Federation of European Accountants
Fédération des Experts comptables Européens

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Dear Ms Flores,

Re: FEE comments on the EFRAG research paper: "The role of the Business Model in Financial Statements"

FEE (the Federation of European Accountants, www.fee.be) is pleased to provide you below with comments on the EFRAG research paper: "The role of the Business Model in the Financial Statements" ("Research Paper").

FEE welcomes the EFRAG's initiative of issuing this Research Paper as a means to stimulate discussion among the constituents on the use of the business model in Financial Statements.

FEE believes that the business model is an important concept to consider in determining what constitutes decision-useful information. Giving proper recognition to the business model as part of standard setting would help ensure that financial statements serve as a communication tool between management and users of financial statements with respect to stewardship. Setting out the concept of business model as part of the conceptual framework could help to clarify the differences between both the business model and the management intent. Accordingly, we believe that it is important that further work be performed on that concept.

However FEE believes that introducing the business model as a qualitative characteristic should not override the existing qualitative characteristics of financial statements; rather it should complement them. It can be seen that the business model concept is already implied in relevance and faithful representation; therefore, an explicit reference may enhance the understanding around the business model concept.

The Research Paper establishes an assumed meaning of the business model concept based on the value creation cycle. FEE agrees that the cash conversion cycle and its attributes can be seen as factors that differentiate specific business models.

As a point for consideration, FEE draws attention to the need to identify the unit of account for the Business Model. The discussion that is relevant to the business model concept relates to whether an entity can accommodate more than one business models.

In conclusion, FEE believes that in order to make practical use of the business model in financial reporting, the overall concept should be defined and there should be a clear distinction between the business model and management intent in the Conceptual Framework.

Enclosed please find our responses on the detailed questions included in the Research Paper together with our views on other relevant issues.

For further information on this letter, please contact Pantelis Pavlou, project manager, from the FEE Team on +32 2 285 40 74 or via e-mail at pantelis.pavlou@fee.be.

Yours sincerely,

André Kilesse
President

Olivier Boutellis-Taft
Chief Executive

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?

FEE agrees with the analysis in the Research Paper regarding the implicit examples in current IFRSs that use the business model concept. Similar transactions can be recognised, measured and presented differently between entities due to different business models.

FEE is not aware of any additional implicit examples in IFRSs where the business model concept is being used. However, FEE identifies 2 additional examples where the business model concept could be introduced to enhance existing Standards. IFRS 10 – Consolidated Financial Statements and IFRS 11 – Joint Arrangements.

The first example is linked to the exception for investment entities not preparing consolidated financial statements as described in IFRS 10. The business model concept could have enhanced the definition of investment entities.

As a second example, FEE believes that the classification of Joint Arrangements between Joint Operations and Joint Ventures in IFRS 11 could have been easier to implement with an explicit reference to the business model concept. This would have enhanced the identification and classification of the Joint Arrangements.

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?

FEE agrees with the views expressed in the Research Paper that entities exist to create value and that the cash flows, and the risks associated with them, describe the value creation process. FEE also agrees with the view that the attributes of the cash conversion cycle are elements of the assumed meaning of the business model and thereby justify different recognition and measurement principles.

FEE believes that the attributes discussed in the Research Paper adequately present the way in which value is created and converted to cash can differentiate a specific business model from other business models. However the linkage between capital intensity and the appropriate basis for recognition/measurement of transactions is less convincing.

Question 3.1 - Banking example

(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?

FEE believes that this is an example of business models defined based on the risk management of each entity, the length of the cash conversion cycle, the way performance is assessed and the value is created. Entity A has a longer term cash conversion cycle than Entity B. Normally, Entity A accepts more risks and enjoys higher returns, while Entity B reduces the risk of non-repayment with immediate cash conversion of the financial asset, however, pays a premium for doing so.

FEE supports View A in this specific example. Entity A holds the loans to maturity, therefore, accounting for the financial assets using the amortised cost measurement basis best reflects the entity's business model. Entity B converts the financial asset to cash on a different basis. The fair value measurement basis provides more relevant information to the users of financial statements as the short-term fluctuations on the fair value of the loans affect Entity B's results.

FEE would continue to support View A if the different activities were conducted by the same entity as long as it is based on a defined strategy implemented according to specific policies/tools/organisation which enables identification of the loans that will be held to maturity and those to be sold to third parties. The entity should report the transactions using the accounting treatment that best reflects the substance of the transactions within the context of the business model(s) in which the transactions are conducted.

Question 3.2 - Mobile network operator example

(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 sales channels 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?

FEE believes that entering into transactions directly with end users as opposed to transacting through a distributor can represent different distribution models. However, the description of the businesses of Entity A and Entity B is not sufficiently detailed to allow us to assess whether or not we face different business models. For example, it is not clear whether the distributor is acting as an agent of Entity B or as a principal and whether Entity B is entitled to a penalty from customers should the customers terminate the contract early.

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If we assume that the distributor is acting as an agent of Entity B (such that Entity B is the principal in the relationship with the end customers) and assuming that both Entity A and Entity B are entitled to a penalty from the customers in case of early termination, it would seem reasonable that the subsidy (for Entity A) and the commission paid to the dealer (for Entity B) be accounted for in the same way.

Question 3.3 - Insurance example

(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 both insurance products of Entity A and Entity B were provided by the same entity, would your answer to the above question be different? If so, why?

FEE believes that this example does not illustrate different business models but rather describes two different insurance contracts/products: non-participating as opposed to participating contracts.

Consequently, the entities face different risk and performance patterns. Entity A is expected to invest in assets that provide a return that at least equals the fixed return promised to policyholders, while Entity B passes part of the risks to policyholders.

As a starting point, accounting for liabilities under the insurance contracts should reflect the dependence on assets, i.e. the resulting obligation should be reflected through a consistent measurement of the degree to which future cash flows depend on the assets and the risks. There are still ongoing discussions within the IASB insurance project on how this can be best achieved.

Nevertheless, irrespective of the contractual linkage, there is an economic relationship between assets and insurance contracts liabilities – the assets being the source to finance liabilities. Therefore, assets and liabilities should use a consistent measurement basis in order to avoid any artificial accounting mismatches, i.e. if liabilities are discounted on a current basis, assets should as well be measured on a current basis (e.g. fair value), and if effects of changes in discount rates are presented in OCI, so should changes in the values of covering assets should be reflected in the OCI as well.

In concluding, FEE does not believe that view A or view B are appropriate.

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?

FEE believes that the business model is an important concept to consider in determining what constitutes decision-useful information. Therefore, FEE supports further exploring the business model as part of the conceptual framework.

In particular, we believe that the business model may be relevant in areas such as identifying the most relevant subsequent measurement basis, defining performance and establishing whether changes in assets and liabilities should be recognised in profit or loss or in OCI.

Giving proper recognition to the business model as part of standard setting would help ensure that financial statements serve as a communication tool between management and users of financial statements with respect to stewardship. Accordingly, we believe that it is important that further work be performed on that concept.

Setting out the concept of business model as part of the conceptual framework could help to clarify the differences between both the business model and the management intent. It would also assist in ensuring that when a reference is made to the business model at standard level, its meaning is clear and consistent.

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.

FEE agrees with the Research Paper that there is a need to introduce criteria that will enable the standard setters to identify whether the business model concept should be used in a standard.

As indicated in our response to Question 4, FEE supports further exploring whether those criteria should be included in the Conceptual Framework as this may promote consistency in the development of future standards, in particular in deciding when the business model concept should be used.

In FEE's opinion, the five considerations that have been presented in Chapter 5 of the Research Paper provide a solid basis to develop a framework to assess whether the business model should be used. However, FEE believes that the main objective of the financial statements should not be solely to provide information that can be used as a predictor of future performance (point (e) of paragraph 5.7). We believe that an additional criterion to be considered is the capacity to transform the predictive performance into cash within an appropriate time frame. As defined in the Conceptual Framework, the financial statements should present information that has confirming or predicting value, or both. Therefore, FEE suggests that the confirming value of financial statements should be included in these criteria.

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?

FEE agrees with the main implications presented in the Bulletin and the way that the business model concept would affect financial reporting.

Furthermore, FEEs identifies that disclosures for the business model will be relevant to the users. An entity should disclose its business model(s), nature of deviations from the business model, if any, and whether they might constitute a change of the business model.

Finally, FEEs believes that the introduction of the business model in financial reporting would facilitate the assessment by the IASB of whether capital maintenance might be applied to more IFRSs where applicable.