German Banking Industry Committee

Die Deutsche
Kreditwirtschaft

Comments

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

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General Remarks

The general objective of financial reporting is to provide financial information about the reporting entity to allow stakeholders to make decisions depending on expected future returns. Financial statements should provide faithful representation of the financial position and performance of an entity, so that stakeholders can evaluate the prospects for future net cash inflows. The business model concept plays an important role in how an entity is managed and how an entity will generate its future cash flows on the asset and liability side.

A properly articulated business model will be helpful in communicating management's understanding of the business to the market. As in entities, the same types of assets and liabilities may be used within different activities, business model will help in identifying the relevant measurement basis and apply the proper accounting. Therefore, stakeholders will be able to better understand the different economic contributions that same types of asset and liabilities may have in an entity's activities.

The business model approach is already being developed within financial reporting, e. g. by the new classification and measurement provisions of IFRS 9 'Financial Instruments', or the concept of Integrated Reporting. However, given the wide range of aspects of value creation the business model affects, a common understanding of the concept of business model is needed. Therefore it is appropriate that this concept is also addressed by the conceptual framework.

Addressing the business model on a conceptual level would help to take into consideration circumstances which are specific to particular industries that might not be reflected adequately without such business model considerations.

As banking entities typically have different characteristics as to other commercial or industrial entities, we would like to emphasize the relevance of the consideration of the business model for entities in the financial sector. Essentially, this is inherent in the relationship between assets and liabilities and how these are managed to create value.

It is our view that the consideration of the business model approach is necessary to present financial information in the most relevant context, and should be given a prominent place, both in the Conceptual Framework, and on an standard-by-standard basis where appropriate.

This is, however, not the case for the IFRS which deal with other matters than financial instruments as discussed in the research paper, especially IAS 17 and IAS 40.
We think that IFRS should allow the consideration of business models, but we are not calling for new requirements to identify and describe business models on a standard-by-standard basis with additional and compulsory extensive documentation and disclosure provisions.

The Business model approach in IFRS 9

The GBIC welcomed the introduction of the term "business model" and the use of this concept in IFRS 9 as, in our opinion, the "business model" should, in most cases, be the real driver for the classification and measurement of a financial instrument. Only through consistency between the management of a financial instrument and its measurement criteria, can the financial statements provide an adequate representation of an entity's financial performance, and position.

In circumstances where financial instruments are managed on a fair value basis this information alone is sufficient for management to explain the business model and performance of the entity and for users to fully understand the future expected cash flows. Fair value reflects both the business model and the expected future cash flows for financial instruments that are actively traded in liquid markets.
If the instrument is held for use in the business to generate cash flows and there is no current or future intention to sell significant amounts, the aim is to achieve a stable income flow earned on an ongoing basis over a certain period. In this case, material profit from short-term market movements will not arise. The assets are expected to be held for substantially all their lives, and this means that the future cash flows are readily identifiable. Holding a financial instrument to maturity is similar to holding inventory, where it is considered inappropriate to recognize any increase in market value until the item is sold and the revenue is earned (although it is appropriate to recognize impairment).

Some other financial instruments are not managed on a short-term taking profit basis and may not be held until maturity. They are held with the objective of medium or long term holding horizon retention in order to maximize the return of the collection of principal and interests or the appreciation of capital. An appropriate measurement should be considered in the balance sheet and profit and loss statement consistently with their characteristics and their holding purpose.

Banking example of EFRAG

Sales should not be the sole driver of the business model assessment. Referring to the rather simplified banking example given by EFRAG, a bank A holds loans until their maturity to collect cash flows; a bank B holds loans but generally to sell them to other financial institutions. Recognizing the loans in the two banks at different measurements is not necessarily appropriate under real circumstances. Retaining the sale criterion as the only criterion to determine the measurement would imply that loans held by bank B would be measured at fair value. Fair value measurement could lead in this case to financial statements being misleading and misleading information for users, introducing volatility where not appropriate.

Asymmetry between the accounting treatment and the way loans are managed should be avoided.
Sale information should be considered in conjunction with other information when assessing the way financial assets are managed such as how revenue is generated, how risk is managed, historical sale information, reasons of the sales, conditions of the sales, and expectations about future sales activities. This can be shown by the aims of banks to achieve a stable interest margin, for example. A certain interest margin is often constantly maintained using so-called replicating portfolios. In this case and with a view to refinancing with matching maturities, the liability structure is reflected by securities on the asset side (according to the repayment periods). Changes in liability structure, for instance, due to withdrawals of customer deposits, then have to be carried out on the asset side in order to maintain the structure and this means regular sales. However, this does not change the original aim of generating contractual cash flows. But in order to keep the interest margin constant, adjustments are necessary in the form of sales. The bank's intention with the portfolio is still to collect the contractual cash flows rather than to achieve short-term profits. Therefore, recognition and measurement of bank A loans and bank B loans could be the same using amortised costs if justified by circumstances.

Having said this we would generally mention that the examples A and B are very summarized wherefore it could be details in the examples that may lead us in other directions. E.g. bank B: is derecognition achieved or is the bank still exposed to significant risks inherent in the credit portfolios that have been sold? Furthermore, the examples are to a certain extent complex. Bank A is actually significantly exposed to different kinds of risk; mainly interest, liquidity (defined as funding risk in this example) and basis risk. It is mentioned that there is hedging taking place. We cannot from the example conclude in what way, but assumes that derivative contracts are used. Therefore it may be useful if these examples will be described in more detail by EFRAG.

The business model approach and its implications to comparability

The inclusion of the business model concept in the Conceptual Framework and where appropriate, in certain standards, would provide more viable information in the financial statements. We do not share the criticism, that using a business model approach will increase subjectivity at the expense of comparability. It is more useful to have entity's measure assets and liabilities in a way that represents how these are used to generate value. Consistent with the guidance in IFRS 9, changes to a business model would represent a fundamental change and so would generally be very rare, and would have to be justified and documented in an adequate manner.

Recognizing the business model in financial reporting means that an entity's financial statement contains information that reflects the entity's specific circumstances and is more likely to be useful in predicting future cash flows. Therefore comparability implies that specificities and performance of the entity should be assessed through the entity's business model, the way the entity has conducted its activities and has specifically operated in its environment. Comparability does not mean uniformity.

If two entities have different business models, then differences can be expected to arise in their future cash flows and reflecting this in the financial reporting should be more useful for investors than a single approach which would be less reflective of these differences. It should also be borne in mind in this context that, owing to differences in legal regimes and economic specificities, a given requirement may be applied differently from one country to the next. This is certainly true of IFRS. It will therefore be extremely difficult to achieve comparability in the sense of uniformity.

As noted by EFRAG, the business model approach is already implicitly used in certain IFRS, e.g. IAS 39, IAS 17 or IAS 40.

With regard to IAS 17 Leases and IAS 40 Investment Property, we do not think that a similar clarification is needed. We think that these standards lead to appropriate accounting results without explicitly referring to the business model. Identifying and describing business models requires a lot of time and effort. We think that such extra time and effort is only justified, if it results in improved accounting. We think that this would not be the case for leases or investment property.

Also the IFRS Practice Statement on Management Commentary portrays the relevance of the business model (Para 22 states: "Management commentary should be clear and straightforward. The form and content of management commentary will vary between entities, reflecting the nature of their business…").

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A description of a business model is required

A business model is a concept encompassing a set of elements or indicators, and their relationships with the objective to accurately portray the way an entity creates value and generates cash flows in order to provide useful information to stakeholders. The type of business model may determine the most appropriate accounting. Although a strict definition is not necessary, a common understanding of such approach is essential. Due to the fact, that different definitions/forms of the business model concept are used in the current IAS/IFRS (e.g. management intention, operating segments, management accounting choices in some standards) a kind of a common description of the definition and the hierarchy of the business model concept in the framework may be helpful to gain a common understanding on this issue. The suggestions made by EFRAG would, in our view, support such understanding and setting the grounds for common application which leads to better comparability of financial statements.

Therefore the following indicators of a business model, amongst others, could be considered:
- The way an entity will realize its future cash flows on the asset and liability sides.
- The relationship with the notion of performance and with what the financial position and profit and loss are supposed to represent.
- The risks that may affect the performance of the business model and the way these risks are managed.
- The objective of short or medium or long term horizon retention in order to maximize the return of the collection of principal and interests or the appreciation of capital.

Conclusion

The notion of 'business model' is already (explicitly or implicitly) employed in certain financial reporting contexts, and illustrates its relevance. In summary, using a business model approach is an effective way for entities to present financial information to investors in a way that is appropriate to that entity's operating environment. Consequently, we are in favor of recognizing this notion within the Conceptual Framework, and on a standard-by-standard-basis as appropriate. Recognizing the business model in standard setting should lead to the creation of financial information that is more relevant to how the entity operates in its economic environment and provides a more faithful representation of an entity's financial position and performance.

Yours sincerely,
on behalf of the German Banking Industry Committee
National Association of German cooperative banks

Gerhard Hofmann　　　　Dirk Peters