



THE ROLE OF THE BUSINESS MODEL IN FINANCIAL STATEMENTS

ICAEW welcomes the opportunity to comment on the research paper *The Role of the Business Model in Financial Statements* published by the European Financial Reporting Advisory Group (EFRAG), French Autorité des Normes Comptables (ANC) and UK Financial Reporting Council (FRC) on December 2013, a copy of which is available from this [link](#).

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MAJOR POINTS

Support for the initiative

1. The research paper (RP) is a follow-up to the *Getting a Better Framework* bulletin, *The Role of the Business Model in Financial Reporting*, issued by EFRAG, ANC, Accounting Standards Committee of Germany, Organismo Italiano di Contabilità and FRC in July 2013. As we stated in our response to the bulletin (ICA EW Rep 130/13), business models already play a significant role in financial reporting, we support this role, and we believe that a firm's reporting should reflect its business model so that the model's success or failure can be properly assessed.
2. In our response to the bulletin we commented on some of the principal issues now raised again in the RP, but dealt with others in our response to the IASB discussion paper (DP) *A Review of the Conceptual Framework for Financial Reporting* (ICA EW Rep 06/14). The RP provides background information to some of the issues discussed in the bulletin, but also raises a number of new questions. It may therefore be helpful to bring together briefly in this response some key points on the role of the business model in financial reporting. We are not responding to the specific questions in the RP.

General considerations

3. We believe that, by and large, financial reporting already reflects a firm's business model (or models – firms may have more than one business model). We would not support any approach, whether based on business models or not, that would involve significant changes to current practice on the grounds that they are required in order to achieve consistency with some theory, rather than because they can be shown to provide more useful information. Partly for this reason, we do not advocate dealing explicitly with the role of the business model in the conceptual framework as this is likely to lead to too rigid an approach.

Measurement

4. In our response to the bulletin we stated that, in general, we are supportive of an approach where the measurement of assets and liabilities (or groups of assets and liabilities) reflects the way in which they will give rise to future cash flows. We also noted, though, that it is possible to apply this principle in ways that would not necessarily lead to the most useful information, and we questioned specific applications of the principle in the bulletin. The IASB DP also advocated basing the measurement of assets and liabilities on how they are expected to contribute to future cash flows, and again we argued that the specific applications of this principle in the DP were not always appropriate and indeed that the whole approach needed substantial further work.
5. Perhaps the most obvious interpretation of basing an asset's measurement on how it contributes to cash flows is to measure assets held for sale at a current exit price and assets held for use on a cost-related basis. This does not correspond to how measurement in financial reporting currently works in practice (consider, eg, manufacturers' finished goods and retailers' inventories) and we do not advocate a change in this direction – nor, as we understand it, would EFRAG and its associated bodies or the IASB.
6. Another interpretation of the business-model approach is to look at whether the asset contributes to cash flows jointly with other assets or independently. Again, we do not think that this approach works, as assets that are assumed by its advocates to contribute to cash flows independently usually in fact depend on other assets for the realisation of their full value. In our response to the IASB DP we gave the example of a derivative financial instrument, the realisation of whose full value typically requires skilled traders, access to the relevant markets, and expensive infrastructure, including technology and back-office support.
7. In our response to the IASB DP, we drew attention to an alternative way of thinking about how the business model concept can be applied to measurement questions, which corresponds

more closely to existing practice. This is to consider whether the item in question forms part of a process of transformation of assets and services into other assets and services or whether it remains unchanged by the business between purchase and sale.

8. This approach would help explain why, for example, manufacturers' finished goods and retailers' stocks are usually measured at historical cost. Manufacturers' finished goods are the last stage in a process of transformation and so are retailers' inventories – where the transformation is one of division and relocation into amounts and to places where they can be sold to retail customers. In such processes of transformation, the most useful information is usually provided by an income statement based on matching revenue from sales with the relevant costs incurred, which users can employ as a basis for calculations of repeatable income. Revaluing to current exit price the assets that form part of such a process of transformation does not usually provide particularly useful information.
9. By contrast, many items that are usually measured at current value, such as investment properties or financial assets held for trading, are not transformed by the business, but are held for investment income or to be sold in the same market in which they were acquired (as opposed to, eg, being bought from a wholesaler and sold retail). Revaluing such assets to current exit price may well provide useful information as it shows in some cases how successful the business has been in buying assets that have risen in value and/or in others the value of the investment on which a return is being made. For these businesses, income still measures performance, but is less useful – where assets are traded – as a basis for calculations of repeatable income, and the balance sheet becomes relatively more important.
10. We are not suggesting that this approach provides an answer to all asset measurement questions, and we suspect that there is no single approach that would do so.
11. Neither the RP nor the IASB DP devotes much space to articulating how exactly a business-model approach would apply to liabilities specifically. The cash-conversion cycle idea in the RP (paragraph 3.39) seems to focus on whether inputs are subsequently used or sold and so to be primarily relevant to the measurement of assets. In the DP, key distinctions proposed are between liabilities that do, and liabilities that do not, have stated terms (which does not appear to be a business-model issue) and between liabilities that will, and liabilities that will not, be transferred. Whether a liability will be transferred is arguably a business-model issue and one that affects how the liability will give rise to future cash flows. But, as we pointed out in our response to the DP, it is difficult to think of categories of liability that are in practice transferred other than, occasionally, pension obligations.
12. The discussion of measurement in the RP is more complex than in the bulletin and recognises a number of aspects of business models that might be relevant to deciding on a basis of measurement (paragraph 3.42), although the idea of the cash-conversion cycle is put forward as a unifying concept. However, if we interpret it correctly, the RP does not adopt a different approach from that in the bulletin.
13. In Chapter 3 of the RP, examples are given of cases involving banking, a mobile network operator, and insurance, in which business-model-based and non-business-model-based alternatives are put forward. Of these examples, we only wish to comment on the insurance one, where the business-model-based alternative involves, in the particular circumstances described, linking the measurements of assets and liabilities so that they are on consistent bases. The difficulties of accounting for insurance business are well known – the IASB has been grappling with them, including the issue described in the RP, for more than a decade – and the supposedly business-model-based solution suggested in the RP seems to us to be an over-simplified approach to a complex issue.

Other issues

14. In our response to the IASB DP, we indicated two other respects in which the business model can play a role in financial reporting: in deciding what is to be included in profit or loss (or in OCI); and in defining revenue. Again, however, we would not support any particular formula that should be rigidly followed in applying the business model concept to these issues.