25 September 2013

Our ref: ICAEW Rep 130/13

Ms Françoise Flores
Chairman
EFRAG
35 Square de Meeûs
B-1000 Brussels
Belgium

By email to commentletters@efrag.org

Dear Françoise

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

ICAEW is pleased to respond to your request for comments on the *Getting a Better Framework* bulletin: *The Role of the Business Model in Financial Reporting*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

Dr Nigel Sleigh-Johnson
Head of Financial Reporting Faculty

T +44 (0)20 7920 8793
E nigel.sleigh-johnson@icaew.com

ICAEW REP 130/13

ICAEW REPRESENTATION

GETTING A BETTER FRAMEWORK: THE ROLE OF THE BUSINESS MODEL IN FINANCIAL REPORTING

Memorandum of comment submitted in September 2013 by ICAEW, in response to the European Financial Reporting Advisory Group, French Autorité des Normes Comptables, Accounting Standards Committee of Germany, Organismo Italiano di Contabilità and UK Financial Reporting Council *Getting a Better Framework* bulletin *The Role of the Business Model in Financial Reporting* published in June 2013

Contents **Paragraph**

INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the European Financial Reporting Advisory Group, French Autorité des Normes Comptables, Accounting Standards Committee of Germany, Organismo Italiano di Contabilità and UK Financial Reporting Council *Getting a Better Framework* bulletin *The Role of the Business Model in Financial Reporting* published in June 2013, a copy of which is available from this link.

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 140,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

4. The Financial Reporting Faculty is recognised internationally as a leading authority on financial reporting. The faculty's Financial Reporting Committee is responsible for formulating ICAEW policy on financial reporting issues, and makes submissions to standard setters and other external bodies. The faculty also provides an extensive range of services to its members, providing practical assistance in dealing with common financial reporting problems.

MAJOR POINTS

The *Getting a Better Framework* initiative

5. As we have stated in our responses to the first three bulletins in this series, we welcome the initiative of EFRAG and its associated national standard setters in setting up the *Getting a Better Framework* project. Now that the IASB has issued its discussion paper, *A Review of the Conceptual Framework for Financial Reporting*, commentators' resources will inevitably be focused primarily on that. The bulletins have served a useful purpose in promoting discussion on issues that should form part of the conceptual framework debate. However, two further bulletins have now been published, two months into the consultative period for the IASB's discussion paper: *Accountability and the Objective of Financial Reporting* and *The Asset/Liability Approach*. We think that, as the series continues, the bulletins are unlikely to attract the attention they deserve, as commentators will give priority to the IASB discussion paper and any subsequent IASB publications on the conceptual framework. We therefore suggest that EFRAG and the associated national standard setters should consider bringing the series to an end, at least as consultative exercises to which responses are expected.

6. The key conclusions set out in the bulletins are expressed as tentative and, as – until the two most recent bulletins – they were prepared before the IASB had published its proposals, we believe that this is the right approach. For the same reason, our own comments on the bulletins should be seen as provisional views, as we are still considering the IASB's discussion paper, and will be revisiting the issues discussed in the bulletins as we do so.

The Role of the Business Model in Financial Reporting

7. As the bulletin recognises, 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. We discuss the role of the business model in financial reporting in our 2010 report *Business Models in Accounting: The Theory of the Firm and Financial Reporting* and more recently in our response (ICAEW REP 52/13) to the IASB exposure draft *Classification and Measurement: Limited Amendments to IFRS 9*.

8. In general, we are supportive of an approach where the measurement of assets and liabilities (or groups of assets or liabilities) reflects the way in which they will give rise to future cash flows, although it is possible to apply this principle in ways that would not necessarily lead to the most useful information (see, for example, the point raised at paragraph 12 below). A similar approach is suggested in the IASB discussion paper, which we will be commenting on in detail in our response to that document.

RESPONSES TO SPECIFIC QUESTIONS

Q1: Do you think that our assumed meaning makes sense from a financial reporting perspective?

9. Paragraph 12 of the bulletin states that 'our assumed meaning of the term "business model" focuses on the value creation process of an entity, ie how the entity generates cash flows'. We agree that this makes sense from a financial reporting perspective, although other considerations may also be important. Also, a single entity may have several business models. We discuss these points further in our response to Question 4.

Q2: Do you support the tentative view that management intent and business model are distinct?

10. We agree with the tentative view expressed in the bulletin (paragraph 50) that a distinction can be made between business model and management intent, and that, if such a distinction is made, then it can be expressed as 'business models tend to focus on the larger picture, are, generally, more stable, and usually require much less documentation to make them verifiable'.

Q3: Do you support the tentative view that the business model should play a role in financial reporting?

11. As we have stated above (paragraph 7), we think that the business model already plays a significant role in financial reporting and should continue to do so. Its role could perhaps be made more overt in future. We will be considering in our response to the IASB discussion paper whether this is best achieved by using the term 'business model' in the conceptual framework or by the IASB's suggested approach (in relation to measurement) of referring to how assets and liabilities will give rise to future flows of resources.

Q4: Do you support the proposed implications for the IFRS literature?

12. As regards measurement, it is not entirely clear from the bulletin what the implications are of adopting a business model approach. The cotton example at paragraph 7 of the bulletin distinguishes between cotton held for resale and cotton to be used in the business to make shirts. Using a business model approach, the former would be measured at its current selling price, the latter at historical cost. Each basis could be said to reflect 'how the entity is generating cash flows' in relation to the respective assets. However, if the distinction here is between assets that contribute to cash flows by being sold as they are and assets that contribute to cash flows by being combined with other assets (eg, to make shirts), then it is not clear how the finished product (the shirts) should be measured. As they are finished products that will be sold, does reflecting how they will contribute to cash flows mean that they should be measured at current selling price? Clearly this would be a significant change to current practice, which we would not support.

13. It will sometimes be necessary to specify the firm's business model in some detail in order to determine how particular items should be accounted for. Where, for example, a company holds properties for various purposes – some for owner-occupied use within the business, some for resale, some as investments for rental income – it is necessary to look at them individually or at the portfolio of assets to which they belong to see how they fit into the firm's business model or models and so how they should each be accounted for. The same applies to certain financial instruments (or portfolios of financial instruments), whose role may involve either sale or retention within the business. In effect, a single entity may employ a number of different models within its overall business, and each needs to be reflected in its financial reporting.

Q5: Do you have any other comments on this Bulletin?

14. The example at paragraph 7 concerning cotton inventory, referred to above, prompts a number of questions. It is stated at line 2 that the cotton is 'worth' 120 and that 'the entity could readily sell it at that price'. This implies that 'worth' means something different from what the asset could readily be sold for. It would have been useful to explain what 'worth' does mean. It would also have been helpful to clarify that, under IFRS, the 'current practice' said to be adopted by the commodity trader is not the only permitted one. While paragraph 3(b) of IAS 2, *Inventories*, does indeed exempt from its historical cost measurement requirements commodity broker-traders who measure their inventories at fair value less costs to sell, historical cost measurements remain optional for commodity traders. We do not have any information on how many commodity traders adopt historical cost and how many fair value, but current practice as represented by IAS 2 assumes that either approach is capable of giving a fair presentation. Also, while we are not suggesting that the shirt manufacturer in the example should be required to abandon historical cost for its cotton inventory, there is an argument for disclosing the inventory's current value, which may well be useful information – for example, when there are significant changes in replacement cost and the shirt is being sold at below that.

15. At paragraphs 20 and 42 there are references to 'academic research'. As we have noted in our comments on earlier bulletins, it would be helpful in such cases to indicate what research is being referred to.

16. We do not follow the argument at the end of paragraph 24, which states that the requirement in IAS 16, *Property, Plant and Equipment*, for all assets in a particular class to be measured in the same way ignores the notion of the business model as different assets may be used in different ways. Paragraph 37 of IAS 16 requires assets to be grouped into separate classes on the basis of 'a similar nature and use in an entity's operations'.

E brian.singleton-green@icaew.com