Business Model-based (Intent-based) Accounting

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Overview

- *Starting point:* ICAEW (2010) paper on business models in accounting suggests "it is impossible to devise a sensible approach to financial reporting measurement that does not reflect firms' business models"
  - *Question to consider:* What does it mean to base financial reporting partly or entirely on business models?
- Do accountants agree on what is a "business model" for purposes of financial reporting?
  - 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
    - – *Possible example* of intent by implication: certain scope decisions
- Examples of accounting based on management intent or the business model or both
  - – In existing guidance
  - – Considered and not adopted
  - – Under consideration
- Intent-based accounting in the context of the conceptual framework
- Observations and questions to consider

Business models in financial reporting

- There appears to be no agreed-upon definition of “business model” in financial reporting
  - 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
  - In IFRS 9, “business model” is related to how management “manages” a financial asset—that is, to 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)

    - 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, BC27)

Business models in financial reporting

Questions to consider and an observation:

- Is there a <u>necessary</u> 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 (that is, the actions are inconsistent with the business model)?
- *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 <u>intent</u> is that of management, as evidenced by the business model and the operation of the 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
      - <u>Capacity:</u> Obtaining/creating productive capacity [more on this later]
      - <u>Activities (value realization)</u>: Operating the capacity to create and deliver value to customers, and inducing those customers to pay
      - <u>Converting results of activities to profits:</u> Capturing the profits from transactions (operating the capacity and value creation/transfer activities)
- The accounting for an item encompasses
  - What is recognized and when
  - Measurement attribute (both initial and subsequent)
  - Presentation/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
  - 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
- As discussed later, the IASB and the FASB rejected this accounting for restructurings connected with business combinations. The FASB has also 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 fixed assets (plant property and equipment)
  - From IAS 2, inventories are assets held for sale in the ordinary course of business, or used in production of inventories
  - From IAS 16, property plant and equipment (PPE) are tangible assets that are held for use, for more than one period, in the production or supply of goods and services or for rental to others or for administrative purposes
- A given item could be classified as inventory or fixed assets depending on the entity's business model
  - *Example*: Heavy construction equipment is inventory to a dealer and PPE to a construction company

Observations:

- The classification of the asset is linked to 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 operating segments "on the basis of internal reports that are regularly reviewed by the entity's chief operating decision maker in order to allocate resources to the segment and to assess its performance" [IFRS 8 para IN11]
  - A component that sells "primarily or exclusively to other operating segments of the entity is included in the IFRS's definition of an operating segment if the entity is managed that way" [IFRS 8 para IN12]
  - "…financial information is required to be reported on the same basis as is used internally for evaluating operating segment performance and deciding how to allocate resources to operating segments" [IFRS 8 para IN5]

Observations:

- The Basis for Conclusions refers to this approach as the management approach [IFRS 8 para BC9-BC17]
  - View the entity's operations from the same perspective as management, including the information used for decision making
  - Reduce preparation cost
  - Reduce comparability of information (more on this later)

Example 4: Short term debt classification (display)

- US GAAP (SFAS 6; ASC 470) 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:

- The Basis for Conclusions 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)
  - In this case, the intent-based criterion is combined with an economic condition criterion

Example 5: Two <u>rejected</u> 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?

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 many of the same instrument, should all of those instruments be accounted for the same way?

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
      - » 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 (SFAS 115, ASC 320) provides for:
  - Amortized cost measurement for debt securities that the entity "has the positive intent and ability to hold to maturity."
  - Fair value measurement with changes in income for securities bought and held principally "for the purpose of selling them in the near term."
- At the April 17, 2012 joint meeting the IASB and FASB tentatively agreed to an approach that seems similar to the one in IFRS 9

Should measurement attributes be determined by intent?

- 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 both 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 <u>decision factors</u> 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 July 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 a question to consider:

- Of the five decision factors listed above, primacy is accorded to cost constraints and value realization method
- 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 <u>relevance</u> 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 <u>*and*</u>
  - Classification/measurement based on the value realization method will result in the most relevant measurement <u>*because*</u>
  - Value realization determines cash flows to/from the entity and relevance is defined in terms of assessing cash flows <u>*regardless of*</u>
  - 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 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 basing the accounting on management intent conflict with comparable accounting?
- *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 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 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 economic 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?

Intent-based accounting and qualitative characteristics

- Relevance: Basing the accounting on management intent increases 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)
- 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?
    - Statements versus actions
  - How would a change of intent be accounted for and verified?
- 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?
  - Alternatively, does management intent (that is, management's plans) for an item <u>alter</u> that item's economic substance so that comparable accounting is achieved if items intended to be used the same way are accounted for similarly?

Observations on comparability

- 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 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
  - What determines "similarity"—the same intended use or the same rights and obligations?

Open issues related to intent-based accounting, relevance, comparability and verifiability

Questions to consider

- How much do comparability and, separately, verifiability enhance the decision-usefulness of accounting information?
- What are the effects of basing the accounting treatment on management intent?
  - Does this approach enhance relevance (cash flow prediction) and impair either or both comparability and verifiability?
  - What determines whether two items or arrangements are similar and should be accounted for the same way?
  - With regard to investor resource allocation decisions:
    - To what extent does non-comparable accounting hinder the capital allocation process of assessment and evaluation of alternative investments?
    - To what extent does basing accounting on intent, so as to increase the predictability of cash flows, assist this process of assessment?