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Business models as a basis for regulation of financial reporting

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Abstract The paper observes that the term 'business model' has been incorporated in recent financial reporting regulations. The first section of the paper describes various meanings of 'business model' and demonstrates that the term has no settled or agreed meaning. The second part of the paper considers the suitability of the term 'business model' as a basis for a measurement standard (IFRS 9) or for requirements for narrative reporting and concludes it is not suitable for either purpose. Examples from the UK FTSE 100 index companies are used to illustrate existing usage in narrative reporting, finding varying levels of informativeness of disclosures about business models. The final part of the paper discusses reasons for incorporating an ambiguous and contested term in reporting guidance. It identifies parallels with ambiguity in other branches of financial reporting and the potential utility of ambiguity in allowing consensus to be arrived at on a form of words, apparently tightening up reporting regulation, while allowing participants 'wiggle room'.

Keywords Business model · Financial reporting standards · IFRS 9 · Management commentary · Ambiguity

1 Business model

Two authoritative documents have recently incorporated the term 'business model' as a part of financial reporting regulation. IFRS 9 paragraph 4.1 (IASB 2009a) states:

> An entity shall classify financial assets as subsequently measured at either amortised cost or fair value on the basis of both:

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(a) the entity's business model for managing the financial assets; and
(b) the contractual[1] cash flow characteristics of the financial asset.

And, the recently issued UK Corporate Governance Code (hereafter UKGCG 2010, p 18) states:

> The directors should include in the annual report an explanation of the basis on which the company generates or preserves value over the longer term (the business model) and the strategy for delivering the objectives of the company.

The term 'business model' is a new addition to the lexicon of financial reporting and, as such, one is prompted to ask what is its function and why it is necessary. In this section of the paper the origins of the term and plausible interpretations are discussed.

Words matter. And words mean what people use them to mean, rather than what prescriptive dictionaries or individual authorities would like them to mean. However there is a great deal of diversity in what people mean by a 'business model'. Baden-Fuller and Morgan (2010) and Demil and Lecocq (2010) analyse some of these differences. The term 'business model' is a relatively recent arrival in the management literature. The earliest example of it I have come across was an isolated usage in the nineteenth century referring to a young man using another businessman's behaviour as an exemplar. This is an example of one meaning for 'model' as something to be emulated.

But, although there are sporadic instances of 'business model' appearing in print thereafter, the frequency of use grew in the 1970 and 1980s when the term was employed mainly to describe computer-based models of business events and processes. In the pre-spreadsheet era, expensive software was needed to produce models that would now be routine to implement using spreadsheets. This form of modelling illustrates the predominant management science and information systems usage, in which a model is a simplified version of reality. Models, in general, can take many forms, such as spreadsheets, systems of equations, diagrams or narrative description; however, business models are usually expressed in narrative form, illustrated by diagrams.

The advantage of simplifying reality is that real situations may be too complex to analyse fully, and, by focussing attention on important decision variables, decisions can be made more cheaply and reliably. For example, a road map is more useful than a more 'realistic' aerial photograph, if one wants to navigate from Pisa to Siena.

The widespread use of the term 'model' in the strategy and organisational theory literature emerged in the 1990s from use within management science and information systems, particularly in relation to e-business (Demil and Lecocq 2010), but as use of the term spread there has grown an assumption that there is a finite number of models and that businesses can be classified as adopting one or other of these models either in a bottom up way based on induction (a taxonomy) or top down way based on theory (a typology—e.g. Malone et al. 2006; Morris et al.

[1] Note the emphasis on the contractual characteristics rather than the substance of the arrangements.

2005) or a combination of the two. In this sense, a particular business might be regarded as the expression of some underlying ideal form of business model, in the Platonic sense.

Baden-Fuller and Morgan (2010) suggest that for management academics 'business model' is a generic term that carries an intermediate level of detail between the levels of the individual entity and the broad brush approach of economic theories of the firm. As such, the concept embodies aspects of both a simplified version of reality (scale model) and an approach to be emulated (role model or recipe).

Various writers stress that "business model" is both a static and an evolutionary concept. The static concept involves looking at the inter-relationship of the different parts of the model whereas, in practice, models are descriptive, predictive and instrumental. Managers use analysis of models as a spur to innovation and change. Change is largely evolutionary and successful business models are rarely conceived fully formed but are way points in a process of change that requires continual 'fine tuning' of the core components of the business (Demil and Lecocq 2010, p 230; Harford 2011, p 4).

Models are subjective; different observers may well describe an entity's model in different ways. There are alternative perceptions of what businesses are doing, particularly their 'value propositions'. For example, is a company selling posh cigarette lighters in the market for tobacco-related products, or is it in the gift market? Is Diageo in the market for tasty alcoholic drinks or does its key strength lie in its distribution channels? (Parmalee 2007). Does a university provide education, a signal of intellectual quality, a pleasant way for students to pass their time, access to a network of soon-to-be influential people or a credential?

The UKCGC (above) characterises the business model as "the basis on which the company generates or preserves value over the longer term".[2] The word 'value' is itself open to interpretation. For whom is the firm creating value? One view is that value is the total economic surplus generated by the firm's activities comprising consumer surplus and organisational slack, possibly together with normal economic profit. Another view is that 'value' is to be equated with shareholder value. The concept of value adopted is important for financial measurement: if the former concept were adopted, it seems at least plausible that financial reporting would need to open its scope of enquiry considerably; if the latter, then a focus on shareholders seems to render the variety of models much less relevant, as firms are all presumed to be intent on a single objective—maximisation of shareholder value—a road we have been down before.

What is the relationship of an entity's business model with objectives, strategy and value? These concepts have been familiar terms in management theory for a long time. It would have been quite possible for IFRS 9 to have couched its requirement in terms of a strategy for particular assets rather than a business model.

[2] This characterisation seems to embrace 'value' as both a stock and a flow. Generating value seems to imply a flow, whereas preserving value seems to imply a stock.

2 Does the concept of 'business model' have a place in financial reporting regulation?

In this section I first of all examine the two recent examples of 'business model' appearing in financial reporting regulations, discuss whether extensions of the concept are feasible or desirable and then conclude that they are not.

The IASB has long sought to eliminate accounting choices based on managerial intention. IFRS 9 partially replaces IAS 39 and its much-criticised classification of financial instruments into the categories: financial asset or liability at fair value through profit or loss (FALVPL); held-to-maturity investment (HtMI); loans and receivables (L&R); and, available for sale financial assets (AS). Under IAS 39, classification of instruments depends, at least in some instances, on managerial intention. In particular, HtMI are (a) non-derivative financial assets with fixed or determinable payments and fixed maturity; and (b) the entity has the positive *intention* (emphasis added) and ability to hold these investments to maturity (Alfredson et al. 2007, p 218).

By basing classification of financial instruments, as in IFRS 9, on a company's business model there is the appearance that the classification is no longer based on intention. For this to be the case, it needs to be demonstrated that, inter alia, (a) management does not have discretion in assigning an asset to a particular business model, (b) it is possible to identify the business model by which a financial asset is managed, and (c) business models are inherently stable and cannot be changed quickly without significant cost. Each of these assertions is, at best, doubtful.

Consider, if you will, a group that has both trading subsidiaries and ones that hold assets. When assets arrive in the group, there is likely to be a considerable discretion in assigning them to either kind of subsidiary. And, although a particular subsidiary may tend to hold assets to maturity, it is unlikely to be the case that no assets are bought or sold as part of prudent portfolio management, for example to maintain portfolio balance. As IAS 7 is an international standard, its requirements are independent of any national or regional regulatory regime for financial business. It may be possible to undertake transactions in one regime to achieve an accounting effect in another, as has been alleged to have occurred with certain REPO 105 transactions.

As far as I am aware there is no generally agreed set of business models for the financial sector. This is not to deny that there are well understood industries and businesses—such as life assurance, pension funds, property investment and so on. But within industries there is a considerable (and sometimes bewildering) range of 'value propositions' and there are hybrids at the margins of different industries. It follows that managers have a great deal of latitude in describing the business model of particular parts of their organisation, and, as we know, where an inch of latitude exists managers will take a mile, when occasion demands.

Finally, there appears to be an assumption of stability of business models that depends on further assumptions that are of dubious validity. The assumptions that underpin modern finance theory imply that where opportunities for abnormal profit arise, they are almost immediately taken up by arbitrageurs, who, in the process, bring about changes in prices that make the opportunities disappear. Putting it another way, in finance theory, the only strategy that makes sense is to do whatever makes the most money from one moment to the next. What stops a business changing its business model from day to day?

We need to look at different theories of the firm to explain continuity of behaviour. Market imperfections and information asymmetry are key components of two theories. In Agency Theory, managers will make long term commitments to do (or refrain from doing) various things and to enter profit sharing arrangements that align their incentives with various stakeholders. Oliver Williamson's Transactions Cost Economics makes the same assumptions as Agency Theory, but focuses on asset specificity and observes that settling up agreements can be so costly and time consuming that other arrangements are also put in place that lead to continuity, without the need to resort to complex agreements and the law.

Announcing strategy and describing a business model can have a place in these kinds of arrangements, if people can be induced to believe such announcements. The audience of stakeholders for such announcements can be either external or internal. For example if a company announces that it intends[3] to be 'number one in the widget market by 2012' it needs a business model to achieve the objective, if its announcement is to be convincing. The business model needs, at least, to connect the resources and capabilities at its command with the 'value proposition' that is intended to induce customers, or other stakeholders, to pay for the company's output.

Teece (2010) suggests strategy exists at a finer level of detail than a business model. Within a given model it is necessary to segment markets and create a value proposition for each segment together with methods to capture value and to isolate competitors, so that value can be sustained.

The beneficial effects of such an announcement could include: deterring competitors (if, for example, they believe the company will engage in price-cutting); motivating employees (if, for example, they believe the company will provide stability and promotion opportunities through growth); reassuring or attracting customers and so on. Negative effects can occur, for example, if the company continues to pursue a strategy after it has become clear that it is unlikely to be as profitable as hoped, or that the risks are greater than expected, particularly if the announcement of strategy causes the company to enter into long term commitments that subsequently turn out to be onerous.

Without wishing to prolong this discussion unduly, it is received wisdom that devising a strategy and announcing it is a vital task for top management, and, as with all received wisdom, it is worth questioning occasionally.

[3] It is very difficult to write about strategy without ascribing to organisations human traits of wants and desires, intent, objectives and so on. For the most part this article will adopt such a 'pathetic fallacy' but it needs to be borne in mind at all times that 'Company X's objective is Y' is probably best interpreted as 'The senior management of Company X would like people to believe that the company will act in a way that is consistent with the achievement of objective Y'. Clearly the management of Company X may be lying, or deceiving themselves, and other people in the organisation may be working to achieve other objectives so that the behaviour of the organisation may turn out not to be consistent with the announced objective.

Returning to the case of asset measurement, Penman (2007) discusses the advantages and disadvantages or fair-value accounting and historical cost accounting, or, as he prefers to call it, 'historical transaction accounting'. In his analysis, he proposes a distinction between business models that provide a "one-to-one relationship between exit prices and fair value to shareholders" (p 42) and those that do not. Penman suggests examples of assets to which the one-to-one condition applies include portfolios of securities and derivatives held for trading, pension assets, investments by insurance companies, real estate held for speculation; and, that assets or liabilities where the condition does not hold include inventory, investments in subsidiaries, loans and liabilities that involve customer relationships such as core deposits, performance obligations, real estate held as an input to business enterprise, environmental clean up liabilities and others. He suggests that

> fair value is a minus where firms are involved in (expectational) arbitrage of (input and output) prices in their business model; that is, the business model adds value to market prices

This conclusion would probably lead to very limited application of the use or fair values, less than required in IFRS 9, but seems to consider only a limited range of business models. The simple input/output conceptualisation of business models is one which is hard to apply to many new businesses where 'value propositions' are complex. For example, Google delivers free internet searching to millions of people but earns its revenue from charges to advertisers. Free-to-air commercial television works in the same way. The inputs to Google's business include salaries and costs of vast arrays of computer servers but do not just generate current advertising revenue. Included in the outputs are hard to describe, still more quantify, intangibles that maintain the pre-eminence of the search engine by improvements and erection of barriers to entry and other devices that sustain the flow of future revenue. The rise and fall of other software and internet companies suggests that in many cases the companies' value propositions and business models were mis-identified not only by outsiders, but also by company managements.

To express this in another way, many businesses have some control over the markets that they operate in. Where a business has sufficient market share to control the market, or can erect barriers to entry, or can in some other way influence prices, the prices are endogenous with the actions of the business. In these circumstances there is limited value in reporting current market prices of assets and liabilities since the eventual realisations will be contingent on the entity's actions.[4] Where prices are endogenous to the activities of the company, there ceases to be a distinct boundary to the organisation and internal processes are not separate from external activity. I

[4] Because of discontinuities arising from regulation and agreements entered into by firms, there is no general fixed point theorem that says that there will be a market price of an item and a value reported by a company that is consistent with that price, or if there is such a price, that it will be unique. For example, there is the possibility that reporting values of items will be self-negating. Suppose a company has a choice of two measurements of a liability and that if it chooses the higher value, the market will be nervous about the company's stability and mark down the liability. If the company chooses the lower value of the liability then the market will be reassured and the company will eventually discharge the full value. There is no value for the liability that the company can report that is consistent with the eventual realisation.

would guess that the majority of big companies subject to IFRS exert considerable power in some of their markets, and, furthermore, that asking them to describe how they exert that power and ward off competition is not likely to elicit informative answers.

The idea of market power is in the definitions of the 'business model' since there is an implication that the value that companies are creating contains an element of economic rent that would not exist in a fully competitive market. That is to say, the rhetoric of business models assumes that management are aiming to achieve a return greater than the normal economic return on their invested capital.

2.1 Management commentary, the UKCGC and business models

Various authorities provide, or are seeking to provide, guidance about the narrative commentary included within annual reports. The IASB has issued an exposure draft (ED) of guidance (IASB 2009b) on a framework for management commentary, which it regards as within the scope of financial reporting (IASB 2009b, paragraph 3). The ED suggests management commentary covers:

(a) the nature of the business;
(b) management's objectives and strategies for meeting those objectives;
(c) the entity's most significant resources, risks and relationships;
(d) the results of operations and prospects; and
(e) the critical performance measures and indicators that management uses to evaluate the entity's performance against stated objectives (IASB 2009b, paragraph 24).

Under the heading 'nature of the business', entities are asked to disclose

(a) the industries in which the entity operates;
(b) the entity's main markets and competitive position within those markets;
(c) significant features of the legal, regulatory and macro-economic environment that influence the entity and the markets in which the entity operates;
(d) the entity's main products and services, business processes and distribution methods; and
(e) the entity's structure and its *economic model* (emphasis added). (IASB 2009b, paragraph 26).

There is no more guidance about what an 'economic model' might be, but I expect it is pretty similar to a business model, although, for some writers a business model might also comprise items (a–d).

A proposed SEC rule of 2002 mentioned 'business model' as follows:

> In MD&A, a company must discuss its results of operations, liquidity and capital resources and other information necessary to an understanding of the company's financial condition or changes in financial condition. A well-prepared MD&A discussion focuses on explaining a company's financial results and condition by identifying key elements of the business model and

> the drivers and dynamics of the business, and also addressing key variables. (SEC 2002, IIA)

But as far as I can see, this was not carried through to a final document.

In the UK, the ASB published draft recommendations for an 'Operating and Financial Review' which were countermanded by the then Chancellor of the Exchequer, Gordon Brown. However the need for a review remained under EU legislation, which was incorporated into the Companies Act (s417) which requires a business review "to inform members of the company and help them assess how the directors have performed their duty under section 172" (duty to promote the success of the company—Companies Act, 2006, s417). The UK then published guidance (ASB 2006) that states:

> A description of the business is recommended in order to provide members with an understanding of the industry or industries in which the entity operates, its main products, services, customers, business processes and distribution methods, the structure of the business and its *economic model* (emphasis added), including a review of the main operating facilities and their location.

As noted above, the recently published UK Corporate Governance Code (UKCGC) requires directors of listed companies to "include in the annual report an explanation of the basis on which the company generates or preserves value over the longer term (the business model) and the strategy for delivering the objectives of the company" (FRC 2010). The requirement arose from responses to consultation on revision of the previous version of the code where respondents asked for more context with which to interpret directors' identification of key risks.[5]

An interesting question in interpreting management commentary is the extent to which the commentary is meant to be an objective, and hence refutable, statement of fact, as compared with a description of directors' opinions and thinking. The IASB guidance (para 13a) is explicitly subjective in that the management commentary presents "management's view of the performance, position and development" of the entity, whereas the UKCGC is not so explicit. If the description of the business model is located within the Business Review, required under the UK Companies Act, then there is some external scrutiny of what needs to be said there. Furthermore, the new UK coalition government has announced an intention to include the whole of the operating and financial review within a new Companies Act.

Here is what Tesco, the largest UK retailer, says about its business model in its annual report for 2009:

> At the core of Tesco's business model is a focus on trying to improve what we do for customers. We aim to make their shopping experience as easy as possible, lower prices where we can to help them spend less, give them more choice about how they shop—in small stores, large stores or online—and seek to bring simplicity and value to sometimes complicated markets. We aim to be

[5] Note that there is clear duplication with the ASB (2006) guidance which nevertheless remains in force.

> a good neighbour in the communities we serve, be responsible, fair and honest in our dealings and give customers the information and products they need to make greener choices. We are also an inclusive business—everyone is welcome at Tesco.

It is hard to think of a national retailer that couldn't make such a statement. Narrative reporting of corporate governance arrangements has been widely criticised as degenerating to 'motherhood statements' and 'boilerplate' and there is very little reason to believe descriptions of 'business models' will be any different.

Similarly, the following extract from the BAE Systems 2009 annual report is not very informative:

> The Group's land sector business is adapting its *business model* (emphasis added) for agility, flexibility and responsiveness. It is adjusting its product offerings to match the procurement priorities and order sizes of the global customer base. By realigning the business and tightly controlling costs, the land business remains a sustainable enterprise with a balanced risk profile that delivers shareholder value.

Nor is this extract from the Imperial Tobacco 2009 Report:

> Imperial Tobacco is a leading international tobacco company which manufactures, markets, distributes and sells a comprehensive range of cigarettes, tobaccos, cigars, rolling papers and tubes.
>
> Our *business model* (emphasis added) provides a virtuous circle of investment and sustainable growth and has consistently delivered strong returns to our shareholders.
>
> We continue to build on our long track record of creating sustainable shareholder value.

This is not to say that there are no informative disclosures, as the following extract from the Shire Holdings 2010 annual report shows:

> Our *business model* (emphasis added) has always been one of the most important keys to our success. The way we exploit that model is evolving over time, especially as we grow internationally, but our basic approach has remained unchanged for many years: a focus on specialist physicians, niche markets, unmet needs and symptomatic conditions where the impact of a successful treatment is immediate and tangible. This strategy started out as a positive response to a very practical business challenge—how do you build a successful pharmaceutical company when you have neither the resources to undertake large-scale high-risk research, nor the sales infrastructure to compete in mainstream therapy areas in primary care. Shire decided that the smart answer was to focus on lower-risk research and development, and make maximum use of the oral drug delivery know-how we already had in Pharmavene, a business we acquired in 1997 and renamed Shire Laboratories.

Without expanding the number of examples unduly, it is clear that the informativeness of disclosures varies and that business model disclosures are no less likely to be anodyne or boiler-plate than other mandated disclosures covering such topics as risk management. There is a refreshing honesty about one CEO's business model, compared with the slogans of other organisations:

> I'm reminded of Sir Alan Sugar giving a lecture about management way back in the 1980s. He was mocking the catch-phrase/mission-statement culture, memorably saying, "'Pan Am takes good care of you', 'Marks and Spencer loves you', 'Securicor cares' … at Amstrad, 'We just want your money'". (Richard Clayton 2007)

The situations in IFRS 9 and Management Commentary can be regarded, at least for the present, as polar extremes of uses of the notion of 'business model' in financial reporting.

2.2 Extensions of the business model concept in financial reporting

The IASB, with its principle-based approach, has been wary of issuing standards based on different business models. Only six of 38 extant IFRSs and IASs relate to specific industries, assets or transactions (IFRS 4 Insurance contracts; IFRS 6 Exploration for and evaluation of mineral resources; IAS 11 Construction contracts; IAS 26 Accounting and reporting by retirement benefit plans; IAS 40 Investment Property; IAS 41 Agriculture—there are also several IFRIC Interpretations that could be described as industry specific.) Any widespread use of a business model approach would require the IASB to develop its own taxonomy or typology of business models in so far as they are relevant to financial reporting. This is hard to conceive of at present and would lead to loss of comparability. For example, would it be beneficial to have separate financial reporting rules (it's hard to think of them as principles) for online retailers and high street retailers?

Much of the work of IASB, and in particular IFRIC, is 'fire-fighting'; certain kinds of items or transactions are perceived as giving rise to problems, or unacceptable variety of practice, and so new guidance is formulated to deal with these problems. It is possible that analysis of how entities seek to derive value from these transactions would be instructive and that articulation of entities' business models would be useful for this purpose. It does not follow that the concept of business model would then need to be enshrined in guidance, for, as already implied, management intention is an inherent part of a business model and it would be too easy for management to switch the espoused model to achieve their preferred reporting alternative.

3 Ambiguity

The analysis so far has attempted to show that the term 'business model' is open to a wide variety of interpretation because there is a lack of agreement about what a business model comprises and that an individual company's model could be described in many ways. Why would standard setting bodies such as IASB and the UK Financial Reporting Council light on such an ill-defined concept?

Page and Spira (2005) discuss ambiguity of regulatory terms with reference to the meaning of 'independence' in auditing. They tentatively propose a law of 'conservation of ambiguity' and suggest that ambiguity is inherent in the regulatory process and that attempts to tighten meaning in one place will give rise to ambiguities in others.

There are a number of reasons for this. One is that any system of rules must contain undefined terms to avoid circularity of reasoning. It follows that attempts to define elements of the system will give rise to new undefined terms.[6] However, in practice, ambiguity of meaning is valued by all parties in the standard setting process since it permits consensus. Kay (2011) describes ambiguity as arising from 'incompletely theorised' agreements and suggests that in some situations stability is likely but that in others moral hazard will ensure that the situation is unstable and that it is the 'skill of the statesman' to distinguish between the two kinds of situation.

Ambiguity provides everyone with some 'w(r)iggle room' for parties to adapt to circumstances as they unfold (Page and Spira 2005, p 312). Spira and Page (2009) also discuss ambiguity in relation to corporate governance risk and compliance disclosures.

A comparable case to the sudden appearance of 'business model' in IFRS 9 is the appending to the phrase 'internal control' the words 'risk management' in the Turnbull Report (Internal Control Working Party 1999, p 4). Both cases remind me of the story of a 'penny dreadful'[7] that was publishing a serialised story about a hero named Jack. At the conclusion of one episode Jack was left bound to a stake with fire licking at his ankles. Unfortunately, the story writer went absent without leave and none of the other writers could think of any convincing continuation to the story. Eventually the writer was tracked down, sobered up and set down to write the next week's episode. He began, "With one bound, Jack was free." Sometimes regulatory solutions give the impression that, at the end of a long meeting, an engaging form of words has been adopted to cut through a Gordian knot of problems without too much thought about where it will lead.

IFRS 9 has all the hallmarks of such a situation. Accounting for financial instruments is notoriously controversial, the standard is an interim solution, the technical problems are formidable, the political temperature is white hot, the financial markets are in disarray and there is no consensus on how to move forward. By introducing a new concept it is possible the IASB hopes to bound free of at least part of the controversy.

As noted above, the UK Governance Code is facing some similar, although perhaps not so stark, problems with narrative reporting.

[6] For example, the draft definition of an asset in the IASB's conceptual framework project defines the once reasonably well understood term 'asset' concepts of concepts of 'present right of other access', 'economic economic resource' 'generating' and 'economic benefits' that themselves will become the subject of debate and elaboration.

[7] A lurid kind of nineteenth century periodical for teenagers that published serialised, cliff-hanger adventure stories.

In both of these cases, the ambiguity surrounding what constitutes a business model may be useful, at least in the short term for regulators, but in the longer term a better analysis of whether it leads to stability or instability is needed. My guess is the latter.

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