

The Business Model in Accounting

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Overview

- What is “business model-based” accounting?
 - Does “business model” capture the same notion as management intent?
 - The idea of “intent” as a criterion for financial reporting appears several times in IFRS and US GAAP, sometimes explicitly and sometimes by implication
 - Examples of accounting based on management intent or the business model or both
 - In existing guidance
 - Considered and not adopted
 - Under consideration
- Effects of intent-

Business models in financial reporting

- There appears to be no agreed-upon definition of “business model” in financial reporting (ICAEW, *Business Models in Accounting*, 2010)
 - In common parlance, “business model” is related to use or disposition of assets and holding or transferring/settling obligations, with the understanding that these actions are taken with a profit motive
 - An entity’s business model is a determinant of the accounting for financial assets
 - *Example:* In IFRS 9, “business model” is related to how management “manages” a financial asset—that is, management’s use or intended disposition of that asset
 - “Business model” is distinguished from “intent” (for example, by the FASB)
 - “...an entity’s business strategy for a financial instrument would be evaluated based on how the entity manages its financial instruments rather than based on the entity’s intent for an individual financial instrument” (FASB 2009 tentative decisions on financial instruments; referenced in IFRS 9, para BC24)
 - Unclear whether the distinction is based on several instruments versus one
 - Unclear whether the distinction is based on plan (intent) versus actions (the act of managing the asset)
 - “Business model” is described as “a matter of fact that can be observed by the way an entity is managed and information is provided to its management” (IFRS 9, para BC27)

Business models in financial reporting

Questions to consider and an observation:

- Is there a meaningful distinction between business model and intent?
- Is there a necessary alignment between management's intent (goal, objective) and what management does (the actions taken) when it carries out its intent?
 - Is there a one-to-one link between management's intent for a given asset, liability or equity item (or group of items) and actions taken to generate revenues and profits?
 - If yes, is there a one-to-one link between management's intent for a given item and the business model?
- Comparing "business model" with "intent" for a given item or group of items:
 - Are they equally stable? Are they equally verifiable?
 - Can either or both be ascertained, and verified, from management's assertions?
 - What if management's assertions do not match management's actions?
- *Observation:* If a business model is a plan for taking actions to generate revenues and profits and intent is a plan/objective or goal, then perhaps the most (or only?) meaningful difference between the two is the level at which they operate
 - Business model: a plan for the entity as a whole
 - Intent: plan for an asset, liability or equity item (or a group of items)
 - Financial reporting operates at the level of the item or group of items

A potential meaning of intent-based accounting

- The accounting for an item is determined wholly or partly by management's operation of the business model (that is, management's plans for that item, or the business strategy for that item)
 - The intent is that of management, as evidenced by the business model and management's operation of the entity's business model
 - The standard setting task is to provide guidance that links some or all of recognition, measurement and display/disclosure to management intent
 - The implementation task is to apply the standard so that the result captures management's plans (intentions) for operating the business model and the outcomes of those plans, for example:
 - Capacity: Obtaining/creating productive capacity [more on this later]
 - Activities (value realization): Operating the capacity to create and deliver value to customers, and inducing those customers to pay
 - Converting results of activities to profits: Capturing the profits from transactions (operating the capacity and value creation/transfer activities)
- The accounting for an item encompasses
 - What is recognized and when (recognition timing)
 - Measurement attribute (both initial and subsequent)
 - Presentation/classification/display (including disclosures)

Example 1: Timing of liability recognition

- Provisions of IAS 37 (as currently written) for the timing of recognition of obligations arising in connection with restructuring activities
 - Restructuring is not defined, and is illustrated by examples
 - Sale/termination of a line of business; Closure/relocation of activities; Changes in management structure; “Fundamental reorganisations that have a material effect on the nature and focus of the entity’s operations” [IAS 37 para. 70(d)]
 - The *timing of recognition* is determined by management intent
 - Existence of a detailed formal plan that has raised a valid expectation that the plan will be carried out (implementation has begun or the plan has been announced).
 - Meeting this condition is linked to creating a constructive obligation [IAS 37 para 72, 74, 75]

Observations:

- The obligating event for the restructuring obligation (provision) is linked to management’s plans and intentions
 - The accrual is based on actions that would be expected to be necessary in the future because of the entity’s normal business activities under the plan
 - One interpretation is that the accrual reflects what management expects to pay to carry out the restructuring
- As discussed later, the IASB and FASB rejected this accounting for restructurings connected with business combinations, and FASB rejected it for other restructurings [SFAS 146, para. B21]

Example 2: Asset classification (display and measurement)

- Authoritative guidance for classifying nonfinancial (operating) assets as inventory or as property, plant and equipment (PPE)
 - From ASC 330-10-20, inventories are assets held for sale in the ordinary course of business or used in production of items to be sold
 - From ASC 360-10-05, PPE are long-lived tangible assets used to create and distribute an entity's products and services
 - A given item could be classified as inventory or PPE depending on the entity's business model
 - *Example:* Heavy construction equipment is inventory to a dealer and PPE to a construction company
 - The classification indicates how management intends to realize value from the asset

Observations:

- The classification of the asset reflects management's plans and intentions for how the asset will be used to create and deliver value to customers
- The accounting (including impairment) for inventory and PPE is different. Should it be?
 - To what extent should *classification* of otherwise similar items be linked to different accounting for those items?

Example 3: Segment disclosures (presentation)

- IFRS/US GAAP bases the identification of segments and the information to be provided on the entity's business model
 - Identify segments on the basis of internal reports that “are regularly reviewed by the public entity's chief operating decision maker to make decisions about resources to be allocated to the segment and to assess its performance” [ASC 280-10-50-1]
 - A component that sells “primarily or exclusively to other operating segments of the public entity” is a segment if the entity is “managed that way” [ASC 280-10-50-2]
 - Segment financial information is reported on the same basis as is used internally for evaluating operating segment performance and deciding how to allocate resources to operating segments [ASC 280-10-50-27]

Observations:

- The Basis for Conclusions of SFAS 131 (para 60-65) describes the approach:
 - View the entity's operations from the same perspective as management, including the information used for decision making
 - Reduce preparation cost (para 114)
 - Reduce comparability of information (more on this later)
 - Both segment definitions and the way information is reported are based on the entity's business model (the structure of the entity's internal organization)

Example 4: Short term debt classification (display)

- US GAAP (ASC 470-10-45-14) specifies that short term debt will be classified as a long term obligation *if*
 - The entity intends to refinance the debt on a long term basis *and*
 - The entity has the ability to refinance the debt on a long term basis

Observations and questions to consider:

- The Basis for Conclusions of SFAS 6 explains the basis for this guidance
 - An entity may use short term instruments (for example, commercial paper) as a means of long term financing or replace the currently maturing portion of long term debt with other long term debt. These borrowings are sometimes **in substance** long term financing (para 23, emphasis added)
 - Intention to refinance is essential but not sufficient—the entity must also have the ability to carry out its intent (para 24)
 - The intent-based criterion is combined with an economic condition criterion
 - The classification conveys management's intent not to settle the obligation by paying cash in the next year or operating cycle
 - Do the intent + ability to refinance change the economic phenomenon being accounted for?

Example 5: Two rejected proposals for intent-based accounting

- IFRS 3, Business Combinations
 - Costs the acquirer **expects** to incur to restructure the acquired firm's operations are not recognized as liabilities at the acquisition date [IFRS 3 para 11, emphasis added; US GAAP guidance is similar]
 - The costs would be recognized as liabilities when they qualify as liabilities, given the definition in the IASB's *Framework* [IFRS 3 para BC274]
 - The 2005 Exposure Draft to revise IAS 37 contains similar reasoning
 - The IASB rejected a proposal that a separately recognized intangible asset must be one that “management of the entity **intends** to sell, lease or otherwise exchange” [IFRS 3 para BC169, emphasis in original]
 - The capability of being separated and exchanged is the pertinent characteristic
 - “...management's intentions are not a characteristic of an asset” [IFRS 3 para BC169; US GAAP guidance is similar]

Question to consider:

- What would be the circumstances in which management intentions are a characteristic of a financial statement item (asset or liability) such that some aspect(s) of the accounting would be determined by management intentions?¹⁰

Example 6: Financial assets

- Features of (some) financial assets that might affect the accounting
 - Fungible—one item is readily substitutable for another, for example, ownership shares (common stock)
 - Exchangeable—items can be readily bought and sold, for example, many bonds, ownership shares listed on exchanges
 - A variant: the item is readily convertible to cash
 - Passive—depending on the nature of the item and the amount owned, items may require no decisions in order to receive cash, for example, certain bonds and loans
 - A variant: for some items, the only decision is whether to hold or to sell
 - May or may not have contractually specified cash flows, for example, a loan with a fixed interest rate and a fixed term that cannot be prepaid

Observation and questions to consider:

- Fungible and exchangeable financial assets are particularly suitable to alternative approaches to value realization based on management intent, and changes in management intent are particularly easy to implement
 - If an entity holds many of the same instrument, should all of those instruments be accounted for the same way?
 - *Example:* In both US GAAP and IFRS, the same marketable debt instrument could be accounted for differently depending on management intent

Example 6: Financial assets (continued)

Measurement and display

- IFRS 9: Measure financial assets at amortized cost or fair value
 - Amortized cost items must meet two criteria
 - Business model test: Asset is held within a business model whose objective is to hold the assets to collect contractual cash flows
 - » Reclassification is required if the business model changes
 - » Analysis is neither at the individual instrument level nor at the reporting entity level (the portfolio level?)
 - » The entity need not hold the asset to maturity
 - Contractual cash flows test: Contractual terms of the asset specify principal and interest only
 - » *Except that* management must look to the assets and liabilities of the issuing entity if the financial asset is linked to other securities in a way that affects the concentration of credit risk (for example, arrangements that specify the order in which losses are allocated)

Observations:

- US GAAP provides for amortized cost measurement for debt securities that the entity “has the positive intent and ability to hold to maturity.”
- US GAAP provides for fair value measurement with changes in income for securities bought and held principally “for the purpose of selling them in the near term.”

Should measurement attributes be determined by intent? If yes, why?

- IASB-FASB conceptual framework project's measurement phase is intended to provide guidance for selecting measurement bases that satisfy the objectives and qualitative characteristics of financial reporting
 - Should there be one measurement basis for all assets and liabilities?
 - If more than one measurement basis, it is necessary to devise criteria for determining which basis (or bases) to require (or permit)
 - How to consider and apply relevance and representational faithfulness to select measurements
 - How to consider and apply other factors such as comparability and cost constraints

Observation:

During summer 2010 the IASB and FASB reached a tentative decision that:

- the objective of selecting a measurement for an item is to **maximize the information about the reporting entity's prospects for future cash flows** (emphasis added)
- subject to the ability to faithfully represent the item
- at a cost that is justified by the benefits

Factors to consider in selecting a measurement attribute

Five decision factors derived from the qualitative characteristics of decision-useful information in the Boards' conceptual frameworks and described in the IASB staff paper [Draft Measurement Chapter of the Conceptual Framework (dated June 2009; discussed by the IASB and FASB in 2010; currently listed as inactive project)]

- Level of confidence (easily and precisely verifiable)
- Consistency of measurement for similar items and items used together
- Separability of income components of measurement changes
 - Separate components with different effects on cash flow prospects
- **How value will be realized from the item (value realization method)**
[emphasis added]
- Cost constraints (compliance burden on preparers and auditors)

Observation and questions to consider:

- Of these five decision factors, primacy is accorded to cost constraints and value realization method
- Is there a meaningful difference between comparability and consistency of measurement for similar items?
- Should the approach sacrifice consistency of measurement if consistent measurement conflicts with measurement based on value realization method?

Value realization

- Value realization = Conversion of the economic value of an asset or liability to cash, other assets, services or release from obligation
- Value realization is linked to relevance in the Boards' discussions
 - A relevant measure contributes to the assessment of future cash flow prospects and to the evaluation of past performance
 - Therefore, a relevant measure would be based on how the flows an item will generate will arise (that is, how value will be realized by management operating the business)
 - *Aside:* This seems to be the reasoning in IFRS 9, BC22

Questions to consider:

- Does value realization refer to management intent with regard to how to use or dispose of the asset or hold or settle the liability?
- Does this reasoning suggest that:
 - An entity's business model and the way management operates that business model determine the value realization method and
 - Classification/measurement based on the value realization method will result in the most relevant measurement because
 - Value realization determines cash flows to/from the entity and relevance is defined in terms of assessing cash flows regardless of
 - The effect on comparability?

More on value realization

- Applying the value realization factor suggests that *how* an item is used by management to create value would affect the accounting
 - *Example 1:* Is a brand, acquired as part of a business combination, that management intends to discard (does not intend to use or sell) not an asset?
 - Cash intended to be realized = zero (there could be an indirect defensive value)
 - *Example 2:* Can management intent to transfer assets create a liability?
 - Cash intended to be paid is nonzero
 - IAS 37 (as currently written) suggests management intentions for restructuring can create a constructive obligation
 - *Example 3:* Can management intent to obtain future benefits create an asset?
 - Customer acquisition costs or contract acquisition costs are incurred with the intent of obtaining future revenues

Questions to consider:

- Does accounting based on management intent enhance relevance while impairing comparability?
- Or, does the way an item is used, or intended to be used, alter its economic characteristics (its commercial reality) and, therefore, how to account for it?
- Do accountants agree on what is the economic phenomenon to be accounted for in a given arrangement or item?

Example 1: WorldCom (Can management intent create an asset)

- WorldCom paid for the right to use other firms' communication networks
 - In 2001, payments for these “line charges” exceeded 40% of revenues (about \$17-18 billion). WorldCom classified approximately \$3 billion of line charges as capital expenditures (assets not expenses)
 - The justification arose from WorldCom's strategy: the costs were incurred in anticipation of future revenues, to which expenses would be “matched”
 - The cost deferrals were viewed as arising from arrangements that allowed WorldCom to expand its capacity to serve future customers; therefore the costs would qualify as assets
 - If WorldCom did not obtain the anticipated (intended) customers/revenues, the asset would be impaired

Questions to consider:

- Are there two types of line charges that are economically distinguishable based on management's intent in incurring those charges?
- Is comparability achieved by accounting the same way for arrangements with similar rights and obligations or by accounting the same way for arrangements that are intended to be used in the same way?
 - *View 1:* Comparability is based on similarity in rights and obligations
 - *View 2:* Comparability is based on similarity in intended use

Example 2: Guarantees (Do accountants agree on the phenomenon to be accounted for)

- Are these two guarantee arrangements economically similar?

Arrangement 1: Entity A transfers the right to receive 100% of the cash flows of Financial Asset X to Entity B and provides a guarantee of the credit quality of those cash flows, in exchange for arms-length, market-value consideration

Arrangement 2: Entity C guarantees the credit quality of 100% of the cash flows of Financial Asset X (which Entity C has never owned and Entity B has always owned), in exchange for arms-length, market-value consideration

- Outcome of the arrangements:

A and C have guaranteed the credit quality of an asset (Asset X) whose cash flows are owned by B. Neither A nor C has access to those cash flows

Questions to consider:

- Are these two arrangements economically similar, so that comparable accounting would require they receive the same accounting treatment by Entity A and Entity C? If they are not, why not?
- Does economic similarity depend on whether the guarantee is written by an entity that once owned (controlled) the guaranteed assets versus an entity with no previous association with the guaranteed assets?
 - The only difference between the two arrangements is the path taken to the outcome

Intent-based accounting and qualitative characteristics

- Relevance: Does basing the accounting on management intent increase relevance?
 - Relevance => accounting that maps into how management intends to generate inflows of cash (and other assets) and manage outflows of cash (and other assets)
 - *Conclusion:* Intent-based accounting increases relevance
- Comparability: Similar economic phenomena are accounted for the same way; dissimilar economic phenomena are accounted for differently
 - Is the economic phenomenon the rights and obligations in an item or arrangement regardless of how management intends to realize value from that item or arrangement?
 - Or, does management intent (that is, management's plan) for an item alter the economic phenomenon so that comparable accounting is achieved if items intended to be used the same way are accounted for similarly?
 - *Example:* short-term debt classified as long-term because of intent and ability to refinance

An aside on verifiability:

- Basing the accounting on management intent requires assurance as to what is that intent
 - What kinds of documentation/evidence of intent would be required?
 - Management's statements (assertions) versus management's actions
 - How would a change of intent be accounted for and verified?

What does “comparable accounting” mean?

- Comparability is described conceptually by standard setters (the FASB and IASB) as a qualitative characteristic of decision-useful information
 - In Concepts Statement 8, comparability enhances the usefulness of information that is relevant and representationally faithful
 - “Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items” [Concepts Statement 8, para QC21]
 - “Although a single economic phenomenon can be faithfully represented in multiple ways, permitting alternative accounting methods for the same economic phenomenon diminishes comparability” [Concepts Statement 8, para QC 25]

Observations and questions to consider:

- Comparability means similar economic phenomena are accounted for the same way; dissimilar economic phenomena are accounted for differently
- “Comparability” is applied in Concepts Statement 8 to an economic phenomenon (an event, a transaction, an arrangement, an item) as opposed to a summary performance indicator such as earnings
 - What determines whether two economic phenomena are “similar”?
 - What can research tell us about comparability?

Why is comparability important?

- Selected IASB/IASC statements about comparability
 - The IASC's *Constitution*: the objectives of the IASC Foundation include “to develop...accounting standards that require high quality, transparent and **comparable** information....” [IASC Foundation Constitution para 2(a)]
 - The *Preface to IFRSs*: “The IASB’s objective is to require like transactions and events to be accounted for in a like way....[t]he IASB intends not to permit choices in accounting treatments” [Preface to IFRSs para 13]

Observations and a question to consider.

- If comparable accounting does not matter, there is little reason to have authoritative accounting guidance (standards). Management could select the accounting treatments it prefers and (possibly) disclose those choices
- Investors’ capital allocation decisions involve choices among alternatives
 - Those choices require assessing/evaluating current performance and forming expectations about future performance, *across alternative investment possibilities*
 - Using the language of Concepts Statement 8, investors identify similarities in, and differences among, possible investments
 - To what extent does non-comparable accounting hinder this process of assessment and evaluation of alternative investments?
 - *Example*: Did WorldCom’s non-comparable accounting hinder the resource allocation process?

Observations on standard setters and accounting comparability

- Standards contain (at least) two variants on the notion of basing accounting measurement on management intent
 - Management has free choice, possibly constrained by meeting conditions
 - *Examples:* IAS 38 (cost vs fair value measurement for intangible assets with active markets); IAS 39/SFAS 133 (designation of items as hedged items vs non-hedged items); IAS 40 (cost vs fair value measurement for investment property)
 - Do management's choices convey decision-useful information?
 - Management has choice that specifies as a *necessary condition* meeting certain business-model-based or intent-based conditions
 - *Example:* The accounting for certain financial assets at amortized cost under IFRS 9 requires that management intend to hold the assets to collect contractual cash flows
 - The justification seems to be based on relevance, in terms of predicting future cash to be realized: “an entity’s business model affects the predictive quality of contractual cash flows....whether the likely actual cash flows will result primarily from the collection of contractual cash flows” [IFRS 9, para BC 22]
 - Does the intent-based accounting in IFRS 9, IAS 39 and SFAS 115 convey decision-useful information?

Observations on standard setters and accounting comparability

- Does noncomparable accounting affect required disclosures?
 - *Example 1:* Existing (as of May 2013) lease accounting standards (IFRS and US GAAP) do not require that rights and obligations of all leases are recognized (for example, operating leases)
 - *Required disclosure:* Information that can be used to approximate the assets and liabilities of operating leases and account for them comparably to capital leases
 - *Example 2:* Entities measure some financial assets and financial liabilities at amortized cost, others at fair value
 - *Required disclosure:* Fair values of financial assets and financial liabilities

Question to consider.

- Does noncomparable accounting increase the number and complexity of footnote disclosures?
- Do standard setters use footnote disclosures to address (some of) the problems that arise from noncomparable accounting?
 - If yes, how effective is this solution?

Open issues related to comparability and relevance

Questions to consider:

- What are the effects of basing the required or permitted accounting treatment on management intent?
 - Does this approach enhance relevance (cash flow prediction)?
 - Does this approach impair comparability?
 - Or, does management intent for an item affect its economic characteristics and therefore how it should be accounted for to achieve comparability?
- How much does comparability enhance the decision-usefulness of accounting information?
 - To what extent does noncomparable accounting hinder the capital allocation process of assessment and evaluation of alternative investments?
 - What degree of comparability is necessary to achieve diversification across investments?
- What are the costs and benefits of intentional departures from comparability in the accounting standards?
 - Is it possible to quantify the gain in relevance versus the reduction in comparability?

Open issues related to comparability and relevance

Questions to consider:

- Researchers sometimes focus on how incentives affect implementations and therefore comparability
 - What is the relation between management's incentives and the entity's business model?
 - Business models may be slow to change, compared to current-reporting-period incentives to bias judgments and estimates
 - Business models may determine what real actions are available to management to change financial reporting outcomes
 - How stable are business models and management incentives over the life of a given financial reporting standard?
 - What is the relative importance of non-incentive-based effects on implementations, such as competence?
- Researchers tend to assess comparability using summary reported amounts such as earnings and book values in relation to outcomes such as returns
 - How well do accounting-research-based measures of comparability capture the comparability concept as stated in Concepts Statement 8?
 - Concepts Statement 8: comparability refers to the asset, liability or arrangement that is being accounted for, not an overall summary indicator such as earnings