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European Financial Reporting Advisory Group
25 Square de Meeûs
B-1000 Brussels
Belgium

Comment on Research Paper *The role of the business model in financial statements*

The Accounting Standards Board of Japan (ASBJ) welcomes the opportunity to provide comments on European Financial Reporting Advisory Group (EFRAG)'s Research Paper (RP) *The role of the business model in financial statements*. Our comments are as follows.

I. General

1. First, the ASBJ is of the view that different measurement bases should be applied to the same asset or liability, where the nature (or characteristics) of the asset or the liability differs. Thus, the ASBJ supports the view stated in EFRAG's RP that different accounting treatments should be applied to the same asset or liability where it is used in different business activities.
2. In this connection, the ASBJ has already expressed its general support for the IASB's preliminary views stated in the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* (IASB DP), which suggested the following¹:
 - (1) For a particular asset, the selection of a relevant measurement basis should depend on how that asset contributes to future cash flows; and for a particular liability, the selection of a relevant measurement basis should depend on how the entity will settle or fulfil the liability.
 - (2) The way an entity conducts its business activities can provide useful basis, when the IASB consider how an asset contributes to future cash flows and how a liability will be settled or fulfilled.
3. The ASBJ believes that this IASB's preliminary views together with rationale stated in the IASB's DP provide good explanation of why the way an entity's business activities are conducted should be considered in determining the relevant measurement basis of an asset or a liability.

¹ Paragraph 6.17 of the IASB DP

4. At the same time, when an entity uses more than one asset (or assets and liabilities) as collective inputs in a process to generate outputs, the ASBJ believes that the relevant measurement bases of these assets and liabilities should not be considered separately. Instead, the ASBJ believes that the measurement bases of these assets and liabilities should be selected together because a group of assets, or a group of assets and liabilities would collectively give rise to future net cash inflows to the entity. This is another reason why the ASBJ believes that the way in which an entity's business activities are conducted is important in selecting the relevant measurement bases.
5. Nevertheless, the ASBJ does not think that a term 'business model' should really be used in the *Conceptual Framework*, because the term 'business model' is used not just in accounting standards but also in various contexts with different meanings throughout the business world. In reading the paper, the ASBJ found that EFRAG's RP endeavoured to explain the term 'business model' without defining what is meant by the term. The ASBJ supposes that it might be because EFRAG encountered challenges in identifying a reasonably agreeable definition for the term. In the ASBJ's view, this would demonstrate how difficult it is to find an appropriate definition for the term 'business model' that could be used in the *Conceptual Framework*. The ASBJ believes that there exists a considerable risk of misunderstanding if we were to progress the debate without giving a clear definition.
6. Accordingly, instead of trying to use the term without a clear definition, the ASBJ suggests that the *Conceptual Framework* should explain the 'key concepts'. Specifically, based on the reasons stated in paragraphs 3 and 4 of this letter, the ASBJ believes that following concepts should be explained in the measurement section of the *Conceptual Framework*:
 - (a) Consideration should be given to whether future cash inflows or future cash outflows will be generated from a group of assets or a group of assets and liabilities. - In the ASBJ's view, this would help the IASB to determine a 'unit of account' in measurement.
 - (i) If future cash inflows or future cash outflows will be generated from a group of assets or a group of asset and liabilities, their measurement bases should be considered together, so that measurement basis of these assets and liabilities would be congruent.
 - (ii) If future cash inflows and outflows are expected to occur from individual assets or liabilities, measurement bases of these assets and liabilities should be considered separately.
 - (b) Consideration should be given to whether assets or liabilities are expected to be

used in combination with other assets or liabilities as inputs in an entity's value-adding activities to generate future net cash inflow to an entity.

- (i) If an entity expects to maximise the return on its assets or liabilities by realising changes in prices in liquid markets, it is likely that remeasurement at current value with gains or losses to be recognised in profit or loss would be appropriate.
- (ii) If an entity expects to generate future net cash inflows by using assets or liabilities as inputs in an entity's value-adding activities and selling outputs to third parties, the cost-based measure is likely to be relevant measurement basis from the perspective of reporting an entity's *financial performance*.

7. The ASBJ believes that clarifying these key concepts, instead of using the undefined term 'business model' could help avoid misunderstandings in the following respects:

- (a) The level of aggregation the term 'business model' should refer to: Some may question if the term 'business model' would mean the business activities at the level of an 'entity as a whole' or at the level consistent with 'segment reporting' or at a much lower level such as a project unit. In this respect, the ASBJ believes that the *Conceptual Framework* should clarify that the appropriate level of aggregation for measurement is consistent with way an asset or liability contributes to the future net cash inflows to an entity.
- (b) Whether the term 'business model' intends to incorporate the notions of 'observability' and 'verifiability': Some may argue that the term 'business model' should embed the notions of 'observability' and 'verifiability' consistent with the definition in IFRS 9 *Financial Instruments*. These notions would be very important in the situation where the usage is easily changed (for example, in a case of financial instrument); however, they would be less important in the situation where a change in the usage is substantially restricted. In this respect, the ASBJ believes that the *Conceptual Framework* should clarify that these notions are not essential factors at the concept level.
- (c) Whether the 'business model' can ever be changed: Some may object to the use of the term 'business model' at the concept level, because this term seems to imply that the measurement basis should not be changed even when the way an asset or a liability is used changes. In this respect, the ASBJ believes that the *Conceptual Framework* should explain that an appropriate measurement basis is changed if the way an asset or a liability contributes to future net cash inflows to an entity changes.

8. The ASBJ also believes that our suggestions in paragraphs 6 and 7 of this letter would contribute to the discussion regarding profit or loss and other comprehensive income (OCI), because a relevant measurement basis determined from the perspective of reporting an entity's *financial performance* would help explain the decisions about measurement and profit or loss / OCI².
9. Specifically, in the situation where an entity expects to maximise a return on its assets or liabilities solely through their price changes without conducting value adding activities (as explained in paragraph 6 (b)(i) of this letter), the ASBJ believes that changes in the price itself would be considered as an *irreversible outcome* of the entity's business activities, thus gains or losses on remeasurement should be recognised in profit or loss at period-end.
10. On the other hand, in the situation where an entity expects to generate future net cash flows by conducting value adding activities using assets or liabilities as inputs (as explained in paragraph 6 (b)(ii) of this letter), the ASBJ believes that gains or losses on remeasurement should not be recognised in profit or loss at period-end, because a price change itself would not be considered as an *irreversible outcome* of an entity's business activities. Instead, the ASBJ believes that incomes or expenses should be recognised in profit or loss, when an entity's process creates value and cash flows are generated by selling outputs (that is, the timing when a 'cash conversion cycle' explained in EFRAG's RP is completed).

II. Comments on Specific Questions

Question 1 - Implicit 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?

11. The ASBJ agrees with the analysis of the examples explained in EFRAG's RP, in that the value creation and cash flow generation has been considered implicitly in the development of IFRSs (Please note that the ASBJ uses the term '*value creation and cash flow generation*' instead of 'cash flow generation and value creation' as used in EFRAG's RP, because this order is more in line with an actual cash conversion cycle.)
12. However, the ASBJ thinks that the analyses in EFRAG's RP did not sufficiently distinguish between the requirements in which the term 'business model' was used to

² Please see more explanation in the ASBJ's Short Paper Series No.1 '*Is OCI Unnecessary?*' https://www.asb.or.jp/asb/asb_e/international_activities/discussion/20140523_e.pdf

refer to the *concept* of value creation and cash flow generation and the other requirements in which the term was used solely to increase the ‘observability’ and ‘verifiability’.

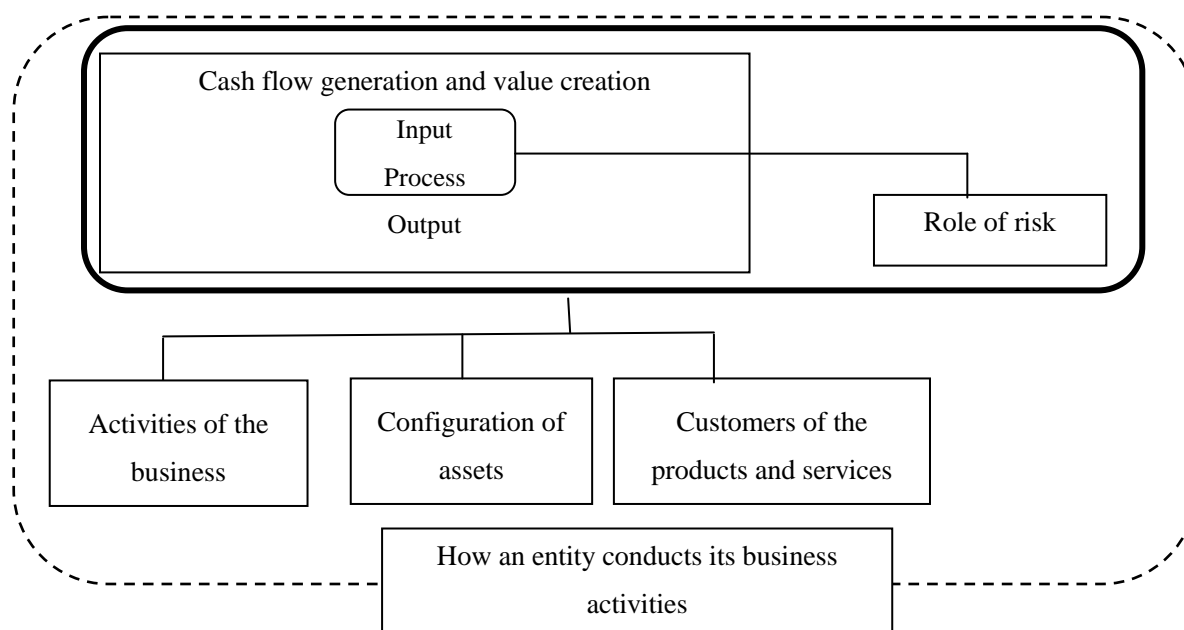
Question 2 - Cash conversion cycle

(a) Do you agree with the analysis of the cash conversion cycle? Please explain.

(b) Are there any other attributes to add?

13. As stated in our response to paragraph 5 of this letter, the ASBJ does not believe that the IASB should use the term ‘business model’ in the *Conceptual Framework*. However, if the term were to be used in the *Conceptual Framework*, the ASBJ believes that it is essential that there is a common understanding of the term.
14. In this respect, the ASBJ thinks that the five key characteristics described in Chapter 3 of EFRAG’s RP highlighted helpful contrasts about the possible meaning of the term ‘business model’. We provide detailed analysis on the five key characteristics in Appendix of this letter.
15. Consistent with EFRAG’s views, the ASBJ believes that ‘value creation and cash flow generation’ is the most relevant characteristic to determine relevant measurement bases of assets and liabilities, and the role of risks should be considered when applying the concept. Accordingly, if the term ‘business model’ were to be used in the development of accounting standards, the ASBJ believes that it should refer to the meaning of ‘value creation and cash flow generation’. In reading the paper, the ASBJ understands that the term ‘cash flow conversion cycle’ stated in EFRAG’s RP is intended to have the same meaning as the ‘value creation and cash flow generation’ but uses different words.
16. The ASBJ also thinks that the relationship between the five key characteristics of the business model (as explained in EFRAG’s RP) and the way an entity conducts its business activities (as explained in the IASB DP) can be illustrated in the following diagram:

Diagram 1: Interactions between the five key characteristics of the business model (stated in EFRAG’s RP) and the way an entity conducts its business activities (explained in the IASB’s DP)



17. The ASBJ thinks that this diagram indicates the following points.

- (a) Some argue that the way an entity conducts its business activities can simply be replaced with the term ‘business model’. However, the term ‘business activities’ is also understood in various ways. Thus, it would be important to articulate the ‘key concepts’ in the *Conceptual Framework*.
- (b) Activities of the business, configuration of assets, and customers of the products and services can be explained as factors that influence the way that value will be created and cash flows will be generated.
- (c) The notion of ‘risks’ can be explained as they relate to inputs and processes. This explanation would help explain the difference between a case where an entity endeavours to maximise its cash flows solely through an asset’s price change risks and the other case where an entity endeavours to maximise its cash flows using its assets together in conducting business activities.
- (d) The term ‘business model’ should not be characterized by the ‘observability’ or ‘verifiability’ at the concept level.

Question 4 - Playing a role in financial reporting

Do you have any additional comments?

18. As explained in paragraph 6 of this letter, the ASBJ believes that value creation and cash flow generation is especially important especially when:
- (a) Determining an appropriate ‘unit of account’; and
 - (b) Determining subsequent measurements of assets and liabilities from the perspective of reporting an entity’s *financial performance* (in other words, value creation and cash flow generation would be important in determining ‘measurement’ and the ‘use of OCI’).
19. In addition, the ASBJ notes that measurement decisions are likely to have a knock-on effect on presentation and disclosures. Further, the ASBJ believes that notions explained in this letter should always be considered in every projects of standard-setting. However, the ASBJ thinks that it is not always necessary to make these notions explicit in each standard, because the scope of a standard presumes specific fact patterns at the outset.

Question 5 - Criteria for use of the business model

(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.

20. As stated in our response to Question 4, the ASBJ believes that value creation and cash flow generation should *always* play a role in the development of accounting standards. This contrasts with paragraph 5.7 in EFRAG’s RP that suggested that relevant criteria should be set out in determining when to consider the business model. Accordingly, the ASBJ does not support this suggestion.
21. In addition, the ASBJ does not support the proposed additional criteria stated in paragraph 5.14 in EFRAG’s RP, which suggested that a notion of ‘observability’ be embedded in the concept of the ‘business model’, even if the IASB were to decide to use the term ‘business model’ in the *Conceptual Framework*.

The ASBJ's analysis on the five key characteristics of the 'business model'

1. The following paragraphs explain the ASBJ's analysis on the five key characteristics of the 'business model' as explained in EFRAG's RP.

Approach focusing on the activities of the business

2. As a mean to clarify what is meant by the term 'business model', one of the approaches explored in EFRAG's RP is to focus on 'activities in which an entity is engaged' (or 'activities of the business'). EFRAG's RP used a pharmaceutical entity as its example, and tried to distinguish its activities based on research, development, manufacturing, and marketing activities.
3. The ASBJ understands that the types of activities an entity is engaged in is highly important, and some identify a business model based on the types of such activities. However, a key consideration for the purpose of developing accounting standards (especially in determining relevant measurement bases) is whether different measurement bases should be applied even for the same asset or liability. The ASBJ thinks that this analysis is not relevant for the said purpose.
4. Accordingly, the ASBJ believes it is inappropriate to focus on 'activities of the business' to progress the discussion about how to identify a business model for the purpose of developing accounting standards.

Approach focusing on the configuration of assets

5. As a means to clarify what is meant by the term 'business model', one of the approaches explored in EFRAG's RP is to focus on the 'configuration of assets'. EFRAG's RP described an airplane company as its example, which structures its flight routes using certain hub airports to optimize its passenger or cargo traffic.
6. The ASBJ understands that the configuration of assets would have a significant impact on an entity's profitability, and would have an effect on how an entity's internal reporting process is structured, and some identify a business model on the basis of the configuration of assets. However, the configuration of assets would not influence the decision as to whether different measurement bases should be applied even for the same asset or liability.
7. Accordingly, the ASBJ believes it is inappropriate to focus on the 'configuration of assets' to progress the discussion about how to identify a business model for the purpose of developing accounting standards.

Approach focusing on customers of the products and services

8. As a means to clarify what is meant by the term ‘business model’, one of the approaches explored in EFRAG’s RP is to focus on ‘customers of the products and services’. EFRAG’s RP described a luxury handbag maker that targets the rich, whilst other handbag makers focus on different customers.
9. The ASBJ understands that which customers an entity chooses to target is highly important and some may argue this as a business model. In addition, the difference between key customers of products and services may have some effects on accounting treatments, including whether an entity should apply product costing system or process costing systems. However, this difference would not give rise to different measurement bases, because it would not affect the way future net cash inflow to an entity will be generated. Thus, the ASBJ thinks that this analysis is not relevant for the said purpose.
10. Accordingly, the ASBJ believes it is inappropriate to focus on ‘customer of products’ to progress the discussion about how to identify a business model for the purpose of developing accounting standards.

Approach focusing on cash flow generation and value creation

11. EFRAG’s RP stated that the business is conducted to create value and distribute the value to its owners, and that value creation and cash flow generation is conducted in all entities.
12. The ASBJ understands that the objective of general purpose financial reporting is to provide useful information to help users assess the prospects for future net cash flows to an entity³ and this information is also helpful in assessing how efficiently and effectively the entity’s management and governing board have discharged their responsibilities to use the entity’s resources⁴. In order to achieve the above objective, the ASBJ believes that it is extremely important to understand the way that the value will be created and cash flow will be generated.
13. Accordingly, the ASBJ believes that we should consider this further by focusing on ‘value creation and cash flow generation’ to progress the discussion about how to identify a business model for the purpose of developing accounting standards.

Approach focusing on role of risk

14. As a means to clarify what is meant by the term ‘business model’, one of the

³ IASB Conceptual Framework, paragraph OB 3

⁴ IASB Conceptual Framework, paragraph OB 4

approaches explored in EFRAG's RP is to focus on the role of risk. EFRAG's RP also explained that types of risks are important to identify and differentiate in a business model, when focusing on value creation and cash flow generation.

15. The ASBJ believes that identifying risks is of high importance in assessing how outputs of the process will contribute to future net cash inflow to an entity. However, the ASBJ believes that the risks of an entity are not a determinant in assessing how future net cash inflows will be generated from assets or liabilities, but is one of factors that should be considered in assessing how future net cash inflows will be generated.
16. Accordingly, as stated in EFRAG's RP, the ASBJ thinks that we should consider risks as a factor in determining how value will be created and cash flow will be generated. This clarification would be helpful when progressing analysis with focus given to the 'price change risk' of assets or liabilities in developing accounting standards.

IASB's Discussion Paper Conceptual Framework

17. In the IASB's DP, the IASB proposed that the business model should not be defined in the *Conceptual Framework*, but stated that financial statements can be made more relevant if the IASB considers, when it develops or revises a particular standard, how an entity conducts its business.
18. In its comment letter to the IASB DP, the ASBJ expressed its support for the IASB's preliminary view that the IASB should consider how an entity conducts its business in determining the relevant measurement bases. However, the ASBJ found that there are differing understandings about 'how an entity conducts its business' (that may include business activities, configuration of assets, customers of goods and services). Therefore, the ASBJ believes that referring to the notion in the *Conceptual Framework* without specifying what is meant would be misleading.