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STAFF PAPER

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Project	**Financial instruments: classification and measurement**		
Paper topic	Business model assessment for financial assets		
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Purpose of the paper

1. This paper discusses the business model assessment for financial assets (specifically debt instruments).[1] The objective of this paper is to explore ways to align the business model assessment for the *amortised cost* classification category in IFRS 9 and in the FASB's tentative model.
2. This paper does not focus on whether financial assets that do not meet the amortised cost business model assessment should be classified at fair value though other comprehensive income (FVOCI) or fair value though profit or loss (FVPL). At a future meeting, the staff will bring a paper on:
   (a) The potential introduction of a third classification category under IFRS 9, ie FVOCI;

[1] In this paper financial assets refer to debt instruments and the terms are used interchangeably in the paper. Under IFRS 9, the business model assessment is performed first and hence is applied to the entire population of financial assets. However, the outcome of the business model test only matters for debt instruments because equity investments and derivatives do not qualify for a measurement category other than at fair value through profit or loss due to their contractual cash flow characteristics. Under the FASB's tentative model, the business model assessment is applied after the cash flow characteristics assessment.

(b) How to align the fair value classification categories (ie FVPL and FVOCI) in IFRS 9 and the FASB's tentative model, including whether one of these categories should be a residual and if so, which one, and;

(c) Other interrelated issues, such as recycling and reclassifications.

3. Therefore, this paper focuses on defining the business model assessment for amortised cost. This assessment would determine which financial assets will be classified and measured at amortised cost and which financial assets will be classified and measured at fair value.[2]

4. The staff is aware that the boards have different starting points in their respective classification and measurement models. The IASB is undertaking a project to consider limited modifications to IFRS 9. The FASB has developed a tentative classification and measurement model through redeliberations of its May 2010 proposed Accounting Standards Update[3] (proposed Update). Questions to the boards are designed to reflect the different starting points and to provide the boards an opportunity to jointly deliberate to a more converged position on the issues discussed.

Background

IFRS 9 approach

5. Under the IFRS 9 business model assessment, a financial asset qualifies for amortised cost if the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows (and satisfies the contractual cash flow characteristics assessment). Otherwise, the financial asset is classified at FVPL, ie FVPL is a residual category. There is no FVOCI category under IFRS 9

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[2] It should be noted that instruments that do not meet the cash flow characteristics assessment would be classified and measured at FVPL. Therefore, this paper assumes that only instruments that pass the cash flow characteristic assessment could qualify for classification and measurement at amortised cost.

[3] FASB Proposed Accounting Standards Update, Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities – Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815).

for debt instruments[4]. The assessment of 'hold to collect' does not depend on management's intention for an individual instrument but rather requires consideration of the objective of the business model as determined by the entity's key management personnel at a higher level of aggregation. IFRS 9 also provides an option to classify financial assets eligible for amortised cost at FVPL to address accounting mismatches.

6. Although the objective of an entity's business model may be to hold financial assets in order to collect contractual cash flows, the entity does not need to hold all of those instruments until maturity. Thus, sales of financial assets classified at amortised cost are permitted. IFRS 9 provides the following examples of when an entity may sell financial assets classified and measured at amortised cost:

   (a) the financial asset no longer meets the entity's investment policy (eg, the credit rating of the asset declines below that required by the entity's investment policy);

   (b) an insurer adjusts its investment portfolio to reflect a change in expected duration (ie, the expected timing of payouts); or

   (c) an entity needs to fund capital expenditures.

7. However, an entity needs to assess whether and how such sales are consistent with the objective of collecting contractual cash flows. This assessment is explicitly required if more than an infrequent number of sales are made out of a portfolio.

8. Financial assets that are held with the objective of realising cash flows through sale (eg an entity actively manages a portfolio to realise fair value changes arising from changes in credit spreads and yield curves) or financial assets whose performance is evaluated on a fair value basis do not meet the objective of collecting contractual cash flows. Also, a portfolio that meets the definition of held for trading is not held to collect contractual cash flows. Such portfolios would be classified at FVPL.

[4] Under IFRS 9, an entity may make an irrevocable election at initial recognition to present fair value gains and losses on an investment in an equity instrument in other comprehensive income (OCI).

9. Paragraphs B4.1.1–B4.1.6 in IFRS 9 provides guidance on an entity's business model for managing financial assets. The relevant application guidance from IFRS 9 is included in Appendix A of this paper.

10. IFRS 9 requires reclassification of financial assets if the objective of an entity's business model for managing financial assets changes. However, such changes in the business model are expected to be very infrequent and determined by senior management as a result of external or internal changes and must be significant to the entity's operations and demonstrable to external parties. A change in intention related to particular financial assets (even in circumstances of significant changes in market conditions), the temporary disappearance of a particular market for financial assets or a transfer of financial assets between parts of the entity with different business models are not changes in business model[5].

Feedback received on the IASB exposure draft

11. The majority of the respondents to the IASB exposure draft[6] (the IASB ED) supported the mixed measurement attribute approach proposed in the exposure draft, ie amortised cost and FVPL. These respondents also **supported the proposed conditions** for classifying financial instruments (ie the business model assessment and the contractual cash flows characteristics assessment) and believed that amortised cost provides relevant and useful information for qualifying assets because it reflects the entity's likely cash flows.

12. Furthermore, respondents **did not support the alternative approach** to classification and measurement set out in the IASB ED. The alternative approach proposed to restrict the amortised cost category to financial assets that:

    (a) pass the business model assessment (ie are held to collect contractual cash flows);

    (b) pass the contractual cash flow characteristics assessment; and in addition

[5] IFRS 9 paragraph B.4.4.3

[6] Exposure Draft ED/2009/7, Financial Instruments: Classification and Measurement

(c) meet the definition of loans and receivables, as defined in IAS 39[7].

13. Financial assets that passed the business model and the contractual cash flow characteristics assessments but were not loans and receivables would have been accounted for as follows:

    (a) changes in recognised value determined on amortised cost basis (including impairment) would be presented in profit or loss (P&L);

    (b) any difference between the amount in (a) and the fair value change for the period would be presented in OCI (without recycling).

14. All other financial assets would have been classified at FVPL.

15. In discussions with **users** of financial statements about the IASB ED, the IASB also received support for a mixed measurement model for financial instruments and for a model where amortised cost accounting is determined based on a 'hold to collect' notion. Investors consistently expressed a preference that loans and receivables be measured at amortised cost. For other debt investments (eg corporate or government debt), while some investors preferred a greater prominence for fair value information, the IASB did not receive significant requests for these items to be measured at fair value.

16. The staff have received feedback that some users believe that the mere availability of quoted prices should be elevated as a consideration in classification of financial assets. However, while some investors have expressed this view to the IASB, other investors are of the view that irrespective of the nature of the instrument, if it is held to collect contractual cash flows, amortised cost provides useful information.

[7] IAS 39 defines loans and receivables as 'non-derivative financial assets with fixed or determinable payments that are not quoted in active market other than (a) those that an entity intends to sell immediately or in the near term, which shall be classified as held for trading, and those that the entity upon initial recognition designates as at fair value through profit or loss; (b) those that an entity upon initial recognition designates as available for sale; or (c) those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which shall be classified as available for sale'.

Feedback received on IFRS 9

17. Subsequent to the publication of IFRS 9, the IASB has received feedback from some constituents regarding the need for a FVOCI classification category. This feedback mainly relates to the potential accounting mismatch that may arise due to the interaction between accounting for financial assets and accounting for insurance liabilities under the insurance contracts project (currently being deliberated by the boards). If a financial asset portfolio held by an insurer qualifies for amortised cost, an accounting mismatch arises because insurance liabilities are measured at current value through profit or loss. This mismatch in effect could be eliminated through the use of the fair value option for financial assets. However, respondents to the Insurance Contracts ED have stated that a better solution would be to reintroduce a FVOCI classification category.

18. Some other constituents have also highlighted concerns about the business model criteria resulting in outcomes that are too limited, ie an entity holds assets either to collect contractual cash flows or to sell and realise fair value changes. Some of these constituents have noted the available-for-sale category in IAS 39 was useful for those strategies in which an entity holds financial assets for as long as it wanted but would sell when there is a good opportunity. Constituents have questioned whether FVPL appropriately reflects this business strategy. In addition, some have expressed the view that the removal of such a category makes it more difficult to apply IFRS 9's business model criteria to an entity's business models and its business behaviours.

19. The IASB also has received questions from constituents on the application of the IFRS 9 business model test to liquidity portfolios. These constituents indicated that significant judgement is involved in classifying some liquidity portfolios into an amortised cost or FVPL category and there may be some inconsistency in interpretation of whether the business model is to hold to collect contractual cash flows.

20. Additionally, some constituents have raised questions about what level of turnover is 'more than infrequent' and the degree to which 'some sales would not contradict' the objective of the amortised cost category. For example, would sales of 5 percent be acceptable in most circumstances (eg if the asset sold is always the

one with the highest difference between fair value and cost) or could a turnover of 20 percent be acceptable in some circumstances (eg the asset no longer meets the investment objective or there is an unexpected need for cash)? Questions have also been raised about whether frequency should be measured based on number of sales or volume of sales.

FASB's tentative approach

21. The FASB's tentative classification and measurement model also requires an assessment of the entity's business model for acquiring and managing financial assets. An entity would classify financial assets (originated or acquired) either at amortised cost, FVOCI or FVPL (assuming the cash flow characteristics criterion is met) on the basis of the ***business activity*** the entity uses in acquiring and managing those financial assets. This business activity approach does not include a notion of the assets being held for a particular period or length of time but rather focuses on the strategy that resulted in an entity's initial recognition of the financial assets. Similar to IFRS 9, the assessment of the business model is performed at a higher level of aggregation rather than being based on an entity's intent for an individual instrument. An entity may have more than one business model for managing its financial instruments. Paragraphs 23 - 30 describe the business activity conditions applicable to the three classification categories.
22. The FASB's tentative model requires classification of financial assets upon initial recognition and prohibits reclassification between classification categories subsequent to initial recognition. Furthermore, for financial assets classified at FVOCI, credit impairments, and realised gains and losses from sales or settlements would be recognised in net income.

Amortised cost

23. For financial assets to be classified at amortised cost, an entity's business model must be to manage the instrument through ***lending or customer financing activities***. The purpose of an entity's lending activities is to provide competitive sources of funding to meet the financing needs of customers and generate income

from the fees and interest charged to those customers. Therefore, lending or customer financing activities involve financial assets that are held to earn a return on the initial outlay of cash through the return of principal plus interest over the effective life of the instrument.

24. The key components of lending or customer financing activities involve (1) collection of *substantially all* of the contractual cash flows from the borrower and (2) the lender’s ability to manage credit risk by negotiating any potential adjustment of contractual cash flows with the counterparty in the event of a potential credit loss.

25. Furthermore, the business activity conditions for amortised cost classification also permit sales of financial assets under limited circumstances. That is, sales are permitted either to (1) minimise losses due to deteriorating credit or (2) exit a particular market for risk management purposes. Therefore, financial assets originated or acquired that meet the conditions of a lending or financing activity discussed above result in those financial assets being classified at amortised cost.

26. ***Activities*** that typically would be associated with a business model that would be classified into the amortised cost category ***include***:

    (a) The financial assets are issued or acquired through a business activity primarily focusing on the collection of contractual cash flows and the collection of the fees charged to customers, with the primary objective of generating profits from the spread between the interest collected and the interest paid on the liabilities used to fund the assets.

    (b) The business activities occur in a lending operation that is typically conducted by a financial institution or in a financing operation that is typically conducted by a non-bank entity with a financing subsidiary.

    (c) The ultimate cash flows are expected to come from the original counterparty, rather than from a sale of the asset to a third party.

    (d) The financial assets for which credit risk is the primary risk monitored by management, acknowledging that management typically monitors the fair value of these financial assets to a certain extent. These instruments are not held for sale.

FVOCI

27. For financial assets to be classified at FVOCI, an entity's business model must be to manage the financial assets as part of the entity's ***investing activities***. The primary purpose of an investing activity is to invest the excess capital of the entity to (1) maximise the total return on the investment or (2) manage the interest rate or liquidity needs of the entity. An entity may either hold or sell financial assets that are being managed as part of an investing activity to achieve its investing objective. However, the financial assets may not be held for sale at acquisition or issuance (ie initial recognition).

28. ***Activities*** that typically would be associated with a business model that would be classified into the FV-OCI category ***include***:

    (a) The financial assets are acquired in a business activity that invests the excess cash of the entity for income generation and manages the interest rate or liquidity risk of the consolidated entity.

    (b) The financial assets may be sold for strategic purposes, thus realising gains or losses through earnings. Any sales or purchases are primarily made to support the entity's risk management and investment objectives through adjusting the interest rate or liquidity risk profile.

    (c) The financial assets are held for liquidity or capital adequacy purposes or to execute a particular interest rate risk positioning strategy by selecting a risk profile that may change over time.

    (d) The ultimate cash flows come from either the original counterparty of the instrument or from a third party through sale of the asset.

FVPL

29. For financial assets to be classified at FVPL, an entity's business model must be to hold the instrument for sale or actively manage and monitor the assets at fair value.

30. ***Activities*** that typically would be associated with a business model that would be classified into the FVPL category ***include***:

    (a) All financial assets held by the entity for trading purposes or held for sale.

    (b) Financial assets issued, purchased, or sold for short-term profit taking.

    (c) Inventories or portfolios of financial instruments managed to satisfy the needs of clients who wish to buy or sell those financial instruments.

    (d) Financial assets that are actively managed and monitored internally on a fair value basis because the price at which they can be sold or hedged is an important factor in the profitability and risk of the portfolio.

    (e) Cash flows related to the financial assets are expected to come from a third party through sale, rather than through the original counterparty of the instrument.

Feedback received

31. The FASB's tentative model has been developed based on the extensive feedback received from constituents on its proposed Update (and other outreach activities conducted by the FASB staff with users, preparers, auditors and other practitioners). Under the proposed Update, most financial instruments would have been reported on an entity's statement of financial position at fair value, with limited exceptions for short-term receivables and payables, some other investments, and an entity's own debt. For financial instruments measured at fair value, the default accounting would have been to recognise changes in fair value in net income. However, an entity could elect, provided that both the proposed

cash flow characteristics criteria[8] and the business model criteria (ie, held to collect or pay the related contractual cash flows rather than to sell or settle with a third party) were met, to recognise qualifying changes in fair value in OCI.

32. The feedback received indicated that many constituents favoured a mixed measurement attribute model (ie amortised cost and fair value). Many preparers stated that there are three distinct business activities (ie lending, investing and trading) that are consistent with the entity's stated risk management objectives. Feedback from **investors** indicated that debt securities for which a readily available market price exists should be measured at fair value; most investors indicated that measuring all debt securities at fair value would be preferred.

33. Subsequently, the FASB staff conducted outreach with various constituents on the application of the amortised cost business model assessment under the tentative model that has been developed in re-deliberations of the proposed Update (specifically, the application of 'the ability to manage credit' criterion) to loan participation and syndication arrangements. The feedback indicated that loan participations and syndications would be a topic for which additional implementation guidance is needed to apply 'the ability to manage credit' criterion. For example, these constituents noted that typically with loan participations the lead bank manages the credit risk of the borrower on behalf of the participating banks, and based on the facts and circumstances surrounding the participation agreement, the participants may or may not have the ability to 'manage the credit risk'. On the basis of the feedback received, the staff believe that introducing an 'agent versus principal' notion into the amortised cost criterion or providing examples within the implementation guidance may be potential alternatives to address constituents' concerns and clarify whether an interest in a

[8] Under the FASB's May 2010 exposure draft, the cash flow characteristics criteria stipulated that the instrument is a debt instrument held or issued with the following characteristics: (a) there is an amount that is transferred at inception and returned at maturity or other settlement, which is the principal amount; (b) the contractual terms identify any additional cash flows (eg interest) to be paid to the creditor; and (c) the instrument cannot contractually be prepaid or otherwise settled in such a way that the investor would not recover substantially all of its initial investment, other than through its own choice. In addition, the FVOCI category was permissible only if the instrument does not contain an embedded derivative that is not clearly and closely related to the host instrument.

loan participation or syndication would qualify for amortised cost measurement; however, such alternatives would need to be further explored and developed.

Proposed Alternatives – Amortised Cost Category Business Model[9]

34. The assessment of the business model criteria for amortised cost classification under IFRS 9 and the application of the FASB's tentative business model results in similar outcomes for many assets (eg loans and receivables and closely-held bonds that are originated or purchased within a 'hold to collect' business model). However, in other cases the criteria result in different classification and measurement outcomes for financial assets.

35. The FASB's amortised cost classification category is generally more restrictive than that under IFRS 9; however, both IFRS 9 and FASB's tentative business model for amortised cost classification include the notion of collection of contractual cash flows. Under IFRS 9, holding to collect contractual cash flows is the primary criterion for amortised cost classification, whereas under the FASB's tentative model, it is a characteristic of a business activity defined model, which is based on a lending or customer financial activity (as discussed in the background section above). The main consequence of this difference is that while a widely-held bond with qualifying cash flow characteristics that is held within a hold to collect contractual cash flows business model would be measured at amortised cost under IFRS 9, it would generally be classified and measured at FV-OCI under the FASB's tentative model.

36. Given different starting points under the boards' respective business model assessments for amortised cost classification, the staff have presented **three** alternatives for the boards' consideration for a definition of the business model that would result in measurement of financial assets at amortised cost[10]. Financial

[9] An entity must assess both the cash flow characteristics and the business model for the classification and measurement of financial assets. However, this paper focuses solely on the business model assessment.

[10] Provided that the financial assets are eligible for classification at amortised cost under the contractual cash flow characteristics assessment.

assets that do not meet the amortised cost business model criteria will be measured at fair value[11].

37. Under all of these alternatives, no changes are proposed either to the point in time at which the business model is considered in classifying financial assets or to the level at which the business model is assessed compared to in IFRS 9 and the FASB's tentative model. Therefore, the assessment of the amortised cost business model will be performed at initial recognition. In addition, the business model assessment would not depend on management's intention for an individual instrument but rather would require consideration of the objective of the business model as determined by the entity's key management personnel at a higher level of aggregation, and may result in an entity having more than one business model for managing its financial assets.

Alternative 1 – held for collection of contractual cash flows

38. This alternative builds upon the primary *objective* of holding financial assets. This alternative is consistent with the principle in IFRS 9 but provides an adjustment to IFRS 9 to address questions received by the IASB about when sales are consistent with the notion of holding financial assets to collect contractual cash flows.

39. Under this alternative, the following would be retained from IFRS 9:

   (a) financial assets would qualify for amortised cost if the assets are held within a business model whose objective is to hold the assets in order to collect contractual cash flows;

   (b) the assessment of 'held to collect' would not depend on management's intention for an individual instrument but would rather require consideration of the objective of the business model as determined by the entity's key management personnel at a higher level of aggregation;

[11] Whether instruments that fail the amortised cost business model criteria would be classified and measured at FVOCI or FVPL will be discussed at a future meeting. This paper does not discuss the classification between these potential two fair value measurement categories; rather it proposes alternatives for amortised cost classification in order to draw a "line" between the amortised cost and the fair value classification categories.

(c) financial assets that are held with the objective of realising cash flows through sale (eg an entity actively manages the portfolio to realise fair value changes arising from changes in credit spreads and yield curves) or financial assets whose performance is evaluated on a fair value basis would not meet the objective of collecting contractual cash flows and therefore would be classified at fair value;

(d) a portfolio that meets the definition of held for trading would not be held to collect contractual cash flows and therefore would be classified at fair value; and

(e) an entity would consider how management is compensated in assessing the objective of the business model.

40. Under this alternative and similar to IFRS 9, although the objective of an entity's business model may be to hold financial assets in order to collect contractual cash flows, the entity would not need to hold all of those instruments until maturity for the portfolio to qualify for amortised cost. Additionally, there would not be a tainting concept.

41. Consistent with IFRS 9, in order to determine the business model, an entity would need to consider prior selling activity and anticipated future selling activity for the financial assets being assessed to determine whether the financial assets qualify for a 'hold to collect' business model, and thus classified and measured at amortised cost. The change to IFRS 9 under this alternative would be to provide additional guidance on when sales are consistent with a 'hold to collect' business model.

42. This alternative would (re)confirm the guidance in IFRS 9 that an entity may sell a financial asset when it no longer meets the entity's investment policy due to credit deterioration. Such sales would be consistent with a 'hold to collect' business model.

43. For sales other than for credit deterioration, the frequency of past sales and expectations of frequency of future sales would be important. Under this alternative, infrequent sales out of a portfolio that are made with the objective of financing capital expenditures would not be inconsistent with the objective of

holding financial assets to collect contractual cash flows. However, frequent sales to finance capital expenditures would not be consistent with that objective. Similarly frequent sales with the objective of rebalancing the portfolio as part of asset-liability management strategies or as part of active liquidity risk management (such as for a portfolio that is required for regulatory purposes to be actively managed) would not be consistent with that objective. Consequently, financial assets managed in that way would not be eligible for classification at amortised cost. This alternative would address the current inherent tension in IFRS 9 between some of the examples of when an entity may sell financial assets classified and measured at amortised cost (ie sales to manage duration for insurance companies and to fund capital expenditures) and the frequency of sales guidance.

44. This alternative would not define that the notion of 'frequent sales'. Rather, the guidance would be kept at a principle level and judgement would be required.

Alternative 2 – Hold for collection of contractual cash flows plus factors and indicators

45. This alterative builds upon the primary *objective* of the amortised cost business model and lays out the relevant *factors* an entity would consider to support its assessment of the objective of collecting contractual cash flows and how the entity expects to realise value from those financial assets.

46. Under this alternative, the criterion for classifying and measuring financial asset(s) at amortised cost is if **the asset(s) are held within a business model whose objective is to hold financial assets in order to collect contractual cash flows**. In evaluating the objective, an entity would be required to consider:

(a) the primary exposure/risk the entity is managing and how it is managed,

(b) how it expects to realise the contractual cash flows,

(c) specified indicators, and

(d) the nature of sales[12].

47. The assessment of these factors in total would determine whether the objective of the business model 'is to hold financial assets in order to collect contractual cash flows' and would require use of judgment. These factors are further discussed below.

48. **Primary exposure (interest rate, liquidity or credit risk) and how it is managed** – In assessing whether the objective is to hold financial assets to collect contractual cash flows, an entity would assess the primary exposure (or risk) it is managing in respect of the financial asset(s).

49. *Interest rate risk* – Entities hold assets and liabilities that have different maturities, interest rates, prepayment characteristics, and other options or provisions, which give rise to interest rate risk in each time period over the life of the assets or liabilities. One of the ways that an entity that elects to manage these exposures can manage its sensitivities to changes in interest rates throughout the effective lives or maturities timelines is by purchasing non derivative instruments with opposite or contrasting interest rate profiles to the exposure being managed. Therefore, in order to manage those exposures in each time period along the yield curve, entities may purchase highly liquid, high credit-quality, interest rate sensitive debt instruments for management of interest rate risk. For the assessment of the business model, an entity would need to consider *how* interest rate risk is managed. For example, the following would be consistent with the notion of a 'hold to collect' business model assuming buying and selling activities are infrequent:

(a) managing net interest margin by matching duration of financial asset and liabilities; or

(b) maintaining the desired fixed-to-floating ratio.

50. *Liquidity risk* – Because entities manage their exposures to particular financial instruments, financial assets may also be managed from a liquidity risk

[12] The staff note that consideration of sales out of a portfolio is a part of the business model assessment under IFRS 9 and the FASB's tentative model.

perspective, and thus are usually held for longer periods than those held in a trading or held-for-sale portfolio. In order to manage liquidity risk (including duration mismatches arising from managing financial obligations), an entity may hold highly liquid assets that can be sold in a timely manner to respond to changes in the liquidity risk profiles of the entity. That is, financial assets are sold and purchased to rebalance the portfolio to match the risk profile or exposure desired by the entity. Such rebalancing may occur infrequently in stable interest rate, liquidity, and economic environments. Alternatively, very rapid or unexpected changes in market conditions may necessitate more frequent or more significant rebalancing.

51. In addition, entities may hold financial assets that will be sold if a need for cash arises. For example, financial institutions hold liquidity portfolios to ensure they have ready access to cash. Many regulated financial institutions are often required to hold such portfolios and may also be required to demonstrate the liquidity of the portfolio by showing a particular level of sales activity. Other entities also hold financial assets to manage their cash flow needs. These holdings may be relatively small to address working capital needs or at more significant levels such as in anticipation of a business combination. An entity holding financial assets for these purposes would seek to maximise their return from holding the assets, which in part comprises the contractual cash flows realised by holding the assets. However, when liquidity needs arise they will sell the asset(s).

52. The relative importance of these objectives, and thus the primary risk being managed, will depend on the nature of the entity and the liquidity needs that are being managed. For example, if a bank holds a portfolio of long-term bonds to meet liquidity needs and is required to demonstrate that the portfolio is liquid by frequently selling a significant portion of the portfolio, the primary objective is to manage liquidity risk so it is unlikely that (at the portfolio level) those assets are held to collect contractual cash flows. In contrast, if a non-financial entity holds a portfolio of short-term high quality bonds in preparation for a planned purchase of plant and equipment after the maturity date of those bonds, the primary objective is likely to be managing the credit risk. Hence, this strategy could be consistent with the objective of holding to collect contractual cash flows.

53. *Credit risk* – An entity also may originate or acquire financial assets to solely earn investment income by collecting contractual cash flows (ie interest payments). As part of this strategy the primary exposure or risk the entity manages is the credit risk of the counterparty. As such, managing this exposure may entail selling the asset(s) to reduce credit exposure as a result of a significant deterioration in the issuer's creditworthiness or working with the obligor.

54. Therefore, an assessment of the primary exposure the entity is managing and how the exposure is managed may indicate whether the objective of the entity's business model is to hold the financial asset(s) for collection of contractual cash flows. If the entity's objective is to primarily manage credit exposure/risk it may sell the asset(s) due to significant deterioration in issuer's creditworthiness. Such a strategy would be consistent with the objective of holding to collect contractual cash flows. In contrast, if the entity is primarily managing interest rate risk by matching duration/frequent buying and selling or liquidity risk where the expectation is that significant selling activity will occur, such a strategy may be indicative of future sales (or rebalancing) in the portfolio and thus may be inconsistent with the objective of collecting contractual cash flows.

55. **Value realisation –** Under this concept, the focus is the method of realisation of value changes. For example, if an entity actively manages a portfolio of assets in order to earn a yield by realising fair value changes arising from changes in credit spreads and yield curves through the sales of such assets, its business model is not simply to hold those assets to collect the contractual cash flows. Similarly, portfolios of financial assets that are actively held-for-trading do not meet the objective of collecting contractual cash flows[13]. Therefore, if an entity's business model is based on an objective of managing for yield, including through sales of instruments, such a strategy would result in instruments being measured at fair value.

56. Alternatively, circumstances may exist in which an entity's business model is to hold a portfolio of financial assets to collect the contractual cash flows but it may

[13] The staff note that this is included in the business model assessment currently under IFRS 9 and the FASB's tentative model.

sell the financial asset(s) after a substantial portion of the principal amount has been recovered. For example, an entity may have a model whereby it sells its investment in mortgage backed securities (eg pursuant to a 'clean-up' call) after a substantial portion of the principal has been received through prepayments . It is suggested if an entity's business model will result in it collecting *substantially all* (eg, 90 per cent or more) of the initial investment in the financial asset that this be accepted as not invalidating the primary objective of holding to collect contractual cash flows.

57. **Indicators** – In assessing whether the objective of the business model is to hold the assets for collection of contractual cash flows, the boards could specify that an entity also must consider market based, entity-level, and instrument-specific indicators. The presence (or lack thereof) of one or more indicators by itself would not be determinative that the entity's objective is not to hold the assets for collection of contractual flows. However, the indicators should be assessed along with the other factors (discussed above) to determine the objective of an entity's business model. The staff have identified three possible indicators the boards could consider in evaluating whether a business model qualifies for amortised cost classification and measurement. The boards could decide to require an entity to consider each of these indicators or some of them (or others) as outlined below:

    (a) *Term of the instrument* – This indicator is centred on the notion that longer the term to maturity of the instrument, the greater the judgment and uncertainty involved in assessing the objective of holding to collect contractual cash flows, as an entity's strategy may be altered by changes in the economic and business environment . Therefore, if the instrument is 'so near its maturity', the entity may be able to determine at initial recognition that its objective is to hold the instrument to collect contractual cash flows. Similarly, for a longer term to maturity, an entity may be unable to determine solely on the basis of this indicator that its objective is to hold the instrument for collection of contractual cash flows. It is important to note that this is only an indicator and should be evaluated with other factors under this alternative, including the primary exposure being managed (eg many retail banks originate long-term mortgages that they clearly hold with the objective of collecting the contractual cash flows and may manage the credit risk of the counterparty by selling the assets). Accordingly, the boards may need to consider how this indicator would be assessed in conjunction with the primary exposure the entity is managing.

(b) *Readily determinable fair value or liquidity* – This indicator focuses on the marketability or liquidity of the instrument. The marketability or liquidity of the instrument could assist in determining whether the entity's primary objective is to hold to collect contractual cash flows. For example, it is more likely that an entity that may potentially sell financial assets to realise cash flows would acquire instruments with a readily determinable fair value or that may be readily sold to realise cash. Whereas, financial assets with non-readily determinable fair values or that are relatively illiquid may be more difficult to sell in the immediate future and, thus, be indicative of a strategy that the financial assets may be held for collection of contractual cash flows.

(c) *Management compensation* – This indicator focuses on how management compensation is determined. That is, if the compensation of those that manage the financial assets is based on changes in fair value of financial assets it would be indicative of a business model that the financial assets may not be held for collection of contractual cash flows[14]. Generally, managing a portfolio of financial assets on a fair value basis is inconsistent with holding to cash collect and, therefore, would result in being classified and measured at fair value.

58. As noted above, the staff believe that the boards could decide to require an entity to consider each of these indicators or some of them (or others). Furthermore, the boards also would need to consider whether the presence of one or more of these

[14] This is consistent with IFRS 9 that specifically requires the consideration of how management is compensated in the assessment of the business model.

indicators would override the value realisation notion described in paragraphs 55 - 56 that relies on management's assertion to collect the contractual cash flows[15].

59. **Sales** - In assessing the objective and considering the relevant factors outlined above, inherent in the assessment of these factors is consideration of sales that have occurred out of the portfolio and whether such sales are consistent with the objective of collecting contractual cash flows. Sales due to management of credit exposure, for example, when there has been a significant decline in the issuer's creditworthiness, would not be inconsistent with the notion of holding to collect contractual cash flows. However, frequent sales due to rebalancing a portfolio as part of liquidity or interest rate exposure management would not be consistent with that notion. An entity would need to assess what sales have occurred and why in order to conclude whether the business model is truly 'hold to collect'.

Alternative 3 – Business activity based approach

60. This alternative, which is similar to the FASB's tentative model, results in amortised cost classification for debt instruments that are generated through a lending or customer financing *business activity*. Similar to Alternative 2, this alternative also considers the primary exposure/risk the entity is managing. However, unlike Alternative 2, Alternative 3 does not focus on how an entity's expects to realise the contractual cash flows from the financial asset(s). Rather, this alternative also focuses on the business activity the entity utilises in acquiring and managing those financial assets.

61. The purpose of an entity's lending activities is to provide competitive sources of funding to meet the financing needs of customers and generate income on the fees and interest charged to those customers. In some instances, lending activities naturally incorporate the notion of a relationship with the customer and the intention of managing that relationship over a long period of time. Lending activities do not include portfolios held as inventory to be sold to satisfy a client's demand or an entity's capital needs, but rather include portfolios held to earn a

[15] The staff do not believe that the term of the instrument in and of itself would be indicative of the business model and value realisation. Rather the term of the instrument would need to be considered in conjunction with other factors.

return on the initial outlay of cash through the return of principal plus interest over the effective life of the loans.

62. Furthermore, lending decisions are based on an assessment of the ability of the borrower to generate sufficient future cash flows to meet payment obligations over time. Additionally, financial assets held in lending or customer financing portfolios (as this activity is described above) will be held for collection of contractual cash flows rather than being sold, and thus their current fair value is not typically the primary metric for risk management or business performance measurement purposes. As such, the primary measures used to manage and assess the performance of lending or customer financing activities may include, but are not limited to credit risk, counterparty risk ratings and credit scores, net interest margin, nonperforming loan statistics, loan delinquency levels, or net charge-offs.

63. Under this proposed approach, credit risk is the primary risk assessed and monitored by the management in order to qualify for amortised cost measurement. As such, as part of managing credit risk the entity would be expected to have the ability to manage the cash flows or negotiate modifications to the cash flows from the instrument in the event of a potential credit loss. This emphasises that the entity has the ability to modify the terms of the financing arrangement with the original counterparty rather than being limited to a discounted sale to a third party in the event of a substantial credit deterioration of the counterparty.

64. Therefore, this lending based business activity alternative would require the consideration of the following in determining whether a financial asset qualifies for amortised cost measurement:

> Financial asset is acquired/originated and managed as part of a lending or customer financing activity, with the primary objective of managing the credit risk and collecting substantially all of the contractual cash flows on the instrument. As part of managing the credit risk the entity has the ability to negotiate any potential adjustments to contractual cash flows with the counterparty in the event of a potential credit loss.

65. Alternatively, the boards may wish to consider whether the ability to manage cash flows by negotiating modifications to the cash flows from the instrument in the

event of a potential credit loss should be included as a rebuttable presumption or an indicator rather than a requirement in assessing whether an entity's business activity qualifies for amortized cost. However, such an alternative would need to be further explored and developed.

66. Similar to the other alternatives, under Alternative 3 sales due to management of credit exposure would be consistent with the amortised cost business model (eg, when there has been a significant decline in the issuer's creditworthiness). However, sales due to rebalancing a portfolio as part of liquidity or interest rate exposure management would not be consistent with the proposed criteria.

67. This alternative would generally result in particular debt instruments (eg widely held bonds) not being measured at amortised cost. Such instruments would not qualify for amortised cost because in many cases the lender does not have the ability to negotiate contractual terms with the counterparty. Whereas, generally loans and other similar arrangements (eg some closely held bonds), in which the entity's objective is to manage credit risk by (1) having the ability to negotiate modification to terms of the instrument in the event of potential credit loss and (2) collect substantially all of the contractual cash flows, would be measured at amortised cost.

68. If the boards were to select this alternative, the staff will bring back for the boards consideration how the assessment of a lending business activity based model would apply to particular arrangements, such as loan participations and syndication arrangements and for government bonds in some jurisdictions.

Staff Analysis

69. While Alternatives 1 and 2 similarly focus on how an entity expects to realise the contractual cash flows, Alternative 3 focuses on how an entity manages its financial assets. Nonetheless, all alternatives result in many debt instruments being classified in a similar way. The key difference in outcomes generally is in the classification of debt instruments other than loans and receivables. Alternative 1 results in widely-held debt securities that are 'held to collect' contractual cash flows being measured at amortised cost. Alternative 2 provides additional guidance (ie factors and indicators) that an entity would be required to assess to

determine whether its business model qualifies for amortised cost classification. Alternative 3 would typically exclude widely-held debt instruments from being measured at amortised cost as a result of its lending business activity focus that would require the holder has the ability to negotiate contractual terms with the counterparty.

70. Alternative 1 and Alternative 2 are anticipated to result in less debt instruments qualifying for amortised cost compared to IFRS 9 and, thus, to reduce some of the different outcomes compared to Alternative 3. Alternative 1 achieves this result by being more restrictive about the amount of selling activity that is accepted in a hold to collect business model. Alternative 2 also includes restrictions about the selling activity as well as indicators to support amortised cost classification.

71. Alternative 1 focuses on a broad business model in which the primary objective is holding to collect contractual cash flows. This alternative is most consistent with the current business model assessment in IFRS 9 but seeks to address application questions received by the IASB regarding the acceptable frequency of sales. Alternative 1 would result in the least change from IFRS 9 and addresses a known practice issue with IFRS 9. It may be preferred by IFRS constituents that have already adopted or in the process of early adopting IFRS 9.

72. Alternative 2 is largely aligned with IFRS 9 but introduces additional factors and indicators that inform the assessment of the objective of the entity's business model. With this alternative, the boards would need to consider which indicators (as described in paragraph 57) should be included in the assessment and how these indicators would be evaluated with the other factors (ie primary exposure managed, value realisation and sales) in determining whether the objective of an entity's business model is to collect the contractual cash flows. The staff think that the indicators and factors included with this alternative are broadly consistent with the objective of the business model assessment currently included in IFRS 9 and could help to address the application issue with the current frequency of sales criterion in that standard. However, some may believe this alternative would result in the indicators and factors being viewed as a list of rules and, thus, being onerous to apply.

73. Alternative 3 focuses on the business activity an entity uses in originating, acquiring, and managing financial assets and is broadly consistent with feedback received by FASB during the development of the FASB tentative model, including feedback received from users and preparers as described above in paragraphs 31 - 33. Some believe this alternative may be too restrictive in its design about which business models qualify for amortised cost. That is, this alternative would be limited to lending activities and would generally prohibit particular debt instruments from being measured at amortised cost, even when an entity's business model is a hold to collect strategy.

Recommendation

74. The staff acknowledges merit with all proposed alternatives. Some of the staff members prefer Alternative 1, while others prefer Alternative 3.

75. Those that prefer Alternative 1 believe it is closely aligned with the manner in which an entity may manage the financial assets it holds. For example, some entities may acquire liquid debt instruments in a buy-and-hold strategy which they will not sell. These staff members believe that limiting amortised cost measurement to lending activities as described in Alternative 3 could be perceived as a form-over-substance approach. That is, an entity may have a business model to hold debt securities for the collection of cash flows just as any loan pool may be held for the collection of cash flows. Consequently, these staff members noted such instruments may not be managed on a fair value basis or from a liquidity point of view, but rather are held for the collection of principal and interest. Furthermore, some of these staff members are concerned about applying the notion in Alternative 3 that an entity would have the ability to manage the cash flows or negotiate modifications to the cash flows from the instrument in the event of a potential credit loss. They believe this notion could require detailed legal analysis to make the assessment and the outcomes may be dependent on the legal environment of a particular jurisdiction and thus may not result in comparable financial reporting. They also question the relevance of the ability to manage credit when a financial asset is of such high quality that there is no expectation that such rights would be needed.

76. Those that prefer Alternative 3 believe this approach best aligns with the actual business functions of entities and provides more transparent information to users of financial statements, as they believe that Alternative 3 aligns the classification and measurement of financial assets with how and why an entity originated or acquired its financial assets. Furthermore, these staff members believe that since the determining factors between the primary measurement attributes of fair value and amortised cost are the objective of business activities rather than management's intent with regard to the holding period, there would be less subjectivity in determining a financial instrument's measurement attribute or classification. Therefore, these staff members believe that Alternative 3 would result in increased comparability of financial statements.

77. The staff members that prefer Alternative 3 note that during the FASB's outreach activities with users, preparers, and other practitioners that there was considerable concurrence that loans and lending activities should not be measured at fair value. Although many constituents commented on investing activities, there was significant diversity among constituent groups regarding the appropriate measurement attributes of securitized and more liquid instruments, with users often supporting fair value measurements for marketable instruments and other non-loan type instruments. The staff members that prefer Alternative 3 note this approach addresses the key concern of constituent groups (namely, users and preparers) by objectively segregating loans and lending activities from more marketable instruments in a manner that seems to align with the business models of many institutions, including most financial institutions. Furthermore, these staff members believe that issues related to reclassifications and tainting are less critical under Alternative 3. The assessment and classification of financial assets in this approach focus on the activities or business functions an entity utilises to acquire and manage financial assets rather than on an entity's 'hold to collect'" strategy for its financial assets.

Questions 1- 3 for IASB

1) Which alternative does the IASB prefer?

2) If Alternative 2, which of the proposed indicators included in paragraph 57 does the board wish to incorporate in the assessment of the objective of the amortised cost business model? Additionally, how should an entity evaluate those indicators with the other factors?

3) If Alternative 3, does the board believe that the requirement to negotiate modifications of the contractual cash flows should be included as a requirement, rebuttable presumption or as an indicator?

Questions 1-3 for the FASB

1) Which alternative does the FASB prefer?

2) If Alternative 2, which of the proposed indicators included in paragraph 57 does the board wish to incorporate in the assessment of the objective of the amortised cost business model? Additionally, how should an entity evaluate those indicators with the other factors?

3) If Alternative 3, does the board believe that the requirement to negotiate modifications of the contractual cash flows should be included as a requirement, rebuttable presumption or as an indicator?

Appendix A – IFRS 9 business model guidance

Classification of financial assets

A1. Unless paragraph 4.1.5 applies, an entity shall classify financial assets as subsequently measured at either amortised cost or fair value on the basis of both:

(a) the entity's business model for managing the financial assets and

(b) the contractual cash flow characteristics of the financial asset.

A2. A financial asset shall be measured at amortised cost if both of the following conditions are met:

(a) The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.

(b) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

Paragraphs B4.1.1–B4.1.26 provide guidance on how to apply these conditions.

A3. For the purpose of applying paragraph 4.1.2(b), interest is consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time.

A4. A financial asset shall be measured at fair value unless it is measured at amortised cost in accordance with paragraph 4.1.2.

Option to designate a financial asset at fair value through profit or loss

A5. Despite paragraphs 4.1.1–4.1.4, an entity may, at initial recognition, irrevocably designate a financial asset as measured at fair value through profit or loss if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases (see paragraphs B4.1.29–B4.1.32).

A6. IFRS 7 *Financial Instruments: Disclosures* requires the entity to provide disclosures about financial assets it has designated as at fair value through profit or loss.

Application guidance

Classification of financial assets

The entity's business model for managing financial assets

A7. Paragraph 4.1.1(a) requires an entity to classify financial assets as subsequently measured at amortised cost or fair value on the basis of the entity's business model for managing the financial assets. An entity assesses whether its financial assets meet this condition on the basis of the objective of the business model as determined by the entity's key management personnel (as defined in IAS 24).

A8. 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. Therefore, 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.

A9. Although the objective of an entity's business model may be to hold financial assets in order to collect contractual cash flows, the entity need not hold all of those instruments until maturity. Thus an entity's business model can be to hold financial assets to collect contractual cash flows even when sales of financial assets occur. For example, the entity may sell a financial asset if:

(a) the financial asset no longer meets the entity's investment policy (eg the credit rating of the asset declines below that required by the entity's investment policy);

(b) an insurer adjusts its investment portfolio to reflect a change in expected duration (ie the expected timing of payouts); or

(c) an entity needs to fund capital expenditures. However, if more than an infrequent number of sales are made out of a portfolio, the entity needs to assess whether and how such sales are consistent with an objective of collecting contractual cash flows.

A10. The following are examples of when the objective of an entity's business model may be to hold financial assets to collect the contractual cash flows. This list of examples is not exhaustive.

Example	**Analysis**
Example 1 An entity holds investments to collect their contractual cash flows but would sell an investment in particular circumstances.	Although an entity may consider, among other information, the financial assets' fair values from a liquidity perspective (ie the cash amount that would be realised if the entity needs to sell assets), the entity's objective is to hold the financial assets and collect the contractual cash flows. Some sales would not contradict that objective.
Example 2 An entity's business model is to purchase portfolios of financial assets, such as loans. Those portfolios may or may not include financial assets with incurred credit losses. If payment on the loans is not made on a timely basis, the entity attempts to extract the contractual cash flows through various means—for example, by making contact with the debtor by mail, telephone or other methods. In some cases, the entity enters into interest rate swaps to change the interest rate on particular financial assets in a portfolio from a floating interest rate to a fixed interest rate.	The objective of the entity's business model is to hold the financial assets and collect the contractual cash flows. The entity does not purchase the portfolio to make a profit by selling them. The same analysis would apply even if the entity does not expect to receive all of the contractual cash flows (eg some of the financial assets have incurred credit losses). Moreover, the fact that the entity has entered into derivatives to modify the cash flows of the portfolio does not in itself change the entity's business model. If the portfolio is not managed on a fair value basis, the objective of the business model could be to hold the assets to collect the contractual cash flows.
Example 3 An entity has a business model with the objective of originating loans to customers and subsequently to sell those loans to a securitisation vehicle. The securitisation vehicle issues instruments to investors.	The consolidated group originated the loans with the objective of holding them to collect the contractual cash flows. However, the originating entity has an objective of realising cash flows on the loan portfolio by selling the loans to the

The originating entity controls the securitisation vehicle and thus consolidates it. The securitisation vehicle collects the contractual cash flows from the loans and passes them on to its investors. It is assumed for the purposes of this example that the loans continue to be recognised in the consolidated statement of financial position because they are not derecognised by the securitisation vehicle.	securitisation vehicle, so for the purposes of its separate financial statements it would not be considered to be managing this portfolio in order to collect the contractual cash flows.

A11. One business model in which the objective is not to hold instruments to collect the contractual cash flows is if an entity manages the performance of a portfolio of financial assets with the objective of realising cash flows through the sale of the assets. For example, if an entity actively manages a portfolio of assets in order to realise fair value changes arising from changes in credit spreads and yield curves, its business model is not to hold those assets to collect the contractual cash flows. The entity's objective results in active buying and selling and the entity is managing the instruments to realise fair value gains rather than to collect the contractual cash flows.

A12. A portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis (as described in paragraph 4.2.2(b)) is not held to collect contractual cash flows. Also, a portfolio of financial assets that meets the definition of held for trading is not held to collect contractual cash flows. Such portfolios of instruments must be measured at fair value through profit or loss.

Appendix B – Accounting for financial instruments project proposed business model guidance

An Entity's Business Strategy

Financial Assets

B1. An entity would classify financial assets that meet the characteristics of the financial instrument criterion based on the business activity the entity uses to manage those financial assets rather than on the entity's intent for an individual financial asset. An entity would be permitted to manage identical or similar assets through different business activities. An entity would be required to classify all financial assets into one of three categories as follows:

<u>Amortized Cost Category</u>

B2. The business activity for these financial assets must meet all of the following conditions:

1. Financial assets issued or acquired for which an entity's business strategy, at origination or acquisition of the instrument, is to manage the instruments through customer financing or lending activities. These activities primarily focus on the collection of substantially all of the contractual cash flows from the borrower.
2. Financial assets for which the holder of the instrument has the ability to manage credit risk by negotiating any potential adjustment of contractual cash flows with the counterparty in the event of a potential credit loss. Sales or settlements would be limited to circumstances that would minimize losses due to deteriorating credit, or to exit a particular market for risk management purposes.
3. Financial assets that are not held for sale at acquisition.

FV-OCI Category

B3. The business activity for these financial assets must meet all of the following conditions:

1. Financial assets issued or acquired in a business activity for which an entity's business strategy, at origination or acquisition of the assets, is to invest the cash of the entity either to:

   a. Maximize total return by collecting contractual cash flows or selling the asset; or to

   b. Manage the interest rate or liquidity risk of the entity by either holding or selling the asset.

2. Financial assets that are not held for sale at acquisition or issuance.

FV-NI Category

B4. The business activity for these financial assets must meet either of the following conditions:

1. Financial assets that are held for sale at acquisition; *or*

2. Financial assets that are actively managed and monitored internally on a fair value basis.