

# Rådet **för** **finansiell rapportering**

The Swedish Financial Reporting Board

RFR-rs 2014:06

EFRAG  
35 Square de Meeus  
B-1000 Brussels  
Belgium

## **Re: Research Paper on the role of the business model in financial statements**

Dear Sirs,

The Swedish Financial Reporting Board is responding to your invitation to comment on the Research Paper on the role of the business model in financial statements.

We support that EFRAG explores the role of business models in financial reporting. We believe that the various examples in individual standards show that there sometimes is a need for entity-specific circumstances to be the decisive factor for a prescribed accounting treatment. We think that references to an entity's business model might be a way to achieve this in a consistent manner.

We agree that the discussion should be driven by the objective of determining which characteristic could be of interest for accounting purposes and we put specific emphasis on how cash flows are generated.

Regarding the suggested potential criteria in the conceptual framework for when the business model needs to be considered, we think that these are no different from the qualitative characteristics in general and would prefer a more general reference to relevance, such as e.g. the one suggested for principles to distinguish profit or loss from OCI items in the recent discussion paper on the conceptual framework ("All items should be recognised...unless...enhances the relevance..." 8.81 b). Furthermore, we believe it is important that it is clear from the framework that in situations where the business model concept is used for individual standards, this should be the prescribed treatment.

Although the concept of the business model is relevant for accounting purposes, and applications within the different areas of recognition, measurement and classification are justified, the question of whether it is useful will depend on issues like if the application of the concept could be sufficiently precise, if it is stable and verifiable, and if neutrality could be assured.



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We believe that the key to a good solution lies in analyzing in more detail what is referred to in 5.19 as “practical problems”. We don’t think that concerns of this nature should be separated from a “theoretical” analysis, they are two sides of the same coin.

We think that the need for a standard-setter to conduct extensive field studies is especially large in an unexplored area like this. We think that simple examples like the cotton example are justified to convey the basic idea of how the business model could/should influence the accounting treatment, but it does not serve any further purpose. Therefore, we welcome the extended examples from the banking and insurance industries. Our general observations from these examples are (the analyses are enclosed in an appendix):

- It seems that it is feasible, through a thorough analysis of the business model, to establish the most relevant accounting method, e.g. measurement method, also for more realistic, complicated cases.
- However, there are problems related to the establishment of the link between the business model and the required accounting treatment. Although it seems possible to establish the most relevant accounting method, the conclusion of which measurement method to use is quite sensitive to the further specification of relevant factors on a quite detailed level.
- Consequently, documentation, verifiability and neutrality issues become crucial. The business model has to be observable – a choice of accounting method with reference to a specific business model, where the link is not clear will not be credible. Furthermore, if the business model is decisive for the choice of accounting method, this has to be auditable.
- Having two different business models within the same entity and thus use different measurement principles puts especially high requirements on the definition of the business models in the entity.
- We also observe that linking the accounting to an entity’s business model sometimes involves a choice between different accounting standards (cf “the simple example” in 3.44ff). We believe that this fact should be mentioned in the conceptual framework.

If you have any questions concerning our comments please address our Executive member Claes Janzon by e-mail to: [claes.janzon@radetforfinansiellrapportering.se](mailto:claes.janzon@radetforfinansiellrapportering.se)

Stockholm, 4 June 2014

Yours sincerely

  
Anders Ullberg  
Chairman

## Appendix

### Banking example

We do believe that the example highlights two different business models; generate to hold contra generate and sell. Bank A lock in their cash flows during the life of the contract given their assumptions are accurate regarding access to funding in the form of deposits, while Bank B has no intention to generate cash-flows from holding the generated loan portfolio, instead the cash-flows are generated by selling the assets that generate the cash-flows to investors.

That said, there could be details in the examples that may lead us in other directions. Regarding Bank B: Is derecognition achieved or is the bank still exposed to significant risks inherent in credit portfolios which have been sold? Regarding Bank A: The bank is actually significantly exposed to different kinds of risk; mainly interest risk, liquidity risk (defined as funding risk in this example) and basis risk. It is mentioned that hedging takes place. We cannot from the information given conclude in what way, but assume that derivative contracts are used. These significant exposures could be considered to make the business models of Bank A and Bank B more similar. If Bank A instead had funded its lending portfolio with issued debt instruments with the same interest fixing and maturity, including eventual call options, we would certainly conclude that the business models of A and B would be materially different from each other.

Given that Bank A have plain vanilla loans, allocate a certain part of its deposits to each and every loan portfolio and given that the interest risk position is not altered during the life of the loan portfolios by entering into different derivative transactions, we believe that Bank A should measure its loan portfolio at amortised cost. If bank B for the whole portfolio, or well defined parts of the portfolio generate the portfolio for the immediate realization, we believe that the portfolio should be measured at some kind of current value. If that current value should include changes in credit spreads or not, depends on if changes in credit spreads are a relevant factor for the realization price that Bank B achieves when it realizes the loan portfolios or not (the portfolio is not the unit of measurement in IFRS 13).

If the two business models exist within the same entity, we still believe that it is relevant to use different measurement principles for the different portfolios, given that the portfolios are well defined.

### Insurance example

We do not really believe that there are any differences in business models between the two insurance companies. Instead we consider that they have different types of insurance contracts. Both insurance companies have a high proportion of fixed rate



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interest bearing instruments which they hold until maturity. Thus, their investment policies are the same; there is no active management of the asset portfolios. What is unclear in the example is if Entity B has any guaranteed minimum returns. The uncertainty arises because the example states that the liability cash flows are “significantly dependent” on the asset returns. However, it then seems that there are other risk factors as well, which are not described. Is there a guaranteed return or does the contracts contain the same risk as are inherent in Entity A’s portfolio? Looking at the liability side, we question if the assets of Entity A really are independent of the liabilities. Since Entity A also is involved in life insurance products, we assume that the contracts are for a certain number of years. Since the liabilities are long-dated, they have an inherent interest rate risk embedded in them. Based on that, we assume that there is a need for Entity A to hedge that interest rate risk, even though the assets and liabilities are not contractually linked. This also explains the choice of interest bearing fixed rate assets in the asset portfolio. This makes two entities even more similar and we question if there is any differences in the two business models.

The two entities also seem to want to secure the expected outgoing contractual cash flows with investments in fixed rate assets at the inception of the contracts which further seems to indicate that they both aim at earning a steady margin from the passive servicing of the insurance contracts. If one of the entities instead would have had a different investment strategy, we may have concluded that the entities had different business models.

We believe that there is a link between assets and liabilities in both entities. However, neither of them have perfect hedges. Since both contracts are insurance contracts, there has to be some kind of insurance risk inherent in the contracts. Since neither of the entities seems to be involved in reinsurance, those risks are kept unhedged in both Entity A and Entity B. Therefore our first conclusion is that the insurance risk inherent in the insurance contracts should be measured at some kind of current value, representing the expected negative outflow of resources due to the inherent insurance risk. We consider this part of the insurance contract to be similar to a non-linear derivative contract and believe that the most useful information for such a position is a current value measurement.

We assume that both entities have some kind of inherent profit margin. The example does not describe how that margin is calculated or if it is separately priced when the entities calculated the insurance premium. Given our experience, we assume that both entities have included a separate premium for covering the administrative expenses, and profit margin including assumed cost of capital. Therefore our second conclusion is that the part of the premium covering the charge for servicing the contracts, including profit margin and assumed cost of capital, should be identified at initial recognition and recognized at cost during the life of the contracts. The reason for advocating a cost measurement is that we consider it to be something that is earned during the life of the contract and similar to revenue recognition standard accounting and similar to the



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recognition of loans and receivables we believe that the profit should not be recognized up-front, since it is unknown how large the profit margins will be during the long life of the contracts. The implication of this is that both entities will need to identify the part of the premium that relates to the servicing of the contract. Lastly we believe that both entities have inherent interest rate risk in their portfolios. The lack of information in this respect makes it a little bit difficult to conclude what the business model is and consequently what measurement method to prescribe. One essential parameter is the regulatory framework in which the entities operate. If, for example, regulatory solvency rules require a current value measurement of both assets and liabilities, or at least of the market risks of the liabilities, we believe that the accounting standard at least should allow a current value measurement for both assets and liabilities. Otherwise, the entities would not be able to achieve "hedging" of both regulatory and accounting.

Assuming that the regulator requires a use of a current discount rate and since both entities invest in fixed rate interest bearing securities, our final conclusions are: (1) To avoid accounting mismatches, the interest rate risk in both the assets and the liabilities should be measured at some kind of current value. (2) Since both entities seems to have a long-term horizon on their investments decisions, it has to be clarified, also based on the view of management, if those values changes should be recognized directly into Profit & loss or if some kind of temporary accounting via Other Comprehensive Income should take place. (3) Regardless of that accounting choice, realized market risks should be recognized in P&L.

## **Mobile network example**

There are definitely different set-ups for doing business under entity A and B and there are different types of risks if sales are carried out according to A or B. In our view, the business model should perhaps be defined on a higher level, considering the total business of the network. Regardless of this, even rather small differences in business set-up could result in different kinds of risk and levels of risk.

Main risks in relation to sales for entity A: Leasing of facilities. If unfavorable development of sales should occur provisions for onerous contract might be required. The same logic is applied for any equipment or software used by the stores. Allowances might be required. Own staff – in a down-turn redundancy costs might have to be recognized. In summary, under A there is typically a fixed cost risk. As long as the capacity is not too stretched the cost per unit sold will be reduced with larger revenue (opportunity).

Main risks in relation to sales for entity B: Under this model costs are fully variable, perhaps with different commission levels due to actual sales. This model has another risk profile. Fixed cost risk does not exist but with successful sales selling expenses might "explode" compared to under entity A.

