EFRAG
European Financial Reporting Advisory Group

ANC Autorité des Normes Comptables

FRC

CNC Luxembourg Commission des Normes Comptables

DRSC

Norsk RegnskapsStiftelse

Rådet för finansiell rapportering

ΣΕΛΚ

CBN CNC Commissie voor Boekhoudkundige Normen Commission des Normes Comptables

Danske Revisorer FSR

KSR Komitet Standardów Rachunkowości

OIC Organismo Italiano di Contabilità

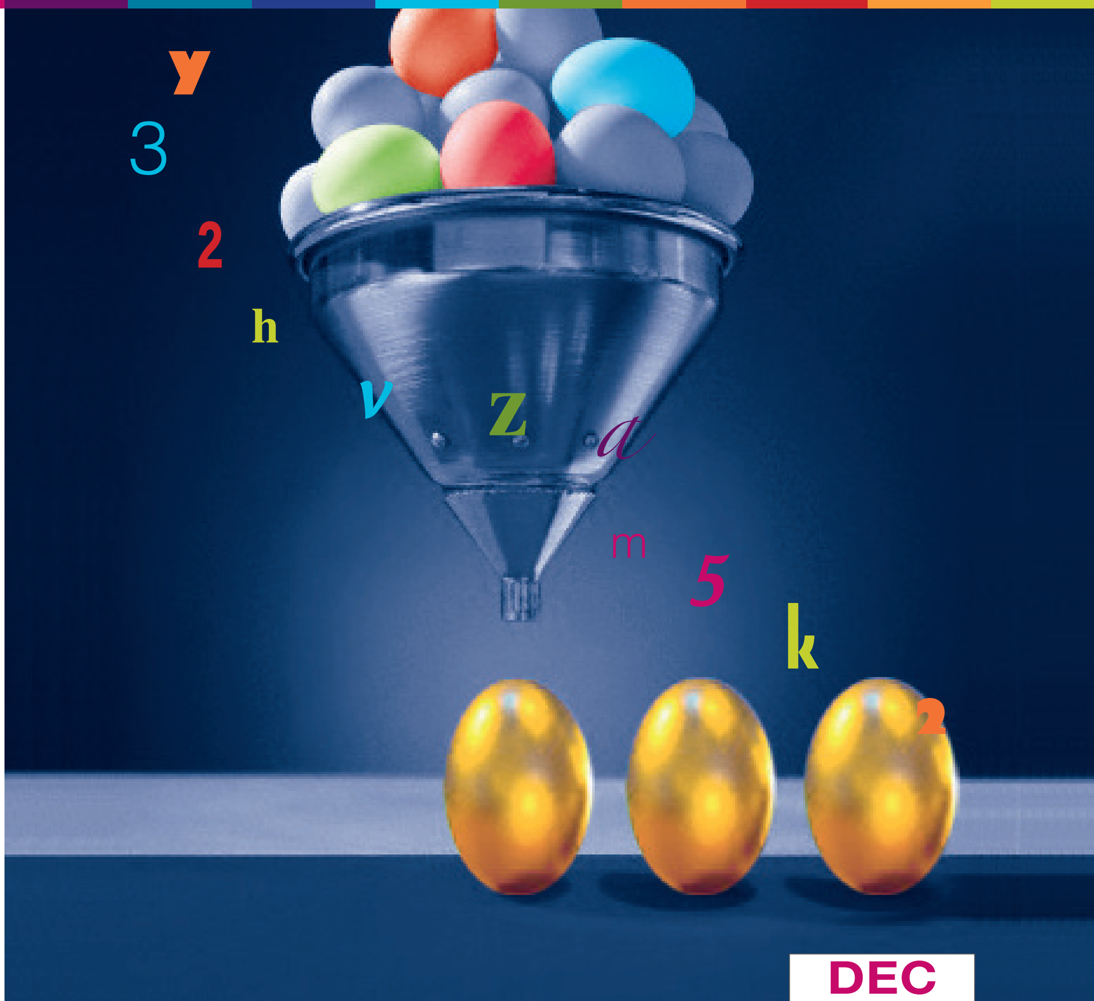
The Malta Institute of Accountants

RJ Raad voor de Jaarverslaggeving

The Slovenian Institute of Auditors

The role of the business model in financial statements

RESEARCH PAPER



DEC 2013

This Research Paper is issued by the European Financial Reporting Advisory Group (EFRAG), the French Autorité des Normes Comptables (ANC) and the UK Financial Reporting Council (FRC).

The following standard setters in Europe also support the issue of this Research Paper:

Belgium, CNC/CBN – Commission des Normes Comptables/Commissie voor Boekhoudkundige Normen
Cyprus, ICPAC – The Institute of Certified Public Accountants of Cyprus
Denmark, FSR – Danske revisorer
Germany, DRSC (ASCG) – Accounting Standards Committee of Germany
Italy, OIC – Organismo Italiano di Contabilità
Luxembourg, CNC – Commission des normes comptables
Malta, MIA – The Malta Institute of Accountants
Netherlands, RJ – Raad voor de Jaarverslaggeving
Norway, NRS – Norsk RegnskapsStiftelse
Poland, KSR – Polish Accounting Standards Committee
Slovenia, Slovenski Institut za Revizijo
Sweden, Rådet för finansiell rapportering

DISCLAIMER
These bodies, while encouraging debate on the issues presented in the paper, do not express any opinion on those matters at this stage.

Copies of the Research Paper are available from the websites of those bodies issuing it. A limited number of copies of the Research Paper will also be made available in printed form, and can be obtained from EFRAG.

The paper invites comment on its proposals via the 'Questions for Respondents' at the end of each section (which are summarised in the Invitation to Comment). Such comments should be sent by email to:

commentletters@efrag.org or by post to:

EFRAG
35 Square de Meeûs
B-1000 Brussels
Belgium

so as to arrive no later than 31 May 2014.

All comments will be placed on the public record unless confidentiality is requested.

EFRAG's Proactive Work in Europe

It is important to set the project within the broader context of our Proactive Work. EFRAG aims to influence future standard-setting developments by engaging with European constituents and providing timely and effective input to early phases of the IASB's work. This proactive work is carried out in partnership with National Standard Setters in Europe to ensure resources are used efficiently and to promote stronger coordination at the European level. Four strategic aims underpin proactive work:

- Engaging with European constituents to ensure we understand their issues and how financial reporting affects them;

- Influencing the development of global financial reporting standards;

- Providing thought leadership in developing the principles and practices that underpin financial reporting; and

- Promoting solutions that improve the quality of information, are practical, and enhance transparency and accountability.

More detailed information about our proactive work and current projects is available on the EFRAG website.

Table of contents

Table of contents

Table of contents

Preamble

Although the term 'business model' appeared in the IFRS literature for the first time in 2009, when IFRS 9 *Financial Instruments* was issued, this paper shows that the notion had previously been an implicit part of IAS/IFRS for a long time. The business model does not, however, play a role or is discussed in the present IASB *Conceptual Framework.* As a result, if the notion is used, it is not always clear why this is the case or why it is ignored, and there is no consistency from standard to standard.

This paper argues that it is time for a change: the business model should play a role in financial reporting and be part of the revised *Conceptual Framework.* The business model introduces the notion of the 'cash conversion cycle', which is able to provide insight into how value is captured and net cash flows are generated through income in the normal course of a business. All standards must, therefore, be capable of representing faithfully the business model, and, where applicable, the business model should explicitly be incorporated on a standard-by-standard basis. On this level, its consequences for recognition, measurement, and presentation and disclosures should be assessed, and decisions should be taken whether and how the business model should affect financial reporting.

Various recent discussions show that EFRAG, the ANC and the FRC are not alone in their view of the importance of the business model notion in financial reporting. For instance, as explained later in this paper, EFRAG, the ANC and the FRC were joined by the standard setters of Germany and Italy when they jointly issued a Bulletin on the topic, as part of a series to promote discussion on topics related to the *Conceptual Framework.* This Bulletin was based on the research presented in this paper, and is included as the next section.

In our view, it is now time to open the debate among a wider audience. This is the purpose of the paper, and it therefore asks a number of specific questions to the constituents. EFRAG, the ANC and the FRC are interested in your views.

BULLETIN Getting a Better Framework: The Role of the Business Model in Financial Reporting

On 8 July 2013, EFRAG and the national standard setters of France, Germany, Italy, and the United Kingdom published a Bulletin on the role of the business model in financial reporting. The Bulletin was based on the work done to develop this Research Paper. The following is the text of that Bulletin, including the Bulletin's questions to constituents. The intent of including a reprint of those questions is to provide background to the reader. This Research Paper includes additional questions to constituents.

INTRODUCTION AND BACKGROUND

B.1 The term 'Business Model' was used for the first time in an accounting standard issued by the IASB when it was explicitly introduced in 2009's IFRS 9 *Financial Instruments*. A reference to the business model was also included in the 2008 Exposure Draft of the *Conceptual Framework*, but not maintained in the final version.

B.2 However, the notion of the business model has already been implicit in IFRS a long time in, for example, IAS 2 *Inventories* (issued in 1975), under which the use of the assets defines whether or not they are considered as inventory, or IAS 40 *Investment property* (issued in 2000) which differentiates between real estate assets depending on the economic purpose pursued in holding the asset.

B.3 Whether or not the business model should play a role in financial reporting has been controversial for some time, with many commentators arguing that referring to the business model would enhance relevance, while others oppose the idea claiming that it introduces bias that would be detrimental to transparency and comparability of financial reporting.

B.4 EFRAG, the ANC and the FRC have been working on a proactive project researching this topic. They intend to publish the results of their work later in 2013 in the form of a Research Paper. Given the relevance of the issue to the *Conceptual Framework* project of the IASB, and the tentative view of EFRAG, the ANC, the ASCG, the OIC and the UK FRC that the business model should have a role in financial reporting, this Bulletin has been prepared in advance of the Research Paper. It is one in a series the five partners are issuing to stimulate the debate in Europe on the *Conceptual Framework.*

B.5 This Bulletin presents our assumed meaning of the term 'business model', which is, at the moment, an undefined term in the IFRS literature. The document also provides a conceptual discussion as to whether financial statements based on the business model meet the qualitative characteristics in the IASB *Conceptual Framework.* Our tentative view is that this is the case. The following section discusses the distinction between the business model and management intent, presenting our view that a valid distinction exists. The Bulletin concludes by considering the implications of the business model for financial reporting under IFRS.

B.6 The following example puts the discussion in a practical context.

B.7 Suppose an entity purchases a quantity of cotton for CU100. It still owns the cotton at the reporting date, when it is worth CU120 (and the entity could readily sell it at that price). If the entity is a shirt manufacturer and will use the cotton in its operations, current practice would be simply to report the cotton as 'inventory' at its cost of CU100. But if the entity is a commodity trader that seeks to make profit from short-term price movements, that accounting may not reflect fairly the entity's financial position or financial performance: current practice reflects this view by stating the asset at its current selling price of CU120, with the gain of CU20 included in profit. However, there might be other ways in which the business model might impact the financial statement: if the transaction is a non-recurring speculation that is outside the normal activities of the entity, it would probably have to be separately presented, whatever the accounting treatment. Thus the nature of an entity's business may affect the measurement of assets, the reporting of profit and presentation.

AN ASSUMED MEANING OF THE TERM FOR FINANCIAL REPORTING PURPOSES

B.8 Whilst there is no universal defined meaning of the term 'business model', academic literature evidences that the term is increasingly referred to in corporate reporting to describe an entity's activities, its asset configuration (for example, capital intensive or heavy reliance on R&D), and its customers, products and services.[1]

B.9 The literature also shows that there is no universal view on the relationship and distinction between business purpose, strategy, management actions, management intent, and similar notions.

B.10 It could be difficult to arrive at a universally acceptable definition of the term that could be consistently applied by those who prepare financial information and adequately understood by those that use financial information. For example, there is no agreement as to whether there are two business models such as a trading and a holding model, or if there are more business models that reflect how each entity tries to differentiate itself from its competitors.

B.11 For the purpose of this Bulletin, we have adopted an assumed meaning of the term for financial reporting purposes. Financial reporting is meant to provide the basis for assessing the financial position and performance of an entity. It assesses and understands how the entity is 'making money', how it provides capital providers with appropriate returns on the resources invested in the entity, and how it is exposed to risks and organised to mitigate those risks.

[1] An overview of the relevant academic literature and background information on our assumed meaning will be presented in the Research Paper.