European
Banking
Federation

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# EBF Comment letter on EFRAG's Research Paper: The role of the business model in financial statements

***Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interests of some 4,500 banks, large and small, wholesale and retail, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU alone.***

## Introduction

The concept of a business model plays an important role in how an entity is managed and how an entity will realize its future cash flows on the asset and liability sides. Financial statements should provide a faithful representation of the financial position and performance of an entity, so that stakeholders can evaluate the prospects for future cash inflows.

A properly articulated business model should 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 has always played an important role in standard setting (e.g. revenue recognition for recognizing income and in classification; IAS 2 or IAS 16 contra IAS 40). However, lately it has been explicitly mentioned in standard setting e.g. by the new classification and measurement provisions of IFRS 9 'Financial Instruments', and 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.

As banking entities typically have different characteristics as to other commercial or industrial entities, the EBF 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.

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## Existing consideration of the business model and its implications

The EBF 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 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 until maturity 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 detention 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.

We believe this analysis underpins view A in the Banking example, which we support. As noted in the example however, in real life the situation is more complex. Providing details in the examples may lead to different conclusions (such as whether derecognition is achieved in bank B or whether the bank is still exposed to significant risks inherent in the credit portfolios that have been sold). Further details could be provided such as whether derivative contracts are used for hedging etc.

<u>In the view of EBF, sales cannot be the sole driver of the business model assessment</u>. Retaining the sale criterion as the only criteria to determine the measurement would imply that loans held by bank B would be measured at fair value. Fair value measurement could in this case lead to misleading information for users, introducing volatility where not appropriate. Asymmetry between the accounting treatment and the way loans are managed should be avoided.

Information about the sales 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 including regulatory requirements, conditions of the sales, and expectations about future sales activities. This can be demonstrated by the objective 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

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repayment periods). Changes in liability structure, for instance due to withdrawals of customer deposits, have then to be carried out on the asset side in order to maintain the structure resulting in regular sales. While this does not change the original objective of generating contractual cash flows, 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 since justified by circumstances.

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. Recognising the business model in financial reporting means that an entity's financial statements contain 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 evaluated 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 used in certain IFRS, e.g. IAS 39. Also the IFRS Practice Statement on Management Commentary portrays its relevance (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…").

The importance of the business model is also recognized outside the IFRS. In its recently issued framework on Integrated Reporting, the business model is a fundamental concept for the IIRC: "At the core of the organization is its business model, which draws on various capitals as inputs and, through its business activities, converts them to outputs (products, services, by-products and waste). The organization's activities and its outputs lead to outcomes in terms of effects on the capitals. The capacity of the business model to adapt to changes (e.g., in the availability, quality and affordability of inputs) can affect the organization's longer term viability"(Para 2.23).

The above mentioned examples show that the notion of business model is already (explicitly or implicitly) employed in certain financial reporting contexts, and illustrate its relevance. 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.

## Definition of business model

The inclusion of the business model concept in the Conceptual Framework and certain standards would lead to providing more useful information in the financial statements. 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) high level description of the concept of the business model 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 detention in order to maximize the return of the collection of principal and interests or the appreciation of capital.

## Conclusion

In summary, using a business model is an effective way for entities to present financial information to investors in a way that is appropriate to that entity's operating environment. This approach is already used in several IFRSs, most notably in IFRS 9, and other areas, for example Integrated Reporting. We are in favour of recognizing the business model in the Conceptual Framework and standard setting as we believe it provides a representation of an entity's financial position and performance which is more useful to stakeholders.

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