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Accounting Standards Committee of Germany
IFRS-Fachausschuss®

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EFRAG
Françoise Flores
Chairman EFRAG TEG
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Berlin, 26 May 2014

Dear Françoise,

The role of the business model in financial statements RESEARCH PAPER

1 On behalf of the Accounting Standards Committee of Germany (ASCG), I am writing to comment on the Research Paper *The role of the business model in financial statements* by EFRAG, ANC and FRC. We appreciate the opportunity to respond on the Research Paper.

2 We agree with the underlying statement of the Research Paper that the business model should play a role in financial reporting when specific conditions are met. We believe that financial statements can be made more relevant if standard setters take into account how entities conduct their business activities when developing or revising standards. However, the more challenging question is *how* the consideration of the business model in standard setting should be designed.

3 We believe that the notion of the business model should be included in the IASB's Conceptual Framework in Chapter 3 as an enhancing element for faithful representation instead of identifying specific criteria or including a stand-alone characteristic. In particular, the IASB should consider the business model in the standard-setting process when this meets the objectives of the general purpose of financial reporting and, specifically, enhances the faithful representation of the information provided. Standards should be designed in a way that the user is able to understand the entity's business model on the basis of the financial reporting. In our view the role of the business model should be investigated in light of financial reporting and not only regarding financial statements, as the Research Paper assumes, because the business model has an impact on more than just financial statements. We believe that a general consideration of the business model when developing or revising standards might not be meaningful. If deemed necessary, it is easier to determine specific criteria at a stan-

dards level for distinguishing business models and deriving appropriate accounting requirements.

4 Regarding the definition proposed in the Research Paper, we do see difficulties in determining the business model through the cash conversion cycle. Although we acknowledge that value creation is an important characteristic of an entity's business model, we think this criterion should not be considered in isolation as it cannot be applied to all industries. From our point of view, the cash conversion cycle cannot be identified in all cases or does not always help distinguishing business models. The definition proposed is just one way of defining this term. The assessment of the issues raised in the Research Paper would be different when the business model was defined as business activities or would have, for instance, focused on asset allocation.

5 We believe, next to the cash conversion cycle, there are lots of other characteristics as well, for instance, an entity's risk profile that can have an impact on an entity's business model and could play a role when deriving accounting requirements. In our view, not an isolated focus on the cash conversion cycle but a holistic assessment of all key characteristics mentioned in the Research Paper seems to lead to more meaningful outcomes. Additional criteria could be, for instance, the use of distribution channels or how an entity achieves its corporate goals. What makes up a business model might vary from case to case. For these reasons we do not agree with the cash conversion cycle being the sole criterion for the definition of an entity's business model.

6 From our perspective, the link between an entity's business model and the respective accounting is not always clear or given. There might be circumstances where different business models exist but do not automatically lead to different financial reporting requirements. Sometimes this link exists and sometimes the accounting requirements need to be derived from other criteria in order to achieve a faithful representation. As mentioned earlier, there is a wide range of characteristics that need to be taken into account when determining whether or not there should be an impact on financial reporting. Thus, the cash conversion cycle or another criterion might be a distinguishing feature and a justification for doing something special in financial reporting in some, but not in all cases. Considering these difficulties, we think taking the business model into account cannot be standardized, as an isolated and unique definition for the term does not seem to be applicable to all financial reporting issues.

7 Further, we believe that the Research Paper should have focused on more realistic examples to figure out what a proper definition across the industries could be and in order to determine under which circumstances the business model should lead to specific accounting requirements. We think the examples provided show that the definition chosen is not appro-

priate in all cases and do not always help identifying if the accounting should depend on the business model.

8 In addition, the Research Paper does not provide actual implications on IFRSs, especially regarding recognition and measurement. It is not mentioned in which way or where existing standards should be amended or what exactly the consideration of the business model implies when developing new standards. We question whether there is any need for action regarding the current standards. Since the Research Paper does not identify concrete fields for action but rather proposes some general possible implications for future IFRSs, we believe a more general inclusion of the business model in the Conceptual Framework seems to be sufficient.

9 We refer to the appendix, which includes our responses to the questions raised by EFRAG. If you would like to discuss our comments further, please do not hesitate to contact me.

Liesel Knorr

President

Appendix A - Answers to the questions of EFRAG's Research Paper

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 any additional implicit examples in IFRS?

a)

1 In general, the ASCG agrees with the analysis of the implicit examples in IFRSs as it shows that the business model notion is already implicitly used in IFRSs. That the accounting standard setter already paid attention to this topic when developing some standards – even though not directly – demonstrates that the debate is not a completely new issue. Nevertheless, it is important to keep in mind that the different implicit references in IFRSs do not always refer to the business model meaning the same thing. Furthermore, considering the business model in financial reporting might be appropriate in some but not in all cases.

b)

2 Even though there might be additional implicit examples in IFRSs using the notion of the business model, we do not think that a further analysis would help investigating this issue. As the notion used might have different meanings in different standards and not always have different accounting treatments as a consequence, we do not believe that carrying out further research would reveal new insights.

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?

3 Although we do agree that the business model could play a role in financial reporting, we do not agree with the analysis of the cash conversion cycle being *the* or *the only* way of determining and distinguishing business models, especially for deriving specific accounting treatments. From our point of view, the differentiation made in the Research Paper is just one way of determining the business model and does not consider other factors that are important for determining and differentiating business models. If there was a different basis for the assumed meaning of the business model, e.g. business activities or the customer needs, the reasoning and answering of the questions might be different. In our opinion, the analysis of the business model as the cash conversion cycle is too simplistic. We believe that the cash

conversion cycle might be a criterion appropriate for some industries and in some instances but not for all industries or all instances, respectively.

4 We feel that the examples included in the Research Paper are overly simplified. The discussion below shows that, even when considering easy examples, the assessment whether or not there are different cash conversion cycles would not always lead to a definitive answer as to whether or not a specific consequence for financial reporting should follow from that. The application to real life cases will probably raise more problems and not lead to a common understanding. For some industries it is not even possible to determine the cash conversion cycle as entities are able to generate cash in a variety of ways (e.g. the banking industry) or might be acting differently than usually due to market conditions without generally changing their business model (e.g., some entities in the manufacturing industry might generally sell end products, but might also sell parts or pre-products in certain scenarios due to an adverse business environment). As the cash conversion cycle cannot be determined in all circumstances it becomes clear that this criterion might be one out of many criteria who make up a business model.

5 Another question is whether different cash conversion cycles should always lead to a different treatment in financial reporting. There might be circumstances where entities either have different cash conversion cycles but should be accounted for in the same way or where entities have the same cash conversion cycle but should be reported on in a different way for other reasons. The application of the cash conversion cycle to the examples shows that it is not always possible to derive only one definitive and appropriate treatment. Therefore, we do not agree that the assumed meaning of the business model as the cash conversion cycle is the appropriate criterion to determine and differentiate business models and especially to derive specific treatments in financial reporting.

6 We believe that an isolated analysis of a criterion, i.e. the cash conversion cycle, to describe a business model is not going to achieve the goal of determining and distinguishing different business models and, potentially, deriving specific accounting or reporting requirements. In our view, although the cash conversion cycle might provide useful information and could be an appropriate indicator in some cases, there are other criteria as well that have a significant impact when defining business models and deriving at the appropriate reporting treatments. For instance, we strongly believe that exposure to various risks is a key characteristic of a business model and should not just be seen as a part of the value creation but rather as a separate criterion. We believe there are a lot more criteria that determine a business model, though they may differ between industries. In our view, the other key characteristics identified in the Research Paper can have a significant impact on an entity's business model, too. We

therefore do not concur with EFRAG's view to focus on the cash conversion cycle in isolation but rather suggest considering all characteristics. Taking into account business activities, the asset configuration or the customer's needs might play a significant role in some cases as well. Criteria could also include the use of distribution channels or how an entity achieves its corporate goals. We strongly believe that there is a wide range of criteria to determine a business model. Since the key characteristics of an entity's business model differ from industry to industry, it might be difficult to set criteria that define the term business model in only one way across all industries. .

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?

a)

7 We are not sure whether this example describes business models but rather different business activities. In our view, holding or selling financial instruments depict different activities, which might belong to a business model but do not describe different business models in general. Further, we do not agree that the cash conversion cycle is the only criterion to determine the business model in this example. As we mentioned in our response to question 2, we believe there are also other parameters for identifying different business models or the business model itself. We note that the example provided does not appear to be a fair reflection of the banking industry. In our view, there are more business activities than just 'holding' or 'selling' financial instruments. As other intermediate stages are ignored, the example can hardly be applied to real life. The discussion dealing with the fair value through other comprehensive income category of IFRS 9 shows that there are more than just these two dimensions. An example dealing with the cash conversion cycle(s) of the banking industry needs to take other activities into consideration in order to assess whether the definition of the business model works for this industry as such "in between things" exist in real life.

8 As mentioned earlier it is not that easy to determine an or even define 'the' cash conversion cycle for the banking business. When the business model is described as being determined with reference to the cash conversion cycle, it requires that the generation of cash flows arises out of the business itself. This does not encompass all alternatives, because it is also possible to generate cash in between different transactions. Such different ways of realising cash exist mainly for financial services providers as they can bundle, arrange or split financial instruments as they like..

b)

9 In our view, it is not possible to decide whether the activities should be accounted for similarly or differently when the decision is based solely on the cash conversion cycle(s). Since financial reporting should reflect how the entity actually generated cash, which is not predetermined (see para. 8), and should provide the user with relevant information, we believe that the activities of the two entities should be accounted for differently.

c)

10 Assuming that the business activities should be reported differently, the question should be answered in the same way, if the two business activities occurred in the same entity. In order to avoid cherry-picking and to ensure that the user is able to understand financial statements where business models or business activities with different accounting treatments exist, standard setters should require some documentation to disclose choices made and impose restrictions under which circumstances an entity is allowed to change its business model.

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?

a)

11 We do not think that the example describes different business models with regard to different cash conversion cycles. We are not sure whether having different compensation arrangements represents an appropriate and robust indicator for different cash conversion cycles and different accounting requirements. In our opinion, the example shows that the cash conversion cycle is not an appropriate criterion for distinguishing different business models, at least not in this case.

b)

12 We believe the decision how to account for the activities in this example is not linked to having the same or different business models. The core question in this example is whether or not to capitalise the commissions paid to dealers as intangible assets. The transaction with a third external party (commission paid to the dealers) is not immediately presented in the statement of comprehensive income but meets the criteria to be recognised as an asset. We believe that, regardless of whether there are the same or different business models, different facts and circumstances in this example lead to different accounting treatments. Features such as different sales structures can play a role for deciding on the appropriate depiction in accounting as well.

13 For the definition of the business model things like how an entity achieves its corporate goals, which products or services are offered or the (non-)existence of a vertical integration are important indicators. Another characteristic for different business models could be different risk exposure of entities. We think the cash conversion cycle does not help identifying business models and does not clarify whether the entities in the example should account for these transactions similarly or differently.

c)

14 If the different sales channels of Entity A and Entity B were both pursued in the same entity, the accounting still should differ due to having a transaction with a third external party in one entity. As already mentioned in Example 3.2, there should be some requirements to document these activities in order to ensure that the financial statements are understandable and that the entity is not able to choose the preferred accounting.

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?

a)

15 We think the example describes different product types rather than different business models. In our view, the differentiation does not result from different cash conversion cycles.

b)

16 We believe, the different product types in this example require a different accounting in order to depict the lines of businesses adequately. However, this assessment is not derived from the cash conversion cycle but rather due to the different diversification of risks and other factors. From our point of view, the risk-sharing is one of the main drivers for the accounting in this example.

c)

17 When an entity distributes both kinds of product types, they still should be accounted for differently. This requires that the entity has clearly defined units and that the shifting of insurance contracts from one pool to another is only allowed under restrictive circumstances.

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?

18 As we believe that providing relevant information in line with faithful representation is very important for financial reporting, we are supportive of the view that the business model could play a role in financial reporting as one aspect for representing facts and circumstances faithfully. As we mentioned in our comment letter to the IASB regarding the Discussion Paper to the Conceptual Framework, financial statements can be made more relevant if the IASB considers how an entity conducts its business activities etc. when developing or revising particular standards.

19 Nevertheless, example 3.2 shows that there are as well circumstances in which the assessment of having one business model or different business models does not always help deriving appropriate financial reporting requirements. In other words, the existence of a different business model as such cannot be used to justify overruling reporting requirements. On the other hand, standard-setting should always ensure that the entity is able to depict its business model faithfully, taking into account that sometimes the unit of account or other facts and circumstances have a greater impact on the accounting than the business model itself when depicting the business and the underlying activities adequately. That means that having different business models does not automatically lead to different accounting (and the other way around), but the accounting requirements have to be set in light of faithful representation

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 any additional criteria that should be included? Please explain.

20 From our point of view, there is no concrete demand for amending existing IFRSs. Further, we identified a wide range of difficulties regarding the definition proposed and the vague connection between the business model and accounting requirements from an overall perspective. Therefore, we prefer not to include criteria in the Conceptual Framework but to

rather include a general statement that the business model should be considered when developing or revising standards when this leads to more faithful representation. We could well imagine taking the business model into account in Chapter 3 of the Conceptual Framework as an explanatory element to describe when financial information is faithfully represented. The IASB should make sure when developing IFRSs that the standards are designed in such a way that entities are able to depict their business models faithfully. We think a more detailed consideration of how an entity conducts its business should be applied at standard level. At this level it seems to be easier to determine distinguishing features.

21 Although we acknowledge that identifying criteria would be helpful to systematically consider the business model in the standard-setting process we do not believe this is possible from an overall perspective, since there is probably not an exhaustive list of criteria for identifying when the business model should be used for differential financial reporting. As we do not see a clear relation between a business model and financial reporting requirements and as the business model cannot always be converted into appropriate accounting treatments, a more general consideration of the business model concept in the Conceptual Framework appears to be the better way to us. The analysis of the examples included in the Research Paper has shown as well that it seems to be difficult to determine a definition that works for all industries and enables the derivation of accounting requirements. Another difficulty arises from the fact that there is no agreement as to whether there is a limited or an infinite number of business models.

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?

22 The Research Paper notes in paragraph 5.12 that the analysis of the impact of business models on the cash flow generation can be objectively observed and provides a solid base for identifying business models that justify different accounting treatments. Our responses to questions 3.1 – 3.3 indicate that the assumed meaning of the business notion as the cash conversion cycle does not always enable identifying business models and does not automatically answer the question whether to account for in the same way or apply different accounting requirements.

23 When the business model is taken into account, it could have an impact on recognition, measurement and presentation requirements. The specific requirements in the standards should be designed in a way that users of financial statements are able to understand the entity's business model. We believe a general assessment of what constitutes a business model and what the reporting treatment should be is not possible. As we see no implications

on current IFRSs we consider a more general description that financial statements should enhance the understanding of an entity's business model as a more appropriate cause of action, which is why we believe it should be included in the Conceptual Framework.