

## Accounting for Business Models : Increasing the Visibility of Stakeholders

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### Abstract

**Purpose:** This paper conceptualises a firm's business model employing stakeholder theory as a central organising element to help inform the purpose and objective(s) of business model financial reporting and disclosure.

**Framework:** Firms interact with a complex network of primary and secondary stakeholders to secure the value proposition of a firm's business model. This value proposition is itself a complex amalgam of value creating, value capturing and value manipulating arrangements with stakeholders. From a financial accounting perspective the purpose of the value proposition for a firm's business model is to sustain liquidity and solvency as a going concern.

**Findings:** This article argues that stakeholder relations impact upon the financial viability of a firm's business model value proposition. However current financial reporting by function of expenses and the central organising objectives of the accounting conceptual framework conceal firm-stakeholder relations and their impact on reported financials.

**Practical implications:** The practical implication of our paper is that 'Business Model' financial reporting would require a reorientation in the accounting conceptual framework that defines the objectives and purpose of financial reporting. This reorientation would involve reporting about stakeholder relations and their impact on a firm's financials not simply reporting financial information to 'investors'.

**Social Implications:** Business model financial reporting has the potential to be stakeholder inclusive because the numbers and narratives reported by firms in their annual financial statements will increase the visibility of stakeholder relations and how these are being managed.

**What is original/value of paper:** This paper's original perspective is that it argues that a firm's business model is structured out of stakeholder relations. It presents the firm's value proposition as the product of value creating, capturing and manipulating firm-stakeholder relationships. The originality of this paper is that it calls into question the nature of the accounting conceptual framework. Business model financial reporting will involve reporting about material stakeholder relationships and how these impact upon the viability of a firm's business model value proposition.

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Key words: business model, stakeholder theory, value creation, value capture, conceptual framework and accounting disclosure

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## 1. INTRODUCTION

This paper constructs an alternative conceptualisation of a firm's (reporting entity) business model as a means to challenge the way in which information, as narratives and numbers (Froud *et al.*, 2006), could be disclosed by firms in their financial statements. The professional accounting bodies and standards setting agencies have progressively reformed the 'Conceptual Framework' that governs the general purpose of financial statements disclosed by reporting entities. A number of these accounting bodies: Institute of Chartered Accountants in England and Wales (ICAEW, 2010), the European Financial Reporting Advisory Group (EFRAG, 2013) and International Integrated Reporting Council (IIRC, 2013) have recently considered how a business models approach to corporate disclosure could enhancing the relevance and clarity of information disclosed in financial statements, including the notes to the accounts.

This recent debate in accounting about the relevance of business models to financial reporting and disclosure practices is informed by a more long-standing use of the term 'business model' derived from the business management and consultancy literature. Chesbrough *et al.* (2007, 2010) observes that a business model serves a variety of functions but in general terms it (the firm's business model) articulates the so-called value proposition. The value proposition (of a business model) is itself the product of value creation and value capture. Management's value creating initiatives involve the deployment of intellectual capital (Beattie *et al.*, 2013), physical resources, technologies and capabilities (within and outside of a firm) to generate new innovative products and services that map onto consumer needs. Chesbrough (2010) argues that the barriers to business model innovation are inertia and a lack of entrepreneurial and managerial leadership that are required to experiment and effectuate change to a business model. Magretta (2002) observes that firms deploy capabilities and resources to generate new product and services, which Magretta characterizes as 'value creating insight'.

Value capture is concerned with the share of the financial value chain that is secured inside the boundary of a firm and the extent to which this also

enhances operating margin. How much profit margin the firm captures from its total value chain depends upon its pricing strategy, relation to distributors, retail network and capacity to out-source and offshore operating expenses. That is, to what extent can the firm within its business model exert sufficient control over stakeholders to prevent price erosion, lock-in customers and adjust the balance between internal and external costs to inflate profit margin. Zott and Amit (2010) observe that the business model co-determines the firm's bargaining power and this facilitates value capture out of its value creating initiatives. They stress the importance of locating a firm's value creating and capture initiatives within an activity network where the business model describes both intra and extra firm relations. This introduces the notion of a network architecture that involves partners in the delivery process of products and services. A firm's business model is also about total value creation for all parties involved. It lays the foundations for the firm's value capture by co-defining (along with the firm's products and services) the overall 'size of the value pie,' which can also be considered as the upper limit of the firms value capture potential (Zott and Amit, 2010:218). Because this involves transactions between firms and other 'partners' it is the collective efforts of this network that matters in a business model not simply the actions of one firm. Baden-Fuller and Morgan (2010) also observe that a business model (as a model) connects up the 'workings inside the firm' to elements outside of the firm, 'the customer side', as a means to capture value (from the application of innovation and new technologies). According to Bowman and Ambrosini (2000) it is the binding between value creation and value capture that frames the viability of a business model.

The strategy literature is focussed on how a firm's value proposition in its business model involves creating and capturing value within a network of transactions with 'partners' where the financial boundary of the firm is not stable but malleable. Amit *et al.* (2011) summarise the business models literature as generating four important themes: the notion of the business model as a *new unit of analysis*, offering a *systemic perspective on how to "do business,"* encompassing *boundary-spanning activities* and *focusing on value creation as well as on value capture*. These themes are

interconnecting and mutually reinforcing' (Amit *et al.*, 2011:1038). However, Teece is concerned that the business model concept lacks a theoretical grounding in economics and business studies (Teece, 2010:5).

In this paper our argument is that stakeholder theory provides a useful foundation upon which to structure a firm's business model. Accounting for a firm's stakeholder relations generates critical insight about the nature of a firm's business model and the viability of its value proposition. Osterwalder *et al.* (2005), in their review article 'Clarifying Business Models: Origins, Present and Future of the Concept', list one article that mentions 'stakeholders' and this article was concerned with ensuring that the concept of business models is easily understood by stakeholders. Morris *et al.* (2005) in their survey of the business model literature also note that the word 'stakeholder' is mentioned once in the titles surveyed in a paper by Gordijn *et al.* (2001). Casadesus-Masanell and Ricart (2010) observe that a business model refers to the logic of the firm, the way it operates and how it creates value for its stakeholders (Casadesus and Ricart, 2010:196). Demil *et al.* make a similar observation that 'any organization aims to create value for some stakeholders; customers in a broad sense, suppliers, shareholders, etc. (Demil *et al.*, 2010:217). Whilst referred to 'stakeholders', it has not been central to developing a business model framework of analysis. This paper employs stakeholder theory to structure a firm's business model and this leads on to an argument for modifying the accounting conceptual framework that governs the purpose of financial disclosures. The accounting conceptual framework is concerned with *disclosures to investors* whereas a business model-driven disclosure framework would require reporting entities to disclose information *about stakeholder relations* and their contribution to securing a firm's value proposition, that is, how 'firms make money in many ways' (Jacobides, 2009).

A common thread running through stakeholder theory, as applied to corporations, is the role and contribution of management in both satisfying and reconciling the needs of a variety of stakeholders that have a legitimate interest in the organisation. This responsibility of management can be broadly specified as 'stakeholder-agency' or more narrowly as 'shareholder-agency'

(Jensen, 1986 & 2002). Evan and Freeman (1993) observe that:

A stakeholder theory of the firm must redefine the purpose of the firm. The very purpose of the firm is, in our view, to serve as a vehicle for coordinating stakeholder interests (Evan and Freeman, 1993:102-103).

Freeman defines stakeholders in broad terms as: 'any group or individual who can affect or is affected by the achievements of the organization's objective' (Freeman, 1984:46). Within this theoretical framework, co-ordination between stakeholders is delivered through legally binding contracts or loose informal relationships that are structured and monitored for the mutual benefit of all parties (see Freeman and Evan, 1990; Hill and Jones, 1992). Freeman *et al.* (2004) observe that a primary concern for management, within the firm, is with aligning various stakeholder interests. On the one hand the firm is a normative locus for reconciling stakeholder interests and on the other there is an instrumental purpose, which is to generate 'outstanding' performance. According to Freeman, stakeholder theory:

Encourages managers to articulate the shared sense of the value they create, and what brings its core stakeholders together. This propels the firm forward and allows it to generate outstanding performance, determined both in terms of its purpose and marketplace financial metrics. (Freeman *et al.*, 2004:364)

In this paper we argue that a firm's business model is structured by the nature of a firm's relations with stakeholders. These stakeholder relations may be contractual and transactive but also advisory and regulatory in nature but collectively they can impact upon a firm's reported financials. For example regulatory bodies, credit rating agencies, valuation experts and accounting standards setting bodies are stakeholders that can influence a firm's disclosed financials even though they are not directly involved in contracts and transactions.

Within accounting there is also an ongoing debate about the purpose of financial disclosure that of

informing investors or a broader group of stakeholders. Zeff (1999) provides a valuable account of the evolution of the conceptual framework that governs financial disclosures for business enterprise in the US. Zeff observes that in 1966 the American Accounting Association (AAA) published a pioneering monograph entitled 'A Statement of Basic Accounting Theory (ASOBAT)'. Significantly this, according to Zeff, redirected attention away from the inherent virtues of asset valuation models towards the 'decision usefulness' of financial statements. It defined accounting as 'the process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by users of the information' (AAA, 1966:1). ASOBAT was focused on the information needs of investors specifically earnings upon which predictions and valuations might be made.

Zeff observes that ASOBAT also opened up the possibility for firms to record a variety of information with, for example, assets valued at historic or current cost depending upon the needs of the user(s) where users may not simply be investors but employees and managers. The American Institute *Committee Report: Objectives of Financial Statements - Trueblood Report* (AICPA, 1973) carried forward the issue of decision usefulness for investors. However, the Trueblood Committee report again discussed the use of multiple values to describe performance to a range of user groups and also proposed that social goals are no less important than economic goals. The International Accounting Standards Board (IASB, 2013) is still engaged in a process of clarifying the purpose of the accounting conceptual framework for the financial statements. It is also suggested that information disclosed in financial statements should be relevant to a wider group of stakeholders (IIRC, 2013).

In the next section of this article we argue that stakeholder theory provides a basis upon which to structure a firm's business model and understand its value proposition. This leads us to argue for a reorientation of accounting disclosure. That is a shift from '*disclosure to investors*' towards '*disclosures about stakeholders*' to increase the visibility of stakeholder relationships and their impact on the outcome of a firm's business model value proposition.

## 2. BUSINESS MODELS: STRUCTURE AND VALUE PROPOSITION

In this section of the paper we structure a firm's business model as the outcome of managing and (re) acting to complex firm-stakeholder relations to achieve an instrumental outcome which is the need to preserve liquidity and solvency for a going concern. Freeman's (1984) work on stakeholder theory informs this paper's structure of a firm's business model in terms of bilateral firm-stakeholder relations. Freeman defined stakeholders as 'any group or individual who can affect or is affected by the achievement of the organizations objectives' (Freeman, 1984:46). Berman *et al.* (1999) discussing stakeholder theory observe that firms 'view their stakeholders as part of an environment that must be managed in order to assure revenues, profits and ultimately returns to shareholders' (Berman *et al.*, 1999:491). There is both a normative and instrumental aspect to the firm's relations with stakeholders because managers need to 'foster trust' with their stakeholders and from an instrumental point of view this can also 'help firm profitability'. According to Berman *et al.* (1999) a firm's resource allocation decisions and stakeholder relations are inseparable because the way in which resources are allocated also impacts upon the firm's relationship with its stakeholders.

This paper constructs a business model theoretical framework using two organising elements: structure and value proposition. In terms of structure we argue that a firm's business model can be broadly described as the product of interactions with stakeholders both internal and external to the firm. The value proposition of a firm's business model is how liquidity and solvency are extracted from value creating, value capturing and value manipulating arrangements with stakeholders.

A firm's business model is structured out of interactions with a complex network of stakeholders and the information that arises from these relations serves to broadly define the nature of a firm's business model (Haslam *et al.*, 2012). Haslam *et al.* argue that 'A business model exists where information attributes congeal to establish a broad boundary within which firms can be situated: for example investment

banking, mixed retail, bio-pharma and digital lifestyle' (Haslam *et al.*, 2012:55). Jacobides (2009) observes that 'many "BM (Business Model) innovations" are either changes within Industry Architecture; or changes of Industry Architecture'. The drivers of these changes, we argue, are adaptive and evolving interactions with a range of stakeholders. These interactions are with primary and secondary stakeholders including: customers, employees, suppliers, advisers, credit ratings agencies, industry and valuation analysts, consultants, regulatory and professional institutions to name a few. Primary and secondary stakeholder relations help to broadly define the nature of a firm's business model and may have a material financial influence over the firm's business model value propo-

sition in circumstances where contractual and transactive relations are informal and immaterial.

The 'value proposition' arising out of a firm's business model enables it (the firm) to generate liquidity and solvency to secure a going concern. Cash from operations (liquidity) provides valuable information to: credit rating agencies, valuation analysts and suppliers that are making judgements about the viability of a firm's value proposition. Solvency is the difference between total assets and liabilities (current and long-term) and is a measure of net worth and an important index of enterprise value and a requirement for auditors signing off the accounts.

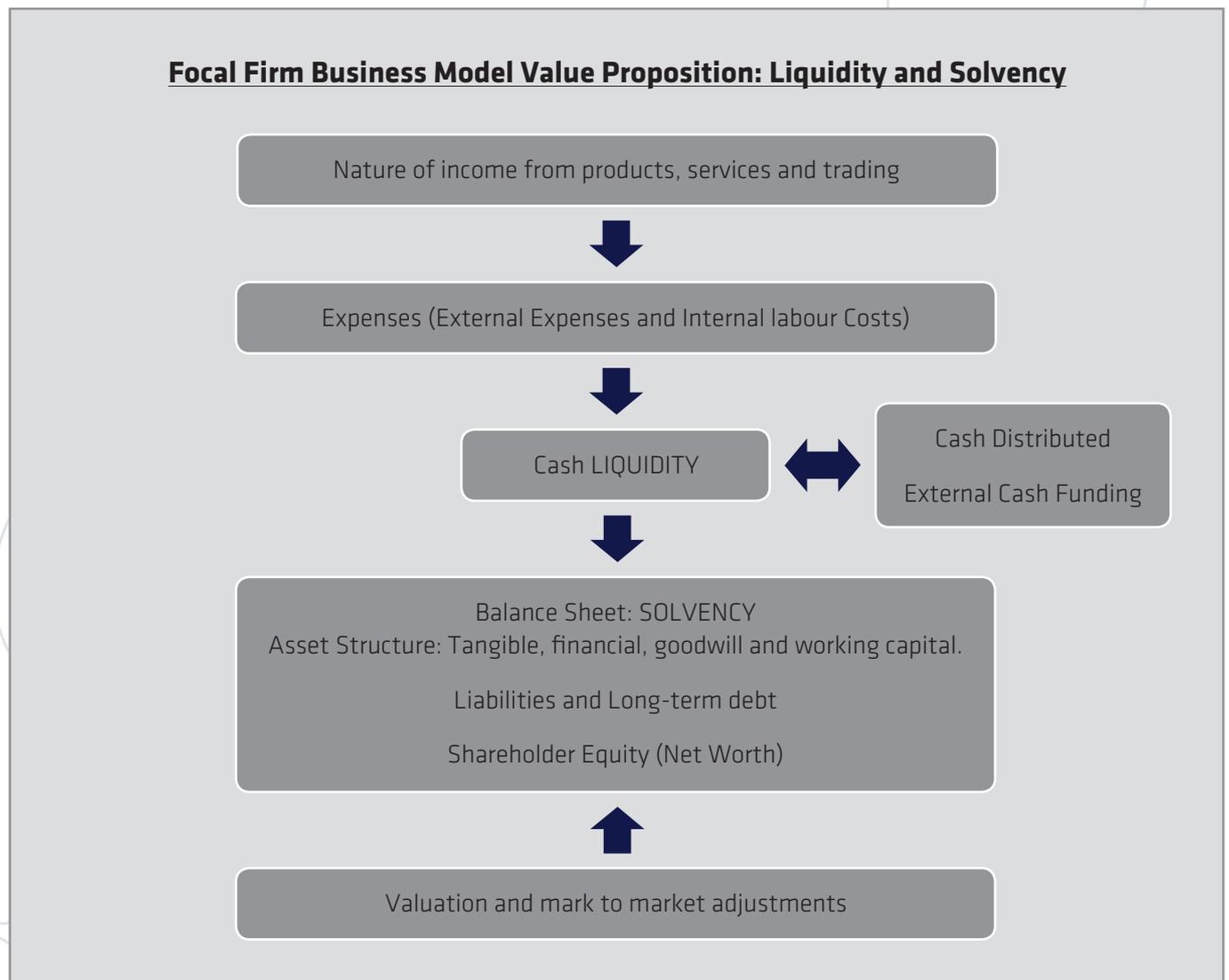


Figure 1: Source: Authors

This depiction of a firm's business model value proposition emphasises the importance of complex stakeholder relations and how these need to be managed and influenced to sustain liquidity and solvency. Liquidity depends upon maintaining a complex balance between: old and new products and services sold to a multiplicity of customers, households, corporate and non-corporate clients. It is also influenced by the share of the financial value chain, a firm is able to capture and management of internal labour costs because both determine the margin extracted out of sales revenue. Increasing the firms outsourcing arrangements without lowering internal labour costs could damage a firm's cash margin (liquidity) within its business model (see Lee and Yin, 2012). Sustaining a solvent firm within its business model is also a complex process that depends upon the extent to which total asset values inflate ahead of current and long-term liabilities. Solvency is augmented because the firm's business model is growing operating profits (posted into shareholder funds) or extracting asset windfalls that generate holding gains, which also inflate shareholder funds. Jacobides (2009) on business models notes that firms make money in many ways - not just by summing up profits - Financial structure and capitalization is key - Game-plan includes not only profits, but asset windfalls'.

Subsumed with the value proposition of a firm's business model is how value: creation, capture and manipulation are acting upon the reported financial numbers. The firm, subtended in its business model, will be constantly adapting to its stakeholder relations creating value by upgrading processes and generating

new innovative products and services that are critical for sustaining demand and future income streams. At the same time stakeholder relations are being dynamically recalibrated to enhance the value capture potential of a firm's business model. This might involve the displacement of costs and expenses and the capture of profit margin from outsourcing and off-shoring and general restructuring within its value chain. On the other hand value manipulation is focussed on generating on-going asset windfalls / holding gains that generate financial leverage beyond that simply from creating and capturing value from products and services sold for consumption.

The value proposition of a firm's business model is thus the outcome of complex stakeholder arrangements where value creation, capture and manipulation are operating simultaneously. For example, new product development might reinforce a strong future income trajectory but this could be associated with limited growth in cash and balance sheet solvency if value capture policies fail to gain traction. The stakeholder relations that constitute a firms business model value proposition may promote or frustrate liquidity and solvency that underwrite a going concern. This is because the value proposition of a firm's business model depends upon complex stakeholder interventions some of which are focussed on creating value others enhancing value capture or facilitating value manipulation to generate asset windfalls. The three elements that underwrite the value proposition of a firms business model may or may not align to secure liquidity and solvency for a going concern because it is often the case that contradictory forces are in play (see fig.2).

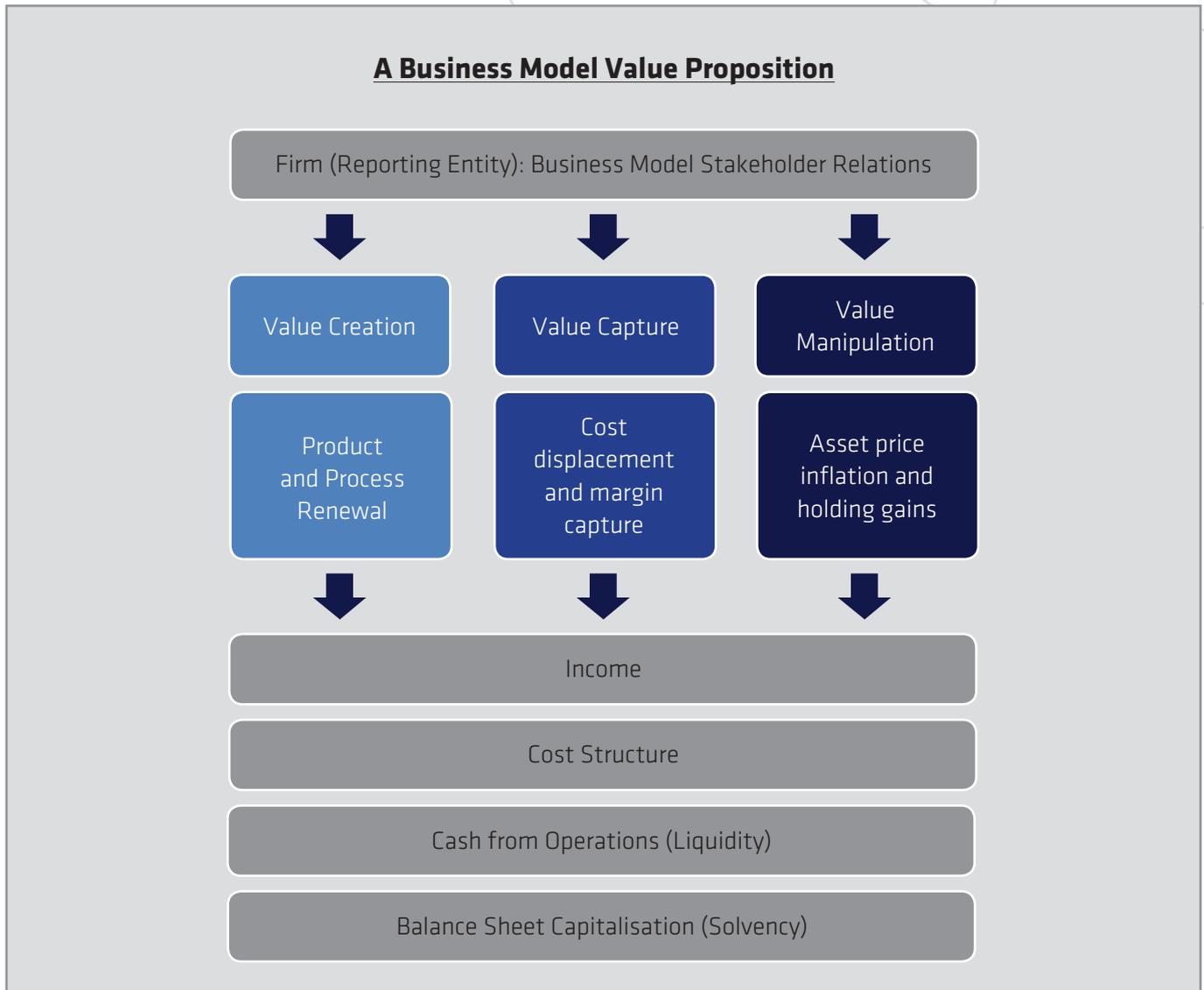


Figure 2: Source: Authors

In this next section we argue that there is a significant role to be played by accountants and their professional bodies in raising the visibility of stakeholder relations and their impact upon a firm's business model value proposition. There are two key issues which, we argue, currently restrict the potential of this contribution. First, firms tend to disclose expenses by 'function' rather than by 'nature' in their financial statements and this conceals the impact that different stakeholders have upon financial line items. Second, the conceptual framework governing the purpose of financial disclosure is concerned with providing information to the 'investor' as key stakeholder. When a broader financial disclosure project has been considered by the international accounting standard

setting bodies this tends to focus on '*disclosure to stakeholders*' rather than '*disclosure about stakeholder relations*' and the impact these on-going arrangements have on a firm's reported financials. For example, Bukh and Nielsen (2010) consider that the value of the 'business model' is that it offers up a new management technology that can inform disclosure to investors.

Thus, we perceive the business model as a management technology that helps management communicate and share its understanding of the business logic to external stakeholders, in our case primarily analysts and investors. (Bukh and Nielsen, 2010:11).

Alternatively, a business model framework of analysis might best be described as a management technology that can be employed to reveal information *about* the firm's broad stakeholder relations and how these are enhancing or degrading a reporting entities value proposition. That is, to what extent are firm-stakeholder relations contributing to value creation, capture and manipulation and are financial outcomes sustaining liquidity and solvency for a going concern?

### 3. ACCOUNTING FOR STAKEHOLDERS: REFRAMING FINANCIAL DISCLOSURE

The accounting profession and key professional bodies have been preoccupied with establishing a conceptual framework that can effectively govern the relevance and purpose of financial disclosures by reporting entities (firms). Zeff (1999) provides a valuable account of the evolution of the conceptual framework governing financial disclosures for business enterprise in the US. Zeff observes that in 1966 the American Accounting Association (AAA) published a pioneering monograph entitled 'A Statement of Basic Accounting Theory (ASOBAT)'. ASOBAT shifted the field of the visible away from types of valuation approach towards the information needs of investors specifically for '*decision usefulness*', for example, earnings upon which predictions and valuations might be made.

Such predictions are most crucial in the case of present and prospective equity investors and their representatives-considered by many to be the most important of the user groups (AAA, 1966:23)

Zeff (2013) observes that Staubus (1972) 'provides a coherent theory which effectively linked decision usefulness to the information required to make investment decisions: using discounted future cash flows as the most relevant attribute of assets and liabilities' (Zeff, 2013:24).

The accounting profession continues to refine the conceptual framework governing the purpose and relevance of a reporting entities financial disclosures but

this is still focussed on the provision of information that is 'decision useful' for investor stakeholders.

A reporting entity is a circumscribed area of economic activities whose financial information has the potential to be useful to existing and potential equity investors, lenders and other creditors who cannot obtain the information they need in making decisions about providing resources to the entity (IASB, ED,2002/3: para RE2).

The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit<sup>1</sup> (IASB, 2010: para OB2)

The financial statements are designed to 'provide information to help existing and potential investors, lenders and other creditors to estimate the value of the reporting entity' (IASB, 2010: para OB7). These financial statements conforming to the structures laid out in International Accounting Standards 1 (IAS 1). It is significant that IAS1 (IASB, 2011) takes a broad view about the users of financial information: 'The objective of financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions' (IAS1: p-3). In addition IAS1 is concerned with the practical presentation and structure of a reporting entity's financial statements outlining two approaches to the measurement of income; by nature of expenses and by function of expenses.

The first form of analysis is the 'nature of expense' method. An entity aggregates expenses within profit or loss according to their nature (for example, depreciation, purchases of materials, transport costs, employee benefits and advertising costs), and does not reallocate them among functions within the entity. This method may be simple to apply because no allocations of

1 <http://www.ifrs.org/News/Press-Releases/Documents/ConceptualFW2010vb.pdf>

expenses to functional classifications are necessary. (IAS1, para 102)

In practice most firms report their income statement employing the function of expenses rather than nature of expenses and within IAS1 there is a suggestion that this approach provides more relevant information to the users of accounts. However, this approach to the framing of the income statement conceals rather than increases the visibility of stakeholder relations embedded in the financial numbers.

The second form of analysis is the 'function of expense' or 'cost of sales' method and classifies expenses according to their function as part of cost of sales or, for example, the costs of distribution or administrative activities. At a minimum, an entity discloses its cost of sales under this method separately from other expenses. This method can provide more relevant information to users than the classification of expenses by nature, but allocating costs to functions may require arbitrary allocations and involve considerable judgement. (IAS1, para 103)

For example, the functional costs line item 'cost of goods sold' mixes up employment costs with external costs of materials and services from suppliers whilst 'marketing and distribution' includes labour costs but also the expenses of marketing which may be bought-in from outside agencies. Whilst 'research and development' expenses include labour costs but also expensed capital charges associated with research and development infrastructure. If the function of expenses approach obscures stakeholders this can be contrasted with the nature of expenses approach to structuring the income statement and this is shown in table 1. The presentation format of the nature of expenses income statement shown in table 1 modifies that which is presented in IAS1 to include two sub-total line items which we describe as value retained (also known as value added) - see Accounting Standards Steering Committee (ASSC, 1975) - and earnings before interest, tax and depreciation (Cash earnings or EBITDA). Where earnings before interest, tax, depreciation and amortisation is equivalent to a firm's cash generating ability from operations (liquidity).

**Table 1: Income statement by nature of expenses**

Revenue		X
Other Income		X
Changes in inventories	(Y)	
Raw materials and consumables used	(Y)	
Value retained		X
Employee Expense	(Y)	
Other Internal Firm Expenses (e.g. Pensions)	(Y)	
Total Expenses	(Y)	
Earnings before interest tax, depreciation and amortisation (EBITDA)		X
Depreciation and amortisation	(Y)	
Taxation	(Y)	
Dividends/Share buybacks	(Y)	
Interest payments	(Y)	
Retained earnings		X

Source: [http://ec.europa.eu/internal\\_market/accounting/docs/consolidated/ias1\\_en.pdf](http://ec.europa.eu/internal_market/accounting/docs/consolidated/ias1_en.pdf)

Note: Authors have adjusted this table from IAS1 to include line for value retained and EBITDA

This alternative approach to formatting the statement of income reveals the way in which income is generated from sales of products and services to customers. From this income is deducted all external costs (suppliers of materials and services). The value retained used to cover employee costs so as to leave the residual cash from operations (EBITDA). This cash from operations then distributed as: tax (government) dividends, share buy-backs (shareholder), interest payments (providers of debt financing) and retained earnings to boost assets and reinvestment.

In 2005 the Chartered Financial Analysts (CFA) Institute called for the disclosure of financial information by its nature because this would enhance comparability and that aggregating expenses by function congealed information with variable properties thus limiting its interpretative and decision-making quality.

By 'nature', we mean that items should be reported by the type of resource consumed, such as labor or raw materials, rather than by the function or purpose for which it is used, for example, cost of goods sold or selling, general, and administrative expense. Categorization according to nature can greatly enhance comparability across companies and consistency within the statements of a single company(...) The statistical distribution properties of the various resources consumed in operations behave very differently over time. Consequently, aggregation by function, the current practice, merges items with different properties, reducing the information content of the items and significantly reducing their value as decision-making factors (CFA Institute, 2005:18).

The authors of the Corporate Report (ASSC, 1975) were not simply concerned with the technicality of different reporting formats but wished to contextualise profit from a stakeholder perspective and make visible the fact that bottom line earnings are the outcome of a collective effort from a range of stakeholder groups and that value is created and captured by this effort.

The simplest and most immediate way of putting profit into proper perspective vis-à-vis the whole enterprise as a collective ef-

fort by capital, management and employees is by the presentation of a statement of value added (that is, sales income less materials and services purchased). Value added is the wealth the reporting entity has been able to create by its own and its employees' efforts. This statement would show how value added has been used to pay those contributing to its creation. It usefully elaborates on the profit and loss account and in time may come to be regarded as a preferable way of describing performance (ASSC, 1975: Para 6.7:49).

According to Zeff (2013) 'The Corporate Report spawned a considerable literature on value added statements, raising issues about the broader social accountability of profit-seeking enterprise. More than one-fifth of the largest UK companies produced value added statements in the late 1970s (Zeff, 2013:50). Michael Porter was not so convinced about the significance of this accounting format, observing that:

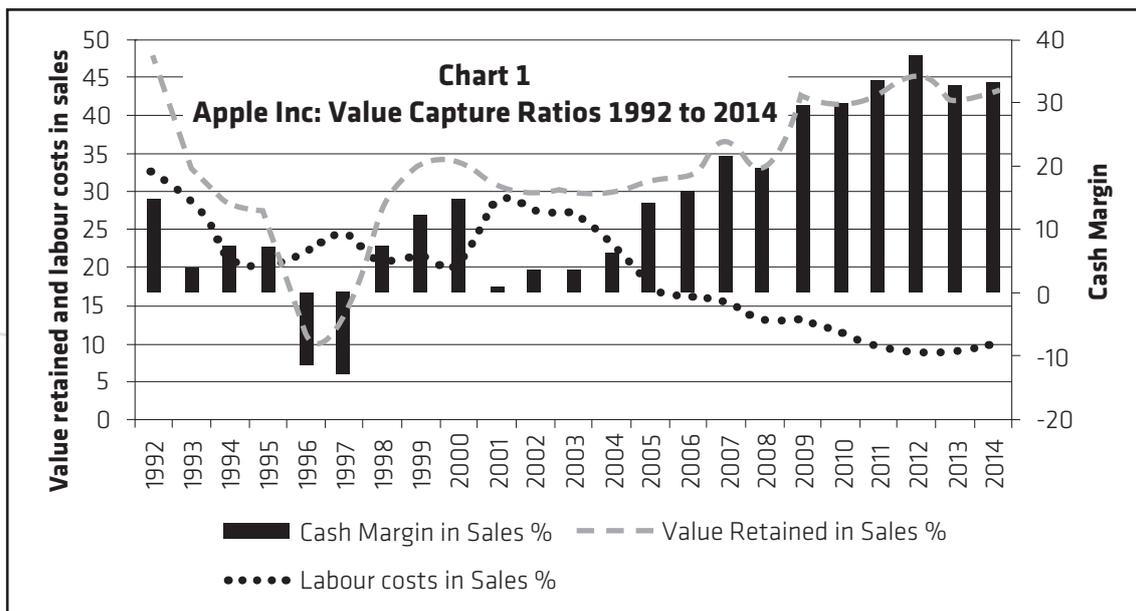
An analysis of the value chain rather than value added is the appropriate way of examine competitive advantage. Value added (selling prices less the cost of purchased raw materials) has sometimes been used as the focal point for cost analysis because it was viewed as the area in which a firm can control costs. Value added is not a sound basis for cost analysis, however, because it incorrectly distinguishes raw material from the many other purchased inputs used in a firm's activities. Also, the cost behaviour of activities cannot be understood without simultaneously examining the costs of the inputs used to perform them. Moreover, value added fails to highlight the linkages between a firm and its suppliers that can reduce costs or enhance differentiation (Porter, 1985:39).

We agree in part with Porter's specific argument that a firm's strategy will be an endeavour to influence costs or product differentiation in its global value chain and not simply focus on its own internal cost structure and capacity to influence product differentiation. However, we disagree with Porter's general conclusion that leads him to discard this accounting approach. Our argument is that a nature of expenses income statement is

valuable because it identifies stakeholders and their impact on financial performance. In addition the nature of expenses format can be employed to discriminate between internal and external expenses and stakeholder relations and thereby also make visible adjustments in the value capture arrangements of a reporting entity. To illustrate this point we have reproduced the key value capture financial ratios using a nature of expenses<sup>2</sup> approach for Apple Inc. covering the period 1992 to 2014. We observe that the value-retained ratio is transformed after the year 2000 rising from 30 to 45 per cent of sales revenue. Internal labour costs in total sales revenue fall from 30 to 10 per cent as manufacturing activity and research and development (for example Apps development) are outsourced. This combination of higher value retained and lower labour costs combined to boost the cash margin from 5 per cent to 35 per cent of sales (see also Haslam *et al.*, 2013). A disclosure format using the nature of expenses makes visible the extent to which value capture

has been transformed. These disclosed numbers could then be accompanied with narratives that describe how relations with stakeholders have changed to deliver this financial transformation and associated benefits and risks. In practice it is difficult to reproduce a nature of income and expenses statement and hence undertake value capture analysis. This is because expenses by nature are often not disclosed by firms, for example, total employee expenses by US firms. Furthermore, the narratives in the annual financial statements tend not to account for changes in stakeholder relations and their impact on the financial numbers. Zeff (2013) notes that:

‘The Corporate Report, issued in 1975 in Great Britain, has been by far the most innovative and enterprising of the frameworks, and it reflected a much broader vision of social accountability than the investor-creditor focus which has been predominant in the United States (Zeff, 2013:77).



Source: Apple Inc. 10K's

Note: Value retained / Sales is value retained as a per cent of sales revenue and labour costs are estimated using various corporate disclosures.

A nature of expenses disclosure format reveals the influence of changing stakeholder relations on the income, expenses and the cash residual from operations (EBITDA for liquidity) but it does not include a

balance sheet dimension. In an era of shareholder value managers are under constant pressure to generate excess returns on capital (i.e. returns above the cost of capital) because managerial remuneration

<sup>2</sup> Note we estimate employment costs from the accounts as total employee compensation is not disclosed

is tied into key financial performance metrics. Stock market analysts are focused on valuation multiples that combine earnings with balance sheet capitalization and they use this analysis to issue buy and sell recommendations. There are no fixed or standard measures of financial performance but there exist a range of financial metrics including, for example, cash flow return on investment (CFROI), Economic Value Added (EVA™), cash return on capital employed (Cash ROCE), earnings per share (EPS), Enterprise Value to EBIT and the price to earnings ratio (PE). These key valuation metrics used by analysts often combine market value of equity (or enterprise value) with a relevant financial metric that is assumed to have a material correlation with market value of equity. Thus, financial variables such as Cash ROCE are correlated with higher or lower market valuations when, for example, the ratio increases or falls. The inclusion of balance sheet financials into the accounting framework is significant because most analysts compare income and cash flow relative to assets or capital employed for valuations.

The balance sheet is not simply a snapshot of the 'stock' of financial values against which we benchmark profit and cash earnings to establish investor returns. The balance sheet also records the outcome of complex stakeholder relations that have influence over a firm's value proposition within its business model. These stakeholder interactions are influencing balance sheet values and impacting upon solvency. A property management firm can legitimately call in specialist advisers to revalue its stock of commercial and retail real estate. If valuations are raised this will generate a windfall holding gain, increase comprehensive income, shareholder equity and solvency. Private equity partnerships also depend upon the revaluation of their investment portfolios held on balance sheet to improve solvency and gearing metrics that contribute to levering additional debt financing. Apple Inc. relies upon benchmark information provided by investment banks to adjust the recorded value of its \$140bn of marketable securities held for trading on its balance sheet. In recent years Apple has invested \$67billion of this cash (as of September 2014) on share buy-backs a sum equivalent to double that spent on R&D over the period 1992 to 2014. These treasury shares have accumulated implicit holding gains of roughly \$14 billion because Apples share price has inflated to \$110

as at January 2015. These windfall asset gains are a sum equivalent Apples R&D spend over the period 2010 to 2014. Pension actuary advisers may value a firm's pension assets higher than liabilities when stock markets are inflating, helping, in turn, to secure reduced pension provisions out of profit as they take a pension holiday (or not as the case may be). Changes in accounting regulations also impact upon the recorded financial numbers. Goodwill arising from the acquisition of another firm will be accumulated as an asset on balance sheet and periodically tested for impairment rather than amortised. An impairment test reveals whether the earnings or market value attached to this goodwill are sustainable and if not the goodwill is written down. In 2008 the Royal Bank of Scotland (RBS) was forced, by advisers, to write down £35bn of goodwill and this forced the bank towards insolvency as the net worth of bank dissolved.

Thus financial statements and their associated narrative disclosures could be employed to reveal how stakeholder relations within the firm's business model are impacting on its value proposition. In order for this to become a practical reality it would be necessary to present the income statement using a nature of expenses format and review how balance sheet assets and liability valuations are also the product of specific counterparty/stakeholder relations. The professional accounting bodies are moving closer to this possibility because they are considering how a 'business models' framework could enhance disclosure in terms of the relevance of financial information for users. However, the accounting bodies that govern the role and purpose of accounting standard setting are still focussed on enhancing financial *disclosure to* the investor stakeholder. In this article we call for a reorientation in the balance of the accounting conceptual framework towards *disclosures about* stakeholder relations associated with the financial numbers. This would increase the visibility of material firm-stakeholder relationships and how these are evolving, adapting and impacting upon the viability of the firm's business model value proposition.

The Institute of Chartered Accountants in England and Wales (ICAEW) report on Business Models in Accounting: The Theory of the Firm and Financial Reporting (2010) suggests that the concept of the

'business model' can support the provision of relevant disclosures to those providing capital funding. The ICAEW report observes that the nature of a firm's business model can influence whether fair value (market value) or historic cost recording of transactions in the balance sheet may be more appropriate.

Assumptions about business models have always been implicit in financial reporting standards, as it has always been the case that different businesses will account for the same asset in different ways depending on what its role is within the firm's business model. Questions of cost allocation and revenue recognition for different firms and different sectors are also closely tied to the interpretation of their business models (ICAEW, 2010:8).

Thus a business models approach can be employed to discriminate between methods of asset valuation depending upon the purpose for which these assets are to be employed. If assets are actively traded they should be 'marked to market' and if they are held long-term, say in insurance companies, they could legitimately to be kept at historic cost. However, the ICAEW application of a 'business model' framework for corporate disclosure is focused on *disclosure to investors*. A recent European Financial Reporting Advisory Group (EFRAG, 2013) research report: 'The role of the business model in financial statements' focuses on how a business models framework would contribute to modifying the 'Conceptual Framework' that governs the purpose and objectives of financial disclosure. Specifically, how might a business models approach to financial disclosure affect the fundamental qualitative characteristics of the conceptual framework namely: relevance and faithful representation, comparability, timeliness and understandability. The EFRAG report is, like predecessors, focussed on how the reporting entity business model would enhance the way information is disclosed to investors. The International Integrated Reporting Council report 'Integrated Reporting' (IIRC, 2013) also employs the business model concept and in contrast to the professional accounting bodies the IIRC report does incorporate the need to report to a broader group of stakeholders. The IIRC report takes the position that a large group of stakeholders 'employees, customers, suppliers, business

partners, local communities, legislators, regulators and policy-makers' (IIRC, 2013:4) are interested in the value creating capacity of an organisation.

The professional accounting and standard setting bodies are considering how a firms 'business model' could enhance the disclosure of relevant information to stakeholders. In this paper we argue for a clear definition of a firms 'business model' one that is structured out of managing and reporting about material stakeholder relations. Disclosures about material stakeholder relationships would reveal how a firm's value proposition is being articulated through value creating, capturing and manipulating endeavours and how these endeavours are impacting on the risk to liquidity and solvency.

#### 4. DISCUSSION AND SUMMARY

In this paper we conceptualise firms as belonging to a specific business model because they share common and materially significant stakeholder relation characteristics. Our argument is that a firm's business model and its associated stakeholder relations can facilitate or frustrate a viable value proposition. A firm's value proposition within its business model is informed by elements of: value creation, value capture and value manipulation. The first of these, value creation, involves understanding how a firm's relations with stakeholders contribute towards product and process renewal to generate innovate products and services that map on to consumer demand. Value capture is about the capacity of firms, within their business model, to modify their share of the value chain and extract a higher profit margin out of total income. The third element, value manipulation, recognises that in a credit based financial system asset inflation and trading financial and tangible assets can extract windfall holding gains. These elements of a firm's business model value proposition are collectively influencing liquidity and solvency reported by a firm.

Central to understanding the financial viability of a firm's business model value proposition is the need to make visible information about how stakeholder interactions are contributing to value creation, capture and manipulation. In this paper we argue that there is a significant role for the accounting profession and associated professional bodies because a business

models disclosure project could significantly enhance our understanding of corporate performance and risk. There are already a number of very important initiatives but they lack a coherent business model framework. The ICAEW, EFRAG and IIRC have a different perspective on what constitutes a business model depending on whether it is influenced by economic theory of the firm or a strategic management literature on business models.

Accounting practitioners and professional standards setting bodies could enhance stakeholder reporting by focusing on the contribution of material stakeholder relations to financial performance. There are two obstacles to this initiative. The first relates to the presentation of information in financial statements of income, which obscure than make visible the contribution of stakeholders to the financial numbers. The second relates to the primacy of investors as the key stakeholder in the accounting conceptual framework and how this governs the purpose of financial statements, which is to *report to* investors.

Currently public firms do not disclose the structure of their income statement in terms of the nature of expenses, rather preferring to disclose expenses by their function. Structuring the income statement in terms of the nature of expenses would increase the visibility of stakeholders and their impact on a firm's financials. It would also be possible, using this nature of expenses approach, to discern a firm's financial boundary and capture intelligence about changes in the capacity of a firm to capture value and profit out of the value chain. Whilst a stakeholder account

of the statement of financial position (balance sheet) would capture the nature of advisory, regulatory and counterparty risk embedded in (re)valuations.

Zeff (1999) describes how the accounting bodies in the US have historically vacillated between reporting to investors or a broader group of stakeholders. This theme is carried forward into recent reports from the accounting profession about the value of a business models approach to corporate disclosure (EFRAG, 2013; ICAEW, 2010; IIRC, 2013). On the one hand the business model can act as a filtering device that managers can use to decide whether or not to use different valuation methods for assets for investors (ICAEW, 2010); enhance relevance and faithful representation for investors (EFRAG, 2013); or help to generate coherence and integration for all stakeholders (IIRC, 2013). These approaches are a valuable step forward. However they are concerned with how a business model framework might enhance disclosures *to* stakeholders (as users of information) rather than disclosures *about* stakeholder relations and their impact on the firm's business model value proposition and its financial results in terms of liquidity and solvency for a going concern. Beattie and Smith (2013) observes that 'the external reporting challenge is to find ways of reporting holistically whilst leaving out detail that cannot be included for contractual, regulatory or proprietary cost reasons' (Beattie and Smith, 2013:24). There is no reason why managers cannot report in general terms about the impact of their key stakeholders on the viability of their business model. Business model reporting will require a reorientation in the presentation of 'numbers and narratives'.

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