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STAFF PAPER

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CONTACT(S)	Riana Wiesner	rwiesner@ifrs.org	+44 207 246 6926
	Yulia Feygina	yfeygina@ifrs.org	+44 207 332 2743
	Rahul Gupta	rgupta@fasb.org	+1 203 956 5317
	Nick Milone	nmilone@fasb.org	+1 203 956 5344

Introduction

Purpose of the paper

1. This is the first paper in the series of papers for the October joint education session on the **business model assessment** in IFRS 9 *Financial Instruments* and the FASB's proposed Accounting Standards Update *Financial Instruments- Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities* ('FASB's proposed ASU').

2. This paper focuses on the business model assessment **generally** and therefore the topics discussed are relevant to **all** of the measurement categories in the boards' classification and measurement model for financial assets. This paper does not discuss the business model requirements specific to each of those measurement categories. Those specific requirements are discussed in Agenda Paper 6B/FASB Memo 250 and Agenda Paper 6C/FASB Memo 251.

3. This paper:

(a) Provides relevant background information that includes:

i. A summary of—and staff observations on—the current articulation of the business model assessment in IFRS 9 (including the proposals in the IASB's exposure draft ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9* (Proposed amendments to IFRS 9 (2010)) ('the IASB's Limited Amendments ED') and the FASB's proposed ASU (paragraphs 5-15), and

ii. A brief overview of the relevant feedback received on the IASB's Limited Amendments ED and the FASB's proposed ASU (paragraphs 16-32);

(b) Discusses clarifications to the overall business model assessment:

i. the meaning of 'business model' (paragraphs 33-38);

ii. the level on which the business model is assessed (paragraphs 39-43);

iii. the information that should be considered when making the assessment (paragraphs 44-48);

iv. the role of sales in the business model assessment (paragraphs 49-58); and

v. change in business model (paragraphs 59-66); and

(c) Provides a summary of staff recommendations and question for the boards (paragraph 67-74).

4. The staff note that the recommendations made in this agenda paper are only clarifications to the guidance in IFRS 9 and the boards' respective proposals. The staff have not recommended any fundamental changes to the business model assessment.

Background

Overall business model assessment

Current language in IFRS 9

5. Paragraph 4.1.1of IFRS 9 requires an entity to classify financial assets on the basis of the entity's business model for managing the financial assets subject to the assessment of the assets' cash flow characteristics.[1] Paragraphs B4.1.1 and B4.1.2 provide relevant application guidance. Those paragraphs state that the objective of the business model is determined by the entity's key management personnel and that the entity's business model does not depend on management's intentions for an individual instrument. Therefore, the business model assessment is not an instrument-by-instrument approach to classification and should be determined on a higher level of aggregation. However, IFRS 9 states that a single entity may have more than one business model for managing its financial instruments and, therefore, the classification need not be determined at the reporting entity level.

Guidance proposed in the boards' respective exposure drafts

6. Paragraph 825-10-55-28 of the FASB's proposed ASU provided similar guidance to that in IFRS 9, which is described above in paragraph 5, however, the FASB's proposals did not explicitly state that the business model assessment is not an instrument-by-instrument assessment.

7. Paragraphs B4.1.2A and B4.1.2B of the IASB's proposed Limited Amendments to IFRS 9 and paragraph 825-10-55-28 of the FASB's proposed ASU included additional guidance on the business model assessment. Those paragraphs stated that an entity's business model for managing the financial assets is a matter of fact that can be observed by the way the business is managed and its performance is evaluated

[1] The assessment of the cash flow characteristics is outside the scope of this paper. The boards discussed the cash flow characteristics condition in September 2013.

by the entity's key management personnel. The business model therefore determines the entity's likely future cash flows from the financial assets.

8. Furthermore, the determination of the business model for managing financial assets is not driven by a single factor; rather, all objective evidence that is relevant to assessing the entity's business model must be considered. Such evidence includes, but is not limited to:

   (a) how the performance of the business is reported to the entity's key management personnel;

   (b) how managers of the business are compensated (for example, whether the compensation is based on the fair value of the assets managed); and

   (c) the frequency, timing and volume of sales in prior periods, why such sales have occurred and expectations about the sales activity in the future.

9. Using the considerations described above in paragraphs 5-8, both the FASB's proposed ASU and the IASB's Limited Amendments ED would require financial assets to be subsequently measured[2] as follows:[3]

   (a) **Amortised cost** if the financial assets are held and managed within a business model whose objective is to hold assets in order to collect contractual cash flows (the requirements specific to this business model are discussed in Agenda Paper 6B/FASB Memo 250);

   (b) **Fair value through other comprehensive income** ('FVOCI') if the financial assets are held in a business model in which assets are managed both in order to collect contractual cash flows and for sale (the requirements specific to this business model are discussed in Agenda Paper 6C/FASB Memo 251); or

[2] For the purpose of this paper it is assumed that financial assets have satisfied the cash flow characteristics condition in IFRS 9 (as amended by the Limited Amendments ED) and the FASB's proposed ASU.

[3] Unless the holder meets the requirements for and has elected the fair value option.

(c) **Fair value through profit or loss** ('FVPL') if the financial assets do not qualify for either of the measurement categories described above in bullets (a) and (b) (refer to Agenda Paper 6C/FASB Memo 251).

Reclassifications

10. Paragraph 4.4.1 of IFRS 9 states that when an entity changes it business model for managing its financial assets, it must reclassify all affected financial assets. Paragraphs B4.4.1-B4.4.3 provide additional guidance on reclassifications, including examples of circumstances that **are** changes in business model and circumstances that **are not**.
11. Moreover, paragraph B4.4.1 states:

> …Such changes [in business model] are expected to be very infrequent. Such changes must be determined by the entity's senior management as a result of external or internal changes and must be significant to the entity's operations and demonstrable to external parties.

12. The same guidance is proposed in paragraph 825-10-35-22 of the FASB's proposed ASU.

Reclassification date

13. If an entity reclassifies financial assets, both IFRS 9 and the FASB's proposed ASU require that the reclassification is applied prospectively from the *reclassification date*.
14. However, IFRS 9 and the FASB's proposed ASU define that date differently; specifically:
    (a) IFRS 9 defines the reclassification date as "*…the <u>first</u> day of the first reporting period following to change in business model…*"; whereas

(b) the FASB's proposed ASU describes the reclassification date as "*…the last day of the reporting period in which the change in the business model occurs…*"

Reclassification mechanics

15. IFRS 9 (including the proposed amendments in the IASB's Limited Amendments ED) and the FASB's proposed ASU provide similar guidance on reclassification mechanics. Those mechanics depend on how the financial assets were measured **before** the reclassification and how they will be measured **after** the reclassification—that is, which measurement category the financial assets are being reclassified **from** and which category they are being reclassified **into.** This guidance is set out in paragraphs 5.6.1-5.6.7 of the IASB's Limited Amendments ED and paragraph 825-10-35-23 of the FASB's proposed ASU.

Feedback received

General comments

16. The vast majority of respondents to both the FASB's proposed ASU and the IASB's Limited Amendments ED agreed that the business model is relevant to how the financial assets should be measured. They agreed that measuring assets based on the business model will best reflect how an entity manages its business and provide information about how an entity expects to derive cash flows (and value) from those assets. This is in-line with the feedback that the IASB has consistently received since 2009 on the business model assessment.

17. However, a few FASB respondents did not support the business model assessment proposed in the FASB's proposed ASU. Instead, these respondents supported a classification and measurement model based on the model that the FASB had been developing prior to the boards' joint deliberations. Under that model, financial assets would have been classified at amortised cost, FVOCI or FVPL (subject to an

assessment of the cash flow characteristics) on the basis of the **business activity** that the entity uses in acquiring and managing those financial assets. This model focused on the strategy that resulted in an entity's initial recognition of the financial assets. The business activities that determined how assets were subsequently measured were described as (a) customer financing or lending, (b) investing or (c) holding for sale or actively managing and monitoring the asset's fair value.

18. In addition, a few FASB respondents preferred a full fair value-based model because they asserted that the proposed mixed-measurement model may not accurately reflect the entity's performance as economic and business realities change over time.

19. Finally, some respondents questioned whether the measurement outcomes of the business model assessment would be sufficiently different from the measurement outcomes under existing requirements, and therefore questioned whether the benefits of a new model were greater than the costs.

20. Although the vast majority of respondents supported classifying financial assets on a basis that includes a business model assessment, some respondents requested that the boards clarify some of the relevant application guidance:

    (a) Some questioned the *meaning* of the term 'business model' and how it should be interpreted in the context of IFRS 9 and the FASB's proposed ASU;

    (b) Others raised concerns about the *information* that the holder should consider in making the business model assessment and questioned the evidence that would be required to support that assessment. For example, some non-financial entities were concerned that the guidance seemed to require sophisticated policies and documentation to set out how they manage their financial assets and expressed concern that such requirements would impose a significant operational burden. They pointed out that their business models for managing financial assets are generally not as strictly defined as the business models of banks or insurers, and expressed a concern that it would be unduly difficult for them to provide extensive documentation of their business model(s).

Level at which the business model is assessed

21. Many respondents (especially FASB respondents) expressed concern that the guidance in IFRS 9 and the FASB's proposed ASU is unclear about the level at which the business model assessment should be performed— and requested more guidance on that topic.

22. These respondents noted that the guidance in IFRS 9 (paragraph B4.1.2) states that such an assessment is not an instrument-by instrument approach to classification and should be determined at a higher level of aggregation. The guidance in paragraph 825-10-25-25 of the FASB's proposed ASU refers to the business model assessment for "an asset", depending on how the asset is managed together with other financial assets within a distinct business model.

23. In addition, some respondents asked whether a group of financial assets that is managed together could be further divided for the purposes of the business model assessment so that some financial assets are classified in one measurement category and the others are classified in another measurement category—and if such 'division' is appropriate in only some circumstances, these respondents asked what those circumstances are. They were concerned that entities would have different approaches (for example, because some entities might have more granular information than others), which would reduce comparability.

24. In contrast, other respondents thought there should be room for judgment in performing the business model assessment, and believed that in many cases if an entity was able to further divide a group of financial assets then that would indicate that those assets are not really managed with the same objective (ie the entity has multiple business models for those assets). These respondents encouraged the boards

to avoid developing 'bright-line' guidance on the level at which the business model assessment should be done.

The role of sales in the business model assessment

25. A variety of respondents— including preparers, auditors, and regulators— expressed concerns that the application guidance related to the business model assessment seems to place undue emphasis on the level (ie frequency and volume) of sales of financial assets; particularly those measured at amortised cost. These respondents expressed the view that there should be more focus on the reasons for those sales, as well as other factors such as what information is reported to senior management and on what basis the business' managers are compensated.

26. Many respondents expressed the view that a business model assessment that is based primarily on the level of sales would be complex to apply because the entity will not know at initial recognition exactly how many assets it will sell, and would be prohibited from reclassifying its assets if actual sales are different from what was initially expected. Therefore, these respondents were concerned that if the business model assessment is determined solely by the level of sales, financial assets could be inappropriately classified if an entity does not know exactly how much selling activity will take place at the time of making the assessment.

27. Furthermore, many respondents were unsure how to distinguish between the measurement categories solely on the basis of the level of sales activity. That is because they noted that for all of the proposed measurement categories, the guidance acknowledges that an entity will sell some assets. These respondents expressed the view that the primary distinction in the boards' respective exposure drafts appeared to be the frequency and/or level of sales permitted.

Tainting and restatement risk

28. Some respondents were concerned that an undue emphasis on the frequency and volume of sales will lead to an implicit tainting notion similar to the guidance for held-to-maturity financial assets in IAS 39 *Financial Instruments: Recognition and Measurement* and Topic 320 *Investments – Debt and Equity Securities*. Specifically, if an entity sells 'too many' assets that are measured at amortised cost (eg 'more than an insignificant amount'), these respondents expressed concern that in effect a tainting notion would apply that would require the entity to reclassify any remaining assets that are measured at amortised cost into a fair value measurement category and/or prohibit an entity from measuring similar newly-acquired financial assets at amortised cost.

29. Similarly, in circumstances where the actual level of sales turned out to be different from what the entity expected at initial recognition, respondents questioned whether this would be considered a change in the business model that requires reclassification, which is discussed below, or an accounting error that would require retrospective restatement.

Reclassification

30. Stakeholders also provided feedback on the requirements to reclassify financial assets when the entity changes its business model for managing financial assets. Many respondents agreed both with the requirement to reclassify financial assets when there is a change in business model and with the reclassification mechanics. These respondents acknowledged the added complexity but agreed that the financial statements should faithfully represent how financial assets are managed at the reporting date.

Threshold for reclassification

31. However, several respondents expressed the view that the guidance was too strict about the circumstances in which reclassifications would be required (ie it was too high a hurdle for the entity to prove that it had changed its business model). Respondents stated that as a result of the language in IFRS 9 and the FASB's proposed ASU that said that changes in an entity's business model were expected to be very infrequent, they would not be allowed to reclassify financial assets to respond to changes in market conditions. For example, respondents said that changes in an entity's risk profile may require particular portfolios of assets to be unexpectedly sold. Some respondents believed that this would represent a change in the business model for that portfolio and therefore the assets should be reclassified as soon as the entity decided to sell them.

Reclassification date

32. Several respondents raised concerns that the IASB and the FASB defined the 'reclassification date' differently. As noted in paragraph 14 of this paper, IFRS 9 defines it as the first day of the first reporting period following the change in business model whereas the FASB's proposed ASU describes it as the last day of the reporting period in which the change in business model occurs.

Staff analysis and recommendations

The meaning of the term 'business model'

33. The staff acknowledges that in both business theory and practice, there is a broad range of formal and informal descriptions of the term 'business model'. The term is often used to describe the core aspects of a business—including its purpose, target customers, product offerings, strategies, organisational structures, trading practices, and operational processes and policies.

34. Some literature define the business model as ''a statement of how a firm will make money and sustain its profit stream over time''.[4]

35. Similarly, in its Bulletin on the role of the business model in financial reporting, the European Financial Reporting Advisory Group (EFRAG) and some National Standard Setters noted that:

> Our assumed meaning of the term 'business model' focuses on the value creation process of an entity, i.e. how the entity generates cash flows. In case of non-financial institutions, it represents the end-to-end value creation process or processes of an entity within the business and geographical markets it operates. [5]

The meaning of 'business model' in IFRS and the FASB's proposed ASU

36. However, the boards have used the term 'business model' in particular way. Specifically, consistent with the overall objective of IFRS 9 and the FASB's proposed ASU, the objective of the business model assessment is to ensure that financial instruments are measured in a way that provides relevant and useful information to users of financial statements. Information is useful if it enables users to predict the likely amounts, timing and uncertainty of future cash flows.

37. Both IFRS 9 and the FASB's proposed ASU already include a notion of cash realisation. That is, the objective of the business model assessment is to determine whether financial assets are managed such that the <u>likely actual cash flows</u> will result primarily from (a) the collection of contractual cash flows; (b) both the collection of cash flows and sales; or (c) sales proceeds (ie crystallisation of fair value gains or

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[4] Lee, G. K. and R. E. Cole. 2003. *Internet Marketing, Business Models and Public Policy*. Journal of Public Policy and Marketing 19 (Fall) 287-296

[5] *Getting a better framework: The role of the business model in financial reporting*. Paragraph 12. Publicly available at: http://www.efrag.org/files/Conceptual%20Framework%202013/130601_CF_Bulletin_Business_Model_Role_-_final.pdf

losses). In other words, the business model assessment allocates financial assets to the measurement attribute that will provide the most useful and relevant information about how activities and risks are actually managed to realise value (ie generate income and profit) for the asset holder.

Staff recommendation

38. To amplify the existing notion of cash flow realisation in the context of the business model assessment, which exists in both IFRS 9 and the FASB's proposed ASU, the staff recommend that the application guidance should be supplemented to clarify the following items:

    (a) The term 'business model' should refer to actual management of financial assets in order to generate cash flows and create value for the entity – ie whether the likely actual cash flows will result primarily from the collection of contractual cash flows, sales proceeds or both.

    (b) The business model assessment should allocate financial assets to the measurement attribute that will provide the most relevant and useful information about how activities and risks are managed to create value.

The level on which the business model is assessed

39. Neither IFRS 9, the Limited Amendments ED nor the FASB's proposed ASU mandated the level on which the business model should be assessed. However, paragraph B4.1.2 in IFRS 9 provides the following relevant guidance which the Limited Amendments ED did not propose changing:

    (a) the assessment is not an instrument-by-instrument approach but rather should be determined at a higher level of aggregation; and

    (b) a single entity may have more than one business model; therefore, the assessment need not be determined at the reporting entity level.

40. As noted earlier in this paper, paragraph B4.1.2A in the Limited Amendments ED proposed that the business model for managing financial assets is a matter of fact that can be observed by the way the business is actually managed and its performance evaluated by the entity's key management personnel. Similar guidance was proposed in paragraph 825-10-55-28 of the FASB's proposed ASU. Paragraph BC4.20 in the Basis for Conclusions on IFRS 9 further notes that the business model does not relate to a choice (ie it is not a voluntary designation) that applies to financial instruments in isolation (ie out of context). The business model is therefore very different from management's intentions, which can relate to a single instrument.

41. The staff do not believe that there is one specific ('universal') level of aggregation that would be appropriate and relevant to all reporting entities or in all circumstances. In some circumstances it may be appropriate for an entity to perform the assessment at the reporting entity level (eg if a non-financial entity manages all of its assets with a single objective), whereas in others, it could be at a business unit or portfolio level. We think the reporting entity must use judgement to determine the level that is relevant to the way that it actually manages the assets together to achieve a common objective.

Staff recommendations

42. We do not recommend that the boards specify or mandate the level at which the business model should be assessed. As discussed in both IFRS 9 and the FASB's proposed ASU, we think an entity needs to use judgement to determine at what level this assessment should be applied. We think the determination is made on the basis of how an entity actually manages its business and therefore we do not think there is one specific level that would be relevant or appropriate in all circumstances.

43. However, we recommend that the application guidance should be improved to clarify that the business model should be assessed at a level that reflects (groups of) financial assets managed together to achieve a particular (common) objective. In short, it

should be undertaken in a way that enables the entity to describe how its business is managed.

The information that should be considered when making the business model assessment

Activities aimed at achieving the business model objective

44. Paragraph 7 above noted that the business model is a matter of fact that can be observed by the way the business is actually managed and its performance is evaluated by the entity's key management personnel.

45. The business model for managing financial assets is usually observable through the particular activities that are undertaken to achieve the objectives of that business model. We believe that in addition to the factors listed in paragraph B4.1.2B of IFRS 9 and paragraph 825-10-55-28 of the FASB's proposed ASU (which are reproduced in paragraph 8 of this paper), the specific activities commonly associated with each measurement category could be defined by the:

    (a) way in which the performance of the <u>business model</u> is evaluated and reported;

    (b) risks that affect the performance of the business model and the way in which those risks are managed

    (c) way in which the performance of the <u>financial assets</u> held in the business model is evaluated and reported. The activities undertaken to evaluate the performance of the business model may be different from the activities undertaken to evaluation the performance of the financial assets held in the business model.

Nature of the information to be considered

46. Both IFRS 9 and the FASB's proposed ASU require the business model assessment to be performed at the date of initial recognition. That assessment should consider, in

addition to the factors listed in paragraph B4.1.2B of the IASB's Limited Amendments ED and paragraph 825-10-55-28 of the FASB's proposed ASU, all relevant and objective information available at that time, for example:

(a) historical information about how cash flows were realised and value created in the same or similar business models;

(b) current objectives and the reasons for originating or acquiring the financial assets; and

(c) future expectations about how the assets' cash flows will be realised.

47. This information should reflect the entity's **actual objective** for managing the financial assets. The entity should not necessarily consider (and base its business model assessment on) every 'what if' scenario or the worst-case scenario. For example, if an entity expects to sell a particular portfolio of financial assets **only** in a stress-case scenario—and the entity has no reason to expect that such a scenario will occur—that scenario should not drive the business model assessment.

Staff recommendation

48. We recommend that the boards supplement the existing application guidance to clarify that:

(a) The entity's business model for managing financial assets is often observable through particular activities that are undertaken to achieve the objectives of that business model[6];

(b) These business activities usually reflect the way in the which the performance of the business model and underlying financial assets in that business model are evaluated and reported (ie key performance indicators)

[6] These activities are discussed in more detail in the context of the specific measurement categories in Agenda Paper 6B/FASB Memo 250 and Agenda Paper 6C/FASB Memo 251.

as well as the risks that typically impact the performance of the business model; and

(c) An entity should consider all relevant and objective information that is available at the date of the assessment but should not consider every ’what if’ or worse-case scenario if the entity does not reasonably expect those scenarios to occur.

The role of sales in the business model assessment

49. Most respondents to the Limited Amendments ED and the FASB’s proposed ASU noted that the illustrative examples in the boards’ respective exposure drafts seem to focus on the volume and frequency of sales rather than the reasons for those sales.

50. As previously discussed in this paper, the business model assessment should allocate assets to measurement categories in such a way that useful and relevant information is provided to users of financial statements; ie information about the timing, amount and uncertainty of future cash flows. Therefore, the business model assessment necessarily must consider whether the collection of contractual cash flows and/or the realisation of cash flows through sale (which will include fair value changes) are integral or only incidental to achieving the business model’s objective. For example, for the amortised cost measurement category, the collection of contractual cash flows is integral to achieving the business model objective, whereas the realisation of cash flows through sale is only incidental. However, for the FVOCI measurement category, both the collection of contractual cash flows and the realisation of cash value through sale are integral to achieving the business model objective.

51. Paragraph B4.1.2B(c) of IFRS 9 and paragraph 825-10-55-28 of the FASB’s proposed ASU note that all objective evidence that is relevant to assessing the entity’s business model must be considered, which includes :

> …the frequency, timing and volume of sales in prior periods, **why such sales have occurred and expectations about the sales activity in the future**. [emphasis added]

52. Sales activity could therefore be one of the activities that are aimed at achieving the business model objective (refer to paragraph 45 above). Historical sales information and patterns could provide useful information about how an entity currently manages its financial assets, but should not be considered in isolation and therefore are not determinative. Rather, such information should be considered in the context of the reasons for those sales (eg whether they were due to the assets' credit deterioration or another factor) the conditions that existed at the time of those sales and the relevance of the same for the business model looking forward. For example, if an entity had a large volume of sales activity in a particular business unit during a prior period but it was caused by an event that is not expected to recur (eg an once off change in the prudential risk weighting of particular asset classes caused a significant portfolio rebalancing), the historic sales activity would be unlikely to provide relevant information for assessing the business model. Moreover, historical information should not be considered in isolation but should be considered in combination with other information such as the entity's expectations about future sales activities, including the reasons for those expected future sales.

Tainting and restatement risk

53. As discussed previously in this paper, many FASB respondents and a few IASB respondents questioned whether the guidance on the volume and frequency of sales activity (especially in relation to the hold-to-collect business model) results in an implicit tainting notion—and some respondents questioned whether a significant volume of unexpected sales would require the entity to restate prior periods as a result of making an 'error' when it assessed its business model at initial recognition.

54. Paragraph BC4.45 of IFRS 9 explains that IFRS 9 does not contain a tainting notion and states the following:

> The Board considered whether it should prohibit an entity from classifying a financial asset as measured at amortised cost if the entity had previously sold or reclassified financial assets rather than holding them to collect the contractual cash flows. A restriction of this kind is often called 'tainting'. However, **the Board believes that classification based on the entity's business model for managing financial assets and the contractual cash flow characteristics of those financial assets provides a clear rationale for measurement. A tainting provision would increase the complexity of application, be unduly prohibitive in the context of that approach and could give rise to classification that is inconsistent with the classification approach in IFRS 9.** [emphasis added]

55. Although the concerns about tainting and restatement risk were raised in the context of the amortised cost measurement category, we think such topics are relevant to the other measurement categories as well. This is because respondents seem to be asking whether an entity would need to restate prior periods if a group of financial assets turned out to be managed with a different objective than what the entity expected at initial recognition; ie in hindsight, the business model assessment appeared to have been incorrect.

56. As discussed in the previous sections, the business model assessment is made at initial recognition based on all relevant and objective information available at the time, including expectations about future sales activity. If at initial recognition an entity determines that its objective is to hold a portfolio of assets to collect their contractual cash flows but actual sales are significantly greater than originally expected, that does not mean that the business model assessment was an error that requires restatement— **as long as** the entity considered all relevant and objective information that was available at the time it made the assessment.

57. However, when the entity originates or acquires the same or similar financial assets in the future, the entity will need to take these significant sales into consideration in determining whether its objective still is to hold those assets to collect their contractual cash flows.

Staff recommendation

58. The staff recommend that the application guidance should be supplemented to clarify the following:

    (a) Information about sales activity should not be considered in isolation. It should rather be considered in conjunction with other information as part of a holistic assessment of how such financial assets will be managed.

    (b) Historical sales information and patterns could provide useful information about how an entity currently manages its financial assets but that information should not be considered in isolation and therefore is not determinative. Rather such information should be considered in the context of the reasons for those sales, and the conditions that existed at that time as compared to the existing conditions. Moreover, historical information should always be considered in conjunction with the entity's expectations about future sales activities, including the reasons for those expected future sales.

    (c) If cash flows are realised in a way that is different from the entity's expectations at the date the business model assessment was made, it will neither:

        (i) result in the restatement of prior period financial statements; nor

        (ii) change the classification of the remaining financial assets in the business model.

    as long as the entity considered all relevant and objective information that was available at the time it made the assessment.

Change in business model

Threshold for reclassification

59. Both IFRS 9 and the FASB's proposed ASU require financial assets to be reclassified when there has been a change in the business model. A change in business model is something that is determined by an entity's senior management, significant to the entity's operations and demonstrable to external parties. Such changes are expected to be very infrequent.

60. Therefore, we think that a change in business model would occur only when an entity has either stopped or started doing something on a level that is significant to the entity's operations and thus demonstrable to both internal and external stakeholders. Generally this would be the case only when the entity has acquired or disposed of a business line to ensure that reclassifications provide information that is useful, relevant and comparable. This was done to address concerns from users of financial statements about the potential for opportunistic reclassifications and the consistency and rigour with which the reclassification requirements would be applied.

Reclassification date

61. Several respondents commented on the fact that IFRS 9 and the FASB's proposed ASU define the reclassification date differently (refer to paragraph 32 on this paper).

62. When developing IFRS 9, the IASB reasoned that defining the reclassification date as the first day of the reporting period following the change in business model would provide objectivity and the most discipline. That is because the entity would be required to change its business model before it knows the effect on its financial statements of the resulting reclassifications —and is therefore unable to achieve a particular accounting result in the current or next reporting period.

63. In developing the proposed ASU, the FASB were aware of (and in fact discussed) the IASB's choice of reclassification date. However, they reasoned that the effects of a change in business model and the resulting reclassifications should affect the entity's

financial statements in the reporting period in which the change occurs. It believed that requiring the reclassification date to be the last day of the reporting period in which there is a change in business model provides sufficient discipline to prevent an entity from choosing a reclassification date to achieve a particular accounting result while also providing objectivity by reporting the effect of the reclassification in the period in which it occurs.

64. We do not believe that the date of reclassification is a key difference between the boards' respective classification and measurement models for financial assets, *particularly given the anticipated infrequency of such events occurring*. Furthermore, although IFRS 9 defines the reclassification date as the first day of the subsequent reporting period, we note that an entity most likely will disclose information about a change in business model in its financial statements in the reporting period in which it takes place given the significance of such an event. Therefore, information about a change in business model will be provided in the same reporting periods under both models, although the change will be accounted for in different periods.

Staff recommendation

65. We recommend that the boards supplement the existing application guidance to clarify that a change in business model will occur only when an entity has either stopped or started doing something on a level that is significant to its operations—and that generally would be the case only when the entity has acquired or disposed of a business line.

66. We do not recommend any changes to the requirements for the reclassification date.

Summary of staff recommendations and question to the boards

67. As stated in paragraph 4, we are not recommending any fundamental changes to the business model assessment and the recommendations made in this agenda paper are only clarifications to the guidance in IFRS 9 and the boards' respective proposals. The staff recommendations set out in paragraphs 33-66 of the previous section, can be summarised as follows:

The meaning of the term 'business model'

68. We recommend that the application guidance should be supplemented to clarify the following items:

    (a) The term 'business model' should refer to actual management of financial assets in order to generate cash flows and create value for the entity – ie whether the likely actual cash flows will result primarily from the collection of contractual cash flows, sales proceeds or both.

    (b) The business model assessment should allocate financial assets to the measurement attribute that will provide the most relevant and useful information about how activities and risks are managed to create value.

The level on which the business model is assessed

69. We do not recommend that the boards specify or mandate the level at which the business model should be assessed.

70. However, we recommend that the application guidance should be improved to clarify that the business model should be assessed at a level that reflects (groups of) financial assets managed together to achieve a particular (common) objective. In short, it should be undertaken in a way that enables the entity to describe how its business is managed.

The information that should be considered when making the business model assessment

71. We recommend that the boards supplement the existing application guidance to clarify that:

    (a) The entity’s business model for managing financial assets is often observable through particular activities that are undertaken to achieve the objectives of that business model[7];

    (b) These business activities usually reflect the way in the which the performance of the business model and underlying financial assets in that business model are evaluated and reported (ie key performance indicators) as well as the risks that typically impact the performance of the business model; and

    (c) An entity should consider all relevant and objective information that is available at the date of the assessment but should not consider every ’what if’ or worse-case scenario if the entity does not reasonably expect those scenarios to occur.

The role of sales in the business model assessment

72. The staff recommend that the application guidance should be supplemented to clarify the following:

    (a) Information about sales activity should not be considered in isolation. It should rather be considered in conjunction with other information as part of a holistic assessment of how such financial assets will be managed.

[7] These activities are discussed in more detail in the context of the specific measurement categories in Agenda Paper 6B/FASB Memo 250 and Angda Paper 6C/FASB Memo 251.

(b) Historical sales information and patterns could provide useful information about how an entity currently manages its financial assets but that information should not be considered in isolation and therefore is not determinative. Rather such information should be considered in the context of the reasons for those sales, and the conditions that existed at that time as compared to the existing conditions. Moreover, historical information should always be considered in conjunction with the entity's expectations about future sales activities, including the reasons for those expected future sales.

(c) If cash flows are realised in a way that is different from the entity's expectations at the date the business model assessment was made, it will neither:

(i) result in the restatement of prior period financial statements; nor

(ii) change the classification of the remaining financial assets in the business model.

as long as the entity considered all relevant and objective information that was available at the time it made the assessment.

Change in business model

73. We recommend that the boards supplement the existing application guidance to clarify that a change in business model will occur only when an entity has either stopped or started doing something on a level that is significant to its operations—and that generally would be the case only when the entity has acquired or disposed of a business line.

74. We do not recommend any changes to the requirements for the reclassification date.

Questions for the boards
Do the boards have any comments or questions on the staff discussion and analysis and staff recommendations?