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Review Article

Considering an Entity's Business Model in Financial Reporting

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Abstract

This paper discusses and evaluates the International Accounting Standards Board's proposal to consider incorporating the business model concept into its Conceptual Framework for financial reporting. After pointing out the various ways in which the business model concept is either explicitly or implicitly incorporated in international accounting standards and analyzing the various proposed definitions of "business models", the paper concludes that rather than incorporating the business model concept in the Conceptual Framework, the IASB should develop a single definition of the term for application throughout IFRS.

Introduction

In July 2013, the International Accounting Standards Board ("IASB") issued Discussion Paper (the "DP"), *A Review of the Conceptual Framework for Financial Reporting* p [1]. The DP is the initial public document associated with the IASB's project considering a revision of the existing conceptual frame work and obtaining comments on IASB proposals related to the conceptual framework.

The DP solicits comments on numerous issues identified as either "problems in the existing conceptual framework" or topics that the Board indicates are not fully and clearly explicated in the current version of the Conceptual Framework. In the DP, the IASB addresses the following:

- Revising the fundamental objective of the conceptual framework
- Amending the asset and liability definitions while retaining the existing definition of equity
- Reconsidering the recognition and measurement concepts for assets and liabilities
- New guidance on de recognition of assets and liabilities
- Distinguishing profit and loss from other comprehensive income in the notion of Comprehensive Income and
- Other topics related to financial reporting that the IASB identified during its on-going standard-setting deliberations.

In the final section of the DP, the IASB asks its constituents to consider whether, in a revised or amended conceptual framework, they should incorporate the business model concept. The discussion on the business model concept addresses:

- Using the business model concept in existing financial accounting and reporting standards,
- Summarizing the advantages and disadvantages of considering an entity's business model when developing accounting and reporting standards; and
- Providing several definitions of the business model concepts discussed by others.

Use of the Business Model Concept in IFRS

In the DP, the Board does not define the term (or concept meant by the term) the "business model concept." However, in the summary of the DP, the IASB notes that they are considering adding the business model concept into the Conceptual Framework because "financial statements can be made more relevant if the IASB considers, when it develops or revises particular Standards, how an entity conducts its business activities." (IASB, 2013, p. 14)

As explained in the DP, the Board believes that an entity's business model influences:

- Measurement of the way assets contribute to future cash flows or settlement of a liability and
- Presentation of financial statement information, particularly with respect to the "level of aggregation or disaggregation in the primary financial statements" (IASB, 2013, 9.33).

In the DP, the IASB lists numerous situations, in which the authoritative guidance refers specifically to an entity's conduct of business, including:

1. [2] *Financial Instruments*, states that the classification and measurement of financial assets depends on an entity's business model for managing those assets;
2. [3] *Consolidated Financial Statements*, notes that under certain circumstances investment entities do not consolidate "certain subsidiaries" because those investment entities have a "unique' business model supporting reporting of their investment in those unconsolidated subsidiaries on a fair value basis.
3. Classifying and measuring
   a. Inventories;
   b. Investment properties held to generate rental income or for purposes of appreciation;
   c. Property, plant and equipment held for sale; and
   d. Noncurrent assets held for sale or to be discontinued.

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4. [4] *Operating segments*, which establish criteria for reporting certain information about its separately identifiable operating segments.

Of course, given the subjective approach commonly assumed to be taken by the IASB in its guidance, one could assert that much of existing authoritative literature sets out criteria that should be applied based on the way the entity conducts its business activities.

In fact, one could argue that the business model notion is implicitly captured in the current Conceptual Framework. For example, Paragraph OB 4, which gives the IASB's objective of general purpose financial reporting, states:

The objective of general purpose financial reporting is to provide financial information about the entity that is useful to existing and potential investors, lenders and creditors in making decisions about providing resources to the entity.

Paragraph OB 5 of the Conceptual Framework, the Board argues that to achieve their objectives:

Potential investors, lenders and other creditors need information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity's management and governing boards have discharged their responsibilities to use the entity's resources.

Explaining and reporting on "how efficiently and effectively" an entity's management has discharged their responsibilities inherently includes reporting on the effectiveness of management in the conduct of the business activities of that entity, which is captured in the additional discussions about the reporting on changes in economic resources and reporting on an entity's financial performance.

In addition, in [5] *Presentation of Financial Statements*, the IASB provides guidance on presentation and contents of the basic financial statements, including related financial statement disclosures.

Paragraphs 19-24 provides criteria for financial reporting and disclosure when an entity's management decides to depart from authoritative guidance because they believe that implementing the required guidance would be so misleading that it would be inconsistent with the objective of financial reporting, as laid out in the IASB Conceptual Framework. Although rarely applied, such guidance recognizes that in specific instances an individual entity's business approach might suggests financial reporting and disclosure that differs from the approach required by authoritative literature.

Another example of an international accounting standard that implicitly requires consideration of an entity's business model is [6] *Accounting Policies, Changes in Accounting Estimates, and Errors*. Paragraph 10 of [6] provides qualitative considerations for an entity when selecting an accounting and financial reporting approach in the absence of a specific international accounting standard addressing an accounting event or transaction of interest. Paragraph 10 states: In the absence of an IFRS that specifically states applies to a specific transaction, other event or condition, management shall use its judgment in developing and applying an accounting policy that results in information that is:

(a) relevant to the economic decision-making needs of users and

(b) reliable, in that the financial statements

(i) represent faithfully the financial position, financial performance and cash flows of the entity

(ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form

(iii) are neutral, i.e. free from bias

(iv) are prudent and

(v) Are complete in all material respects.

One could argue that faithfully representing the financial performance and cash flows of the entity and reflecting the economic substance of the transaction, free from bias, would capture specific concerns related to the way the entity conducts its business, i.e. the entity's business model.

Paragraph 12 of [6] explains the considerations that should influence application of paragraph 10. It states:

In making the judgment described in paragraph 10, management may also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature and accepted industry practices, to the extent that these do not conflict with the sources in paragraph 11 [Emphasis added].

The reference to "accepted industry practices" would, when relevant for accounting and reporting, reflect the manner by which entities in an industry "conduct their business activities," i.e. companies in the same industry would likely have similar business models.

Of course, one could identify numerous other criteria in the authoritative literature for which the application of the guidance is contingent on the way in which the entity conducts its business, such as for accounting and financial reporting of sales transactions in accordance with the revised revenue recognition guidance, *Revenue Recognition for Contracts with Customers*. Under the new revenue recognition guidance, an entity determines its revenue recognition policies consistent with the specific contractual relationship between the entity and its customers.

In addition, of course, the IASB has issued several standards that are to be applied to specific industries. These include:

- [7], Construction Contracts.
- [8], Accounting and Reporting by Retirement Benefit Plans.
- [9], Agriculture.
- [10], Insurance Contracts.
- [11], Exploration for and evaluation of Mineral Resource.

Lastly, on its current technical agenda, the IASB has a project on financial accounting and reporting for rate regulated entities.

Advantages and Disadvantages of Considering an Entity's Business Model in Financial Reporting

In paragraph 9.30 of the DP, the Board discusses the advantages of including the business model concept as a factor when the IASB develops authoritative guidance. It says:

Some have argued that the business model concept should play a significant role in standard-setting. They think that applying the business model concept when developing IFRSs provides relevant information because it provides insights into how the entity's business activities are managed. Consequently, it helps users of financial statements to assess the resources of the entity, claims against the entity, and how the entity's management and governing board have discharged their responsibilities to use the entity's resources.

However, the Board recognizes that others use the Conceptual Framework to interpret the application of IFRS for the preparation and interpretation of financial statements and related information. As a result, in paragraph 9.31, the DP notes that including a business model concept in the Conceptual Framework might reduce financial statement comparability. It says:

(a) Having a business model approach could result in different classification, measurement or disclosure of the same economic phenomenon or transaction. For example, identical financial assets could be accounted for differently depending on whether the entity will hold the asset for collection or for sale.

(b) Some believe that the business model approach to financial reporting provides entities with a choice about how to report the same economic phenomenon or transaction.

Therefore, as long as the Conceptual Framework can be used by preparers and users for interpreting and applying existing authoritative literature, the IASB must consider balancing its use in the Framework with its use by financial statement preparers of financial statements and related information.

In an April 2013 staff memorandum discussing the business model concept, the staff noted that some "other concerns about adopting [this] concept" as a component of the formal Conceptual Framework includes:

(a) Reducing the emphasis on neutrality in financial reporting information; and

(b) Developing a definition that is clearly defined and can be consistently applied.

In the existing Conceptual Framework, the IASB states that one of the two fundamental qualitative characteristics of financial information is that it "faithfully represents [the economic] phenomena that it purports to represent". Faithful representation has three features: (a) its complete, (b) it's free from bias, and (c) its neutral.

In paragraph QC14, the Conceptual Framework defines neutral financial information as:

Without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasized, de-emphasized or otherwise manipulated to increase the probability that financial information will be received favorably or unfavorably by users. Neutral information does not mean information with no purpose or no influence on behavior. On the contrary, relevant financial information is, by definition, capable of making a difference in users' decisions.

Of course, as noted above, in the DP, the IASB expressed concern that introducing the business model concept might result in entities applying IFRS in a way that might bias the "depiction" of a transaction or event in their reported financial information.

Further, the DP indicates that, currently, when the Board uses the business model notion in a standard or an interpretation, they describe their meaning rather than providing a single definition.

For example [12], *Financial Instruments*, requires an entity to classify, reclassify and measure financial assets consistent with the entity's "business model" for managing those assets and the cash flow characteristics of the asset.

In a summary discussion explaining the meaning of the term "business model" for managing financial assets, the IASB states that: A business model refers to how an entity manages its financial assets in order to generate cash flows—by collecting contractual cash flows, selling financial assets or both.

Given their current approach of describing the business model notion based on an entity's approach for managing it business activities, the Board's concerns about reaching a definition that would result in comparable application among entities with unique economic concerns and approaches for resolving those concerns is valid.

Business Model Concept Defined by Others

In December 2013, the International Integrated Reporting Council (the "IIRC"), a private sector group calling for an approach to corporate reporting that will "explain to financial capital providers how an organization creates value over time" issued *The International <IR> Framework* [13].

The report notes that the business model is at the core of any organization's value creation process. Therefore, an integrated report should describe and explain the organization's business model. The IIR Framework defines an entity's business model as follows:

An organization's business model is its system of transforming inputs, through its business activities, into outputs and outcomes that aims to fulfill the organization's strategic purposes and create value over the short, medium and long term [14].

As explained in the IIR Framework, an entity's integrated report would describe the key characteristics and features of its business model. The list of topics that an entity would discuss about its business model is rather extensive. Among the information about the business model that an entity the IIR Framework proposes for inclusion in an integrated report are:

- The key inputs to the business model
- Associated business activities
- Key business model outputs
- Key outcomes from using capital to implement and apply the entity's business model.

It should be noted that the IIR Framework's description of a business model focuses on an objective of linking the entity's business model with its "strategic purpose" and its ability to use capital in its efforts to create value. With reference to "creating value", the IIR Framework states:

Value created by organization overtime manifests itself in increases, decreases, or transformations of capitals caused by the organization's business activities and outputs. That value has two interrelated aspects – value created for:

- The organization itself, which enables financial returns to the providers of financial capital
- Others (i.e. stakeholders and society at large) [15].

Thus, the IIR Framework focuses mainly on reporting the link between the ways an entity employs capital in the conduct of its business such that the entity generates value to providers of capital. According to the IIR Framework, the "value created" should be in the form of a financial return to providers of capital and others interested in the way in which the entity conducts its business.

A challenge for the IASB, were they to adopt the IIRC business model definition, is that the IIRC's objective differs from the objective of general purpose financial reporting as stated in the IASB Conceptual Frame work for financial reporting. OB2 states:

The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit.

In providing such information, the Conceptual Framework states that financial information should provide information about the financial position of the organization, which is represented by the economic resources of the organization and the claims to those economic resources, and financial information should provide information about changes in the economic resources of the organization and changes in the claims to those economic resources.

So, from the perspective of the IASB, general purpose financial reporting should focus on reporting financial position and changes in financial position, rather than use of capital to create value. Therefore, one might expect that to the extent the IASB identifies a need to incorporate the business model concept into the Conceptual Framework, the IASB's definition and related descriptions will differ somewhat from that of the IIR Framework. Unless, of course, the IASB revises its stated objective for general purpose financial reporting such that it's consistent with that of the IIR Framework.

Unrelated to financial accounting and managerial reporting, others have offered a definition of (or description for) the business model notion. Usually, those descriptions focus specifically on an entity's profit generating activities.

For example, in a paper that provides a set of rules for entities to follow when developing their business models, [15] states that a "business is about selling what you make for a profit." Dr. Chatterjee defines the term "business model" as: a configuration (activity systems) of what the business does (activities) and what it invests in (resources) based on the logic that drives the profits for a specific business.

Similarly, in a discussion of an approach for transitioning from "a current to a desired business model" [16], define an organization's business model as: a description of how an organization or network of organizations intends to create and capture value from offering a service to its customers [17]. Our notion of business models goes beyond the revenue model and also includes the service being offered and the technological and organizational resource configuration that supports the offering of that service (Page 3).

In their paper [18] acknowledge the challenges of designing a viable "business model" and they discuss some of the issues that entities should consider when they are redefining their accepted model.

Similar to the IIR Framework, those other descriptions do not address the objectives of financial information expressed in the IASB [19] Conceptual Framework. So, even though such descriptions are helpful for developing an IFRS business model concept, the other definitions should not be adopted into IFRS without considerable debate and discussion.

Concluding Comment

As discussed above, in the DP, the IASB provides several areas in IFRS in which an entity's conduct of business explicitly influences the entity's approach for implementing the related authoritative guidance [11].

As pointed out in this paper, IFRS guidance implicitly and explicitly requires application of its guidance with consideration of an entity's approach for the conduct of its business. Thus, the notion of considering an entity's business model is already an important aspect of applying international accounting standards.

Clearly, the IASB can clarify its views on how an entity's business model will be considered in developing new authoritative guidance. However, because, in certain instances, financial statement preparers can use the Conceptual Framework as a guide when selecting accounting policies, the IASB is concerned that incorporating the business model concept into the Conceptual Framework might introduce unwanted bias in the financial information presentation and reporting.

In my view, the IASB should develop a single definition of the term "business model" and use that definition, or refer to it as appropriate. As noted in the [12] project summary discussion: A business model can typically be observed through the activities that an entity undertakes to achieve its business objective. As such, a business model is a matter of fact rather than an assertion. Objective information, such as business plans, how managers of the business are compensated and the amount and frequency of sale activity should be considered. Judgment needs to be used when assessing a business model and that assessment should consider all relevant available evidence [2].

Interestingly, in [18], *The Effects of Changes in Foreign Exchange Rates*, the IASB provides a definition of "functional currency" that seems to capture most, if not all, of the characteristics necessary for identifying an entity's "business model." Paragraph 9 of IAS 21 provides the primary factors that should be considered when selecting a foreign subsidiaries functional currency:

An entity considers the following factors in determining its functional currency:

(a) The currency:

(i) That mainly influences sales prices for goods and services (this will often be the currency in which sales prices for its goods and services are denominated and settled); and

(ii) Of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services?

(b) the currency that mainly influences labor, material and other costs of providing goods or services (this will often be the currency in which such costs are denominated and settled).

Paragraph 10 of IAS 21 adds the following considerations, which they enhance in later paragraphs of IAS 21:

The following factors may also provide evidence of an entity's functional currency:

(a) The currency in which funds from financing activities (i.e. issuing debt and equity instruments) are generated.

(b) The currency in which receipts from operating activities are usually retained.

The point here is that with some minor revision, the IAS 21 description could be adopted to address the relevant factors to consider when determining an entity's business model. And, of course that is a sensible observation because, as discussed in paragraph 9 of IASA 21, a functional currency represents "the primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash," which implies that the functional currency is the currency in which the entity primarily conducts its business activities, or said another way, implements the entity's business model.

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