IFRS

STAFF PAPER

October 2019

IASB® meeting

Project	**Management Commentary**
Paper topic	Introduction to business model

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Purpose of this paper

1. The Board's discussions to date have covered the objective of management commentary and guidance on considering the qualitative characteristics of useful financial information in preparing management commentary.

2. Future agenda papers will cover guidance to be provided in the revised Practice Statement 1 *Management Commentary* (Practice Statement) on topics (content elements) that are expected to be discussed in management commentary to meet primary users' information needs, starting with business model and strategy.

3. The staff have been developing recommendations for guidance on business model covering a number of interrelated topics. This paper is designed to provide an introduction to the Board's future discussions of business model. It provides an overview of the staff's research on business model, identifies questions the Board will need to consider in developing proposals for guidance on business model and includes the staff's preliminary analysis of these questions. This paper is for information only and does not ask the Board for decisions.

Structure of this paper

4. This paper is structured as follows:

    (a) overview of staff's research:

        (i) guidance issued by the Board (paragraphs 7–14);

(ii) primary users' information needs and current reporting issues (paragraphs 15–19);

(iii) other standard-setters' guidance on business model (paragraphs 20–28);

(iv) feedback from the Board's consultative group (paragraphs 29–30);

(b) questions to consider in developing guidance on describing business model:

(i) what is an entity's business model? (paragraphs 32–49);

(ii) what is the objective of describing business model in management commentary? (paragraphs 50–54); and

(iii) which types of information about business model should the guidance discuss? (paragraphs 55–59);

(c) Appendix A—Extracts from the Board's guidance on business model;

(d) Appendix B—Investor information needs identified by the FRC Financial Reporting Lab;

(e) Appendix C—Extract from *Business Model Background Paper for <IR>*;

(f) Appendix D—Extracts from meeting notes of the Management Commentary Consultative Group on the discussion of business model.

Overview of staff's research

5. The revision of the Practice Statement is intended to support preparers in preparing management commentaries that better meet the information needs of the primary users of financial reports. To do so, the guidance in the revised Practice Statement is expected to:

(a) address gaps in reporting practice;

(b) consolidate innovations in narrative reporting; and

(c) remain principles-based but contain sufficient detail to promote rigorous application by preparers and effective review by auditors or other providers of assurance.[1]

[1] See May 2019 Agenda Paper 15 *Overview of the staff's approach to revision*.

6. In developing recommendations for the revised guidance on business model in line with this approach, the staff have:

   (a) reviewed guidance issued by the Board on business model and related notions of ‘business’ and ‘business activities’ (paragraphs 7–14);

   (b) explored primary users’ information needs in relation to business model and current reporting issues (paragraphs 15–19);

   (c) considered guidance issued by other standard-setters (paragraphs 20–28); and

   (d) discussed the staff’s preliminary recommendations with the Board’s consultative group (paragraphs 29–30).

Guidance issued by the Board

Practice Statement

7. The existing Practice Statement identifies ‘nature of the business’ as a content element and includes guidance on describing the nature of the business in management commentary (see Appendix A). However, the existing guidance is limited. In developing that guidance the Board noted that the focus of management commentary should depend on the facts and circumstances of the entity and management should be able to discuss those matters ‘most relevant to their individual circumstances’.[2] Therefore, the Board did not specify disclosures on business model that would be required for all entities. Instead, the existing Practice Statement:

   (a) explains that users need a description of the business to help them gain an understanding of the entity and of the external environment in which the entity operates. That information serves as a starting point for assessing and understanding an entity’s performance, strategic options and prospects.

   (b) identifies broad types of information about the business that management may consider including in management commentary. Those types of information include information about the entity’s structure and how it

[2] See paragraph 24 of the Practice Statement and paragraph BC47 of the Basis for Conclusions on the Practice Statement.

creates value, about the entity’s main products, services, business processes and distribution methods and about the entity’s operating environment.

8. The Practice Statement also includes guidance on resources and relationships (see Appendix A). In particular, the Practice Statement requires management to describe ‘the most important resources, risks and relationships that management believes can affect the entity’s value and how those resources, risks and relationship are managed’.

Conceptual Framework for Financial Reporting (*Conceptual Framework*)

9. The *Conceptual Framework* links the nature of the entity’s business activities to producing cash flows for the entity. The *Conceptual Framework* states that ‘how economic resources are used, and hence how assets and liabilities produce cash flows, depends in part on the nature of the business activities conducted by the entity’ (see Appendix A).

10. The notion of business activities is discussed in the *Conceptual Framework* to assist the Board in developing Standards because the Board concluded that the nature of an entity’s business activities can affect the relevance of some types of financial information. As a result, the nature of an entity’s business activities is, for example, one factor that may need to be considered when selecting a measurement basis for an asset or liability.

11. In the *Conceptual Framework* the Board decided to use the term ‘business activities’ rather than the term ‘business model’ to avoid confusion with various definitions of ‘business model’ used by various organisations.

12. The Board noted in developing the *Conceptual Framework* that the notion of business activities discussed in the *Conceptual Framework* can be further explained and developed in a particular Standard. The discussion of business model in IFRS 9 *Financial Instruments* is one example of applying the concept of business activities (see paragraph 13).

Business model in IFRS 9

13. IFRS 9 requires an entity to consider its business model for managing the financial assets in classifying financial assets into measurement categories (see Appendix A). That Standard:

(a) explains that an entity's business model for managing financial assets relates to 'how an entity manages its financial assets in order to generate cash flows'. The focus on cash flows is consistent with the *Conceptual Framework* (see paragraph 9).

(b) notes that 'an entity's business model for managing financial assets is a matter of fact and not merely an assertion. It is typically observable through activities that the entity undertakes to achieve the objective of the business model'.

Definition of a business in IFRS 3 Business Combinations

14. IFRS 3 includes guidance on the definition of a business. IFRS 3, as amended in October 2018:

(a) defines a business as 'an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing goods or services to customer, generating investment income (such as dividends or interest) or generating other income from ordinary activities';

(b) identifies inputs, processes and outputs as elements of a business;

(c) clarifies that to be considered a business, 'an integrated set of activities and assets must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs'.

Primary users' information needs and current reporting issues

15. As mentioned in paragraph 5, the revision of the Practice Statement is intended to promote preparation of management commentaries that better meet primary users' information needs.

16. To identify gaps in current management commentary reporting practice and to better understand what information about an entity's business model primary users need, the staff reviewed recent publications on business model reporting and discussed the topic with the Board's consultative groups—Management Commentary Consultative Group (MCCG), Capital Markets Advisory Committee (CMAC) and Global Preparers' Forum (GPF).

17. In particular, the staff reviewed the October 2016 report *Business model reporting* published by the Financial Reporting Lab (Lab) set up by the Financial Reporting Council (FRC). The report examined the views of investor participants on the key attributes of business model reporting. The report states:

> Investors are unanimous that business model information is fundamental to their analysis and understanding of a company and its performance, position and prospects, both at the initial investment stage and for their ongoing monitoring and stewardship responsibilities. […] It provides context to all other information in the annual report.

18. The report states that 'investors note improvement is needed in linkage and consistency between the business model and other information in the annual report'. It also provides a list of information that investors told the Lab they are looking for companies to provide in their business model disclosures ('investor wants') (see Appendix B). The list indicates that investors want:

    (a) information that is sufficiently broad to give them an understanding of the business, including information about what the entity does, how it is structured and where it sits in the value chain; and

    (b) enough detail to understand what makes an entity unique, what it depends on for its success and whether its business model is sustainable in the long-term. Such information includes information about:

        (i) an entity's competitive advantage;

        (ii) key inputs (assets and liabilities, relationships and resources) and how they are maintained or enhanced;

        (iii) key revenue and profit drivers; and

        (iv) value created for other stakeholders that supports economic value generation.

19. The staff discussed with the Board's consultative groups which information is currently missing from narrative reports. The discussions indicated that gaps in reporting practice relate to lack of some of the information mentioned in paragraph 18. CMAC and GPF members suggested that entities should provide better descriptions of how their business model generates returns by creating value.

Consequent discussion with the MCCG indicated that gaps in reporting practice related to business model are mainly because descriptions of business model lack details, focus, and information needed by primary users for understanding sustainability of the entity's business model. Those gaps include:

(a) key features of how the business operates are either not described or over-generalised.

(b) key drivers of an entity's success are not identified.

(c) key business resources or relationships, in particular those that the entity depends on for its long-term success, are not described. Such resources and relationships can include intangible resources and relationships, including those not recognised in financial statements. Investors also lack information on how the entity's operations could affect its key resources and relationships, including the effects of environmental, social and governance (ESG) matters that could affect the entity's long-term success.

Other standard-setters' guidance on business model

20. In developing proposals for guidance on business model for the revised Practice Statement, the staff reviewed guidance issued by other standard-setters to find out:

(a) how they explain what is meant by an entity's business model (paragraphs 22–24);

(b) what guidance they provide on types of information to be included in an entity's description of its business model (paragraphs 25–26); and

(c) what other guidance on describing business model they provide (paragraphs 27–28).

21. The staff's review covered responses from 24 national standard-setters to the staff's request for information about the requirements and commonly applied non-mandatory guidance on management commentary in their jurisdiction.[3] The staff also reviewed the EU Non-financial Reporting Directive (2014/95/EU) and the related European Commission Guidelines on non-financial reporting, and the International Integrated

[3] See Appendix A of November 2018 Agenda Paper 15B *Summary of research on the objective of management commentary* for details of the respondents and the survey questions.

Reporting <IR> Framework (<IR> Framework) because some of the respondent jurisdictions either require or encourage management to use them in preparing management commentary. In addition, the staff reviewed guidance issued by the participants in the Corporate Reporting Dialogue that was set up to promote greater coherence, consistency and comparability between corporate reporting frameworks, standards and related requirements.[4]

22. Few standard-setters explain what is meant by 'business model'. Where such explanations are provided, they most commonly refer to 'value creation' or a similar notion rather than directly to generating cash flows for the entity. For example, the European Commission Guidelines on non-financial reporting state:

> A company's business model describes how it generates and preserves value through its products or services over the longer term.

23. The most detailed definition of business model is provided in the <IR> Framework:

> An organization's business model is its system of transforming inputs, through its business activities, into outputs and outcomes that aims to fulfil the organization's strategic purpose and create value over the short, medium and long term.

24. In developing this definition, the International Integrated Reporting Council considered the findings of its Technical Collaboration Group's research into business model definitions set out in *Business Model Background Paper for <IR>* (Background Paper). Appendix C includes an extract from the Background Paper that summarises recurrent themes in business model definitions based on the academic literature review. Specifically, the Background Paper states that business model definitions most often refer to:

(a) value creation or ability of an entity to make money or generate revenues and returns;

(b) the entity's purpose; and

[4] The participants in the Corporate Reporting Dialogue are: CDP, Climate Disclosure Standards Board, Financial Accounting Standards Board (observer), Global Reporting Initiative, International Accounting Standards Board, International Integrated Reporting Council, International Organization for Standardization and Sustainability Accounting Standards Board.

(c) elements or components of business model—inputs, activities and outputs or outcomes.

25. Staff's research also found that standard-setters provide various levels of guidance for describing business model in narrative reports:

(a) some do not specifically require a description of the entity's business model;

(b) some require a description of the entity's business model, but leave it to management to determine what to include in that description; and

(c) some provide guidance on the types of information about business model that management should consider including in management commentary.

26. Where standard-setters provide such guidance on the types of information, examples of disclosures for management to consider include:

(a) the entity's structure;

(b) the entity's most important operating segments;

(c) locations of the entity's operations;

(d) sources of the entity's value, being the entity's key resources and relationships that support the generation and preservation of value;

(e) market(s) in which the entity operates and how the entity engages with those markets, including:

(i) what part of the value chain the entity operates in;

(ii) main products and services;

(iii) customers and distribution methods; and

(iv) competitive position within the market(s);

(f) the entity's activities;

(g) business processes or methods of production of goods and methods of provision of services;

(h) outcomes or consequences of an entity's activities, other than products and services produced or provided by the entity;

(i) external factors influencing the business;

(j) the entity's dependence on foreign operations; and

(k) the extent to which the business is cyclical or seasonal.

27. In addition, many standard-setters emphasise the importance of the description of an entity's business model as a context or a starting point for management commentary. Some require management to consider whether information about the entity's business model is linked to—or is consistent with— information provided in other parts of management commentary, for example, on strategy, operating environment and risks or performance, position and prospects.

28. A few standard-setters also provide guidance on specific topics related to business model, in particular on how to describe business model if an entity operates more than one business model.

Feedback from the Board's consultative group

29. The staff discussed their initial proposals for guidance on business model for the revised Practice Statement with the MCCG. The staff's proposals discussed with the MCCG included:

(a) explaining the role of the business model description as the foundation for a coherent narrative that is necessary for users' understanding of:

(i) trends reflected in financial statements; and

(ii) matters identified in other parts of management commentary that could affect the prospects for future net cash inflows to the entity;

(b) specifying the following components of the description of business model: structure (legal and operating) and business activities (inputs, processes, outcomes and impacts) to provide a structured approach to preparing management commentary;

(c) explaining which features of business model the description of the business model should focus on, for example, on those features that give an entity a competitive advantage;

(d) providing guidance to help entities identify resources and relationships that the entity depends on and impacts of the entity's activities on those resources and relationships.

30. Appendix D provides a summary of that discussion. Overall, members agreed with staff's proposed approach to reporting business model. However, the discussion suggested that there is a need to further consider:

(a) the link between business model, value creation and net cash inflows to the entity;

(b) the link between business model and the entity's purpose;

(c) whether sufficient prominence was given to the guidance on identifying and reporting the entity's key resources and relationships, including intangible resources and relationships, and on ESG matters that could affect the entity's key resources and relationships;

(d) what guidance should be included on reporting the structure of the entity;

(e) whether the description of business model focus on the changes in the entity's business model(s) from the previous reporting period, or also cover standing information about business model(s); and

(f) the terminology used in the proposals.

Questions to consider in developing guidance

31. The staff's research and work to date suggest that in developing guidance on business model that could help management prepare management commentaries that would better meet primary users' needs, the Board will need to consider the following questions:

(a) what is an entity's business model? (paragraphs 32–49);

(b) what is the objective of describing business model in management commentary? (paragraphs 50–54); and

(c) which types of information about business model should the guidance discuss? (paragraphs 55–59).

What is an entity's business model?

32. The existing Practice Statement asks management to describe 'nature of the business' and does not use the term 'business model'. However, most stakeholders, as well as many narrative reporting frameworks and guidelines and academic literature, commonly refer to 'business model'. The staff think that the Board would need to consider whether to use the term 'business model' in the revised Practice Statement and if so, how to explain it.

33. The staff note that there is no single widely accepted definition of 'business model' and the term can be understood differently. Therefore, if the term is used in the revised Practice Statement, the staff expects that the Practice Statement would briefly explain what is meant by 'business model'. A clear explanation would provide a starting point for management in developing a description of business model and, together with related guidance being developed by the staff, could help management provide more detailed, specific and useful descriptions of an entity's business model.

34. Based on the findings of the staff's review mentioned in paragraph 24, the staff think that the Board would need to consider whether, and if so, how the explanation of the meaning of business model in the revised Practice Statement should refer to:

    (a) how an entity creates value or how it creates cash flows (paragraphs 35–41);

    (b) the entity's purpose (paragraphs 42–43); and

    (c) elements or components of business model (paragraph 44–49).

Value creation

35. The existing Practice Statement includes a brief mention of value creation stating that the description of the nature of the business may include 'how it creates value'.[5] The Practice Statement does not elaborate what is meant by 'value', how it can manifest itself or for whom it is created.

36. The staff think that if the Board chooses to explain business model in terms of 'value creation', the revised Practice Statement would need to explain how the notion of

[5] See paragraph 26(e) of the Practice Statement.

value creation links to the notion of generating net cash inflows to the entity which has been applied by the Board in the *Conceptual Framework* and in IFRS 9.

37. Some members of the MCCG suggested that description of business model needs to capture value creation for a wide range of stakeholders. They suggested that users need this information to understand the extent to which the entity is meeting its stakeholders' needs and so can sustain or develop its operations in the future. For example, if an entity's products or services create a high degree of customer satisfaction, this may provide it with a competitive advantage. Conversely, if an entity's activities have an adverse effect on its local community, it may be required to curtail those activities. The primary users may need information about how the entity creates value for other stakeholders—but only to the extent that is a necessary part of the explanation of how the entity creates value for itself and, ultimately, for the primary users.

38. The staff note that 'value creation' is a prominent feature of the <IR> Framework, which defines value creation as:

> The process that results in increases, decreases or transformations of the capitals caused by the organization's business activities and outputs.

39. The <IR> Framework (which—similarly to the Practice Statement—is intended to meet the needs of providers of financial capital) goes on to state that:

> Providers of financial capital are interested in the value an organization creates for itself. They are also interested in the value an organization creates for others when it affects the ability of the organization to create value for itself, or relates to a stated objective of the organization (e.g., an explicit social purpose) that affects their assessments.

40. The staff observe that value created for an entity will ultimately manifest itself as cash inflows to or cash outflows from (net cash inflows to) the entity. Accordingly, the staff think that if the notion of value creation is used in explaining business model in the revised Practice Statement, it would not be inconsistent with how the Board previously used the notion of business model and business activities in the Standards and the *Conceptual Framework.* Also, it would not be inconsistent with the objective of management commentary that the Board discussed in November 2018, which is to give context for financial statements by providing primary users with historical

financial and operational information and analysis that is useful in assessing the prospects for the entity's future net cash inflows, and its management's stewardship of the entity's economic resources.

41. In a future paper, the staff will present their analysis and recommendation on whether to refer to value creation when explaining the meaning of an entity's business model in the revised Practice Statement.

Purpose

42. As mentioned in paragraphs 24 and 30, standard-setters and members of the Board's consultative groups highlighted the importance of linking the entity's business model with the entity's purpose. The staff agree with this approach and think that the Board should consider referring to the entity's purpose when explaining the meaning of business model in the revised Practice Statement. Creating the link between business model and purpose in explaining an entity's business model could:

(a) help users understand the extent to which the entity's business model aligns with its stated purpose.

(b) articulate any aspects of an entity's purpose that extend beyond creating financial returns to shareholders. For example, an entity's stated purpose may be to cure diabetes. In this case, research and development activities, especially at an early stage, will not lead to cash inflows to the entity in the short term, but will be contributing towards the entity's purpose.

(c) highlight the long-term aspect of value creation because the staff expect the revised Practice Statement to describe purpose as the long-term focus of an entity's strategy.

43. In a future paper, the staff will present their analysis and recommendation on whether to refer to the entity's purpose when explaining the meaning of an entity's business model in the revised Practice Statement.

Elements of business model

44. As mentioned in paragraphs 24 and 14, some standard-setters and the Board in IFRS 3 describe business model or business in terms of its elements or components—inputs, activities or processes, and outputs. In addition, as discussed in paragraph 18, the

types of information that primary users need were identified as information about inputs, activities and outputs. Lack of such information was identified as a gap in current reporting practice (paragraphs 19(a) and 19(c)).

45. The staff therefore think that the Board could consider specifying the elements of business model in the revised Practice Statement. Specifying those elements could help management provide complete information about an entity's business model that would better meet primary users' information needs.

46. If the Board decides to specify elements of business model, the Board will need to consider whether to:

(a) identify the elements as inputs, processes and outputs based on the guidance in IFRS 3 (see paragraph 14 and Appendix A); or

(b) extend that description of the elements and specify an additional element, covering consequences or 'impacts' of the entity's activities that are wider than just producing products and providing services.

47. Specifying 'impacts' as an additional element:

(a) may be appropriate for management commentary because its scope is broader than that of financial statements and it is intended to provide context for financial statements and additional insights into an entity's long-term prospects.

(b) would not be inconsistent with the Board's focus on providing guidance to promote provision of information needed for primary users' assessments of the prospects for future net cash inflows to the entity (paragraph 40);

(c) could help address the reporting gap mentioned in paragraph 19(c) because it would emphasise that management needs to provide information about the impacts of the entity's activities on its key resources and relationships.

(d) would be similar to the approach in the <IR> Framework that identifies 'outcomes' as a component of business model in addition to inputs, business activities and outputs. Outcomes are explained as 'the internal or external consequences (positive and negative) for the [six] capitals as a result of an organization's business activities and outputs'.

48. If the Board decided to specify impacts as an element of business model, the Board would also have to specify how broad the disclosure about impacts should be in management commentary—whether it should cover impacts that could ultimately affect the net cash inflow of the entity and all impacts of the entity on a wide range of stakeholders.

49. In a future paper, the staff will present their analysis and recommendation on whether to specify in the revised Practice Statement elements of an entity's business model, and if so, which elements to include.

What is the objective of describing business model in management commentary?

50. As mentioned in paragraph 19, in practice descriptions of an entity's business model can lack detail and focus. To help address this gap in reporting the staff are developing recommendations for the Board on guidance on types of information about business model to be discussed in management commentary (see *Which types of information about business model should the guidance discuss* section). That guidance is not intended to be used as a checklist, so to help management exercise judgement the Board could consider introducing a high-level catch-all disclosure objective for describing business model in management commentary.

51. The existing Practice Statement already indicates why users need a description of business model (see paragraph 7(a)) but that explanation may not be sufficiently prominent or focused.

52. Including an explicit disclosure objective:

    (a) could help explain the intent behind the requirement to describe an entity's business model and could prompt management to consider as a whole the disclosure related to business model, ie serve as a 'test of success' for disclosures.

    (b) would be consistent with the approach to revision of the Practice Statement set out in paragraph 5 that the guidance in the revised Practice Statement would remain principles-based.

    (c) would be consistent with the proposal to include high-level catch-all objectives in Standards that is included in *Guidance for the Board to use* *when developing and drafting disclosure objectives and requirements in future* that is being developed and tested by the Board as part of the Disclosure Initiative.

53. The Board could develop a more focused objective based on:

    (a) clearer explanation of the meaning of business model and its elements as discussed in paragraphs 32–49; and

    (b) the information needs of primary users in relation to the description of business model as identified in paragraphs 17–19.

54. The staff will present their analysis and recommendation on what the objective of describing business model could be in a future paper.

Which types of information about business model should the guidance discuss?

55. Paragraph 19 identifies current reporting gaps—lack of information on key features of business model, on its drivers of success and on key resources and relationships that an entity depends on for its future success.

56. To help address these gaps, the Board could:

    (a) provide guidance on what types of information should be provided about the entity's operating structure and its inputs, processes, outputs and impacts. (The Board could provide such guidance irrespective of whether it decides to explicitly identify inputs, processes, outputs and impacts as elements of business model). For example, such guidance on outputs could require management to provide a description of its main categories of products and services and main categories of customers and distribution methods.

    (b) consider whether to include guidance on types of information to be provided about the entity's operating environment as part of guidance on business model or move it to guidance on another content element. The Board could consider focusing guidance on business model on what information primary users need about the substance of what the entity does and present separately guidance on all matters that could affect the entity (eg operating environment and risks).

(c) highlight in the revised Practice Statement that management commentary should focus on those features of business model that the entity depends on for its future success—'key' features of business model. For example, management commentary would not list all inputs into its business model. Instead, it would need to focus on those inputs that the entity depends on. In addition, the revised Practice Statement could provide guidance to help management identify those key features of business model. For example, it could indicate that key features are those that give an entity a competitive advantage or that are subject to uncertainty or expected to change over time.

(d) extend guidance on resources and relationships (see paragraph 8 and appendix A) and link it to business model. This would help emphasise the dependence of an entity's business model on its resources and relationships and be consistent with approach adopted by many standard-setters (see paragraph 26). To help management identify key resources and relationships that an entity depends of for its future success and determine what information about them should be included in management commentary the Board could:

   (i) provide examples of resources and relationships that may commonly need to be addressed in management commentary;

   (ii) emphasise that resources and relationships that need to be discussed in management commentary can include intangible resources and relationships that are not necessarily recognised in an entity's financial statements;

   (iii) specify what information about resources and relationships primary users commonly need, for example, information on the durability of the entity's relationships and availability of resources.

57. In addition, the staff's research indicated that stakeholders highlight the importance of the description of business model as a context for other information provided in management commentary (see paragraphs 17 and 27). The Board could consider whether, and if so what, guidance could be included in the revised Practice Statement on disclosures that should be provided when describing business model to help

primary users understand disclosures on other content elements, for example, on strategy.

58. The Board could also consider whether the revised Practice Statement should provide guidance for entities operating multiple business models (see paragraph 28).

59. The staff will present their analysis and recommendation on what guidance to include in the revised Practice Statement on types of information to provide in management commentary about the entity's business model in a future paper.

Question for the Board
Do you have any comments or suggestions on the discussion and analysis in this paper?

Appendix A—Extracts from the Board's guidance on business model

Practice Statement 1 Management Commentary

Nature of the business

26 Management should provide a description of the business to help users of the financial reports to gain an understanding of the entity and of the external environment in which it operates. That information serves as a starting point for assessing and understanding an entity's performance, strategic options and prospects. Depending on the nature of the business, management commentary may include an integrated discussion of the following types of information:

(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 environments that influence the entity and the markets in which the entity operates;

(d) the entity's main products, services, business processes and distribution methods; and

(e) the entity's structure and how it creates value.

Resources, risks and relationships

29 Management commentary should include a clear description of the most important resources, risks and relationships that management believes can affect the entity's value and how those resources, risks and relationships are managed.

Resources

30 Management commentary should set out the critical financial and non-financial resources available to the entity and how those resources are used in meeting management's stated objectives for the entity. Disclosure about resources depends on the nature of the entity and on the industries in which the entity operates. Analysis of the adequacy of the entity's capital structure, financial arrangements (whether or not recognised in the statement of financial position), liquidity and cash flows, and human and intellectual capital resources, as well as plans to address any surplus resources or identified and expected inadequacies, are examples of disclosures that can provide useful information.

…

Relationships

33 Management should identify the significant relationships that the entity has with stakeholders, how those relationships are likely to affect the performance and value of the entity, and how those relationships are managed. This type of disclosure helps users of the financial reports to understand how an entity's relationships influence the nature of its business and whether an entity's relationships expose the business to substantial risk.

Conceptual Framework for Financial Reporting

Contribution to future cash flows

6.54 As noted in paragraph 1.4, some economic resources produce cash flows directly; in other cases, economic resources are used in combination to produce cash flows indirectly. How economic resources are used, and hence how assets and liabilities produce cash flows, depends in part on the nature of the business activities conducted by the entity.

Basis for Conclusions on the Conceptual Framework for Financial Reporting

Business activities

BC0.29 In developing the 2018 *Conceptual Framework*, the Board concluded that the nature of an entity's business activities can affect the relevance of some types of financial information and that the Board may need to consider that factor when developing or revising Standards.

BC0.30 The Board disagreed with the view expressed by some stakeholders that considering the nature of an entity's business activities necessarily leads to subjectivity and impairs comparability of financial statements. An entity's business activities are a matter of fact that can in most cases be determined objectively. Hence, if entities conduct the same type of business activities, the Board expects that those activities would be reflected in a similar manner in the entities' financial statements.

BC0.31 The Board considered whether the nature of business activities should be considered in all areas of standard-setting and should be embedded in the *Conceptual Framework* as an overarching concept. The Board concluded that the nature of an entity's business activities does not affect all areas of financial reporting in the same way and to the same extent and so it should not be included as an overarching concept. Accordingly, the 2018 *Conceptual Framework* does not include a general discussion of how an entity's business activities affect financial reporting decisions. Instead, the 2018 *Conceptual Framework* describes that factor in the context of:

(a) the selection of the unit of account (see paragraph 4.51(a)(iv)).

(b) the selection of a measurement basis for an asset or liability and for related income and expenses (see paragraphs 6.54–6.57). In some cases, this would lead to some items of income or expenses being included in other comprehensive income (see the discussion of more than one measurement basis in paragraphs 6.83–6.86).

(c) classification of assets, liabilities, equity, income or expenses (see paragraph 7.7).

BC0.32 The concept of business activities is discussed in the 2018 *Conceptual Framework* to assist the Board in developing Standards. In a particular Standard, the concept of business activities can be further explained and developed. The discussion of business model in IFRS 9 *Financial Instruments* is one example of how the Board has applied the concept of business activities.

BC0.33 The Board decided to use the term 'business activities' rather than the term 'business model' in the 2018 *Conceptual Framework*. The term 'business model' is used with a range of different meanings by various organisations, for example, the International Integrated Reporting Council, the Enhanced Disclosure Task Force of the Financial Stability Board and various regulators. Adopting the term 'business model' in the 2018 *Conceptual Framework* could have led to confusion with those definitions.

IFRS 3 Business Combinations

Appendix A

Defined terms

…

business	An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities.

Appendix B

Application guidance

...

Definition of a business (application of paragraph 3)

B7 A business consists of inputs and processes applied to those inputs that have the ability to contribute to the creation of outputs. The three elements of a business are defined as follows (see paragraphs B8–B12D for guidance on the elements of a business):

(a) **Input**: Any economic resource that creates outputs, or has the ability to contribute to the creation of outputs when one or more processes are applied to it. Examples include non-current assets (including intangible assets or rights to use non-current assets), intellectual property, the ability to obtain access to necessary materials or rights and employees.

(b) **Process**: Any system, standard, protocol, convention or rule that when applied to an input or inputs, creates outputs or has the ability to contribute to the creation of outputs. Examples include strategic management processes, operational processes and resource management processes. These processes typically are documented, but the intellectual capacity of an organised workforce having the necessary skills and experience following rules and conventions may provide the necessary processes that are capable of being applied to inputs to create outputs. (Accounting, billing, payroll and other administrative systems typically are not processes used to create outputs.)

(c) **Output**: The result of inputs and processes applied to those inputs that provide goods or services to customers, generate investment income (such as dividends or interest) or generate other income from ordinary activities.

IFRS 9 Financial Instruments

The entity's business model for managing financial assets

B4.1.1 Paragraph 4.1.1(a) requires an entity to classify financial assets on the basis of the entity's business model for managing the financial assets, unless paragraph 4.1.5 applies. An entity assesses whether its financial assets meet the condition in paragraph 4.1.2(a) or the condition in paragraph 4.1.2A(a) on the basis of the business model as determined by the entity's key management personnel (as defined in IAS 24 *Related Party Disclosures*).

B4.1.2 An entity's business model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular business objective. The entity's business model does not depend on management's intentions for an individual instrument. Accordingly, this condition is not an instrument-by-instrument approach to classification and should be determined on a higher level of aggregation. However, a single entity may have more than one business model for managing its financial instruments. Consequently, classification need not be determined at the reporting entity level. For example, an entity may hold a portfolio of investments that it manages in order to collect contractual cash flows and another portfolio of investments that it manages in order to trade to realise fair value changes. Similarly, in some circumstances, it may be appropriate to separate a portfolio of financial assets into subportfolios in order to reflect the level at which an entity manages those financial assets. For example, that may be the case if an entity originates or purchases a portfolio of mortgage loans and manages some of the loans with an objective of collecting contractual cash flows and manages the other loans with an objective of selling them.

B4.1.2A An entity's business model refers to how an entity manages its financial assets in order to generate cash flows. That is, the entity's business model determines whether cash flows will result from collecting contractual cash flows, selling financial assets or both. Consequently, this assessment is not performed on the basis of scenarios that the entity does not reasonably expect to occur, such as so-called 'worst case' or 'stress case' scenarios. For example, if an entity expects that it will sell a particular portfolio of financial assets only in a stress case scenario, that scenario would not affect the entity's assessment of the business model for those assets if the entity reasonably expects that such a scenario will not occur. If cash flows are realised in a way that is different from the entity's expectations at the date that the entity assessed the business model (for example, if the entity sells more or fewer financial assets than it expected when it classified the assets), that does not give rise to a prior period error in the entity's financial statements (see IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*) nor does it change the classification of the remaining financial assets held in that business model (ie those assets that the entity recognised in prior periods and still holds) as long as the entity considered all relevant information that was available at the time that it made the business model assessment. However, when an entity assesses the business model for newly originated or newly purchased financial assets, it must consider information about how cash flows were realised in the past, along with all other relevant information.

B4.1.2B An entity's business model for managing financial assets is a matter of fact and not merely an assertion. It is typically observable through the activities that the entity undertakes to achieve the objective of the business model. An entity will need to use judgement when it assesses its business model for managing financial assets and that assessment is not determined by a single factor or activity. Instead, the entity must consider all relevant evidence that is available at the date of the assessment. Such relevant evidence includes, but is not limited to:

(a) how the performance of the business model and the financial assets held within that business model are evaluated and reported to the entity's key management personnel;

(b) the risks that affect the performance of the business model (and the financial assets held within that business model) and, in particular, the way in which those risks are managed; and

(c) how managers of the business are compensated (for example, whether the compensation is based on the fair value of the assets managed or on the contractual cash flows collected).

Appendix B—Investor information needs identified by the FRC Financial Reporting Lab

Investor 'want' identified by the Reporting Lab
'Most investors want the company to include:'
What it does and where it sits in the value chain
Key divisions and their contribution, and legal structure
Key markets and market segments
Its competitive advantage
Key inputs (assets and liabilities, relationships and resources) and how they are maintained / enhanced
Key revenue and profit drivers
Value created for other stakeholders that supports economic value generation
Statistics to indicate relative importance of elements
'Many investors also want:'
Direct threats
Market share
'Some investors also want:'
Culture and values
SWOT analysis
Purpose
Investment plans
How the business model is likely to evolve
Cash flow for each significant business
Capital and assets allocated to each significant business
ROE, ROCE, or ROA

Appendix C—Extract from *Business Model Background Paper for <IR>*[6]

11. Despite considerable variation in business model definitions, several recurrent themes can be identified. As Figure 1 shows, nearly two-thirds of the articles drew an explicit link between the business model and an organization's ability to make money and drive financial performance. More than half viewed the organization's inputs – the resources and capabilities (or capitals) on which it relies – as a key component of the business model. The majority of references also considered actions or activities – the very mechanics of the business – to be within the business model scope. These activities contribute to the quality or uniqueness of the organization's offerings. Just over half of the references considered the business model as also including how an organization creates value, outcomes or impacts for its customers and other stakeholders.

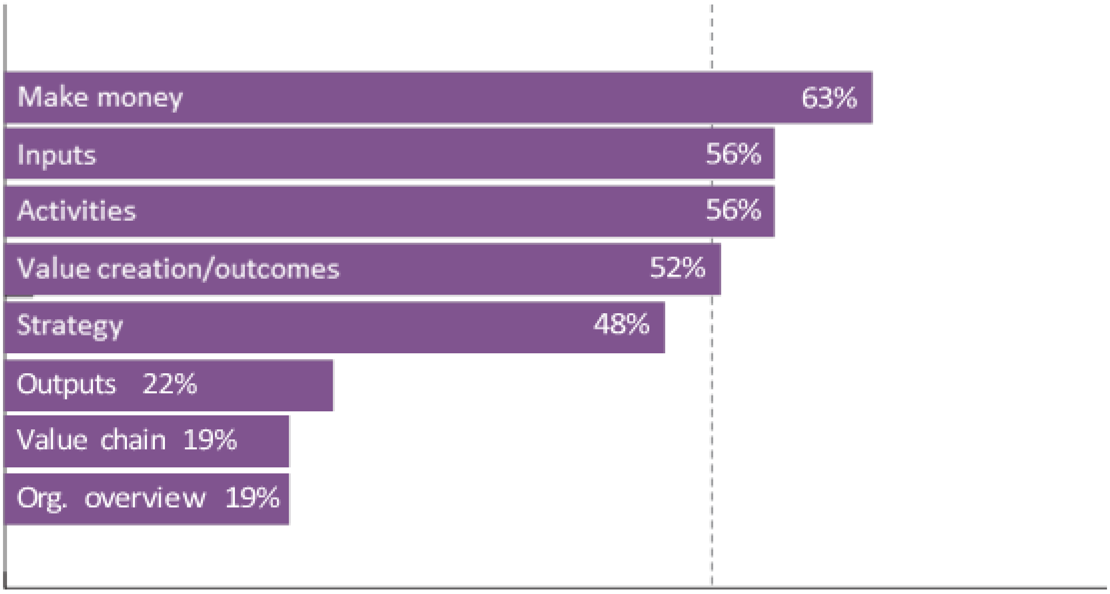

Figure 1. Business model components according to an external literature review. Percentages represent the proportion of researched articles that refer to the relevant component.

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Appendix D—Extracts from meeting notes of the Management Commentary Consultative Group on the discussion of business model

Overall proposed approach to reporting business model, strategy, operating environment and risks

1. The staff provided an overview of the challenges identified in current reporting practice in relation to business model, strategy, operating environment and risks and narrative coherence, and of the staff's proposed approach to addressing these challenges. The challenges identified included not addressing long-term drivers of success and key resources or relationships, a narrow view of the operating environment, a lack of focus in reporting risks, and not providing sufficient detail to help users assess implications of issues included in management commentary on the entity's prospects. The staff explained that the proposed approach is to build on the existing IFRS Practice Statement 1 *Management Commentary* (Practice Statement) and to provide additional guidance on what to report on the content elements, without prescribing the order to follow.
2. Overall, members agreed that the staff had correctly identified the challenges the project should aim to address. However, a few members suggested additional challenges to consider in the project:
    (a) inadequate disclosure of management compensation—users would like to see summarised and easy-to-find explanations of the link between management compensation and long-term strategy as well as of long-term implications of incentives. A few members said they would like to see a greater emphasis on management compensation in the proposed guidance, and a few other members cautioned against being too prescriptive because that could result in a conflict with local regulations on disclosures of management compensation.
    (b) lack of conciseness—a member highlighted the difficulty in achieving conciseness in reporting in the light of increasing reporting requirements. A few members said that the proposals on cross-referencing can help address this challenge to an extent.
    (c) lack of comparability—a member highlighted the difficulty in comparing information about entities' business models. That member referred to an academic study which observed many different descriptions of business models that were considered similar in that study.
    (d) difficulty in determining what information is relevant for management commentary—a member said it can be challenging for entities to determine what matters to address in management commentary and noted that different matters can be important for example, for different industries and over time as circumstances change. That member suggested that guidance was needed to help entities identify relevant information in different or changing circumstances.
3. Overall, members agreed with the staff's proposed approach to reporting business model, strategy, operating environment and risks. However, some members commented that

they expected explicit discussion of long-term value creation to help users understand an entity's business model and strategy, as well as risks arising from the operation of the entity's business model. They stated that the notion of long-term value creation may have been hinted at in the proposals by references to 'long-term drivers of success' and to 'purpose' but did not think such implicit consideration of long-term value creation was sufficient. A few members further commented that the proposed focus on the prospects for future net cash inflows to the entity could be misunderstood as emphasising the short and medium term and might not result in sufficient discussion of long-term value creation.

4. Some members expressed different views on how business model and strategy relate to each other and should be described in management commentary, in particular:
   (a) business model and strategy should be described together rather than separately;
   (b) 'purpose' of the entity should be discussed either before or together with business model, rather than as part of the discussion of strategy;
   (c) discussion of strategy should address *what* the entity seeks to achieve, and the discussion of business model should address *how* the entity will do that;
   (d) the order and the labels of sections in management commentary (for example, as 'business model' or 'strategy') would not matter for the users and should not be prescribed; it is important that the entity tells its story in a coherent way.

5. The staff clarified that the order of content elements presented in the materials for the meeting was intended to illustrate the links across those content elements and to highlight the need for a coherent story rather than to prescribe a structure for management commentary. A few members suggested that a feedback loop or circular diagram could provide a better illustration of how content elements of management commentary should link to each other than a stacked linear diagram. A few members also emphasised that entities should be allowed flexibility in how they structure their management commentary.

6. Other comments included:
   (a) it was not clear how the staff had selected the items that received particular prominence in the proposals and hence whether the proposals were complete. For example, it was not clear why the proposals explicitly addressed funding strategy but not liquidity strategy.
   (b) the proposals should include guidance on reporting relevant ESG (environmental, social and governance) information because this was a challenging area for preparers. One member stated it was surprising not to see explicit proposals on reporting such information.
   (c) it was not clear what level of detail is expected in management commentaries in discussing the prospects for future net cash inflows to the entity. As proposed, the guidance could be interpreted as requiring forecasts in management commentary.

(d) the proposed guidance includes a lot of different criteria for determining what information is relevant and should be included in management commentary (for example, matters critical for success of the business, matters that affect or could affect future net cash inflows to the entity, matters that the entity depends on for its long-term success). The varied language used in the proposals could be confusing and difficult to apply and could create challenges from the assurance point of view.

(e) in developing the revised guidance, it is necessary to consider whether management commentaries should focus on the *changes* from the last reporting period or always provide information about the 'base line' as well. Some members who commented on the topic suggested that the focus on the changes is more appropriate while others including users of financial reports stated that management commentary should not assume the knowledge of the company and should always provide relevant 'base line' information about the company. This could be particularly important in discussing the entity's business model and strategy.

Business model

7. The staff presented the proposed approach to introduce two components for the description of the business model—a discussion of the structure of the entity and a discussion of business activities. Based on the revised guidance in IFRS 3 *Business Combinations*, the staff proposed that the discussion of business activities would cover inputs, including resources and relationships, processes and outputs and impacts. Members generally agreed with the staff's proposed approach. A few members commented that understanding the business model is fundamental for understanding the financial statements, and also central to assessing narrative coherence of management commentary.

8. Some members expressed concerns about the proposals relating to structure, particularly the proposed discussion of how the legal structure relates to the operating structure. A few members suggested that the discussion of legal structure would not be helpful because legal entities are sometimes set up just to meet regulatory requirements and do not necessarily correlate with the group's operations, for example, in China a legal entity needs to be set up for every project undertaken. A member said that the requirement to list the main subsidiaries under IAS 24 *Related Party Disclosures* addresses the need for information about legal structure. That member also questioned why the requirements in IFRS 8 *Operating Segments* were not specifically referred to in the proposed guidance. The member expressed a view that discussion of operating structure in management commentary should be aligned with segment disclosure in financial statements. A member from the user community stated that information on segmental cash flows would be useful to users. However, a preparer noted that entities may not necessarily prepare this information for internal use. Another member commented that users often do not get

sufficient information on the different business units in very large entities, because business units may fall below the entity's materiality threshold.

9. Some members commented on the staff's proposal to link the provision of detailed information about specific features of the business model, including impacts, to the prospects for future net cash inflows to the entity. Some of those members agreed that the discussion of business model in management commentary needs to be rooted in the effect on future cash flows but asked for more clarity on time horizons. However, a few members suggested that a link to 'value creation' or 'value creation through cash flows' could be more appropriate because the effect on cash flows is often viewed though a financial lens only and could be associated with the short term. One view expressed was that although management commentary is aimed at shareholders, it should also address the impact on and value for other stakeholders and therefore the link to cash flows could be too narrow. In addition, those members were concerned that a reference to cash flows could be read to imply a measurable effect on cash flows but there could be matters or trends whose effect on cash flows was not yet known. Overall, members agreed that management commentary should address those matters which are difficult to measure but will ultimately have an effect on cash flows. However, one member urged the Board to be cautious so that management commentary is not too broad and only includes information about matters that management reasonably expects to affect future cash flows. Another member suggested that providing examples of how entities should consider the effect on future cash flows in preparing management commentary could be helpful.

10. Members also made the following comments in discussing particular aspects of the proposals:
    (a) discussion of impacts in management commentary should be linked to discussion of resources and relationships, for example, discussion of declining resource availability, and should distinguish between resources that the entity controls and those that form part of its environment.
    (b) discussion of intangible resources and relationships should be given more prominence in management commentary, rather than just be subsumed in the discussion of the business model.

11. A few members commented on terminology as follows:
    (a) it was not clear how the definition of business model in the staff's proposals aligns with the definition of business model in IFRS 9 *Financial Instruments*. It is important that the same term does not have two meanings in IFRS literature.
    (b) it would be useful to consider aligning some of the terminology in the staff's proposals with the terminology in the *International <IR> Framework*, for example to use the term 'outcomes' rather than 'impacts' and to use verbs in describing components of 'business activities'. It is counterintuitive to describe 'activities' using nouns such as 'inputs' and 'outputs'.