



Project **Financial Instruments – Recognition and Measurement**

Topic **Classification – implications of the business model**

Introduction

Background

1. As set out in the classification cover paper (see agenda paper 2), at its May 2009 meeting the IASB requested that the staff develop a classification approach in more detail as follows:
 - (a) using as the starting point the approach that the IASB decided to use for the forthcoming *IFRS for Private Entities* (IFRS for SMEs)¹; and
 - (b) amending that starting point to reflect that the classification approach would apply to entities other than small and medium-sized entities (SMEs) with the corresponding increase in complexity of instruments, transactions and other aspects that need to be considered.

2. The cover paper also sets out the context of the overall classification approach, which will comprise two steps:
 - (a) **Step 1** is an assessment of the characteristics of the financial instrument. This step determines whether a financial instrument would qualify for the amortised cost category pending the assessment of the business model in Step 2. Financial instruments that would not qualify

¹ See Appendix C of agenda paper 5E of the May 2009 IASB meeting (Approach 2)

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB. The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

for the amortised cost category on the basis of their characteristics would be mandatorily classified into the fair value category (ie Step 2 would not apply). Agenda papers 2B and 2C set out the approach to assessing characteristics.

- (b) **Step 2** is the business model overlay. It determines whether a financial instrument that would qualify for the amortised cost category on the basis of its characteristics (Step 1) would still have to be classified into the fair value category. This agenda paper sets out that business model overlay and complements the approach for Step 1.

Purpose of this paper

- 3. As set out in the classification cover paper², this paper explains how a business model affects the usefulness of information and how a classification approach that includes the business model as criterion could be made operational. The approach used in the forthcoming IFRS for SMEs does not involve a business model overlay, which means this paper cannot build on that approach.
- 4. This paper does not ask the boards for any decisions. Some staff recommendations that are derived from a discussion of how existing IFRSs, if used as a starting point, might have to be adapted for the purpose of a business model related classification criterion are included in this paper.³ A summary of these staff recommendations (and additional staff recommendations) as well as the questions to the Board regarding the classification approach are included in agenda paper 2E.

² See agenda paper 2.

³ See paragraph 21 below.

Implications of business models for classification of financial instruments

Why the business model matters

5. As set out in the classification cover paper⁴, the objective of classification is to ensure that financial instruments are allocated to measurement categories in such a way that the resulting information is useful to users. That means information should assist in assessing the amounts, timing and uncertainty of future cash flows.

6. The agenda paper on classification presented to the Board in May 2009⁵ explained why a classification approach that relied solely on the characteristics of a financial instrument would sometimes not provide users with useful information on the *actual* cash flows that are likely to the entity.

7. For example, if financial instruments are sold in response to changes in their value that affects both the timing and the amount of the actual cash flows to the entity. This outcome can be very different from the outcome that would have resulted from the timing and amount of cash flows in accordance with the contractual provisions. In such situations it is not just the contractual cash flows that matter, but the price (or valuation overlay) that is put on those cash flows by the market.

8. In this scenario, amortised cost is not an appropriate measurement basis. As explained in agenda paper 2B on the characteristics of a financial instrument, it is important to bear in mind the purpose of classification: screening financial instruments for their eligibility for accounting at amortised cost. That

⁴ See agenda paper 2.

⁵ See agenda paper 5E of the (regular) May 2009 IASB meeting, section 'How an entity uses financial instruments' (paragraphs 28 et seq.).

measurement basis uses the effective interest method for *interest* revenue or expense *allocation* over the relevant period.

9. This notion of interest has the following implications: Amortised cost is only an appropriate measurement for financial instruments that are expected to affect profit or loss over time in a way that involves an *allocation* approach. Allocation has only an effect on *profit or loss* if more than one period is involved. Notwithstanding that there is no effect on profit or loss, the presentation in the income statement—ie the line item—is also affected. However, this is more a comparability issue: for example a simple 6-month loan entered into early in an annual accounting period should still result in interest revenue or expense if the business purpose is the same as for a loan with a maturity of 18 months (that requires less frequent replacement).

10. The characteristics of a financial instrument by themselves do not determine whether the cash flows to the entity reflect more
 - (a) the contractual cash flows (ie their collection); or
 - (b) the cash flows that result from realising the value of an instrument by transferring it.

11. Instead, actions taken by the entity determines the outcome. Thus, the business model of an entity matters as it determines in a fundamental way the entity's likely actions.

Meaning of business model

12. Using the business model as a criterion for classification requires elaborating on the meaning of the term 'business model'.

13. A business model is about how business activities are *actually* managed. Many entities have several units that are managed in different ways. For example, a bank with a broad scope of activities may have an investment banking business unit and a retail banking business unit. Thus, a business model is not something that is determined at the reporting entity level (although that may coincide) but one reporting entity can have several different businesses with different business models.⁶
14. Another implication is that a business model does not relate to a choice (ie no voluntary designation) but is a matter of fact. Also, unlike some choices⁷, a business model does not apply to individual financial instruments in isolation (ie out of context). Thus, it does not allow a ‘piecemeal’ approach to classification. Therefore, a business model is different from mere ‘management intent’. For example, a savings bank that operates on the basis of an ‘originate and hold’ business model could not be turned into an investment bank over night even if management changes.

How to make a business model overlay operational

Using ‘held for trading’ as a starting point

15. The quickest way to make a business model overlay operational is to build on existing IFRS requirements.
16. The aspect of cash flows to the entity is to some extent reflected in the existing notion of ‘held for trading’. According to IAS 39.AG14:

‘[t]rading generally reflects active and frequent buying and selling, selling, and financial instruments held for trading generally are used with the objective of generating a profit from short-term fluctuations in price or dealer’s margin.’

⁶ This is consistent with the other areas such as segment reporting or business combinations.

⁷ For example the fair option in order to avoid separation of an embedded derivative (see IAS 39.11A) or an accounting mismatch (IAS 39.9).

17. However, this notion of trading is narrow in scope. It does not appropriately reflect all scenarios in which amortised does not provide useful information.⁸ Thus, held for trading is only one example of a type of business model that would require classification of a financial instrument into the fair value category (irrespective of its contractual characteristics).

Using the fair value option precondition regarding management and performance evaluation as a starting point

18. In the context of determining the appropriateness of fair value as the measurement basis IAS 39 in conjunction with the fair value option uses a broader scope than held for trading. One of the criteria that makes the fair value option eligible is the following scenario regarding the management and performance evaluation (FVO criterion):⁹

‘a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity’s key management personnel’ [emphasis added]

19. This FVO criterion is a good starting point because it focuses on:¹⁰
- (a) what is the more relevant information; and
 - (b) how financial instruments are actually managed (instead of their nature).

⁸ This was the view of many board members in the discussions about classification in the April and May 2009 IASB meetings. It is also reflected in the requirements in IAS 39 that prohibit amortised cost accounting for some instruments that are not classified as held for trading with the consequence of classification as available for sale.

⁹ See paragraph 9(b)(ii) of the definition of ‘financial asset or financial liability at fair value through profit or loss’ and IAS 39.AG4H – AG4K. These paragraphs are replicated in Appendix 1.

¹⁰ See IAS 39.AG4H.

20. Using the FVO criterion for making the business model criterion operational means it will become the basis for a *mandatory* classification (rather than making a choice eligible). In other words, financial instruments that are managed and whose performance is evaluated on a fair value basis in accordance with a risk management or investment strategy must be classified into the fair value category. This is a business model of fair value based management (FVBM).

Adaptations of the starting point

21. The different use of the FVO criterion proposed in this paper (ie for mandatory classification into the fair value or amortised cost category) warrants a discussion of what adaption of this starting point might be required for use as the FVBM criterion (eg changes or additional guidance).
22. The FVO criterion includes a reference to a *documented* risk management or investment strategy. This reflects that this criterion makes the FVO–presumed to be a desirable outcome for management– eligible. Conversely, the FVBM criterion will apply irrespective of whether management considers the classification outcome desirable. Thus, retaining the ‘documentation’ requirement could in some cases provide an unintended de facto ‘opt-out’ of mandatory classification simply by failing documentation requirements. Therefore, the staff recommends eliminating references to documentation.
23. (In fact, in the deliberations that led up to the FVO amendment in 2005, the Board, and others, deliberated at length whether to include the documentation requirement at all. Some were concerned that it would be likened to a hedge accounting documentation requirement, while others thought it was unnecessary and an audit rather than an accounting requirement).
24. The FVO criterion does not elaborate on what *evaluating the performance* on a fair value basis means other than using a ‘performance management system’

approved by key management personnel as an example. For use as a mandatory classification criterion this aspect may have to be more robust. To illustrate: if a business unit runs a loan book on the basis of an 'originate and hold' model it will likely *monitor* fair value information as well. For disclosure purposes every entity using IFRSs *must* determine the fair value of all financial instruments anyway. The question is what the difference between monitoring fair value information and *evaluating performance* on a fair value basis is. If there is none then the FVBM criterion would arguably preclude amortised cost altogether. Since (at least for disclosure purposes) fair value information must be generated requiring it to be ignored in order for an instrument to qualify for amortised cost would neither be operational nor sensible. Therefore, the staff recommends clarifying that performance evaluation is more than simply monitoring fair value information. One way of doing so might be using a similar notion to that used for segment reporting purposes: for example, a reference to the operating result that is regularly reviewed by the decision maker of the business (unit) to make investment decisions. The staff recommends making this aspect more robust (ie clarifying this aspect).

25. Because classification will be a central aspect of the new financial instruments standard(s) the Board should consider adding more examples to the FVO criterion for scenarios that might have been less important in the context of optional classification:
- (a) Clarify whether financial instruments that have a very liquid market and that are held to earn a return while being available as a 'liquidity reserve'¹¹ should be considered to be managed and their performance evaluated on a fair value basis in accordance with a risk management or investment strategy. Arguably, in some cases the performance may be evaluated on a yield rather than a change in fair value basis. But the liquidity management aspect would typically be fair value focused (as

¹¹ This might be financial instruments that do not qualify as cash equivalents (see IAS 7.7) because of their maturity on the date of acquisition exceeding what can be considered a 'short maturity'.

that is the cash amount that can be realised when using the liquidity reserve). Since the FVBM criterion requires both management *and* performance evaluation on a fair value basis the analysis would be that financial instruments held for the purpose of a liquidity reserve as set out above would qualify for the amortised cost category. The staff recommends that this is added as an example and—if that outcome is not the Board’s intention—be changed. However, if this outcome is not the Board’s intention, then the Board will also need to articulate the interaction with the two criteria suggested previously for the FVBM approach.

- (b) Add an example that illustrates in what circumstances a liquid government bond would qualify for amortised cost classification. For example, if the purpose of investing in a government bond is to minimise credit risk exposure the bond would qualify on the basis of the FVBM criterion.¹²

- 26. As a reminder: because of the nature of *amortised* cost equity instruments do not qualify for that measurement category. Therefore, the discussion in this paper does not include aspects specific to equity type investments.

Summary

- 27. This paper:
 - (a) explains why the business model matters for classification: because of its effect on the *actual* cash flows to the entity;

¹² This could be contrasted with the liquidity reserve example should the Board decide that the outcome should not be amortised cost classification; otherwise it might be contrasted with example where the investor in the government bond seeks exposure to interest rate changes in order to realise them, in which case the FVBM criterion would require classification into the fair value category.

IASB Staff paper

- (b) elaborates on the meaning of a business model: that it reflects how business activities are *actually* managed (and hence that one reporting entity can have different business models);
 - (c) proposes an approach how a fair value based management criterion could be made operational using the fair value option precondition regarding management and performance evaluation on a fair value basis as a starting point.
28. The staff recommendations and the questions to the Board regarding the classification approach (including the business model overlay) are included in agenda paper 2E.

Appendix 1

A1. Paragraph 9(b)(ii) of the definition of ‘financial asset or financial liability at fair value through profit or loss’:

A financial asset or financial liability at fair value through profit or loss is a financial asset or financial liability that meets either of the following conditions.

- (a) ...
- (b) Upon initial recognition it is designated by the entity as at fair value through profit or loss. An entity may use this designation only when permitted by paragraph 11A, or when doing so results in more relevant information, because either
 - (i) ...
 - (ii) a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity’s key management personnel (as defined in IAS 24 *Related Party Disclosures* (as revised in 2003)), for example the entity’s board of directors and chief executive officer.

A2. IAS 39.AG4H–AG4K:

Paragraph 9(b)(ii): A group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy

AG4H An entity may manage and evaluate the performance of a group of financial assets, financial liabilities or both in such a way that measuring that group at fair value through profit or loss results in more relevant information. The focus in this instance is on the way the entity manages and evaluates performance, rather than on the nature of its financial instruments.

AG4I The following examples show when this condition could be met. In all cases, an entity may use this condition to designate financial assets or financial liabilities as at fair value through profit or loss only if it meets the principle in paragraph 9(b)(ii).

- (a) The entity is a venture capital organisation, mutual fund, unit trust or similar entity whose business is investing in financial assets with a view to profiting from their total return in the form of interest or dividends and changes in fair value. IAS 28 and IAS 31 allow such investments to be excluded from their scope

IASB Staff paper

provided they are measured at fair value through profit or loss. An entity may apply the same accounting policy to other investments managed on a total return basis but over which its influence is insufficient for them to be within the scope of IAS 28 or IAS 31.

- (b) The entity has financial assets and financial liabilities that share one or more risks and those risks are managed and evaluated on a fair value basis in accordance with a documented policy of asset and liability management. An example could be an entity that has issued ‘structured products’ containing multiple embedded derivatives and manages the resulting risks on a fair value basis using a mix of derivative and non-derivative financial instruments. A similar example could be an entity that originates fixed interest rate loans and manages the resulting benchmark interest rate risk using a mix of derivative and non-derivative financial instruments.
- (c) The entity is an insurer that holds a portfolio of financial assets, manages that portfolio so as to maximise its total return (ie interest or dividends and changes in fair value), and evaluates its performance on that basis. The portfolio may be held to back specific liabilities, equity or both. If the portfolio is held to back specific liabilities, the condition in paragraph 9(b)(ii) may be met for the assets regardless of whether the insurer also manages and evaluates the liabilities on a fair value basis. The condition in paragraph 9(b)(ii) may be met when the insurer’s objective is to maximize total return on the assets over the longer term even if amounts paid to holders of participating contracts depend on other factors such as the amount of gains realised in a shorter period (eg a year) or are subject to the insurer’s discretion.

AG4J As noted above, this condition relies on the way the entity manages and evaluates performance of the group of financial instruments under consideration. Accordingly, (subject to the requirement of designation at initial recognition) an entity that designates financial instruments as at fair value through profit or loss on the basis of this condition shall so designate all eligible financial instruments that are managed and evaluated together.

AG4K Documentation of the entity’s strategy need not be extensive but should be sufficient to demonstrate compliance with paragraph 9(b)(ii). Such documentation is not required for each individual item, but may be on a portfolio basis. For example, if the performance management system for a department—as approved by the entity’s key management personnel—clearly demonstrates that its performance is evaluated on a total return basis, no further documentation is required to demonstrate compliance with paragraph 9(b)(ii).