BUSINESSEUROPE

European Financial Reporting Advisory Group (EFRAG)
35 Square de Meeûs
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30 May 2014

Dear Chairman,

Re: Research Paper – The role of the business model in financial statements

BUSINESSEUROPE appreciates the opportunity to comment on the Research Paper dealing with the Role of the business model in financial statements (the Paper). BUSINESSEUROPE both supports this initiative of EFRAG, the ANC and the FRC in bringing this topic up for wide debate, and agrees with many of the conclusions reached. BUSINESSEUROPE would urge the joint issuers of the Paper to recommend its messages as soon as practical to the IASB in order to assist that body with its current review of the IFRS Conceptual Framework for the Preparation of Financial Reporting (the Framework).

BUSINESSEUROPE's principal comments are:

1) The primary objective of the choice of an accounting approach is to represent the substance of transactions. The purpose of the use of the Business model is to support this objective by facilitating identification of the accounting which best reflects the substance of the transaction.

2) We think that an understanding of the entity's business strategy for the creation of value is essential to enable the user to assess the future prospects and the past performance of the entity. We are convinced that the most relevant and useful financial reporting approach is one that faithfully depicts the value-creation process and the resulting cash flows in a way consistent with the business strategy. The term "business model" is a useful label for this link between transactions and business strategy.

3) The purpose of the use of the business model (BM) is to identify the accounting model which, within the context of the entity's business strategy, best reflects the substance of transactions and the most predictable outcome in terms of cash flows/value creation, and presents these in the most appropriate way.

4) We think that in the Discussion Paper on the Framework, the IASB's proposal to select initial and subsequent measurement methods by taking into account the way the asset (liability) will be used (settled) in the entity's business is an application of the notion of the business model. However, we think that the IASB does not go far enough:

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   a. The Framework should make consideration of the relevance of the use of the business model a compulsory step in the development of an accounting standard;

   b. Use of the business model should be assessed in all aspects of financial reporting: recognition, measurement, presentation and disclosure.

5) We agree with the criteria the Paper proposes to include in the Framework for assessment of the use of the business model (paragraph 5.7), but would add to these:

   a. Use of the business model to deal with accounting mismatches between assets and liabilities; and

   b. That comparability is enhanced also when different economic phenomena are clearly distinguished (that is, not artificially made to be similar).

6) We agree with the principles for identifying business models (paragraph 5.14), but would add a specific point to clarify that a given entity can have two or more business models within its activities.

   a. The business model is not entity- or industry-specific but relates to the specific type of transaction in the context of the way the entity conducts its business. This means that in general a business model can be common to many different entities and industries and will only in very rare cases be limited in use to one of these.

   b. In particular we think it is important that the identification of the business model should be based on observable activity consistent with the business strategy.

7) We think that it is the role of the management to use its judgement to identify the accounting model permitted by the relevant standard that best reflects the way that the transaction will actually add value/result in cash flows, i.e. its business model. It is the standard setter's role to decide, within the context of the transactions dealt with by the standard, whether different accounting models can be justified by different business models, and if so to determine the key features of the business models which shape the accounting models it specifies.

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8) As a general principle, once the most appropriate accounting model has been determined there should be no requirement to provide disclosures on any of the alternative bases which might have been considered but were rejected by the standard-setter. Thus, for example, once amortised cost has been determined to be appropriate for an asset, there should be no obligation to provide disclosures on a current-cost basis. Such disclosure is a burden, clutters the financial statements and can lead to confusion.

We deal with the specific questions raised in the Paper in the Appendix.

Please do not hesitate to contact us should you wish to discuss these issues any further.

Yours sincerely,

J. Chauvin

Jérôme P. Chauvin
Deputy Director General

ANNEX TO BUSINESSEUROPE'S RESPONSE TO EFRAG PAPER ON THE ROLE OF THE BUSINESS MODEL

Question 1 - Implicit use of the business model
Chapter 2 discusses the explicit use of the term 'business model' in IFRS. The chapter also includes implicit examples of earlier 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?

The analysis of explicit and implicit use of the notion of a business model (BM) in current IFRS is reasonable.

We have no specific comments on this, other than to suggest that the amendments made in 2012 to IFRS 10 to exempt investment entities from consolidating certain subsidiaries could also be considered to be the application of a business model approach.

Question 2 - Cash conversion cycle
Chapter 3 discusses the assumed meaning of the business model, including an analysis of the 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?

The term business model is used in many different contexts and can have a variety of meanings, as discussed in paragraph 3.11 and following in the Paper. However, in the context of accounting and financial reporting, we think it is important to identify why the notion of the business model is being used. In broad terms, we think that in this context the business model is a tool whose purpose is to ensure as far as possible that the way transactions are reflected in the financial reporting provides the most relevant and useful depiction of how they will affect the value of the entity through the likelihood of future cash flows. The business model thus represents the link between transactions and the business strategy that determines the reason for entering into those transactions. Finally, this link between the transactions and the strategy also provides an opportunity to reinforce the role of accounting in allowing the user to judge the management's performance in applying the strategy – "stewardship".

We agree with the general lines of the "assumed meaning" of the business model as stated in paragraph 3.34: *"... the Business Model focuses on the value-creation process of an entity, i.e. how the entity generates cash flows. In the case of non-financial institutions, it represents the end-to-end value-creation process of an entity within the business and geographical markets it operates."*

This description is similar in nature to the reasoning behind the measurement proposals in the DP on the Conceptual Framework, in which the IASB proposes the decision on the most appropriate initial and subsequent measurement method should take into account the way the asset (liability) will be used (settled) in the entity's business. We are in favour of the direction taken by the Board in this, but think that the proposal does not go far enough: the use of the business model should be pervasive throughout standard setting.

While we are uncertain of the merits of the cash flow conversion cycle analysis, we do agree with the suggestion of paragraph 3.40 that “Analysing attributes of business models that help to assess how an activity could be able to generate value, including current cash flows as well as future cash flows with the highest probability, would be of greater interest for users of financial statements.” Indeed this seems to be consistent with the assertion in paragraph OB3 of the existing Framework that “Investors’, lenders’ and other creditors’ expectations about returns depend on their assessment of the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity.”

We agree with the suggested attributes of BMs which distinguish them from other BMs to justify different accounting:

a) Length of activity cycle
b) How inputs are used
c) How outputs are used to generate cash
d) Types of risk related to activity
e) Degree of certainty in generation of cash flows
f) Degree of capital intensity

We note that the paper makes a distinction between a business model and management intent. We agree that the two are different, although this is view is based on what we perceive to be a generally accepted interpretation rather than a scientific definition. In our interpretation:

- The business model corresponds to the strategy of the entity and is thus fairly stable over the long term, whereas
- Management intent has a much shorter time-horizon and is thus more volatile.

In the light of this interpretation, in general only the business model will give the rigorous structure consistent over time which is necessary for financial reporting. However, this should not preclude the standard setter, in certain circumstances, from deciding that it is more appropriate that it is management intent rather than the business model that should determine the accounting treatment. An example of this in current IFRS is the accounting for assets held for sale.

Q3 Examples

(a) Do you think the example describes different business models? Please explain.
(b) Do you support View A or View B? Please explain.
(c) If the different activities of Entity A and Entity B were both conducted in the same entity, would your answer to the above question be different? If so, why?

We recognise that these are different business models when judged against the attributes proposed above. However, these are specific and specialised industry examples which we do not feel that it is appropriate for us to judge whether the differences between the models justify different accounting.

Question 4 - Playing a role in financial reporting

Chapter 4 discusses the conceptual debate as to whether the business model should play a role in financial statements. The Bulletin includes a tentative view that the business model should play a role in financial reporting, including financial statements, and asked whether constituents support that view.

Do you have any additional comments?

Question 5 - Criteria for use of the business model

Chapter 5 discusses the implications of the business model in IFRS and proposes criteria to be used in the *Conceptual Framework* to identify when the business model might be used in accounting standards. The chapter also proposes principles for identifying business models in those accounting standards.

(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.

As stated in our response to question 2 above, we think that the business model has an essential role to play in financial statements. This is acknowledged implicitly in the "measurement" chapter of the Framework DP, but we agree with the Paper that consideration of the business model's role should be pervasive throughout financial reporting: in recognition, initial and subsequent measurement, presentation and disclosure.

The purpose of the use of the business model concept is to identify accounting which best reflects substance of transaction and most predictable of outcome in terms of cash flows. However, we think that the primary characteristic to be used in the selection of accounting approach should be to represent substance over form. The use of the business model would be subordinated to this. As discussed above in our response to question 2, management intent should only occasionally be a consideration in determining the accounting approach.

In our view, the concept of the business model should be described in the Framework and consideration of its use by the Board when developing standards made mandatory. We note the criteria suggested by Paper (paragraph 5.7) for inclusion in Framework for assessment of when the BM might play a role in developing standards:

a) *Results in accounting which better reflects the economics of transactions*
b) *Brings consistency between all information reported (linkage Financial Position-Comprehensive Income)*
c) *Enables user to derive Key Performance Indicators*
d) *Enhances comparability by presenting similar economic phenomena similarly*

e) *Information more useful as predictor of future results, incl. Cash flows.*

We agree that criteria of this type should be included in the Framework to provide more rigour in the approach to the use of the BM. We generally agree with these but are not convinced that criteria (b) should be a specific criterion. We would add a complementary criterion to d), i.e. "Enhances comparability by clearly differentiating between economic phenomena which are different."

We would also suggest that the BM might be of use in helping resolve accounting mismatches.

We also agree with the suggested possible principles for identifying BM for accounting purposes (paragraph 5.14):

a) *Not entity-specific but specific to economic situation (relevant/faithful representation of value creation process/cash flows?)*
b) *BM must be observable (not just management assertion)*
c) *Considered in all parts of standard – recognition, initial/subsequent measurement, presentation and disclosure*
d) *High-level principles, not detailed rules*
e) *Reasonable cost-benefit balance in all circumstances.*

We would add the following: A specific point to clarify that a given entity can have two or more business models within its activities.

We think it would be impractical for the IASB to identify all the individual business activities that exist in different industries. We do think however, that it is possible to identify a limited number of generic business models to which all the various cash generating activities could be assimilated, such as, for example, assets for use, transformation, sale or holding. Use of the business model in this context relates not to the industry or entity, but to the transaction and how it will generate / absorb cash flows in the manner consistent with the business strategy.

Thus we think it is the role of the standard setter, when developing a particular standard, to:

a. Analyse the transactions on the basis of the suggested attributes of the BM (as discussed under Question 2 above) in order to identify potential different BMs. This requires the standard setter to identify the attributes that are the most relevant to the depiction of these transactions;
b. Decide whether the different combinations of attributes justify different accounting models;
c. If the differences merit representation using different accounting models, determine the appropriate accounting model s and describe the attributes that correspond to them.

The entity's responsibility is then to analyse its activities using the criteria provided by the standard setter and, using its judgement and knowledge of its business, to determine which of the accounting models specified best reflects its business model(s).

Question 6 - Implications of the business model
The Bulletin proposes some implications to IFRS and asks whether constituents support the implications to the IFRS literature.
Do you have any additional comments?

We have no further comments to add to the above.

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