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Role of "Nature of an Entity's Business Activities" in Accounting Standard-Setting

Accounting Standards Board of Japan

Summary

1. This paper has been prepared to provide the ASBJ's preliminary views on the IASB's work to review *The Conceptual Framework for Financial Reporting* (hereinafter referred to as the "*Conceptual Framework*") in conjunction with the paper titled, *Identification, Description and Classification of Measurement Bases* for the purpose of facilitating the discussion during the March 2015 meeting of the ASAF.

2. During the redeliberation process towards an Exposure Draft of possible changes to the *Conceptual Framework*, the IASB tentatively decided that the ED should **not** provide a single over-arching description of how the nature of an entity's business activities would affect standard-setting.

3. The ASBJ is of the view that the nature of an entity's business activities has a significant effect on various aspects of accounting standard-setting, and thus thinks that there should be an overarching description in the *Conceptual Framework* that should be applied consistently throughout the standard-setting process.

4. Having regards to the proposals previously put forward in the ASAF meetings, the ASBJ believes that the following matters should be clarified in the *Conceptual Framework.*

    (a) How to identify the nature of an entity's business activities conducted that are relevant for the purpose of accounting standards-setting, including:

    (i) **How to classify the nature of an entity's business activities conducted into categories**; and

    (ii) **How they should be described in the *Conceptual Framework***.

    (b) **How the nature of an entity's business activities should be considered in the development of accounting standards**.

5. With regard to how to classify and describe the nature of an entity's business activity, this paper proposes that the *Conceptual Framework* clarify the following principles:

    (a) For an asset (or a group of assets), the measurement basis that is relevant from the

perspective of reporting the entity's *financial performance* should be updated at a period-end to reflect the price changes in the market during the period so that the effect of price changes is recognised in profit or loss, **when an asset (or a group of assets) is held as part of an entity's business activity in which it aims to gain net proceeds from the price changes** under and subject to the entity's practical ability to sell the asset (or the group of assets). In other situations, in principle, the said measurement basis should not be updated to reflect the price changes during the period.

(b) For a liability, the measurement basis that is relevant from the perspective of reporting the entity's *financial performance* should be determined as follows:

(i) Where a liability is managed in combination with an asset or a group of assets, the said measurement basis should be updated at a period-end to reflect the price changes in the market during the period so that the effect of price changes is recognised in profit or loss, **when a liability corresponds to funding of the asset or the group of assets that is held as part of an entity's business activity in which the entity aims to gain net proceeds from the price changes** under and subject to the entity's practical ability to sell the asset or the group of assets. In other situations, in principle, the said measurement basis should not be updated to reflect the price changes during the period.

(ii) Where a liability is not managed in combination with the corresponding asset or group of assets, the said measurement basis should be updated at a period-end to reflect the price changes in the market during the period so that the effect of price changes is recognised in profit or loss, **when in the exceptional situation that the liability is held as part of an entity's business activity in which the entity aims to gain net proceeds by transferring it to third parties** under and subject to the entity's practical ability to transfer the liability. In other situations, in principle, the said measurement basis should not be updated to reflect the price changes during the period.

6. This paper also proposes to clarify the following:

   (a) The nature of an entity's business activities conducted has a major effect on the decisions of:

      (i) whether, and if so, how to group assets and/or liabilities in determining the measurement bases; and

      (ii) their measurement bases relevant from the perspective of reporting an entity's *financial performance*.

   (b) The above decisions have knock-on effects on the determination of 'profit or loss' and OCI (where a measurement basis from the perspective of reporting an entity's *financial performance* is different than the one from the perspective of reporting an entity's *financial position*) and the nature of the disclosure considered necessary.

7. The ASBJ hopes that properly categorising and describing the nature of an entity's business activities and explaining the effect on the development of accounting standards in the *Conceptual Framework* would promote consistency of accounting requirements in IFRSs, thereby contributing to the development of a set of globally accepted high-quality financial reporting standards.

I. Preface

1. This paper has been prepared to provide the ASBJ's preliminary views on the IASB's work to review *The Conceptual Framework for Financial Reporting* (hereinafter referred to as the "*Conceptual Framework*") in conjunction with the paper titled, *Identification, Description and Classification of Measurement Bases,* for the purpose of facilitating the discussion during the Accounting Standards Advisory Forum (ASAF) in March 2015.

2. Having regards to the IASB's discussion on the project to review the *Conceptual Framework*, this paper explores the roles played by the notion of the 'nature of an entity's business activities conducted' in the developments of financial reporting standards.

3. Views stated in this paper are preliminary views of the ASBJ, and they are subject to change in its future deliberation.

II. Background

IASB's DP

4. The IASB initiated the project to review the *Conceptual Framework*, in response to the comments received on *Agenda Consultation 2011*. In July 2013, the IASB issued a Discussion Paper, *A Review of the Conceptual Framework for Financial Reporting* (hereinafter referred to as the "IASB's DP"), where the IASB asked the constituents' views on the use of business model concept in financial reporting.

5. The IASB's DP did not propose to define the concept of "business model"; instead it stated the IASB's preliminary view that financial statements can be more relevant if the IASB considers, when it develops or revises particular Standards, '**how an entity conducts its business activities'**.

Discussion at the Previous ASAF Meetings

6. Before and after the IASB's DP was issued, a number of suggestions have been put forward by the ASAF members with regard to the notion of or similar to the 'nature of an

entity's business activities conducted' including the notion of 'business model'. A list of papers that suggested the categorisations and descriptions of these notions are summarised as follows (relevant descriptions in these papers are summarised in the Appendix of this paper):

(a) A research paper titled, *The Role of The Business Model In Financial Statements*, published by the EFRAG in partnership with the French ANC and the UK FRC in December 2013 (hereinafter referred to as the "EFRAG's Paper");

(b) The ASBJ's paper titled, *Profit or Loss / OCI and Measurement*, which was submitted for the discussion at the December 2013 Accounting Standards Advisory Forum (ASAF) meeting (hereinafter referred to as the "ASBJ's Paper");

(c) A paper titled, *A Revised Model for Presentation in the Statement(s) of Financial Performance: Potential Implications for Measurement*, authored by Dr. Thomas J. Linsmeier, a Board member of the FASB, which was submitted for the discussion at the March 2014 ASAF meeting (hereinafter referred to as the "Dr. Linsmeier's Paper"); and

(d) A paper titled, *The Reporting of Income and Expense and The Choice of Measurement Bases*, authored by Messrs. Roger Marshall and Andrew Lennard of the UK FRC, which was submitted for the discussion at the June 2014 ASAF meeting (hereinafter referred to as the "FRC's Paper")[1].

IASB's Tentative Decisions

7. Since March 2014, the IASB has continued its redeliberations on a review of the *Conceptual Framework*, with a view to issuance of an Exposure Draft (ED). During its July 2014 meeting, the IASB tentatively decided to confirm the proposal stated in the DP (that is, not to define and use the term 'business model' in the *Conceptual Framework*), and instead decided the following:

[1] In the following paragraphs, the phrase "four papers" refers to the EFRAG's Paper, the ASBJ's Paper, Dr. Linsmeier's Paper and the FRC's Paper.

(a) **The ED should not provide a single over-arching description of how the nature of an entity's business activities would affect standard-setting**.

(b) **The ED should describe, for each area affected, how consideration of the nature of an entity's business activities would affect standard setting.**

(c) **The nature of an entity's business activities is likely to affect the following:**

(i) Measurement;

(ii) The unit of account;

(iii) The distinction between profit or loss and other comprehensive income (OCI); and

(iv) Presentation and disclosure.

8. During the same meeting, as part of the discussion on measurement, the IASB tentatively decided the following matters:

(a) The factors to be considered when selecting a measurement basis for an asset or a liability should include the following:

(i) How an asset or a liability will contribute to future cash flows. This will depend in part on the **nature of the business activities being conducted**.

(ii) The characteristics of the asset or liability (for example, the nature or extent of the variability in the item's cash flows, the sensitivity of the value of the item to changes in market factors or other risks inherent in the item).

(b) The relative importance of each of the factors to be considered when selecting a measurement basis will depend upon facts and circumstances.

(c) It may be appropriate to use one measurement basis for the statement of financial position and a different measurement basis for the statement of profit or loss when such an approach better reflects the **nature of business activities conducted**.

III. Needs of Clarifying the Notion 'Nature of an Entity's Business Activities Conducted'

9. As explained in paragraph 7 of this paper, the IASB tentatively decided that the ED should **not** provide a single over-arching description of how the nature of an entity's business activities would affect standard setting. However, the ASBJ thinks that setting out an over-arching description of how the nature of an entity's business activities would affect standard-setting is critical, the reasons of which will be explained in the following paragraphs.

Relationship with Other Parts of the Conceptual Framework

10. The *Conceptual Framework* presumes that users need information that helps them assess the prospects for future net cash inflows to an entity[2]. It also presumed that information about a reporting entity's financial performance helps users to understand the return that the entity has produced on its economic resources, and that information about a reporting entity's past financial performance and how its management discharged its responsibilities is usually helpful in predicting the entity's future returns on its economic resources[3].

11. In order for users to properly assess an entity's past financial performance, the ASBJ thinks that it is critical to properly distinguish the nature of an entity's business activities conducted. This is because what to report for the entity's *financial performance* (including what components of changes in assets and liabilities should be included in profit or loss) varies significantly depending on the nature of an entity's business activities conducted, especially as to whether the effect of price changes of assets or liabilities during the period should be reflected in profit or loss (in other words, whether their measurement bases for the purpose of reporting an entity's *financial performance* should be updated at each period-end).

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2 Please see paragraph OB3 of the *Conceptual Framework*.
3 Please see paragraph OB16 of the *Conceptual Framework*.

12. In line with the IASB's tentative decisions, the ASBJ thinks that 'profit or loss' is widely acknowledged as the primary performance indicator, and that price changes resulting from market risks are often the most significant factor which affects the performance. Accordingly, the ASBJ thinks that making a proper distinction between the different natures of an entity's business activities conducted is very helpful or even necessary.

Consistency with Papers Put Forward by the ASAF Members

13. Although the specific proposals differ in some respects (including whether to explicitly use the term "business model"), all of the papers explained in paragraphs 4 to 6 of this paper (i.e., the IASB's DP, the EFRAG's Paper, the ASBJ's Paper, Dr. Linsmeier's Paper and the FRC's Paper) as well as the IASB's recent tentative decision seemed to emphasise the importance of considering the nature of an entity's business activities conducted. However, as the EFRAG' Paper pointed out (see paragraph 44 of Appendix of this paper), there are various views regarding how to identify the nature of an entity's business activities conducted. In addition, there are a number of academic literatures that explain how to describe the concept of "business model"[4], but in different manners. Thus, the risk of inconsistent application regarding how to identify the nature of an entity's business activities conducted would be significant, unless the *Conceptual Framework* provides sufficient clarity about the notion.

Areas Warranting Further Clarification of the Notion in the Conceptual Framework

14. Accordingly, the ASBJ proposes that the *Conceptual Framework* clarify the following matters:

> **Areas that Warrant Further Clarification of the Notion 'Nature of an Entity's Business Activities Conducted' in the *Conceptual Framework***
>
> (a) How to identify the nature of an entity's business activities conducted that are relevant for the purpose of accounting standards-setting, including:

[4] For example, the Google Scholar hits 2,640,000 records for the term "business model".

(i) How to classify nature of an entity's business activities into categories; and

(ii) How they should be described in the *Conceptual Framework*.

(b) How the nature of an entity's business activities should be considered in the development of accounting standards.

IV. Classifying and Describing Different Nature of an Entity's Business Activities

General Principle in Identifying Different Nature of an Entity's Business Activities Conducted

15. In principle, the ASBJ is of the view that if assets or liabilities are held as part of business activities in which an entity aims to have net proceeds through the price changes in markets and the entity has the practical ability to sell the assets or transfer the liabilities, the price changes should be reflected in profit or loss. In such situations, the effect of price changes is considered as the outcome of an entity's business activity being conducted during the period in reference to the entity's original expectation. In other situations, the ASBJ thinks that the effect of price changes in markets is not relevant to assess the entity's financial performance, because the price change per se is not the supposed outcome of the entity's business activity being conducted.

16. This classification is said to be consistent with enterprise valuation models. For example, there is an academic literature that cites the importance of this sort of classification by explaining that the book value equals market value for 'financial activities', while the value can differ for 'operating activities'. This article modelled the relationship between a firm's market value and accounting data concerning 'financial activities' (that involve assets and liabilities for which there are relatively perfect markets) and 'operating activities'. In connection with financial activities, the article stated that it is plausible to conceptualise accounting measurements such that book values and market values coincide for these assets and liabilities. In contrast, the article

explained that, due to the unrecorded goodwill, measurements of operating earnings focus on cash flows adjusted for accruals to be referenced for a firm's valuation model[5].

17. This interplay between a relevant measurement basis of an asset or liability and the nature of an entity's business activities conducted has also been explained in different ways. For example, Accounting and Business Research, *Financial reporting quality: is fair value a plus or a minus?*[6] stated the following:

> Fair value accounting works well, for both valuation and stewardship, with investment funds (where shareholders trade in and out of the fund at net asset value). This case is instructive for it is the situation **where the one-to-one relationship between exit prices and fair value to shareholders holds**. **That one-to-one condition fails, however, when a firm holds net assets whose value comes from execution of a business plan rather than fluctuation in market prices**, even when exit prices are observed in active markets. Asset and liability matching problems confound the problem further. Overlay the minuses of estimated fair values when actual prices are not observed, and the minuses do add up. [Emphasis added by the ASBJ]

18. In the ASBJ's understanding, this classification is also generally consistent with the papers that have been put forward by the ASAF members, albeit with some variations (see paragraph 6 of this paper). The abridged comparison can be shown as follows:

    (a) The EFRAG's Paper did not refer to categories of an entity's business models (or business activities conducted). However, the paper explained that how values are added and cash flows are generated is the key to identify business models, and identified attributes including how inputs are used (i.e., whether inputs are consumed in the production process or sold without transformation).

    (b) The ASBJ's Paper did not explicitly identify different types of business activities conducted by an entity. However, the paper explained that there is clearly a difference between investments held for trading purposes that can be sold on the market and others.

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[5] For example, see Gerald A. Feltham and James A. Ohlson, *Valuation and Clean Surplus Accounting for Operating and Financial Activities (Contemporary Accounting Research: Spring 1995)*.

[6] Stephen H. Penman (2007) Financial reporting quality: is fair value a plus or a minus?, Accounting and Business Research, 37:sup1, 33-44, DOI

(c) Dr. Linsmeier's Paper indicated that the nature of an entity's business activities conducted can be categorised into different classes, based on (i) whether the asset is used together with other assets to create value to the business and in the case when the asset is being used alone, whether the asset is so hard to replace that the entity would be out of the business without it, and (ii) whether a market exists on which the asset can be transferred.

(d) The FRC's Paper explained that an entity's business model (or nature of an entity's business activities conducted) can be categorised into 'value-added' business and 'price-change' business as stated in paragraph 51 of the Appendix of this paper.

19. In addition, the ASBJ also found that the four papers commonly identified that consideration of the 'nature of an entity's business activities conducted' would affect the accounting standards-setter's decision regarding when to recognise profit or loss (or an alternative performance measure) as well as a relevant measurement basis for the purpose of reporting an entity's *financial performance*. Each of the relevant descriptions in the four papers can be summarised as follows:

(a) The EFRAG's Paper stated that recognition, measurement, and presentation and disclosures would be affected by the concept of business model.

(b) The ASBJ's Paper mentioned that the nature of an entity's business activities is relevant in determining when to recognise profit or loss.

(c) Dr. Linsmeier's Paper stated that the nature of an entity's business activities is relevant in determining whether unrealised gains or losses should be recognised.

(d) The FRC's Paper explained that an entity's business model is relevant for reporting performance.

Principles for Assets

20. Having regard to the matters explained in paragraphs 15 to 19 of this paper, the ASBJ proposes the following principle for assets:

Principles for Assets

A measurement basis of an asset (or a group of assets) that is relevant from the perspective of reporting the entity's *financial performance* should be updated at a period-end to reflect the price changes in the market during the period so that the effect of price changes is recognised in profit or loss, **when the asset (or the group of assets) is held as part of an entity's business activity in which it aims to gain net proceeds from its price changes** under and subject to the entity's **practical ability to sell the asset (or the group of assets)**. In other situations, in principle, the said measurement basis should not be updated to reflect the price changes during the period[7].

21. This principle can be presented visually in the following table:

Table 1: Relationship between the Measurement Basis of an Asset or a Group of Assets for Reporting an Entity's *Financial Performance* and the Nature of an Entity's Business Activities Conducted

Nature of an entity's business activities / Practical ability to sell	**The business activity in which an entity aims to gain net proceeds from the price changes of an asset (or a group of assets)**	**Other types of business activities** (including an asset or a group of assets as the input to generate future cash inflows)
An entity has practical ability to sell an asset or a group of assets	(Category-I) Current market measure[8] *Price changes of an asset or a group of assets (i.e., unrealised gains or losses) should be recognised in profit or loss.*	(Category-II) Other measures[9] *Price changes of an asset or a group of assets should* ***not*** *be recognised in profit or loss.*
An entity does **not** have practical	(Category-III) Other measures	(Category-IV) Other measures

[7] Sometimes, due to the imperfections of accounting standard-setting, accounting mismatch may arise. In such situations, exception to the principle may apply.

[8] The term "current market measures" denotes fair value-based measures, such as fair value and fair value less cost to sell, and is explained in paragraph 41 of the other ASBJ's paper titled, *Identification, Classification and Descriptions of Measurement Bases*.

[9] The term "other measures" denotes any measurement bases other than those classified in the current market measures.

ability to sell an asset or a group of assets	*Price changes of an asset or a group of assets should not be recognised in profit or loss.*	*Price changes of an asset or a group of assets should not be recognised in profit or loss.*

Use of an Asset or a Group of Assets for Generating Future Cash Inflows to an Entity

22. The ASBJ notes that whether an asset (or a group of assets) is held as part of an entity's business activity in which it aims to gain net proceeds from the price changes, is intended to distinguish the manner in which an asset (or a group of assets) is expected to be used for generating the future cash inflows to an entity. Especially, this criterion classifies assets or groups of assets into a category in which an entity aims to generate future cash flows by immediate sales or the other category (such as the case where an entity use them as inputs in the value-adding activities[10] to generate future cash inflows to an entity).

23. The ASBJ thinks that the form of an asset (or a group of assets) itself is not a determinant of the way it would be used. For example, although many financial assets can be sold in exchange for proceeds from its price changes in a market without undergoing value-adding activities, it does not mean that all financial assets should be classified in either Category-I or III of Table 1. This is because there are situations where financial assets are collectively used as inputs to generate the outputs, including when investments in an entity's shares are held as part of the process to forge a business alliance with investees where the supposed outcome of the investment is proceeds from the business operations within the context of the business alliance as opposed to the price change of the investment itself. The ASBJ thinks that the financial asset in this situation is classified in either Category-II or IV of Table 1.

24. In addition, this distinction may be considered different from the distinction based solely on the 'management's intent' which is often criticised for risks of abuse. The distinction based on the way an asset or a group of assets is to be judged in the context of an entity's business activity, and thus, the current usage of the asset or the group of assets provides a reasonable evidence to support the assertion. For example, the use of

[10] In this paper, the term "value-adding activities" refers to the activities based on which an entity purports to generate future cash flows through synergetic use of inputs (assets or liabilities) beyond the market value of inputs itself.

machinery as part of the manufacturing process provides strong evidence that it will be used as an input. Yet this presumption can be rebutted otherwise, in that even if an asset is held as an input to generate future cash inflows to an entity, it could be considered otherwise, for example, when there is a sales plan therewith.

25. The ASBJ also notes that it is not always evident as to whether an asset (or a group of assets) is held in an entity's business activity in which it aims to gain proceeds from the price change. In many situations, an entity may hold an asset (or a group of assets) in its business activity in which it may use the asset (or the group of assets) as an input to generate future cash inflows, while it also consider that it *may* sell the asset (or the group of assets) taking into account favourable or unfavourable changes in the surrounding environments. In such a situation, the ASBJ generally believes that the measurement from the perspective of reporting the entity's *financial performance* should not be updated at a period-end so the effect of price changes will not be recognised in profit or loss, because the price change per se is not the supposed outcome of the entity's business activity being conducted, hence does not reflect the *return* on the asset.

Practical Ability to Sell an Asset or a Group of Assets

26. The condition of an entity's practical ability to sell the asset (or the group of assets) is intended to ensure that its price changes are considered virtually equivalent to the cash flows such that an entity would not be required to carry out significant undertakings to locate customers to sell the asset to. Thus, the notion of the 'practical ability' is generally intended to mean that there is a market in which an entity can exchange the asset or the group of assets for cash or cash equivalents and that an entity is not restricted from selling the asset or the group of assets by contractual or other means.

27. When an entity holds an asset (or a group of assets) in its business activity in which the entity aims to gain net proceeds from its price changes, the ASBJ presumes that an entity's practical ability would usually be met, because otherwise an entity would not

carry out such a business activity. Thus, the ASBJ thinks that classification of an asset or a group of assets in Category-III would be extremely rare.

28. In addition, the ASBJ does not intend that this condition of an entity's practical ability to sell an asset or a group of assets would necessitate the existence of the 'active market' as defined in IFRS 13 *Fair Value Measurement*. If a market in which an asset or a group of assets is sold is active, an entity is supposed to have the practical ability to sell the asset or the group of assets. However, even when the market is not considered as the active market in the context of IFRS 13, an entity would still have the practical ability to sell as far as the entity would not be required to undertake significant undertakings to locate willing buyers.

Grouping Level in Determining Measurement Bases

29. The principle stated in paragraph 20 of this paper acknowledges that it can be assessed either on the basis of a stand-alone asset or on the basis of a group of multiple assets. This means that the decision of whether to update the measurement basis from the perspective of reporting an entity's *financial performance* (hence, recognising unrealised gains or losses) could be determined either on the basis of a stand-alone asset or the basis of a group of assets, depending on how the asset (or the group of assets) is to be used within the course of an entity's business activities conducted. The grouping level would not necessarily be consistent with the notion of the 'business model' explained in IFRS 9 *Financial Instruments*; instead, this grouping level could be an individual asset, a group of assets or a group of assets and liabilities.

30. The ASBJ generally thinks that if multiple assets are used synergistically in the course of an entity's business activities (or, cash flows arising from assets are significantly interrelated), it would be appropriate to consider such assets altogether when considering the measurement basis from the perspective of reporting an entity's *financial performance*. Yet, the ASBJ does not intend that the grouping level considered for this purpose (that is, the grouping level in determining the measurement basis) is equal to the unit of account by which assets should be measured.

Application of the Principles to Liabilities

31. Although there are different characteristics between assets and liabilities, in general, the ASBJ thinks that the principle applied for assets stated in paragraph 20 of this paper are equally applicable to liabilities.

32. The ASBJ recognises that the nature of liabilities has some unique aspects when contrasted with assets, for example:

    (a) Often, liabilities are considered necessary to carry out an entity's business activities to utilise an asset or a group of assets;

    (b) Usually, there are impediments that prevent management from being able to transfer liabilities to third parties.

    (c) In most cases, there is no effective market in which liabilities can be transferred to third parties.

    (d) Many or some liabilities do not have stated terms.

33. Taking into account the nature of liabilities (especially, (a) in the previous paragraph), the ASBJ thinks that it is often appropriate to consider measurement bases of liabilities together with the corresponding assets that are used in the course of an entity's business activity conducted. For example, if borrowings from banks are set aside for the purchase of trading assets, it would be appropriate to determine the measurement basis of assets and liabilities in a consistent manner so as to reflect the nature of the entity's trading business.

34. On the other hand, if liabilities do not correspond to assets (for example, borrowings from banks paid out for the purchase of headquarter office buildings), the ASBJ thinks that the principles for assets (as explained in paragraph 20 of this paper) are generally applicable to liabilities. Taking into account the characteristics of liabilities (as explained in paragraph 32 (b) and (c) of this paper), the ASBJ also thinks, for most liabilities, the measurement bases that are relevant from the perspective of reporting the entity's *financial performance* should not be updated at a period-end to reflect the price changes

of the market during the period. These rare cases may include when an entity conducts short sales as part of its business activity.

35. This paper only discusses whether a measurement basis should be updated to reflect the price change in the market during the period; thus addresses only the effects of market risks. Whether to update the effects of other risks (including credit risks) should be considered separately.

36. Based on the discussion in paragraphs 31 to 35 of this paper, the ASBJ proposes the following principles for liabilities:

Principles for Liabilities

For liabilities, the measurement basis that is relevant from the perspective of reporting the entity's *financial performance* should be determined as follows:

(a) Where a liability is managed in combination with an asset or a group of assets, the said measurement basis should be updated at a period-end to reflect the price changes in the market during the period so that the effect of price changes is recognised in profit or loss, **when a liability corresponds to funding of the asset or the group of assets that is held as part of an entity's business activity in which it aims to gain net proceeds from the price changes** under and subject to the entity's practical ability to sell the asset (or the group of assets). In other situations, in principle, the said measurement basis should not be updated to reflect the price changes during the period[11].

(b) Where a liability is not managed in combination with the corresponding asset or group of assets, the said measurement basis should be updated at a period-end to reflect the price changes in the market during the period so that the effect of price changes is recognised in profit or loss, **when the liability is held as part of an entity's business activity in which the entity aims to gain net proceeds by transferring it to third parties** under and subject to the entity's practical ability to

[11] Sometimes, due to the imperfections of accounting standard-setting, accounting mismatch may arise. In such situations, exception to the principle may apply.

transfer the liability. In other situations, in principle, the said measurement basis should not be updated to reflect the price changes during the period [12].

How to Consider the Different Nature of an Entity's Business Activities Conducted in Standard-Setting

37. As stated in paragraphs 20 and 36 of this paper, the ASBJ thinks that the nature of an entity's business activities conducted is particularly helpful in determining the grouping level as well as its measurement basis that is relevant from the perspective of reporting an entity's *financial performance,* which determines 'profit or loss' in the statement of profit or loss and OCI.

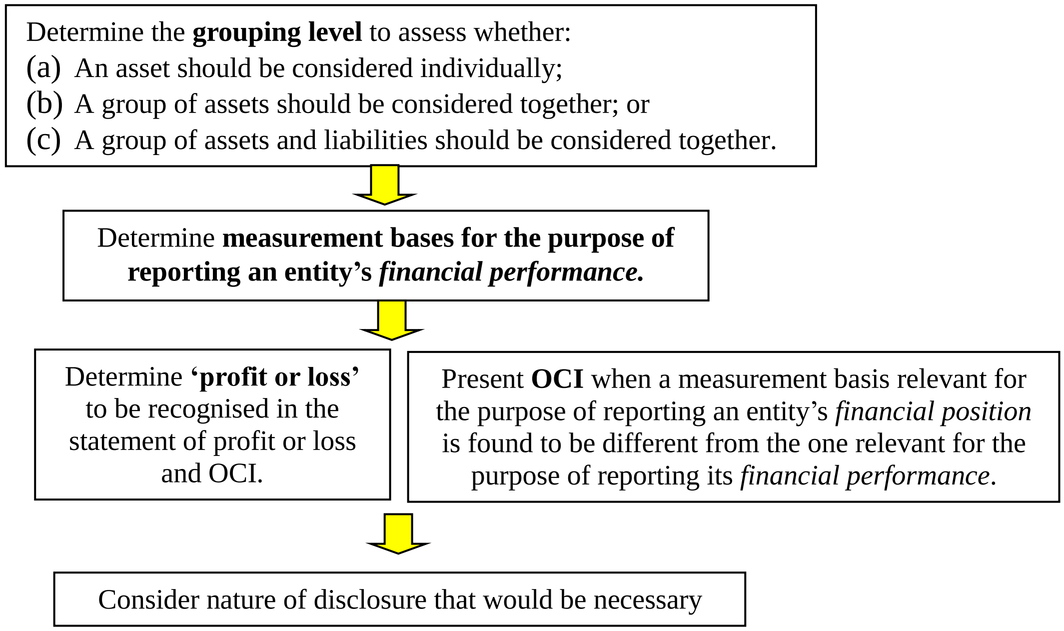
38. In addition, when a relevant measurement basis for the purpose of reporting an entity's *financial performance* is found to be different from the measurement basis for the purpose of reporting an entity's *financial position*, OCI would be used to make the linkage between the two different measurement bases.

39. Depending on the situations, these considerations would give rise to the needs for disclosure requirements to communicate the nature of figures recognised in the financial statements (including the degree of estimation uncertainty).

[12] Sometimes, due to the imperfections of accounting standard-setting, accounting mismatch may arise. In such situations, exception to the principle may apply.

40. This thought-process is presented visually in the following diagram.

Chart 1: Key Considerations in Accounting Standard-setting



41. The ASBJ does not think that this thought-process contradicts the IASB's tentative decision explained in paragraph 7 of this paper. Yet some may consider that the nature an entity's business activities should be considered primarily for the presentation and disclosure requirements albeit with the possible effects on the determination of a measurement basis. Considering the possible conflicting views, the ASBJ proposes that the *Conceptual Framework* clearly describe this effect so as to provide a more solid foundation for consistent judgments in accounting standard-setting.

V. Conclusion

42. The ASBJ believes that the notion of 'the nature of an entity's business activities conducted' is significantly valuable for the development of accounting standards. Therefore, the ASBJ believes that the *Conceptual Framework* should classify and describe the two very different nature of an entity's business activities (as illustrated in paragraph 21 of this paper) and clarify when and how such different natures in an entity's business activities conducted should be considered in the development of accounting

standards. The ASBJ hopes that setting out these matters will promote consistency of accounting requirements in IFRSs; thereby contributing to the development of a set of globally accepted high-quality financial reporting standards.

Appendix

Summary of Relevant Descriptions in Relevant Papers

EFRAG's Paper

43. In June 2013, the European Financial Reporting Advisory Group (EFRAG), in partnership with the French Autorite des Normes Comptables (ANC), the Accounting Standards Committee of Germany (ASCG), the Organismo Italiano di Contabilita (OIC) and the UK Financial Reporting Council (FRC) published the Bulletin, *Getting a Better Framework: The Role Of The Business Model In Financial Reporting*. Having regards to the comments received on the Bulletin, the EFRAG, in partnership with the French ANC and the UK FRC published the Research Paper, *The Role of The Business Model In Financial Statements* (hereinafter referred to as the "EFRAG's Paper") in December 2013.

44. The EFRAG's Paper explained that business models can be categorised in various ways, including those of the following:

    (a) Activities of the business;

    (b) Cash flow generation and value creation;

    (c) Configuration of assets; and

    (d) Customers of the products and services.

45. Having regards to the current use of the business model notion (whether explicitly or implicitly) under the Standards of IFRSs as well as different understandings of how to term the business model, the EFRAG's Paper concluded that the business model has played a role in financial statements, and that **the *Conceptual Framework* should be revised to give accounting standard setters criteria on when and how the business model should be considered**. As a preliminary view, the EFRAG's Paper identified that the concept of the business model plays a role in the following respects[13]:

[13] For example, please see paragraphs 5.22 to 5.29 of the EFRAG's Paper.

(a) Recognition;

(b) Measurement; and

(c) Presentation and Disclosures.

46. In addition, the EFRAG's Paper stated that how values are created and how cash flows are generated is the most important factor, and concluded that the "cash flow conversion cycle" is the critical piece of consideration[14]. Furthermore, the EFRAG's Paper identified attributes of a business model that would differentiate it from others to justify different accounting, include the following:

(a) The length of the activity cycle;

(b) How inputs are used;

(c) How outputs are used to generate cash flows;

(d) The types of risks related to the activity;

(e) The degree of certainty in the generation of cash flows; and

(f) The degree of capital intensity.

ASBJ's Paper

47. The ASBJ submitted a paper titled "Profit or Loss / OCI and Measurement" (hereinafter referred to as the "ASBJ's Paper") for discussion at the December 2013 Accounting Standards Advisory Forum (ASAF) meeting. In relation to the discussion regarding an entity's business activities conducted, the ASBJ's Paper suggested the following:

(a) Profit or loss should represent an all-inclusive measure of irreversible outcomes of **an entity's 'business activities' in a certain period**[15].

(b) The phrase "irreversible outcomes of an entity's business activities" means that the uncertainty regarding **the outcomes of an entity's business activities is reduced to the point where the outcomes are irreversible or deemed irreversible**.

[14] For example, please see paragraphs 3.37 and 3.38 of the EFRAG's Paper.
[15] See paragraph 18 of the ASBJ's Paper.

(c) **This notion of 'outcome of an entity's business activities' can differ depending on the entity's initial expectations thereon[16].** In explaining the difference, the paper contrasted the difference between investments in debt securities held for collection of contractual cash flows and those held for trading purposes.

48. In the paper, the ASBJ expressed its general support for the IASB's preliminary views stated in the DP that a relevant measurement basis of an asset should be determined based on how the asset contributes to future cash flows and a relevant measurement of a liability basis should be determined primarily based on whether they have stated terms and how they will be settled.

Dr. Linsmeier's Paper

49. In March 2014, the ASAF discussed a paper titled "A Revised Model for Presentation in the Statement(s) of Financial Performance: Potential Implications for Measurement", which was authored by Dr. Thomas J. Linsmeier, a Board member of the FASB (hereinafter referred to as the "Dr. Linsmeier's Paper"). Dr. Linsmeier's Paper, among others, stated his assertion that from an income statement perspective, relevance of fair value information depends on the nature of the asset or liability and how it is being used or able to be used within the business[17].

50. This assertion is based on the following thoughts:

(a) Whether unrealised gains/losses information is decision-useful (i.e., relevant) primarily depends on whether the asset is likely to be sold or likely to be transferred before maturity or the end of its useful life.

(b) The likelihood an asset or liability will be sold or transferred before maturity or the end of its useful life depends on:

(i) Whether or not management has a disincentive to sell the asset or settle the liability before the end of its useful life or maturity; and

[16] See paragraph 25 of the ASBJ's Paper.
[17] Please see page16 of Dr. Linsmeier's Paper.

(ii) Whether or not there are impediments preventing management from being able to sell the asset or transfer the liability.

(c) Factors that cause management to have a disincentive and/or in ability to sell an asset before maturity or the end of its useful life include:

(i) Whether the asset is being used internally in a manner that makes it economically unwise to sell (i.e., **the asset is being used together (synergistically) with other assets to create value to the business**) or if the asset is being used alone **the asset is so hard to replace that the entity would be out of business without it**; and

(ii) Whether the asset can be readily sold or exchanged (e.g., a market exists on which it can be transferred.)

(d) Factors that cause management to have a disincentive and/or inability to transfer a liability before maturity are whether there is legal restriction against transfer and, if not, whether there is a market available on which the liability can be transferred.

FRC's Paper

51. Messrs. Roger Marshall and Andrew Lennard of the UK FRC submitted the paper, *The Reporting of Income and Expense and The Choice of Measurement Bases* to the ASAF meeting of June 2014. The FRC's Paper suggested that the business models be classified into the following categories[18]:

(a) **'Value-added' businesses**, in which an entity obtains inputs from suppliers and employees and, usually after some kind of process, uses those inputs to provide goods and services to customers from which revenue is obtained (for example, those used by retailers, manufactures, service providers commercial banks).

(b) **'Price change' businesses**, in which an entity acquires assets (and sometimes liabilities) in order to benefit from gains resulting from changing their value (for example, those used by commodity dealers, investment funds and some other

[18] For example, please see paragraph 2.2 of the FRC's Paper.

financial activities).

52. The FRC’s Paper suggested that **different measurement bases be applied to assets and liabilities held within different business models**. Especially, the paper explains that cost-based measurement basis generally should be applied to assets and liabilities within the value-added businesses, whereas the current market prices should generally be used for those in price change businesses so as to assess the performance of a price change businesses.