help to illustrate the links between the key characteristics. It could integrate the activity through which cash is initially converted into different kinds of non-cash inputs, and the transformation of these inputs into the outputs of the business. The use or sale of these outputs results in cash returns over a certain period of time and with a certain degree of certainty. This cash conversion cycle could provide insight into how value is captured and net cash flows are generated through the normal course of a business. It could also help to explain the use of a business's inputs in combination with other inputs and the need to organise the activity in a certain way, as well as how the outputs of the business are delivered to customers. Finally, it could highlight the extent activities expose the entity to risks through an analysis of expected cash flows.
- 3.40 Attempting to define the notion of a business model for use in financial statements independently from analysing the implications of adding value and cash flow generation could result in a conceptual analysis that would be of little interest for standard setters. Therefore, a discussion of the key characteristics of business models should be driven by the objective of determining which characteristic could be of interest for accounting purposes. Analysing attributes of business models that help to assess how an activity could be able to generate value, including current cash flows as well as future cash flows with the highest probability, would be of greater interest for users of financial statements.
- 3.41 Efforts to analyse the role of the business model in financial reporting could focus on the types of business models that would have significantly different impacts on cash flows. Some argue that this focus on adding value and generating cash flows could justify different accounting treatments for the same transactions.
- 3.42 There could be a number of attributes of a business model that differentiate it from other business models to justify different accounting. These attributes may include:
- a) The length of the activity cycle. This could influence the way and the timing at which inputs are used and the pace cash is consumed and recovered through outputs. For example, in IAS 39, where the business model notion might have been implicitly used, for the actively traded financial assets conditions such as 'selling or repurchasing in the near term' and 'short-term profit-taking' are applied. Therefore, to justify certain accounting treatment, a reference to the length of the activity cycle is made.
 - b) How inputs are used. This relates to how or if inputs of a business activity are transformed in order to generate an output. For example, are inputs used in a production process or sold without any change in their nature. For example, in IAS 2, where the business model notion might have been implicitly used, the different accounting treatment applied to inventories is justified by the difference in the use of the input (consumed in a production process or sold without transformation).

¹⁸ Bezold (2009).

- c) How outputs are used to generate cash. This deals with whether outputs are sold to generate immediate cash flows or whether those cash flows are recovered over time such as through rents.
- d) The types of risks related to the activity. The duration of the cycle or the way access to production tools is obtained may influence both the type and intensity of risk the entity has exposure to. For example, in IAS 17, where the business model notion might have been implicitly used, the distinction on how a lessor recognises an operating lease versus a financing lease has something to do with exposure to risks (and rewards) on the related assets.
- e) The degree of certainty in the generation of cash flows. Based on the attributes mentioned above the degree of certainty of cash flows varies between business models.
- f) The degree of capital intensity. The level of capital investment may impact the time needed to recover the investment or the activity cycle. This may also expose the entity to additional risk for a longer period.

Questions to constituents

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

3.43 Entities create value in different ways, and the cash flow cycle often differs depending on the way the value is created. Some entities create value by holding or using assets to collect a rental type cash flow from those assets. Lessor entities are not the only entities that create value this way. Other examples could include an owner of an amusement park or a wind farm. Another way entities create value is by converting lower value assets into higher value assets. Most manufacturing activities create value this way. Still other entities create value by holding assets in order to benefit from price differentials. This type of business model could include those that engage in retailing or trading activities.

A SIMPLE EXAMPLE OF THE ROLE OF THE BUSINESS MODEL

3.44 If the business model is about adding value, it must have some implicit or explicit role in financial reporting. To illustrate, assume there are three entities in the business of constructing office buildings:

- a) The first entity has a business model where it builds office buildings under pre-existing contracts where the building is sold upon completion at a pre-determined price. The builder adds value based on the entity's ability to construct the building to the customer's specifications at a cost less than the pre-determined sales price of the building.



- b) A second entity has a business model where it anticipates the need for office space before entering into a contract with any customer. The entity expects to be able to make opportunistic acquisitions of land and be able to construct the building at a lower price. The entity would build office buildings and then market the buildings to either companies looking for new office space or companies that lease office space as lessor.
- c) The third entity has a business model where it also anticipates the need for office space. Unlike the second entity, this third entity would build office buildings but after completion would lease the office space directly to others.

3.45 The three business models all have very different risk and reward profiles. The first entity primary risk is that its construction costs exceed the pre-determined sales price. The entity captures value to the extent it can accurately estimate its construction cost before entering into the sales contract and then effectively manages those costs. The second entity primary risk is that it misjudges future demand for office space and it takes more time than expected to sell the office property at a potentially distressed price. Of course, if the second entity anticipates demand correctly, it could have the ability to sell the office property at a premium. The third entity also has office demand risk after the building has been constructed as both the rental occupancy and rates will be based on that demand. However, whether the demand for leased office space is strong or weak after the building is constructed, it will take a much longer time period for this third entity to recover the costs of construction as it is expected to be collected through lease payments over time.

3.46 In some respects, the three business models are similar. Each of the three entities acquires land and constructs office buildings. All three entities incur costs for both the land acquisition and construction. The activities and transactions these entities undertake and enter into in this aspect of their business models are all very similar and current IFRS would provide similar accounting with respect to the cost of the land and building.

3.47 The business models vary significantly after construction is completed. In the case of the first entity, profit or loss recognition is during construction and/or almost immediately after as the entity recognises a sale. Both the second entity and third entity likely have to conduct subsequent marketing activities, one to attract potential buyers of the property and the other to attract potential tenants.

3.48 Assuming the second entity is able to sell the property it will also recognise a profit or loss upon sale. The third entity could also elect the fair value model. The third entity will need to enter into leasing contracts, collect rents, and maintain the property for tenants. This third entity will recognise the rentals as revenue over the lease period, recognise costs to maintain the property and, if it does not elect the fair value model, depreciate the building over its useful life.

- 3.49 As described above, the financial reporting for these three entities with differing business model varies greatly after the construction. The business model likely changes both the assets held by the entity as well as some liabilities incurred. It affects the types of activities the entity must undertake, the types and terms of contracts the entity enters into and the resulting transactions. The business model also affects the risks that the entity is exposed to. The business model undoubtedly plays a role in financial reporting whether or not one chooses to use that term.
- 3.50 The debate is not about whether the business model under the assumed meaning in this Research Paper has a role in financial reporting. This was demonstrated to be true in this example about office buildings. This was also demonstrated by prior IFRS that seem to implicitly portray the business model without explicitly using the business model notion in the standard. The debate is really about whether the business model should be used in IFRS specifically to allow alternative accounting treatments. The presumed consequence of using the business model in IFRS could be the selection of accounting methods by the reporting entity.
- 3.51 This example brings us to the consideration as to whether the business model just changes assets, liabilities and transactions of the entity or if it could also result in the same transaction being treated differently depending on the entity's business model. In the remainder of this chapter, we examine in a more descriptive manner the business models using a value creation notion in examples across different industries. For each example, we discuss in further detail for each of these examples the role the business model has in financial reporting.
- 3.52 We consider whether the business model is going beyond impacts on assets and liabilities held by an entity and on transactions the entity enters into. The focus of these examples is on recognition and measurement. We use these examples and present alternative views on whether the same or similar transaction should be recognised or measured differently because of the entity's business model.



A BANKING EXAMPLE

- 3.53 Banks play a vital role in the economy by providing liquidity. As financial intermediaries, banks allocate funds from savers to borrowers. Banks also provide pricing information regarding the cost of borrowing money. Banks are also different from other commercial and industrial entities because they are highly regulated.
- 3.54 On a very high level, banking activities are normally divided into banking-book activities and trading activities. However, within those main categories you will find a large variation of business models. These variations are partly due to tradition, but also partly depend on the structure and regulatory environment of the markets in which the banks operate. The following focuses on the banking book to illustrate the different business models and the alternative views on accounting treatments.

3.55 A key factor that determines the profitability of a bank in its financial intermediary role is the margin or spread between the interest rate on loans to its borrowers and the interest rate paid on its deposits, which are one of the bank's liabilities. The margin between the loan rate and deposit rate, among other things, depends in part on the credit risk of the bank's borrowers and the operating costs of the bank.

3.56 The business of taking in deposits that are liquid and convertible on demand and investing those deposits into medium and long-term loans is the core activity of some banks. This loan activity may expose the bank to not only credit and interest rate risk but also liquidity risk because of the difference between the length of the lending agreements and the short-term nature of those bank's liabilities (deposits). Banks try to mitigate the liquidity risk by maintaining some of its assets as a cash reserve in order to meet likely withdrawals of deposits. Some banks might invest a portion of its available funds in financial instruments other than loans. Rather than profiting from an interest rate spread, sometimes the profit motive on these investments is to capture either short- or long-term market value appreciation.

3.57 Below you will find two examples of business models for banks whose basic funding comes from deposits.

Entity A

3.58 Entity A is a regional bank that uses customer deposits as the primary source of funding. Entity A provides predominantly customer loans in the markets it serves and generally holds those loans throughout the term of the loan. Entity A's business model is to serve the local markets in which it operates and to maintain long-term relationships with its customers by focusing on service and maintaining the customer relationship throughout the term of the loan.

3.59 Like most banks, Entity A's deposits are short-term in nature. The loans Entity A makes to its customers are much longer term. In addition, many of the long-term loans that Entity A provides to its customers are fixed-rate loans that expose Entity A to interest rate risk. Entity A hedges the interest rate risk on those loans to customers to match the interest rate risk it has on its deposits.

Entity B

3.60 Entity B is also a regional bank that uses customer deposits as a primary source of funding and provides customer loans to the markets it serves. Entity B will generally sell loans it makes to customers to other financial institutions. The financial institutions purchase loans from Entity B with an effective interest rate lower than that charged to the customer. Entity B is then able to capture the premium it makes on the loan.

3.61 Entity B's cash flows and risks differ from Entity A. Entity B quickly monetises the loans made which provides cash and so allows Entity B to make more loans. Entity B captures value based on the interest spread between the rate charged to the customer and the rate at which other financial institutions will purchase the loan from Entity B.

Accounting issue

3.62 The business models described above are not complete descriptions of all details that might be found in a business model of a bank with deposits being the dominant source of funding. Instead, the descriptions provided focus only on the details that pertain to the accounting issue being discussed below.

3.63 Under Entity A's business model it holds loans made to customers until maturity of the loan. Entity B's business model is to package the loans made and to sell the package of loans to other financial institutions.

3.64 Both business models are similar in that each includes making loans to customers. Entity A expects to hold loans made to maturity and Entity B expects to package the loans it makes and sell the package of loans to financial institutions. The difference may be driven by the financing structures of the bank. At the end of any given reporting period, both banks may hold similar loans. The accounting issue is whether the loans should be accounted for similarly or whether there should be a difference based upon the entity's business model.

Alternative views

View A

3.65 One view is that the recognition and measurement of the loans should differ to reflect the differences in the business models. Those that support this view argue that the expected future cash flows of Entity A are better reflected using an amortised cost measurement approach for its loans and that Entity B's are better reflected using a fair value approach.

3.66 Those that hold this view would explain that the amortised cost approach for Entity A is a better representation that matches the collection of the loan payments over the term of the loan. Using a fair value approach for these loans would introduce volatility for Entity A that could make its financial statements misleading because most of the changes in fair value would be temporary and would reverse as the loan payments became due.

View B

- 3.67 An alternative view is that the recognition and measurement of the loans should be the same for both Entity A and Entity B. Those that support this view argue that at the time both entities are holding substantively the same instrument, both entities should measure the instrument similarly for comparability. Those that hold this view point out that the business model of each entity causes those entities to take different actions, and only those differences (i.e. the future actions taken by the entity) should result in differences in financial reporting.
- 3.68 Some of those that argue that recognition and measurement should be the same might favour that the loans are recognised at fair value and others may favour both entities to use amortise cost. There are arguments for both fair value and amortised cost, but the intent of this Research Paper is not to debate that issue.

Questions to constituents

- 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?

A MOBILE NETWORK OPERATOR EXAMPLE

- 3.69 A mobile network operator is a provider of wireless communications services that owns or controls elements necessary to deliver such services.
- 3.70 The business is a capital-intensive business requiring a significant investment in infrastructure. A mobile network operator needs to market its products and services, respond to actions by competitors, and adapt to technological changes and changes in consumer preferences. Part of the business is to enter into subscription or pre-paid contracts with customers. Both types of contracts provide customers with access to a wireless network. These contracts provide different revenue streams and risks to the mobile network operator. Mobile phone devices are often subsidised by the mobile network operator in exchange for a contract of one to two years. These contracts often have a penalty if the customer terminates early which allows the mobile network operator to recover the cost of the subsidy. The subsidy for the mobile phone provided to the customer has become an industry practice, which most customers are expecting when entering into new service agreements.
- 3.71 The following focuses on the distribution channels of a mobile network provider to illustrate the different business models and the alternative views on accounting treatments.

Entity A

- 3.72 Entity A is a regional mobile network provider that owns and operates a wireless communications network and provides wireless communications services to its customers. Entity A's business model is to have a network of its own stores where the entity directly enters into service agreements with customers. As Entity A enters into service agreements, it provides directly a subsidised mobile phone to new customers.
- 3.73 Entity A also has operating costs because of these stores, including the salaries of its sales staff. To recover its investment in the wireless communication network and network of entity owned stores, Entity A attempts to achieve a high volume of new service subscribers.
- 3.74 The very significant part of entity's cash flows consists of cash outflows for upfront investments in wireless network infrastructure. Once the investment is made, the additional costs for rendering service are reduced, therefore the more customers a mobile network operator has, the more profitable (and thus net cash generative) becomes its network. Additional cash outflows come from operating the store network. There are also cash outflows for buying mobile phones from suppliers. All of these cash outflows need to be recovered and are ideally exceeded by the cash inflows from subscriptions, from additional cash inflows (revenues) for excess usage and from other telecommunication services not included in the subscription service contract.

Entity B

- 3.75 Entity B is also a regional mobile network provider that owns and operates a wireless communications network and provides wireless communication services to its customers. Entity B's business model does not require it to invest in a network of its own stores. Instead, under Entity B's business model the entity's customers are subscribed to service contracts through dealers. Entity B has a distribution agreement that provides the dealer with a commission (payment) for each subscribed customer that the dealer can provide. Dealers of Entity B also offer discounts on mobile phones to attract new customers. The commission payment that Entity B makes to the dealers for each customer are fixed and would be expected to exceed to some extent any discount the dealer may provide on the mobile phone that is provided to the customer. Furthermore, the dealer directly buys mobile phones from the manufacturers; therefore, Entity B does not buy or sell mobile phones on its own.
- 3.76 Entity B's business model avoids the extra capital required for a network of stores and the related operating costs. However, the incremental acquisition costs for each new subscriber is higher than most of its direct sale competitors because of Entity B's agreement with its dealers that require commission payments.

3.77 Entity B's cash flows differ somewhat from Entity A. Entity B has lower initial capital investment, and as a result, lower fixed costs. However, Entity B has to pay the dealers the commissions for each subscribed customer they provide. Therefore the main difference compared to Entity A's business model is that the Entity B has a lower threshold of capital costs (cash outflows) to be recovered but Entity B will likely have higher total subscriber acquisition costs because of the commissions paid to the dealers. In addition, as dealers buy the mobile phones on their own, the Entity B does not have cash outflows for buying mobile phones from suppliers.

3.78 If the customer terminates the contract early, the dealer is not obligated to refund any of the commission received from Entity B.

Accounting issue

3.79 The business models described above are not complete descriptions of all details that might be found in an entity's business model. Instead, the descriptions provided focus only on the details that pertain to the accounting issue being discussed below.

3.80 Entity A's business model is the direct sales to its customers. The subscriber acquisition costs, which mainly consist of a direct subsidy for the mobile phone, are expensed at the time the subsidy is provided as a cost of sales. On the other hand, Entity B provides a subsidy on the mobile phone handset indirectly to the customer through its dealer relationships. Under current accounting, the treatment may vary. The commission payments made to the agent are capitalised by some entities. However, some might argue that the differences between the direct and indirect sales business models should be reflected in financial reporting.

Alternative views

View A

3.81 Some argue that the commissions paid to the agent by Entity B should not be accounted in the same way as the direct subsidy on the handset. Those that support this view could point out that the commissions paid to the dealers should be capitalised as intangible assets rather than expensed. They argue that obtaining rights from the two-year contractual agreement meet the definition of an asset and recognition criteria at the inception of the contract.

3.82 They point out that the penalty the customer must pay if the contract is terminated early further justifies an asset recognised at the inception of the contract. Entity B has recourse under the sales contract only with the mobile phone customer.

3.83 Accordingly, financial statements of mobile network operators using a third party distribution network would be different from financial statements of operators selling their services directly through their own sales channels.

View B

- 3.84 Others argue that the two business models should be accounted for the same way. They point out the economic similarity despite using different distribution channels. They maintain that an acquisition of a customer directly through internal sales personnel located in owned stores and acquisition through the dealer are economically similar and therefore should be accounted for similarly. Both entities are in a similar position in that both have a customer under contract and the right to receive revenues from the contract. Both also have recourse to that customer in the event the customer terminates the contract. Apart from commissions paid to the agent, both produce similar cash flows.
- 3.85 Therefore, both should recognise an intangible asset (for the right to recover acquisition costs) and amortise it on a systematic basis consistent with the pattern of expected subscription cash inflows.
- 3.86 Alternatively, some could argue that acquisition costs in both cases are not a resource controlled by the entity and thus does not comply with the definition of an asset as defined in the Framework (CF4.44 and 4.45). Therefore, they argue that these expenditures should be charged to the profit and loss account.

Questions to constituents

- Do you think the example describes different business models? Please explain.
- Do you support View A or View B? Please explain.
- 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?

AN INSURANCE EXAMPLE

- 3.87 Insurance is a form of risk management primarily used to mitigate the risk of a potential loss. An insurance contract transfers the risk of a potential loss from one party to another in exchange for a payment.
- 3.88 Insurance contracts may be classified into two groups:
- Life insurance contracts, which include life insurance, annuities and pension products; and
 - Non-life insurance contracts, which include general or property/casualty insurance products or other types of insurance.
- 3.89 In many countries, life and non-life insurers are subject to different regulatory and tax regimes. The main reason for the distinction between the two types of regulations is that life, annuity, and pension products are very long-term in nature, which impacts the customer of those products as the customer is more exposed to the ongoing viability of the insurance entity. Coverage for life assurance or a pension can cover risks over many decades. By contrast, a non-life insurance product typically covers a much shorter time period, such as one year.

- 3.90 Another distinction that is made within those two broad categories is based on the types of insurance contracts. Insurers enter into many types of insurance contracts with different features. Life insurers enter into contracts with different characteristics, which are priced and managed differently. For example, term life insurance provides coverage at a fixed rate of payments for a limited period of time. It provides pure risk protection and does not provide for a return of premium if no claims are filed.
- 3.91 In contrast, universal life insurance combines the pure risk protection of the term life product with an investment product for the customer. The excess of premium payments above the current cost of the pure insurance are credited to the cash value of the policy. The cash value is credited each month with interest, and the policy is debited each month by a cost of insurance charge if the customer is not required to make ongoing premium payments. Interest credited to the account is determined by the insurance contract. Some of these contracts have fixed returns (non-participating contracts) and other contracts provide a return that may vary depending on the insurers' or an index's investment returns (participating contracts). Participating contracts usually have a contractual minimum investment return rate. Some believe that those contracts have different characteristics that require different approaches in order to ensure that the accounting model reflects the specifics of the contract types.
- 3.92 Insurance companies create value by entering into insurance contracts and pooling various types of risk. They do this by collecting premiums from counterparties to the insurance contracts. The pooling of insurance contracts by the insurance entity lowers the total cost of risk, as not all of the insured risks will require a payment.
- 3.93 An insurer's financial results are usually affected by a number of external factors that relate to the risk insured and investment returns on funds received through premiums. These factors include demographic trends, general economic and market conditions, government policy and legislation and exchange rate fluctuations.
- 3.94 Insurance companies generally make money in two ways:
- a) By charging sufficient premiums to cover the expected insurance claims; and
 - b) By earning investment returns using the collected premiums.
- 3.95 Insurers have investment portfolios that support the range of businesses they operate. The aim of these portfolios is generally to match the investments held to support a line of business to the nature of the underlying contractual liabilities and to be compatible with the insurer's strategy, risk appetite and local regulatory requirements.
- 3.96 The following focus on the two groups of life insurance contracts to illustrate the different business models and the alternative views on accounting treatments.

Entity A

3.97 Entity A is a life insurer, which issues non-participating contracts. Its investment portfolio contains a high proportion of fixed-interest income securities, which it holds to maturity. Liability cash flows depend on expected claims, and are independent of the underlying assets.

3.98 Entity A is operating within a business model where there is no contractual linkage between the assets and the liabilities.

Entity B

3.99 Entity B is a life insurer, which issues participating contracts. Its investment portfolio contains a high proportion of fixed-interest income securities, which it holds to maturity. In addition to expected claims, liability cash flows are significantly dependent on asset returns.

3.100 Entity B is operating within a business model where there is a contractual linkage between the assets and the liabilities. Participating insurance contract liability cash flows generally depend on asset returns. The shareholders' return depends on the mechanism of sharing asset returns with policyholders.

Accounting issue

3.101 Because participating and non-participating contracts have generally different characteristics they require different approaches in order to ensure that the accounting model reflects the specifics of the contract types.

Alternative views

View A

3.102 Some believe that accounting should reflect the business model within which the entity operates. They believe that Entity A is operating within a business model where assets and liabilities are not contractually linked and the measurement basis of the liability does not need to be consistent with the assets backing these liabilities. However, Entity B is operating within a business model where there is a high contractual linkage and the liability measurement basis needs to be consistent with the measurement basis of the assets backing those liabilities. For example, if the investments are measured at fair value through profit and loss, movements in liabilities are also reflected in profit and loss. If investments are measured at fair value through other comprehensive income, then movements of liabilities related to movements of assets should also go through other comprehensive income. If the assets are measured at cost, so should the liabilities.

View B

3.103 Others believe that because Entity A and Entity B are investing in the same assets, the accounting treatment for those assets should be the same. The measurement of the liabilities is based on the terms and conditions of the underlying contract and need not be on the same basis as the assets.

Questions to constituents

- 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?

Chapter 4 – The Conceptual Discussion



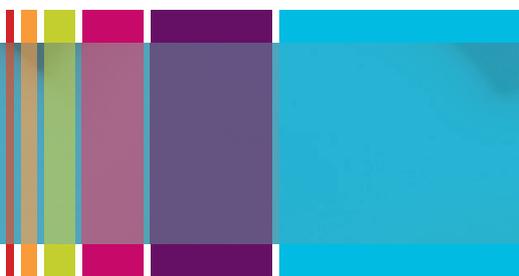
In the prior chapters, we have noted how the notion of business model has been explicitly introduced in new IFRS and was implicitly incorporated in existing ones. An assumed meaning of the business model notion based on value creation and cash flow generation has been developed in order to analyse its role in the financial statements. Some specific examples were created to debate whether the same item could be recognised and measured differently based upon the entity's business model.

In this chapter, we highlight the conceptual discussion that was included in the Bulletin. We also include some additional comments that were not expressed in the Bulletin.

THE DISCUSSION

- 4.1 The debate about the use of the business model in IFRS has generally been between supporters and opponents that have attached different meanings to the notion. Some opponents link the business model with management intent. In chapter 3, we discussed management intent and we explained why we do not accept the premise that the business model is about management intent. We acknowledge that the business model, like management intent, is an entity-specific notion. However, the difference between the two is that the business model is more observable. The intent here is not to further debate the assumed meaning, but rather debate its role using a common meaning based on a 'value creation' meaning that includes cash flow generation.
- 4.2 Some have argued that providing information on the performance of an entity based on its business model(s) is consistent with the objectives of financial statements. Existing standards already have used the business model yet the Framework does not mention it. Financial statements should provide information that assists users in the assessment of the entity's business model performance, and some suggest the Framework should be revised to include that as one of its objectives.
- 4.3 The result of having the business model notion in the Framework is that it would, among other things, systematically consider the business model in the standard-setting process, which would ultimately provide more useful information in financial statements. The inclusion of the business model in the Framework would not necessarily require any strict definition of the term, but would require a common understanding similar to the approach used in this paper or the approach used in the 2008 Exposure Draft of the Framework.
- 4.4 There are areas of the Framework that are important to consider in order to make judgements about the role the business model may have in financial statements. First, the Framework provides the purpose of financial statements in OB7 and states that:

'General purpose financial reports are not designed to show the value of a reporting entity, but they provide information to help existing and potential investors, lenders and other creditors to estimate the value of the reporting entity.'



- 4.5 The Framework also suggests that financial reporting should provide information that could help users to assess prospects for future cash flows in order to achieve the main objective of providing decision-useful information to capital providers in making decisions about allocating resources to an entity. OB14 states:

‘Different types of economic resources affect a user’s assessment of the reporting entity’s prospects for future cash flows differently. Some future cash flows result directly from existing economic resources, such as accounts receivable. Other cash flows result from using several resources in combination to produce and market goods or services to customers. Although those cash flows cannot be identified with individual economic resources (or claims), users of financial reports need to know the nature and amount of the resources available for use in a reporting entity’s operations.’

- 4.6 In discussing the information that is most useful to users, the Framework identifies two fundamental characteristics of that information. The information needs to be both relevant and faithfully represented. The Framework also identifies some enhancing characteristics of that information in QC4:

‘If financial information is to be useful, it must be relevant and faithfully represents what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable.’

- 4.7 That financial statements should contain information on both the results and operation of an entity’s business model is consistent with the objectives of financial reporting of providing information that has predictive value, is relevant to users in making economic decisions and discharging management’s responsibility to provide an account of its stewardship.
- 4.8 The two fundamental qualitative characteristics of the Framework and two of the four enhancing qualitative characteristics, comparability and understandability, are discussed below. Timeliness and verifiability are not discussed further in this paper because we think the former is less relevant to this topic and the latter should be considered a precondition.



Does financial reporting based on the business model notion provide relevant information?

- 4.9 One of the two fundamental qualitative characteristic of the Framework is relevance. QC6 of the Framework states:

‘Relevant financial information is capable of making a difference in the decisions made by users. Information may be capable of making a difference in a decision even if some users choose not to take advantage of it or are already aware of it from other sources.’

4.10 The Framework subsequently explains that to be capable of that, the financial information must have predictive or confirmatory value or both (QC7). In estimating the value of the reporting entity, users need to rely on the reporting entity to provide useful information in order to make estimates of that value. Therefore, an important characteristic about the information provided is that it has predictive value, and the Framework points this out in QC8:

‘Financial information has predictive value if it can be used as an input to processes employed by users to predict future outcomes. Financial information need not be a prediction or forecast to have predictive value. Financial information with predictive value is employed by users in making their own predictions.’

4.11 The decision makers on which this Framework focuses are those existing and potential investors, lenders and other creditors, who cannot require reporting entities to provide information directly to them and must rely on general purpose financial reports for much of the financial information they need.

4.12 Financial statements should therefore assist those users in making an assessment of the prospective future cash flows of the entity. Those cash flows enable repayment of loans to lenders and dividends to be paid to investors or, if retained by the entity, increase the value of their investment in the entity.

What the Bulletin said:

4.13 Having the business model play a role in financial reporting would presume that investors have an understanding of the business model prior to assessing an entity’s financial position and performance.

4.14 Academic research shows that this is indeed the case in practice, in particular for long-term investors.¹⁹ Long-term investors who buy or hold a share in an entity will generally first consider who the main players in this type of business are, whether their strategy is conducive of sustainable market shares in the sector and how they have organised themselves to make money. In other words, what their business models are. Only after they have done so, they start comparing and selecting in which of those players they want to invest.

4.15 The need to understand an entity’s business model is further increased by development of integrated reporting, which suggests that investors need to rely on a cohesive set of information, encompassing more than only financial statements.²⁰ One of the elements to be disclosed under the proposed framework is the business model.²¹ If financial reporting is not consistent with an entity’s business model, the required level of cohesiveness in integrated reporting would not be achieved.²²

¹⁹ The academic evidence is based on a study, performed at the joint request of EFRAG and ICAS as part of the proactive activities. The results of the study will be published in 2013.

²⁰ “Integrated Reporting is an approach to corporate reporting that demonstrates the linkages between an organisation’s strategy, governance and financial performance and the social, environmental and economic context within which it operates.” (International Integrated Reporting Council, *Consultation Draft of the International <IR> Framework, 2013*).

²¹ International Integrated Reporting Council (2013), paragraph 1.20.

²² It should be noted that these references to the Integrated Reporting publication does not represent any views of the partners on the contents of this paper.

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- 4.16 Academic evidence also suggests that many investors rely on the income statement as a first basis for predicting future operating results. Some argue that if results are reported independently of how the entity generates its actual cash flows, such results reflect what the entity would have gained or lost if it had used the same assets and liabilities differently (i.e., an alternative use or hypothetical approach), but not how the entity has created or destroyed value. Again, the example of the cotton explains this: what relevant information would be provided in the financial statements of a shirt manufacturer if they show the gain of CU20 in profit while the material is still part of inventory?
- 4.17 Whilst the Framework contains no reference to an entity's business model, it highlights that some resources (assets) do not generate cash flows on a standalone basis but may be combined with others in order to do so (4.10(a)). This means that, in those cases, the analysis in isolation of the nature of the resources concerned is not sufficient to assess the prospects of future cash flows. Users will need to have information on all interactions between the different resources used in combination by the entity to produce goods or provide services. Some consider that understanding how business models work and how different resources interact with one another will be of great help in this respect. In their view, the role that various resources play in cash conversion cycles is relevant to financial reporting: the way items are used in the context of a business model has an unavoidable impact on the timing and amount of cash flows that will be generated and on the exposure to risks.
- 4.18 Some take this position one step further and argue that ignoring the business model in financial reporting would reflect changes in value that are irrelevant to the financial position and performance of the entity, or delay the recognition of elements. This would result in accounts that are established on what is considered a theoretical basis and produce information that is not based on economic reality. In their view, this results in non-compliance with the Framework, and is therefore not acceptable. At the same time, they do acknowledge that financial statements should also reflect the impact of transactions executed and events occurred outside the business model, for instance when loans held to collect the cash flows until maturity are sold during this period. However, in their view, this deals more with presentation and disclosures than anything else.²³
- 4.19 Some argue that having an understanding of how different business models combine assets, or assets and liabilities, in order to create value for shareholders, suggests that the business model may be a helpful notion in selecting a relevant unit of account for financial reporting purposes.

²³ The discussion on presentation and disclosures will be included in a future Bulletin on Performance reporting.

- 4.20 In their view, this could help to address some of the existing inconsistencies in present IFRS on this topic. They observe that where the unit of account is defined, it sometimes seems to be based on a business model notion, and sometimes not. They note that examples of the first can be found in the hedge accounting requirements in IAS 39 *Financial Instruments: Recognition and Measurement*, where qualifying hedge items can be a group of assets or liabilities, next to individual items. The notion of the business model is, in their view, also observable in the recent IASB deliberations on the unit of account in the *Insurance Contracts* project, where it is defined on the level of portfolios, i.e. a group of contracts that are, among others, managed together as a single pool. An example where the business model notion is, in their view, ignored is in defining the unit of account in IAS 16 *Property, Plant and Equipment*, which allows an accounting policy choice, but the elected policy has to be applied to an entire class of assets, irrespective of their use by the entity.
- 4.21 Many also note that a change in the entity's business model is a significant event, because it implies a change in how assets and liabilities are used in the cash flow generation process, i.e., when and how gains and losses are recognised and reported. Therefore, it is necessary to inform users of this change and the impact on future cash flows. Presenting assets and liabilities as if nothing happened deprives users from information that is directly relevant to how they should assess future cash flows. Assessing the impact of management's decision to change business models is also useful from a stewardship perspective.
- 4.22 However, others argue that accounting standards that allow different methods of accounting based on the business model do not lead to better predictive or confirmatory value. To them, this introduces increased subjectivity, which harms the ability of investors to predict future cash flows and to assess stewardship. For example, measuring assets and liabilities based on the business model instead of on objective external information results, in their view, in biased information. Such a bias, they claim, fails to capture the cash flow potential that has been created or destroyed by the entity, in designing its business model. Therefore, no financial performance can be reliably depicted.
- 4.23 At the same time, they do not deny that proper understanding of a business model and its impact on future cash flows has relevance. However, in their view, entities have the ability to explain or provide supplemental disclosures, if they believe that reported financial results do not reflect their business model. The primary financial statements should, however, not be based on entity-specific information such as the business model.

Other discussion

- 4.24 Long-term investors who buy or hold a share in an entity will generally do so because they take a favourable view of the prospects for its business. An investor who favours an investment in a particular industry could well reject an investment in an entity that is nominally part of that industry, even if it is highly profitable, if much of its profits come from sources other than its core business. For example, a potential investor who believes prospects for the banking sector are good, could avoid making an investment in a profitable banking entity if most of its profits come from the sale of surplus branches in favour of a competitor whose profits are mainly from lending activities.
- 4.25 One of the important aspects of the debate about the business model deals with the predictive value of information that is provided to users. Assuming that the business will continue for future periods, results reported for past periods can be used as the basis for a prediction of future operating results although they are not themselves a prediction or forecast. Some argue users may prefer having this kind of primary information more linked to the generation of cash flows (i.e., the business model) that would assist them better in forming their own predictions about the future.
- 4.26 Some believe that when assessing future cash flows, it should not be only based on rights and obligations that are derived from the contractual terms of resources. They accept that contractual terms could be an initial starting point for this assessment. However, it is also necessary to consider the way rights and obligations are used by the entity when undertaking its activities. In their view, the way assets, liabilities and other resources are actually used in the application of a business model is the most relevant and reliable way to assess future cash flows, therefore providing users with information that has better predictive value. This also highlights that in assessing when an item meets the definition of an asset, a liability or equity, attention needs to be given to the underlying substance and economic reality of the transaction that gives rise to it and not merely its legal form, as noted in the Framework (4.6). The Framework clarifies through the example of a financial lease in this paragraph that this implies considering the way the entity acquires economic benefits of the use of the leased asset.
- 4.27 They think that assessing potential future cash flows based on events that have a low probability to occur or on a valuation references not based on the most likely way an entity will realise its cash flows would not help users. They believe that giving prominence to the most likely scenario – the one that would result from the application of the business model – would be more in line with the Framework requiring that expectation of future economic benefits must be sufficiently certain to meet the required probability criterion and that measurement of an item should be reliable.

- 4.28 They argue that an assessment of future cash flows could require identification of cash-generating units. Not all elements of cash-generating units are currently recognised in financial statements and the resources that are recognised may not provide a complete representation of the future cash flows expected to be generated from the business model. Some argue that it would be better for users to gain greater insight of these cash-generating elements and see their value reflected, in one way or another, in the financial statements. An example of an unrecognised element of a cash-generating unit could be internally generated goodwill.
- 4.29 By focusing on the business model in financial statements, changes in the underlying business could be better reflected. Changes in the economic or regulatory environment could compel an entity to adapt its activities to new external conditions. Such environmental factors could cause the entity to change its business model. Some argue that a focus on the business model would help users to understand the consequences of a change in the business model and it would provide a better comparison with both the previous and future performance of the entity. Those that argue in favour of the business model acknowledge a change to the business model could be a result of a reconsideration of the business model itself rather than external factors, but they believe this would be less frequent. Reflecting the effects of changes in business models would be essential information for users of financial statements. We further discuss comparability later in this chapter.
- 4.30 However, others believe as accounting standards are developed, the same underlying principles should apply to all business models. Those who hold this view suggest that most relevant financial information would enable users to be able to judge whether a business model used by one reporting entity might be preferable to a different business model employed by another entity.

Does financial reporting based on the business model notion provide faithful representation of economic phenomena?

- 4.31 A second fundamental characteristic in the Framework is faithful representation. The Framework states in QC12:
- ‘To be useful, financial information must not only represent relevant phenomena, but it must also faithfully represent the phenomena that it purports to represent. To be a perfectly faithful representation, a depiction would have to have three characteristics. It would need to be complete, neutral and free from error.’
- 4.32 The Framework adds that a complete depiction includes all information necessary for a user to understand the phenomenon being depicted (QC13) and a neutral depiction is without bias in the selection or presentation of financial information (QC14).

What the Bulletin said:

- 4.33 Those who oppose the view that the information presented in financial statements needs to reflect and respond to the business model consider that this brings bias in financial reporting and is therefore undermining neutrality in financial statements. In other words, it creates a conflict with faithful representation. In their view, accounting standards should focus on contractual and economic terms of each individual resource in order to determine the rights and obligations of the entity involved in it. The focus on rights and obligations associated with the resource would provide, they claim, a more objective and neutral manner to assess future cash flows.
- 4.34 In contrast, those who promote the relevance of the business model notion believe that reflecting the business model of an entity is enhancing faithful representation of economic phenomena. Where the business model has an influence on an entity's cash flow generation from assets and liabilities, this business model is part of an entity's economic reality. Reflecting financial information on a basis that is not aligned with the entity's business model is failing to be faithfully representative, as it portrays the assets and liabilities, income and expense, as if they were held and generated in an entity different from the reporting entity. They strongly believe that financial information should be prepared from the perspective of the entity, and that ignoring the accounting consequences of the business model is not providing a faithful representation.

Other discussion

- 4.35 Supporters of the business model believe this would help to faithfully reflect the operations in financial statements beyond the apparent rights and obligations formally attached to transactions and resources. It would help to achieve both fundamental qualitative characteristics of relevance and faithful representation of the economic phenomena.

Does financial reporting based on the business model notion provide information that is comparable?

- 4.36 Comparability is one of the enhancing qualitative characteristics of the Framework. The Framework notes in QC23 that:

'Comparability is not uniformity. For information to be comparable, like things must look alike and different things must look different.'

- 4.37 Comparability allows users to identify and understand similarities and differences among items in financial statements. The question that arises is whether different bases for recognition, measurement and presentation of assets, liabilities, income and expenses based on the business model notion improves or impairs comparability.

What the Bulletin said:

- 4.38 The dividing line between proponents of, and opponents to, the business model being reflected in the primary financial statements seems to be drawn by a different understanding of comparability.

- 4.39 As highlighted before, those who oppose the business model and the use of entity-specific information believe that this introduces bias in the way the financial position and performance of an entity are reported, and therefore make comparisons between entities difficult. The desirable level of comparability is reached, they believe, if financial reporting requirements mandate that potential economic benefits that can be derived from rights or sacrificed from obligations be shown, irrespective of the entity that holds them. Assessing whether the business model an entity has adopted makes it more or less profitable than it would be if it had adopted another model, is part, they contend, of the analysis investors want to undertake themselves. In addition, they believe that, as there is no clear definition of the business model and different stakeholders can understand it differently, this makes it even more difficult to understand the financial information based on such model.
- 4.40 Supporters of the business model hold the view that such approach to comparability is more akin to calling for uniformity, rather than comparability. Comparability is also about accounting differently for dissimilar activities and events, not just dissimilar transactions. Ignoring the effects of the business model is, in their view, misleading to users as it makes investors expect that future economic benefits will arise or be sacrificed as they are reflected in the primary financial statements, although there is observable evidence and knowledge that the pattern of economic benefits will behave quite differently.
- 4.41 Their support for the business model is therefore not based on a trade-off between relevance and comparability, where relevance would be given priority at the cost of a loss of comparability. On the contrary, they believe that reflecting the business model enhances comparability, as the way assets and liabilities are used in the value creation process is one of their economic features. Ignoring that feature is misleading as it presents the deployment of assets and liabilities as quasi-similar although, in reality, they will generate quite different streams of cash flows or be subject to different risk exposures.
- 4.42 Finally, proponents of the business model point out that its application makes financial statements of entities with similar business models more comparable, assisting in, for instance, comparisons between companies within certain industries.

Other discussion

- 4.43 Those that disagree with the notion of the business model within IFRS would generally not dispute that financial reporting should reflect the business model. They would acknowledge that the performance of the business model should indeed influence financial results because the business model influences the transactions that an entity enters into. An entity with a different business model is likely to enter into different transactions and those different transactions are likely to result in different financial results. Those different transactions alone should influence different financial results rather than applying different recognition and measurement criteria to similar transactions. They think users would be better served if financial statements reflect differences between business models that were driven only by performance differences rather than accounting recognition and measurement differences.

4.44 Supporters of the business model contend that the notion of business model could help users in this respect and suggest it could determine when things are alike and when they are not alike. In their view, it would help to achieve both the fundamental qualitative characteristics of relevance and faithful representation. One could consider that the notion of business model helps to provide relevant information especially in terms of helping to assess prospects of future cash flows. Some believe this would help to faithfully reflect the operations in financial statements beyond the apparent rights and obligations formally attached to transactions and resources. It would help to achieve both fundamental qualitative characteristics of relevance and faithful representation of the economic phenomena. As a consequence, it would make operations become more comparable through the assessment that their accounting representations are relevant and faithful.

4.45 Supporters of the business model believe that the notion of the business model could help users better determine which rights and obligations are really similar and which are not similar. They point out that not all resources of a business respond similarly to similar economic events. They believe that presenting assets, liabilities, income and expenses related to the business model separately from the entity's other assets and liabilities would provide users with both a better basis for looking at currently reported financial results and forming expectations of future financial results.

Does financial reporting based on the business model notion provide information that is understandable?

4.46 Another enhancing qualitative characteristic of the Framework is understandability. The Framework states that (QC30):

'Classifying, characterising and presenting information clearly and concisely makes it understandable.'

4.47 The Framework acknowledges that some financial information is complex, but that excluding important information, even if complex, would be incomplete and potentially misleading.

What the Bulletin said:

4.48 Understandability deals with the clear and concise classification, characterisation and presentation of information on economic phenomena (QC30). In that sense, it is clearly linked to the qualitative characteristics discussed before: information that is relevant, faithfully represents economic phenomena, and enables comparison should also be understandable. Because of this linkage, much of the discussions presented above in favour of, or against, the use of the business model in financial statements is applicable to the qualitative characteristic understandability as well and are not repeated.

- 4.49 Some argue that it is difficult to imagine how a dialogue between investors and management on the financial statements could be fruitful, if it did not have a primary focus on the results of the business model. To take part in such a dialogue, users need to understand the business, how the business has performed, and how this performance has been affected by various factors (both those within and outside the control of management). In other words, they need to know the business model. Only with this information can meaningful discussions take place on whether management has effectively implemented the business model in the past, on the options for the future, and how the entity could or should respond to new opportunities and challenges.
- 4.50 Others argue that, while agreeing with the need for users to know the business model, this does not, automatically, mean that this notion should play a role in the financial statements themselves. Often companies present such information outside the financial statements, such as in the management commentary. They state that, to understand the financial statements, users also need to (and do) look at the other parts of financial reporting.
- 4.51 While acknowledging the fact that information about the business model is often presented outside the financial statements, another group of commentators argue that non-incorporation of the business model in the financial statements stimulates the use of non-GAAP measures to communicate with investors. This refers to those key performance indicators which are not easily derived from financial statements or which cover different sets of data. They argue that such measures also include performance indicators that reflect an entity's business model, i.e. which are relevant to the context in which the entity operates and result in understandable information. For example, if net income reflects gains and losses that will not materialise in an entity's cash flow generation in the ordinary course of business, management would need to set up its own performance indicator to eliminate those gains and losses in its communication to investors, a sign that the information contained in the financial statements is not easily understandable. In other words, ignoring the role that the business model should play in the financial statements harms understandability.

Stewardship issues

- 4.52 Information on the results of the business model is also important in the context of stewardship. The Framework notes that users need information about 'how efficiently and effectively the entity's management...have discharged their responsibilities to use the entity's resources' (OB4). Elsewhere it has been noted that the dialogue between management and shareholders is a necessary consequence of the separation of control and ownership, and that financial statements provide a key part of the package for communication between management and shareholders that facilitates that dialogue.²⁴

²⁴ Lennard (2007).

4.53 Some argue that information provided to assess stewardship is unsuitable for predicting future cash flows, as the former type of information is more focused on the past. However, as mentioned earlier, information that is not itself a prediction or forecast can nevertheless have predictive value. Information based on the effective application of the business model and resulting consequences corresponds to this type of information, as it will reflect past performances that are expected to be repeated in the future in a going-concern perspective.

4.54 This kind of information can be used both to assess the stewardship of the management and to help assess future prospects. This has been highlighted by PWC in its studies undertaken in 2007 to assess investment professionals' views:²⁵

'These investors generally did not believe a fundamental re-evaluation of measurement bases used in accounting for assets and liabilities to be a high priority. Instead, the participants want a more transparent view into the underlying operating performance of a business – that is, greater clarity as to the investment returns generated by management as they convert the inputs of production into revenues.'

4.55 Users of financial statements need information to adequately judge how management has fulfilled its responsibilities to use those resources. If entities with similar resources are able to account for those resources differently, some wonder how users of the financial information could determine objectively whether management has effectively used those resources. They consider that alternative accounting treatments for similar resources would make it more difficult for users of financial information to judge whether differences in financial performance is the result of performance differences or accounting differences. However, others would consider that differences in the accounting treatment would reflect differences in the financial performance due to the application of different business models.

Questions to constituents

The Bulletin includes a tentative view that the business model should play a role in financial reporting and asked whether constituents support that view. Do you have any additional comments?

²⁵ PWC (2007).

Chapter 5 – Implications of the Business Model for Financial Statements



In the prior chapter, the arguments both in favour of and against the use of the business model were discussed. Some think the Framework should address the business model notion by providing criteria to systematically consider the business model in the standard-setting process.

If the business model is used by accounting standard setters there are different alternatives in how it can be used in the standard-setting process. In this chapter, we discuss some of those alternatives addressing how the business model notion could be used in standard-setting and implications for specific accounting treatments.

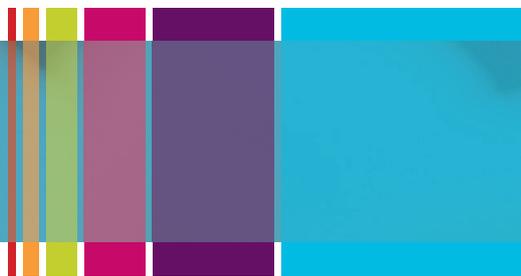
If one accepts the premise that the business model notion should play a role in accounting standards, there must be ways to make it operational. Our suggestions on how to do so are explained below.

PLAYING A ROLE IN THE CONCEPTUAL FRAMEWORK

- 5.1 The IASB has already used the business model in certain accounting standards. There are challenges with this approach that accounting standard setters must deal with. Many suggest that the business model is needed in accounting standards, but few would suggest that all accounting standards should specifically use this in every standard's development. Perhaps the most significant challenge for accounting standard setters is that they need to determine when accounting standards may need to make a distinction between business models.
- 5.2 The Bulletin supported the development of a proper rationale as part of the Framework to identify whether and when to use the business model notion in standard-setting.

What the Bulletin said:

- 5.3 Such guidance would help identify whether and when the business model of an entity should be taken into account on individual standards level. The *Conceptual Framework* should also require that the business model be based on observable and verifiable evidence.
- 5.4 If the business model approach is applied, its meaning would need to be described in the *Conceptual Framework* and in individual accounting standards that use the term.
- 5.5 Furthermore, all standards must be capable of representing faithfully the business model or models. Where applicable, the business model may need to be explicitly incorporated on a standard-by-standard basis, to operationalise the concept in a specific situation.
- 5.6 Additionally, the *Conceptual Framework* should highlight and illustrate how the business model can play a role in recognition, measurement, and presentation and disclosures at standard level. Some suggestions are presented hereafter.



Other discussion

- 5.7 It is suggested above that the Framework should include criteria for accounting standard setters to assess when the business model needs to be considered for standard-setting purposes. Here are some possible criteria to help determine when the business model should play a role and be considered by accounting standard setters:
- a) When it leads to accounting which better reflects the economics of transactions (e.g. when a different recognition and measurement basis will produce an effect on the statement of financial position and the statement of comprehensive income on how value is derived);
 - b) When it brings consistency in all the information reported (e.g. when financial information is reflected in a way which creates a natural linkage between the statement of financial position and the statement of comprehensive income and is read by the user in a comprehensive way to form a valid representation and expectation about the entity's performance);
 - c) When financial statements are produced in a way to enable the user to derive key performance indicators discussed in chapter 4, which are reflective of how the company performs (currently many non-GAAP measures are disclosed outside the primary financial statements to fit that purpose; presentation of segmental information is an example to meet those needs);
 - d) When financial statements based on the business model will present similar economic phenomena similarly to enhance comparability; and
 - e) When it produces information, which is more useful as a predictor of future results, including future cash flows.
- 5.8 The above criteria are not prescriptive or exhaustive but only a high level guide of when it is suitable for the standard setter to explicitly refer to the business model in standard-setting. The criteria may reduce the need for all standards to refer to the business model.
- 5.9 If the business model is used in accounting standards, the standard would need to consider whether verifiability could be an issue and may need to include criteria to verify its application. Criteria could be based on historical patterns or some other method that provides observable evidence.

Questions to constituents

- 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.



ADDRESSING THE BUSINESS MODEL IN VARIOUS ACCOUNTING STANDARDS

5.10 The following discussion is based on an acceptance that the business model has a role in financial statements.

Identifying business models for accounting purposes

5.11 In order to determine business models that justify different accounting treatments, one should identify characteristics of business models that have an objective impact on recognition, measurement and presentation of related operations in the primary financial statements.

5.12 A way to undertake this analysis is to examine cash flow conversion cycles linked to business activities that were discussed in paragraph 3.38. Analyses of the impact of business models on cash flow generation, which can be objectively observed, would provide a solid base for identifying those that justify different accounting treatment and for determining how they should be reflected in accounting. This would also be consistent with the assumed meaning of the business notion.

5.13 Accounting standards setters should systematically verify the list of attributes that identify differences in economic effects, value creation and cash flow generation that could justify a different accounting treatment. Differences in the accounting treatment should be consistent with the way business models influence value creation and cash flows generation, in order to ensure a relevant and faithful representation. This would prevent a proliferation of asserted differences in business models that do not matter for accounting purpose. Analysing the link between impacts on cash flow generation and characteristics of business models would help to classifying them in 'accounting categories'. This may mitigate some of 'the difficulties' discussed later.

5.14 There are some general principles that accounting standard setters could, or perhaps even should, apply:

- a) The business model addressed in a standard should not be entity-specific. It should be described in the standard and justified on economic grounds to address users' concerns of having a different business model for each specific case;
- b) The business model used and described in a standard should be observable;
- c) The business model should be considered equally to all the parts of the standard-setting process (recognition, initial and subsequent measurement, and presentation and disclosures);
- d) The use of the business model should be based on high-level principles and detailed rules should be avoided; and
- e) The use of the business model should meet a reasonable cost-benefit trade-off in all circumstances.

5.15 The need for a different accounting treatment for a business model in financial reporting should be supported by substantive evidence.

Approaches for implementing the business model notion in accounting standards

5.16 The business model should also be taken into account in the development of standards, by appropriate attention to their scope and definition of key terms. This approach has already been adopted in standards that prescribe different treatments for inventory, property, plant and equipment, and investment properties. Which standard should be amended (and hence which accounting treatment is required) will largely be dependent on the entity's business model.

5.17 A different approach would be for an accounting standard to set out two or three possible accounting treatments, and to require entities to select the treatment that is most appropriate to their business model. The extent of guidance provided on the selection of the accounting treatment could be tailored to the circumstances of each standard.

5.18 In these two first approaches, there should be provisions in accounting standards that would help to verify the effective application of business models, determine limits to possible deviations and frame changes in business models.

THE DIFFICULTIES

5.19 The practical problems with using the business model in IFRS should not be underestimated. This Research Paper assumes a certain meaning of the term. It could be difficult to arrive at a universally acceptable definition of the term so that it could be consistently applied by those who prepare financial information and adequately understood by those that use financial information. Moreover, there is no agreement as to whether there are just a few business models such as a trading and a holding model or an infinite number of business models that reflect how each entity tries to differentiate itself from its competitors. If the business model approach is applied the term would need to be defined.

5.20 Any change in the business model should also be reflected with appropriate disclosure of the nature and impact of the change. There may also be transactions that deviate from a business model. If the business model approach is applied, it would also seem necessary that these transactions would need to be disclosed or presented separately.

5.21 This Research Paper has demonstrated that the business model does have a role in financial statements using the meaning assumed by this paper. We have also discussed some of the difficulties that the business model introduces to standard-setting process, and identified some alternatives dealing with how accounting standard setters might address the business model in that standard-setting process.

IMPLICATIONS FOR SPECIFIC ACCOUNTING TREATMENTS

5.22 In this section, we discuss some of the ways in which an emphasis on the business model might influence the accounting treatment used in financial statements. This section draws attention to some of the specific implications of the idea that the business model is an important consideration in the selection of accounting methods. Some of these are already reflected in financial reporting: this could be because current accounting practice has been influenced by the belief that providing information on the business model is a proper part of financial reporting, even if the term ‘business model’ itself is a more recent innovation.

Playing a role in recognition

What the Bulletin said:

5.23 If the business model plays a role in recognition, an item could be an asset for some entities and not recognised by others. An example can be found in IAS 39, paragraph 5, which states that the standards should be applied to “contracts to buy or sell a non-financial items that can be settled net in cash ... with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity’s expected purchase, sale or usage requirements.” This means that a contract to receive an amount of coal is a non-recognised executory contract for an energy producer, but a recognised financial instrument for a commodities trader.

Playing a role in measurement

What the Bulletin said:

5.24 Measurement (and the related accounting policy choice) is an obvious place where the business model can play a role, because current IFRS require, or permit, different measurement requirements depending on how an asset or a liability, or a group of assets or liabilities, contribute to the entity’s cash generation. This is illustrated by the ‘cotton’ example, presented before: under one business model, cost is used as the measurement basis, and under another model fair value accounting is applied with immediate recognition of the gain in profit.²⁶

Other discussion

5.25 Many argue that to maximise the extent to which reported margins are meaningful, the consumption of assets that are to be used in providing goods and services should be reported at cost.

²⁶ Paragraph B.7 of the Bulletin.

- 5.26 Cost is entity-specific: for example, the cost of an asset to an entity that buys a component will differ from that of another entity that manufactures that component itself. The difference in cost is, at least in part, a consequence of the business model: ignoring it on grounds of comparability would be misguided, as it could obscure real differences between the entities.
- 5.27 Consideration of the business model may be useful in considering the value to be assigned to assets. Imagine three identical vans, one is owned by the manufacturer, another by a dealer and a third has just been purchased by a plumber for use in its trade. As the vans are all identical, would comparability not require each entity to report them at the same amount? This is not present practice nor informative: the manufacturer can produce vans at the manufacturing cost. The dealer can generally obtain vans at the wholesale price. The plumber has to pay the retail price. Cost (whether viewed in historical or current replacement terms) varies between the three entities, because their business models provide different opportunities. The vans may be identical but the cost to each owner is different. On the other hand, assets that are held as a store of value should be reported at current value.

Playing a role in presentation and disclosure

- 5.28 The business model notion may provide direction as to the relative importance of information. Information that is directly related to the business model could be highlighted in the primary financial statements. Other information may be reported less prominently, for example in the notes to the financial statements.
- 5.29 The business model could have a role in the various ways in which items of income and expense can be disaggregated, ordered, grouped and totalled. This may help separate recurring and non-recurring items and assist users in distinguishing between items more relevant in making assessments about future earnings and cash flows.

What the Bulletin said:

- 5.30 The discussion above has emphasised the relevance to investors of how assets and liabilities are combined and used in an entity's activities. This requires a disclosure of the entity's business model(s), although such disclosure would often be presented outside the financial statements. Measuring, but also presenting assets, liabilities, income and expenses in such a way that investors can understand how they contribute to the entity's cash flow generation can in itself be a way of representing the entity's business model. Segregating assets and liabilities which play a different economic role in the entity, for example helping provide optimum daily cash management versus creating liquidity for acquisitions and capital expenditures, would provide users with both a better basis for looking at currently reported financial results and forming expectations of future financial results.

5.31 To a certain extent, this was the approach presented in the IASB-FASB joint project on Financial Statements Presentation, which proposed that separation be made into operating, investing and financing activities, based on the nature of the assets and liabilities but also on the economic role they played in the activities of the entity. These underlying principles were widely welcomed (although constituents active in the financial services industry commented that such distinction was not always easy to make), and such a presentation was supportive of more meaningful sub-totals and performance indicators, such as operating profit.

5.32 The business model could also play a role in distinguishing between net income and other items of comprehensive income. This was considered in EFRAG and ICAC *PAAinE paper on Performance Reporting* in March 2009,²⁷ and is discussed in a future Bulletin on Performance Reporting.

Disaggregation of results

5.33 To provide information on the performance of the business model, financial statements should report its results. For convenience, we refer to this as 'operating profit'. Operating profit is widely reported and used, but it is not required by current IFRS. There is a case that it should be, with appropriate guidance as to its content.²⁸

5.34 Financial statements are more decision-useful, and provide information relevant to an assessment of stewardship, if they stated separately the results of the business from operating activities. It is a common practice in many countries for this to be done.

5.35 Disclosure of such an amount is not required by IFRS. However, it would seem helpful for an accounting standard to do so. The most recent proposals in this connection were set out in IASB's 2008 Discussion Paper *Preliminary Views on Financial Statement Presentation*.²⁹ This proposed that results be presented within two sections: business or financing and that the business section be analysed between operating and investing. Unfortunately, 'operating' was to be used as the default category. The other sections and categories were tightly defined: the result was that 'operating profits' would not necessarily reflect the business return: it would be a residual amount showing those income and expenses that were not required to be reported elsewhere. Because of its importance, operating profit should not be a residual, which includes everything that does not meet the criteria to be reported elsewhere, as the IASB has previously proposed.

5.36 The usefulness of the operating result that would be reported under the proposals was further diminished by the 'cohesiveness' principle which required, for example, that all changes in a pension deficit, including interest expense and actuarial gains and losses, should be reported within the operating result.

5.37 Another issue related to these proposals was that the proposed distinction between operating, financing and investing elements was not operational for financial institutions (e.g., banks, insurance companies).

²⁷ EFRAG-ICAC (2009).

²⁸ The requirement to disclose 'the results of operations' was deleted by the IASB as 'the Board decided not to require disclosure of an undefined term' (IAS 1, BC 55 and 56).

²⁹ IASB (2008a).

- 5.38 It is to be hoped that further development of proposals on the presentation of financial performance will establish operating profit as a useful metric and ensure that it faithfully represents the operating results of the business.
- 5.39 The business model could have a role in the various ways in which items of income and expense can be disaggregated, ordered, grouped and totalled. This may help separate recurring and non-recurring items, and those that are influenced by different factors and assist users in distinguishing between items more relevant in making assessments about future earnings and cash flows.
- 5.40 Others support this view, but think the distinction should be made between core and non-core activities as, in their view, this is more related to the application of the business model in financial statements. This paper does not take a firm position in this debate, as previous research on performance reporting shows that there is, at the moment, no generally accepted approach to report performance. However, whatever choice is made, there should be a clear relationship with the business model.
- 5.41 Another issue relates to the determination of priorities in information provided. It is about the placement of information that would represent the same operations for different (complementary) purposes or needs. In order to help users to clearly identify the most important elements of information, it could be assumed that the most important and relevant information should be given priority in the primary financial statements. The business model notion would help in identifying this most important information. Secondary information would be presented somewhere else, for example in the notes. In particular, if there are two ways of measuring the same item or transaction, the one that is more closely related to the representation of the effects of the application of the business model in terms of cash flow generation should be placed in the primary financial statements and the complementary one in disclosures.

Revenues and expenses

- 5.42 The operating result is obviously key, but it simply represents the results of the operation of the business model. By itself, however, it gives little insight into how that result has been achieved and what has affected it. To provide a meaningful insight into the performance of the business model, further segregation is necessary. Components of this operating result may change in volume and value in different ways over time and in response to different economic factors.
- 5.43 For most businesses, the business model involves creating value by selling goods and services and receiving greater value in exchange than the cost incurred in providing them. Financial statements therefore need to provide transparent and reliable information on:
- a) The amounts derived from the provision of goods and services to customers (revenues); and
 - b) The costs of doing so.

- 5.44 It is not possible to confidently predict changes in operating profit without considering the components separately. Thus, in particular, separate complementary information on sales and expenses is necessary. This seems to require adherence to a transaction-based view of accounting under which we report the financial effects of transactions, and changes in selling prices are not reflected prior to sale.
- 5.45 Sales or revenue is generally a clear driver of the success of the business model. It is being addressed in IASB's current project *Revenue from Contracts with Customers*. There are two features of the proposals (as set out in the November 2011 Exposure Draft) that are consistent with an objective of depicting the business model.
- 5.46 It is proposed that revenue be measured at the amount of consideration that is paid in exchange for goods or services supplied. A business creates value by selling goods to its customers: as such, information on the amount that is derived from such sales is vital to an assessment of the performance of the business model.
- 5.47 The focus on 'contracts with customers' also ensures that the reported amount relates to the business model: the definition of 'customer' makes clear that customers are those who purchase 'output of the entity's ordinary activities'. Hence, transactions that do not relate to the business model are to be excluded from revenue.
- 5.48 The amount of sales reported in a period can provide an input to a process to predict future sales. That process will use factors that the users judge to be relevant. Possible examples include change in the volume of sales (having regard to the economic and competitive environment), and changes in selling prices. Users will also want to have the ability to predict future expenses: to be robust, separate estimates could often be required for different types of expense forecasts. For example, raw material prices could be significantly affected by global commodity prices and labour costs by domestic inflation. A useful assessment of future expenses could at least distinguish direct costs and overhead costs.
- 5.49 Businesses need to deliver goods and services and obtain a price for doing so that is greater than the costs they incur. Revenues, expenses, and the resultant margin are precisely the results of doing so: it is unsurprising that these are of key interest to investors.

Measuring the cost of sales

- 5.50 Financial statements present the amount of revenues compared with the related cost. This requires that inventory is valued at cost.
- 5.51 Valuing inventory at cost might not always reflect its true economic value. It is possible to argue that profit accrues and is earned over the whole production cycle, and that it is only prudence that results in all profit being recognised on sale. On this view, financial reporting would more fairly reflect the underlying economics if inventory were reported at its fair value. However, there are two objections to this.

- 5.52 As noted above, businesses need to deliver goods and services. Simply manufacturing goods (however valuable) does not result in cash flows: sales do. Revaluing inventory and recognising profit before sale does not reflect this reality: it also impedes an analysis of the performance of the business model in the reported period as the 'operating result' would include some increases in value of goods that are not yet sold and exclude gains previously recognised in respect of inventory that has been sold in the period.
- 5.53 The relevance of fair value for inventory can be questioned. IFRS 13 *Fair Value Measurement* requires fair value to reflect the amount that would be received on sale from the existing asset on the balance sheet date. A business holds inventory because it is required to do so to carry out its business. They generally would not sell work-in-progress, as it would be difficult to sell. In these circumstances, there is likely to be no information on fair value and no market for the goods. Therefore, there would be little relevance in a fair value measure for most work-in-process. Even for finished products, it would be necessary to make a deduction for expenses related to selling effort. Therefore, it will often be impossible to quantify the amount of this deduction except arbitrarily.
- 5.54 In order to give an insightful portrayal of the performance of the business model it seems to be necessary to retain the main features of financial reporting under which sales are compared with costs, with costs quantified at input prices.
- 5.55 Part of the debate on the presentation of revenue and expenses relates to the use of replacement cost in financial statements. Input prices are generally quantified at historical cost, and replacement cost is a measure that represents the current expenditure needed for the input.
- 5.56 Some argue that the use of current replacement cost provides more relevant information than historical cost. Those who support this view believe that replacement cost is superior to historical cost as current values reflect the value of the economic sacrifice made in using the assets. Replacement cost also ensures consistency in that sales (which are generally in current value terms) are compared with cost of sales also stated in current terms. The differences between historical cost and replacement cost can be significant, particularly where there have been large changes in specific prices, as has recently been the case for many commodities, even though the level of general inflation has been moderate in most countries. Because future costs are more likely to resemble recent costs than those of the past, current replacement cost can arguably provide a better basis for assessment of future costs. If current replacement costs are to be used, consideration needs to be given to the reporting of holding gains. If expenses are to be reported in current terms, it is necessary to deal with unrealised holding gains separately. This concept is not new: it is reflected in the requirements of IAS 16 where property, plant and equipment is revalued and the revaluation surplus is taken to other comprehensive income.



5.57 However, others argue that current replacement cost provides information on the next production cycle rather than on the one resulting in current sales, as inputs bought at an initial purchase price and incorporated in the output sold generally cannot be extracted and replaced by new ones to be bought at current prices just at the moment the output is sold. In their view, one should take into account the necessary steps in completing the production of outputs and the related physical and timing constraints in incorporating inputs. This would avoid mixing elements of performance that belong to different production cycles if these run over more than one reporting period, which could provide confusing information to users of financial statements, as noted in comment letters on the 2012 CICA paper *Toward a Measurement Framework for Financial Reporting by Profit-Oriented Entities*.³⁰ This could be done by considering information on current replacement cost as complementary but not complete information, as there is a need of other prospective information to estimate future margin that could be better placed in disclosure.

Questions to constituents

The Bulletin proposes some implications to IFRS and asks whether constituents support the implications to the IFRS literature. Do you have any additional comments?



Conclusions and next steps

- 5.58 This Research Paper provides background of the business model notion in IFRS in support of the Bulletin *The Role of the Business Model in Financial Reporting* issued by EFRAG and the national standard setters from France, Germany, Italy and the United Kingdom. This paper and the Bulletin discuss the role of the business model notion and its potential implications. It also discusses alternatives that could be used by accounting standard setters.
- 5.59 This Research Paper also suggests that the business model has played a role in financial statements. The Bulletin included a preliminary view that the Framework should be revised to give accounting standard setters the criteria on when and how the business model should be considered.
- 5.60 The next steps depend upon constituents' feedback to the Bulletin and this Research Paper. Once the comment period on the Bulletin paper and Research Paper closes, EFRAG, ANC and FRC will consider the comments received and decide on what steps are appropriate in light of that feedback and other developments.

³⁰ CICA (2012).

Appendix 1 – Academic Review

This appendix provides a short review of mainly academic literature on the business model. The literature focuses more on the meaning of the term ‘business model’ rather than its role in financial reporting. Business thought and practice has evolved for centuries without the term ‘business model’ being explicitly used.

- A.1 Though the term appeared for the first time in an academic article in 1957 (Bellman et al. 1957), it was not commonly used until the late 1990s with the advent of the internet and interest in related technology companies. Since that time there has been a significant number of papers published (according to Zott et al. 2011: 1019). More than one thousand papers have been published in peer reviewed academic journals in which the notion of a business model is addressed, and an abundance of conference sessions and panels on the subject of business models took place.
- A.2 Academics (and practitioners) have yet to develop a common and widely accepted language. The review of literature by Zott et al. (2011: 1024) further revealed that the business model notion has been mainly used in trying to address or explain three phenomena:
- a) E-business and the use of information technology in organisations. In the late 1990s, the ‘business model’ concept became almost synonymous with e-business and the emergence of the so-called new economy. The scholars in this literature stream have 1) defined and represented generic (e-)business models, and/or 2) developed typologies and taxonomies; they have been less concerned with causal explanation or empirical testing. Their mostly descriptive contributions highlight as components, to varying degrees, the notion of value (e.g., value stream, customer value, value proposition), monetary and financial aspects (e.g., revenue streams, cost structures) and aspects related to the architecture of the network between the firm and its exchange partners (e.g., delivery channels, network relationships, logistical streams, infrastructure) (Zott et al. 2011: 1027-1028).
 - b) Strategic issues, such as value creation, competitive advantage, and firm performance. Since strategy scholars are generally interested in a firm’s activities (as these help explain, for example, how a firm distinguishes itself from its competitors), it is not surprising that many of the business model conceptualisations proposed in this literature stream centre on (or at least include) the notion of activities or activity systems. Business model can be a source of competitive advantage, as it emphasises the importance of activities centred on customer needs.
 - c) Innovation and technology management. The business model is mainly seen as a mechanism that connects a firm’s (innovative) technology to customer needs and/or to other firm resources (e.g., technologies). The business model is conceptually placed between firm’s input resources and market outcomes, and ‘embodies nothing less than the organisational and financial ‘architecture’ of the business’ (Teece 2010: 173). The ‘core logic’ of a business model, instead, revolves around a firm’s revenues and costs, its value proposition to the customer, and the mechanisms to capture value.

However, in our opinion, in the context of the business model and financial reporting it would be unfair not to mention the accounting literature that is also inherently connected with the business model and intangibles.

- A.3 Research about the role of business models has taken place in largely isolated fashion within the mentioned literature areas, containing a range of conceptualisations of business models.
- A.4 A lot of the confusion that exists within academic literature about business models stems from the fact that when different authors write about business models they do not necessarily mean the same thing (Linder and Cantrell 2000). In the academic literature, the expression stands for various things, such as parts of a business model (e.g. auction model), types of business models (e.g. direct-to-customer model), concrete real world instances of business models (e.g. the Dell model) or concepts (elements and relationships of a model) (Osterwalder et al. 2005: 8). The meanings authors use in writing about business models could be classified in three different categories:
- a) An abstract overarching concept that can describe all businesses. It consists of definitions of what a business model is and what belongs in them and (meta) models that conceptualise them.³¹ On this level, the business model is seen as an abstract concept that allows describing what a business ‘does for a living’.
 - b) A number of different types of business models (i.e. a classification scheme), each one describing a set of businesses with common characteristics. It consists of several types or meta-model types of business models that are generic but contain common characteristics.
 - c) Aspects of a particular real world business model. It consists either of concrete real world business models or of conceptualisation, representations, and descriptions of real world business models.
- A.5 In our opinion, thus different business model frameworks could be distinguished, differentiating on whether they provide generic descriptions of the business or whether they are more specific in their descriptions.
- A.6 Diversity in the available definitions also leads to confusion in terminology, as business model, strategy, business concept, revenue model, and economic model are often used interchangeably within the academic literature. Therefore, it should not come as a surprise that no generally accepted definition of the term ‘business model’ has emerged (Morris et al. 2005: 726).³²
- A.7 Some authors articulate very general common points to all the business model definitions. Richardson (2008: 135-136) notes that there is a general agreement on the basic high level definition of a business model. It is simply a description of how a firm does business - describes the way it delivers its products and services to customers and the way it makes money. Malone et al. (2006: 5) state that common to all of these definitions of business and e-business models is an emphasis on how a firm makes money.

³¹ According to Steinmüller (1993), a model is information a) on something (content, meaning) b) created by someone (sender) c) for somebody (receiver) d) for some purpose (usage context). If we have a model of a model we might be tempted to call it a ‘metamodel’. After all, we use the prefix ‘meta’ to indicate that some operation has been performed twice. For instance, when classifying twice, we prefer to refer to the result as a ‘metaclass’ instead of ‘class class’.

³² ICAEW report (2010: 9), for example, notes that the language of ‘business model’ is relatively new and perhaps derives from the longer-established idea of economic models.

- A.8 In spite of all the discussion about business models, however, there have been very few large-scale systematic empirical studies of them. Actually, we are aware of only a few econometric studies that link business models to performance.
- A.9 Amit and Zott (2001) look at how the fit of business model themes (novelty- versus efficiency-centred) and product-market strategy (differentiation versus low-cost, and timing of entry) affect firm performance, as measured by market value. Using a sample of Internet-related firms that have gone public between 1996 and 2000, they find that the novelty-centred business model fits all their types of product-market strategies, but the efficiency-centred business model fits only a low-cost product-market strategy.
- A.10 Malone et al. (2006) offer an operational definition of the business model: how businesses appropriate the maximum value of the products or services they have created. Their definition is basically a typological definition based on two fundamental dimensions of what a business does. One dimension is the type of assets involved i.e., what products or services have been created for appropriation. They distinguish among four important asset types: financial, physical, intangible and human.
- A.11 The second dimension is type of rights being sold i.e., how value is appropriated. The first, and most obvious, kind of right a business can sell is the right of ownership of an asset. Furthermore, they distinguish between sales that involve significantly transformed assets from those that do not. This allows them to distinguish between firms that make what they sell (like manufacturers) and those that sell things other firms have made (like retailers). The second obvious kind of right a business can sell is the right to use an asset, such as a car or a hotel room. The next kind of right a business can sell is the right to be matched with potential buyers or sellers of something. Overall, they consider four types of asset rights: Creator, Distributor, Landlord, and Broker. For example, manufacturers create physical assets, and wholesalers and retailers distribute them.
- A.12 The combination of these two dimensions – what type of asset is involved and what asset rights are being sold – leads to sixteen business models, which are shown in the Figure 1 below, where each cell is illustrated with the common name for the model as well as an example firm. In their judgment, this typological definition fits important model criteria, such as parsimony, being mutually exclusive and collectively exhaustive, and has a good fit with intuition.

A.13 Figure 1: The sixteen business models

		What type of asset is involved?			
		Financial	Physical	Intangible	Human
What rights are being sold?	Creator	Entrepreneur (Kleiner Perkins)	Manufacturer (GM)	Inventor (Lucent Bell Labs)	Not applicable
	Distributor	Fin. Trader (Merril Lynch)	Wholesaler/Retailer (Wal Mart)	IP Trader (NTL Inc.)	Not applicable
	Landlord	Fin. Landlord (Citygroup)	Physical Landlord (Hertz)	IP Landlord (Microsoft)	Contractor (Accenture)
	Broker	Fin. Broker (Charles Schwab)	Physical Broker (Ebay)	IP Broker (Valassis)	HR Broker (EDS)

Source: Lai et al. (2006: 28).

Note: The two not applicable models are illegal in most countries today because they involve creating or selling human beings. They are included here for logical completeness.

A.14 They selected a sample of firms, classified their business models, and then analysed their financial performance. They chose the set of publicly traded US firms in COMPUSTAT-CRSP, from 1998 through 2002. They classified firms' business models using the firms' revenue as a guide. They suggested that many firms would have more than one business model, so they classified a firm's business models separately for each revenue segment the firm reported. They found that some business models do, indeed, perform better than others, but on different measures of performance.

A.15 A second example from Andersson et al. (2010) is that business models are constituted within an econo-sphere.³³ The econo-sphere provides the pool of information elements about products/services, human capital, physical and organisational technologies, financial resources, regulatory conditions and institutional arrangements. A business model is thus described by the information elements that constitute it. The focal firm/entity subtended within a specific business model draws upon similar information elements as other focal firms in the business model.

A.16 Given this financial purpose, business models can usefully be located within an augmented financial organising framework.³⁴ In summary, this can be employed to describe a spectrum of possibilities/combinations where the continuum is constructed out of two summary financial elements: cash extractive capacity and capital intensity.

A.17 Andersson and Haslam note that focal firms within a business model will display variable financial performance, in some cases migrating deliberately into what will be a 'new' business model or because a focal firm's financials degrade to such an extent that it becomes re-located outside of the financial matrix that defines its business model (please see Figure 2).³⁵

A.18 Figure 2: Business model typology:

Cash from balance sheet - Depletion		Cash tot balance sheet - Augmentation			Balance sheet - Holding gains	
Cash Burn	Cash Burn + Income	Cash Generative	Strong Cash Generation	Very Strong Cash Generation	Cash positive	Limited/restricted cash from operations
Cash from Operations Negative	Cash from operations neutral	Cash from operations +	Cash from operations +	Cash from operations +	Cash from operations and asset trades	Cash from operations limited
External funding (Debt/Equity) Draw Down	External funding Draw Down	External funding for some applications	External funding strong and high distribution rates	External External funding	High levels of external Debt funding	Very high leverage Debt to Equity
Balance Sheet depletion debt and equity run down	Signs of Balance Sheet Augmentation	Balance Sheet accumulation: tangible Assets	Balance Sheet accumulation tangible plus intangible	Balance Sheet accumulation tangible plus higher ratio of intangible tot tangible	Balance Sheet Debt to Equity Ration increased. Financial assets + intangibles tot tangibles = high	Balance Sheet assets held/ traded for holding gains. Financial assets + intangibles tot tangibles = high

FOCAL FIRM LOCATED IN BUSINESS MODEL = CONTEXT AND NATURE OF VALUE DRIVERS AND CREDIT RISK VARIABLE

³³ 'What's the difference between the economy and the Econosphere? I'm pleased to respond that there is absolutely no difference between the economy and the Econosphere. (Thompson 2010). <http://www.smartplanet.com/blog/pure-genius/the-econosphere-how-the-economy-really-works/1407>

³⁴ Described in Andersson et al. (2010). The sample used is the survivor group of firms listed in the S&P 500 from 1990 to 2008.

³⁵ The following text and Figure 2 was provided by Professor Colin Haslam via e-mail correspondence.

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- A.19 On the left hand, we find business models that burn cash and deplete balance sheet value to develop new product/services. Towards the middle, we have business models delivering strong cash and balance sheet augmentation from productive activity (production and services that are consumed). Whilst towards the extreme right we have business models that rely on thin cash margin skim on volume transactions where holdings gains/losses from a continuous process of balance sheet changes and trade in financial assets becomes more of the norm.
- A.20 A third example is based on a survey conducted by George and Bock (2011), who utilised a survey instrument with open-ended questions prompting text responses as well as quantitative assessments of numerous firm characteristics in a standardised format. The survey asked two open-ended questions: ‘What is a business model?’ and ‘What is your company’s business model?’ The questions were purposefully kept simple and placed at the start of the survey in order to obtain a ‘blank slate type’ response.
- A.21 Managerial discourse demonstrated that the business model is a relevant construct despite the concern expressed by managers that they had ‘never tried to define it before’ or ‘could not explain it clearly’.³⁶ More than 90 % of the survey participants attempted to answer the question ‘What is a business model?’ and also provided a response to the question ‘What is your firm’s business model?’ (George and Bock 2011: 97).
- A.22 Practitioners believe that the business model represents a relevant concept, linked closely to firm performance and survival, and especially relevant to the underlying opportunity that the firm exploits. Practitioner responses reveal that a business model is an organisation-level phenomenon, an architecture or design that incorporates subsystems and processes to accomplish a specific purpose. It is not equivalent to that purpose, nor is it the reason that the organisation exists. It is not a process. The business model is not fully explained by a firm’s revenue model, though aspects overlap. Practitioners apply both resource-based and transactive elements to the business model. Finally, the business model does not subsume nor is it subsumed by corporate strategy (George and Bock 2011: 97).
- A.23 Nielsen and Bukh (2011) prepared a paper, which is based on qualitative interviews with 12 sell-side financial analysts that follow Coloplast, a Danish medical device firm, on a regular basis. They examined the financial analyst’s way of thinking about both strategy and business models.

³⁶ On the basis of the discourse analysis, also referred to as ‘content analysis’ or ‘textual analysis’. It is an analytical tool attributed to Foucault (1982) that distils information from text using quantitative techniques (Fairclough, 2003) in (George and Bock 2011: 90). The survey was administered to 182 senior managers of Indian firms who attended executive education programs between Winter 2008 and Spring 2009. Firms ranged in size from 2 employees to more than 20,000 employees and in age from start-ups to more than 100 years old. A secondary test sample was obtained by administering the survey to 13 managers of U.K. firms who attended an unrelated executive education program in Fall 2009 (George and Bock 2011: 90).



- A.24 Surprisingly, most of the analysts interviewed initially had difficulty answering a direct question not only what the business model of Coloplast was, but also what a business model in itself was. In some cases, the analysts questioned whether the phrase business model was appropriate to apply at all. However, they were able to describe Coloplast's value proposition and how this correlated with their unique value creation logic by showing a detailed understanding of the characteristics and importance of research and development, innovation, production, logistics, marketing and market penetration strategy and distribution methods. These elements that might be part of a business model were in fact all used in the analysts' descriptions of Coloplast's competitive strengths and strategy.
- A.25 The research by Nielsen and Bukh thus indicates that the particularities of strategy and competitive strengths used by the analysts in their understanding of the company in fact comprised a very comprehensive description of the business when pieced together. The fact that Nielsen and Bukh received rather vague answers to the direct questions regarding Coloplast's business model might suggest that the analysts are more interested in the specifics of individual elements that might be part of a 'business model', rather than understanding the whole business model. This could be because it is easier to link these individual elements to cash flow models and price/earnings estimates.
- A.26 Chesborough (2007: 12) states that every company has a business model, whether they articulate it or not. Teece (2010: 172) notes that whenever a business is established, it either explicitly or implicitly employs a particular business model. Magretta (2002: 87) believes a good business model remains essential to every successful organisation, whether it is a new venture or an established player. It is worth noting that even though business have been around for a very long time, the term 'business model' is a relatively recent phenomenon which rose to prominence only towards the end of 1990s with the advent of internet and the steep rise of the NASDAQ index.
- A.27 According to Teece (2010: 175), the study of business models is an interdisciplinary topic that was neglected before the internet era. Despite the business model's obvious importance, it lacks an intellectual home in the social sciences or business studies. The business model lacks theoretical grounding in economics and quite simply there is no established place in current economic theory for the business model.
- A.28 If we try to link business models with financial reporting, we cannot ignore an ICAEW's report (2010), which is actually looking at the economic theory of the firm. It asks what insights we might gain from it in thinking about accounting issues and focuses on the theory of the firm's potential relevance to questions of measurement in financial reporting. The authors argue that it is difficult to make a direct connection between the theory of the firm and accounting measurement, but one way of relating the two to each other is through firms' business models. The study claims that assumptions about business models have always been implicit in financial reporting standards, as it has always been the case that different businesses will account for the same asset in different ways depending on what its role is within the firm's business model. Questions of cost allocation and revenue recognition for different firms and different sectors are also closely tied to the interpretation of their business models.

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