STAFF PAPER

28-31 October 2013

FASB | IASB Education session

Project	**Financial Instruments: Classification and Measurement**		
Paper topic	Business Model Assessment: Fair value categories		
CONTACT(S)	Rahul Gupta	rgupta@fasb.org	+1 203 956 5317
	Nicholas Milone	nkmilone@fasb.org	+1 203 956 5344
	Riana Wiesner	rwiesner@ifrs.org	+44(0)20 7246 6926
	Yulia Feygina	yfeygina@ifrs.org	+44(0)20 7332 2743

Purpose and structure of the paper

1. This is the third 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* ('the FASB's proposed ASU').

2. This paper focuses on the 'hold to collect and sell' business model that results in measurement at fair value through other comprehensive income (FVOCI)—subject to the assessment of the contractual cash flow characteristics[1]—and also discusses the 'residual' business models that result in measurement at fair value through profit or loss (FVPL). This paper:

[1] The assessment of the contractual cash flow characteristics is outside the scope of this paper. The boards discussed the contractual cash flow characteristics condition in September 2013. For the purposes of this paper, we have assumed that the financial asset has cash flows that are solely payments of principal and interest.

(a) Provides relevant background information that includes:

(i) a summary of–and staff observations on the current articulation of the FVOCI and FVPL measurement categories in IFRS 9 (as they would be amended by the proposed guidance in the IASB's exposure draft ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9* (Proposed amendments to IFRS 9 (2010)) ('IASB's Limited Amendments ED')) and the FASB's proposed ASU (paragraphs 4-21); and

(ii) a brief overview of the relevant feedback received on the IASB's Limited Amendments ED and the FASB's proposed ASU (paragraphs 22-34);

(b) Provides staff analysis, recommendations and questions to the boards (paragraphs 35-73).

3. The staff note that the recommendations made in this agenda paper are only <u>clarifications</u> to the guidance in the boards' respective proposals. We have not recommended any fundamental changes to the hold to collect and sell business model—or the residual measurement category (FVPL).

Background

IFRS 9 and the FASB's tentative model prior to joint deliberations

IFRS 9

4. IFRS 9 does not contain a FVOCI measurement category for eligible debt instruments[2]. Under IFRS 9 all eligible debt instruments are classified at either amortised cost or FVPL. IFRS 9 requires financial assets to be measured at amortised cost only if the assets are held within a business model whose objective

[2] 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). That is outside the scope of this paper. As noted above, this paper discusses assets with cash flows that are solely payments of principal and interest.

is to hold the assets to collect contractual cash flows (and the asset has cash flows that are solely payments of principal and interest on the principal amount outstanding (P&I)[3]. Otherwise, the financial asset is classified at FVPL, ie FVPL is a residual category.

5. IFRS 9 notes that an entity's objective is **not** to hold assets to collect the contractual cash flows if the entity manages the performance of those assets with the objective of realising cash flows through the sale of the assets (eg an entity actively manages a portfolio to realise fair value changes arising from changes in credit spreads and yield curves). Furthermore, a portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis—or a portfolio of assets that meets the definition of 'held for trading'— is not held to collect contractual cash flows. Therefore, such financial assets are classified as FVPL.

6. Subsequent to the issuance of IFRS 9, the IASB received feedback from some constituents regarding the need for a FVOCI category. Some questioned whether measurement at FVPL appropriately reflects the performance of financial assets that are managed both in order to collect contractual cash flows and for sale, so as to maximise a return from a combination of contractual cash flows and fair value gains. Others were concerned about the potential accounting mismatch that may arise because of the interaction between accounting for financial assets in accordance with IFRS 9 and the accounting for insurance contract liabilities under the IASB's Insurance Contracts project.

FASB's tentative model prior to joint deliberations

7. In contrast to IFRS 9, the FASB's tentative classification and measurement model prior to the start of joint deliberations included a defined FVOCI category. For financial assets to be classified at FVOCI, an entity's business model would have been to manage the financial assets as part of the entity's investing activities. That tentative model stated that the primary purpose of an investing activity is to

[3] Under IFRS 9, an entity may at initial recognition irrevocably designate a financial asset as measured at FVPL under the fair value option if doing so eliminates or significantly reduces an accounting mismatch.

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's business activity that would qualify for FVOCI measurement would include a combination of holding and selling financial assets to achieve its investing objective. However, to be measured at FVOCI, the financial assets may not be actively held for sale at acquisition or origination (ie initial recognition)—such assets would be measured at FVPL.

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

9. The FASB's tentative model also discussed activities that would typically be associated with the business models that would be classified into the FVOCI and FVPL categories.

10. The FASB performed an extensive outreach on its tentative model prior to the joint deliberations and the feedback received indicated overall support for having two fair value measurement categories, however constituents cited tension between the descriptions of the FVOCI and FVPL categories and raised concerns on the application of the FVOCI business model.

Tentative decisions in joint deliberations

11. The boards jointly decided to propose that financial assets with eligible contractual cash flows should be mandatorily measured at FVOCI if they are managed both to collect contractual cash flows and to sell. Furthermore, both boards proposed that FVPL should be the residual measurement category—that is, financial assets would be measured at FVPL if they do not qualify to be measured at amortised cost or FVOCI.

12. Although both boards proposed FVOCI as a distinct business model, their respective exposure drafts articulated it slightly differently:

(a) Paragraph 4.1.2A of the Limited Amendments ED stated that "*the asset is held in a business model in which assets are managed both in order to collect contractual cash flows and for sale*"; whereas

(b) Paragraph 825-10-25-25(b) of the FASB's proposed ASU states that "*the asset is held and managed within a business model that has the* ***objective*** *of both holding financial assets to collect contractual cash flows and selling financial assets"*. [emphasis added]

Application guidance

13. The application guidance in both the IASB's Limited Amendments ED and FASB's proposed ASU provided guidance on how the hold to collect and sell business model should be assessed, including guidance on both the types of activities and the level (ie frequency and volume) and nature of sales that would be consistent with such a business model. The guidance proposed by the boards in their exposure drafts was similar but not identical. The staff think most of the differences related to how the hold to collect and sell business model was articulated and/or described in the respective exposure drafts, rather than reflecting any fundamental differences in the underlying objective.

IASB's Limited Amendments ED

14. The Limited Amendments ED stated in paragraph B4.1.4A that the entity's business model for managing the financial assets may be to manage assets both to collect contractual cash flows and to sell. In other words, the entity's key management personnel has made a decision that **both collecting contractual cash flows and selling are fundamental to achieving the objective** of the business model within which the financial assets are held. Compared to the business model whose objective is to hold financial assets to collect contractual cash flows, the FVOCI business model will typically involve greater frequency and volume of sales. This is because selling financial assets is **integral** to achieving the FVOCI business model's objective rather than only incidental to it.

15. Paragraphs B4.1.5 and B4.1.6 further state that financial assets should be measured at FVPL if they are not held within a business model whose objective is to hold assets to collect contractual cash flows (ie amortised cost) or a business model in which assets are managed both in order to collect contractual cash flows and for sale (ie FVOCI). Those paragraphs provide examples of assets that must be measured at FVPL, such as financial assets that the entity manages with the objective of maximising cash flows through sale, assets that meet the definition of 'held for trading' and assets that are managed and whose performance is evaluated on a fair value basis.[4] Such financial assets are neither held to collect contractual cash flows nor managed both to collect contractual cash flows and to sell assets. For such portfolios, the collection of contractual cash flows is not integral to achieving the business model's objective but rather is only **incidental** to it. Therefore, such financial assets must be measured at FVPL.

FASB's proposed ASU

16. Paragraph 825-10-55-35 of the FASB's proposed ASU stated that at initial recognition, the entity must measure a financial asset at FVOCI if it has not yet determined whether it will hold an individual asset to collect contractual cash flows or sell the asset to meet certain objectives. Examples provided in the FASB's proposed ASU of a business activity that is consistent with the FVOCI business model include:

    (a) maintaining a certain yield profile by holding and selling financial assets in accordance with a stated risk management policy. The objective of such a business activity is to manage portfolios of financial assets by holding and selling financial assets as needed to achieve the targeted yield; or

[4] IFRS 9 paragraph 4.2.2(b) states that financial assets are managed on a fair value basis when the assets' performance are evaluated on a fair value basis in accordance with a documented risk management or investment strategy and information about the group is provided internally on that basis to the entity's key management personnel.

(b) liquidity management where an entity may hold and sell financial assets (or rebalance the asset mix in the portfolio to achieve a better asset-liability profile) to meet an entity's liquidity needs[5].

17. The FASB's proposed ASU states that holding financial assets for sale would not be consistent with the primary objective of amortised cost or FVOCI.

Examples

18. The IASB'S Limited Amendments ED and the FASB's proposed ASU also included the same three illustrative examples of when the business model may be to manage assets both to collect contractual cash flows and to sell. These illustrative examples are included in Appendix A.

Mechanics of FVOCI measurement category

19. The IASB's Limited Amendments ED and the FASB's proposed ASU proposed the same mechanics to account for gains or losses on financial assets measured at FVOCI.

20. The boards reasoned that for a business model in which financial assets are managed both to collect the contractual cash flows and for sale, performance will be affected by both contractual cash flows and the realisation of fair values. Amortised cost information reflects the decision to hold the assets to collect contractual cash flows unless, and until, they are sold in order to achieve the objective of the business model. Fair value information reflects the cash flows that would be realised if, and when, they are sold. The boards decided that the FVOCI measurement category should result in a fair value carrying amount in the statement of financial position and amortised cost information being provided in profit or loss. Specifically, if a financial asset is measured at FVOCI, all fair

[5] In accordance with the FASB's proposed ASU ,liquidity portfolios that are specifically designated for regulatory compliance may have sales of assets in accordance with paragraph 825-10-55-32(c) through (e) without making them inconsistent with amortized cost measurement

value changes are recognised in other comprehensive income **except**[6] for interest revenue—which is recognised using the effective interest method—and impairment losses[7]. Both interest revenue and impairment losses would be recognised in profit or loss. When a financial asset is derecognised, the cumulated gain or loss previously recognised in other comprehensive income is reclassified ('recycled') from equity to profit or loss.

21. During the joint deliberations leading to the publication of the boards' respective exposure drafts, the boards considered which category—FVOCI or FVPL—should be defined and which should be the residual. The boards acknowledged that there may be some benefits in making the FVOCI category the residual because a clear distinction should be possible between the description of amortised cost and the description of FVPL. However, the boards found it difficult to articulate a business model for FVPL, particularly one that both boards agreed with. The boards further noted that the residual measurement category should provide useful information for all financial instruments classified in that measurement category. Amortised cost information is provided in profit or loss for both the amortised cost and FVOCI measurement categories. This information is relevant only for particular business models; ie those where collecting contractual cash flows is integral to achieving the objective of the business model. As a result, neither of these two measurement categories—amortised cost or FVOCI— would be useful as a residual measurement category. Consequently, the boards agreed that FVPL should be the residual category.

[6] Foreign exchange gains and losses on financial assets measured at FVOCI are measured differently under each exposure draft. However, this difference results from an existing difference between IFRS and US GAAP and will not be deliberated as part the joint redeliberations. The FASB will discuss the feedback received on the guidance in its exposure draft at a later meeting.

[7] Impairment losses would be recognised in accordance with the impairment model proposed by the IASB and FASB respectively.

Feedback received

22. The feedback received from respondents is summarized as follows:

    (a) FVOCI as a defined business model; and

    (b) Application of the proposed guidance.

FVOCI as a defined business model

Common themes

23. The majority of respondents to both exposure drafts supported the proposed FVOCI measurement category as a distinct and defined business model for the classification of financial assets.

24. Prior to the joint deliberations, the FASB had been discussing a tentative model that included a FVOCI measurement category and therefore the hold to collect and sell business model in the FASB's proposed ASU did not represent a significant change from what the FASB had been discussing. However, IFRS 9 does not include a FVOCI measurement category and responses from IASB constituents were therefore more focussed on the proposed introduction of that measurement category than the FASB constituents.

25. While they supported the FVOCI measurement category generally, many respondents to both exposure drafts expressed concerns about the clarity of how the FVOCI business model was described. Some specifically commented on the differences in the boards' articulation of the business model for FVOCI measurement (refer to paragraph 12) and noted that an entity does not have an objective to hold and to sell financial assets. These respondents noted that holding and selling are the result of **how** financial assets are managed **to achieve a specific objective**. In other words, holding and selling are the outcomes of the business model—not the objective.

26. A minority of respondents noted that either ‘end’ of the business model spectrum (that is, hold to collect and trading/ held for sale) were easy to discern in practice, but defining the ‘middle’ (that is, FVOCI) required more judgment. These stakeholders therefore proposed having FVOCI as the residual measurement category rather than FVPL. They noted that this approach would be more aligned with the current available-for-sale guidance in IAS 39 *Financial Instruments: Recognition and Measurement* and Topic 320, *Investments–Debt and Equity Securities*.

IASB-specific feedback

27. The majority of respondents to the Limited Amendments ED agreed with measuring some financial assets at FVOCI, with responses being split relatively evenly into three broad categories:

    (a) Those that **supported** the introduction of the defined FVOCI category as proposed;

    (b) Those that **agreed in principle** with measuring some debt instruments at FVOCI, but subject to *different* conditions compared to those in the Limited Amendments ED; and

    (c) Those that **did not support** the proposed introduction of the third measurement category into IFRS 9.

28. Those that **agreed in principle** with measuring some debt instruments at FVOCI suggested something different from the proposals. Such suggested approaches included:

    (a) Financial assets should be mandatorily measured at FVOCI irrespective of their cash flow characteristics as long as the assets are managed in a hold to collect or for sale business model. For example, some respondents, notably in the insurance industry, stated that their business model is driven by the linkage between financial assets and insurance contracts liabilities and that the business model concept in IFRS 9 fails to reflect this linkage.[8]

(b) The FVOCI category should be an option – either in addition to or instead of – a mandatory measurement category. These suggestions were often made in the context of further reducing accounting mismatches for the insurance industry.

29. Lastly, a minority of respondents did not agree with the proposed introduction of a FVOCI measurement category. They cited one or more of the following arguments:

(a) 'Hold to collect and for sale' is not a distinct business model for the management of financial assets but rather is an accounting construct to achieve a particular accounting outcome; and

(b) Introducing an additional measurement category into IFRS 9 would add complexity, which in their view would not be justified by the usefulness of the information provided[9]. Some felt that by introducing this category, IFRS 9 would be so similar to IAS 39 that the cost of changing to a new accounting model could not be justified.

---

[8] The interaction between the accounting for financial assets and the accounting for insurance contract liabilities under the Insurance Contracts project will be discussed separately by the IASB at a subsequent meeting.

[9] In addition, some noted that it was inappropriate to add complexity to IFRS 9 for all entities simply to address the interaction between the accounting for financial assets and insurance contracts liabilities. Some also thought it would be premature to modify the accounting for financial assets given the stage of the Insurance Contracts project.

FASB-specific feedback

30. The respondents to FASB's proposed ASU commented that the guidance on what is the residual category is unclear, since the proposal requires both of the following types of asset to be measured at FVOCI, which seems to indicate that FVOCI is the residual measurement category.

    (a) An asset that is managed within a business model that has the objective of both holding financial assets to collect contractual cash flows **and** selling financial assets

    (b) An asset for which the entity has not yet determined whether it will hold it to collect contractual cash flows **or** selling.

Application of the proposed guidance

31. Respondents raised questions about the distinction between the FVOCI category, which is a *defined* business model and the FVPL category, which is the *residual* measurement category. They noted that there will be less need for detailed application guidance if the boards more clearly identify the principle of the hold to collect and sell business model.

32. Many respondents stated that it would be challenging to distinguish between the fair value categories. For example, they raised questions about the meaning of *'managed on a fair value basis'* (an example of FVPL set out in both exposure drafts) and *'managed to maximise the return'* (an example of FVOCI set out in both exposure drafts).

33. Some respondents noted that there was difficulty in discerning the level (ie frequency or volume) of sales that would be permitted from the hold to collect and sell business model as compared to the other business models. They questioned whether there is a particular level of sales (either too much or too little) that would disqualify financial assets from being measured at FVOCI-and if so, what that level was. They suggested making a clearer distinction among the three business models by analysing whether collecting contractual cash flows

and/or selling is *integral* or *incidental* to achieving the objective of the business model. The IASB's Limited Amendments ED discusses this notion (ie integral versus incidental) but respondents expressed the view that it should be further emphasized.

34. Other respondents were concerned that financial assets would be required to be measured at FVOCI if some financial assets are held and others are sold, even if the financial assets are managed and performance is reported on a fair value basis, or if fair value information is required to be provided as a result of regulation or investor demand. These respondents expressed the view that measuring such financial assets at FVPL would provide more useful information.

Staff analysis and recommendations

35. The staff analysis and recommendations is structured as follows:

    (a) two fair value measurement categories; and

    (b) clarification of the proposed application guidance

Two fair value measurement categories

36. As noted above, the majority of respondents agreed with having two fair value measurement categories where the FVOCI measurement category is defined and the FVPL measurement category is the residual category. However, a minority of respondents commented that FVOCI should not be a defined business model but rather an option or the residual measurement category.

Retaining FVOCI as a measurement category

37. With regards to including a FVOCI measurement category in their respective classification and measurement models, the staff note the boards' rationale for that proposal—and believe that those reasons are still valid.

38. Specifically, the IASB decided to propose the introduction of FVOCI to IFRS 9 because it believed that the FVOCI measurement category will:

    (a) Provide useful information about the performance of financial assets that are held in a business model in which assets are managed both in order to collect contractual cash flows and for sale. For these assets both amortised cost and fair value information is relevant and useful. This includes addressing concerns raised after the issuance of IFRS 9 about whether it is appropriate to classify financial assets at FVPL if those assets are managed in a business model where both collecting contractual cash flows and selling are integral to achieving the objective of the business model;

    (b) Address the potential accounting mismatch that may arise because of the interaction between the classification and measurement of financial assets and the accounting for insurance contracts liabilities, and

    (c) Provide convergence with the FASB’s proposed ASU.

39. The staff acknowledge that a third measurement category adds complexity to IFRS 9. However, consistent with the Basis for Conclusions on the IASB’s Limited Amendments ED, we believe that such complexity is justified by the usefulness of the information provided. That is because, if assets are managed in a hold to collect and sell business model, we think FVOCI would better reflect their performance compared to measuring those assets at either amortised cost or FVPL-and we note that a rationale would be provided for classification a tFVOCI which does not exist for the available-for-sale category in IAS 39.

40. Similarly, the FASB stated in its proposed ASU that it continues to believe that a FVOCI measurement category is necessary in order to properly classify and measure financial assets that are acquired or originated for managing exposure to interest rate risk, liquidity, or maintaining a desired yield profile in accordance with an entity’s stated risk management policy.

Staff recommendation

41. For the reasons stated above, we recommend that the boards retain two fair value measurement categories—FVOCI and FVPL.

Determining which fair value category should be defined and which fair value category should be the residual

Defining FVOCI

42. With regards to whether the FVOCI measurement category should be defined, the staff acknowledge stakeholders' comments that a business model that involves both holding financial assets to collect contractual cash flows and selling may seemingly lend itself to being the residual category because it involves neither 'pure' holding nor 'pure' selling. Furthermore, the staff also acknowledge that some stakeholders may view FVOCI as more difficult to define than FVPL—ie it would be easier to define two 'ends' of the classification spectrum (that is, amortised cost and FVPL), with the middle area (that is, FVOCI) being the residual category.

43. However, the staff note that one of the boards' key considerations for defining the FVOCI measurement category was that the residual measurement category should provide useful information for all financial instruments classified in that measurement category. Amortised cost information is provided in profit or loss for both the amortised cost and FVOCI measurement categories—**and this information is relevant only for particular business models**; ie those where collecting contractual cash flows is integral to achieving the objective of the business model. Therefore, the staff believes that neither of these two measurement categories—amortised cost or FVOCI— would be useful as a residual measurement category.

44. Furthermore, the staff believes that defining the FVOCI measurement category would strengthen and further clarify the objective of the amortised cost measurement category. In other words, if the boards confirm their proposal to define FVOCI, it will help to clarify 'the line' between amortised cost and FVOCI.

45. The staff also note that under the boards' proposals, the FVPL measurement category is the residual measurement category for **both** the business model assessment **and** the cash flow characteristics assessment. That is:

    (a) As discussed above, assets must be measured at FVPL if they are not held within a business model whose objective is to hold assets to collect contractual cash flows or a business model in which assets are managed both in order to collect contractual cash flows or for sale.

    (b) Similarly, an asset must be measured at FVPL if it has contractual cash flows that are not solely payments of principal and interest. This reflects the fact that amortised cost, being a simple measurement technique that simply allocates interest over time, does not work for more complex financial instruments.

46. The staff believes that having a single residual measurement category in the boards' classification and measurement model would be more understandable and would reduce complexity—as compared to having different residual measurement categories for the business model and contractual cash flow assessments.

Defining FVPL

47. As noted above, some respondents recommended that the boards define the FVPL measurement category—with FVOCI as the residual. To accomplish this, these respondents suggested defining FVPL on the basis of the notions of 'held for sale', (which would include those assets that meet the definition of 'held for trading') or 'managed on a fair value basis'.

48. We note that the boards considered both of those alternatives during their joint deliberations in May 2012[10]. However, at the time, the boards rejected both because they were concerned whether a FVPL measurement category could be sufficiently well-defined, and if not, whether it would allow entities flexibility in determining whether financial assets would be classified at FVPL or FVOCI.

49. Specifically, as described in more detail in the agenda paper for the May 2012 joint meeting, the staff was concerned that the feedback received by the FASB staff during their targeting outreach (prior to the joint deliberations) indicated that 'managed on a fair value basis' is an ambiguous term and could mean different things to different people. In addition, that outreach also indicated that the term 'held for sale' can be construed as very broad or very limited, and it is very hard to define such a term in the context of financial assets. As such the staff was concerned that it would in fact be difficult to clearly define the FVPL measurement category and therefore entities would have an implicit option to measure financial assets at either FVPL or FVOCI.

50. However, the staff acknowledge that while the FVPL measurement category is a residual, to assist in differentiating the business models, the IASB's Limited Amendments ED states that a portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis is neither held to collect contractual cash flows nor managed both to collect contractual cash flows and to sell assets (and therefore would be measured at FVPL)—and many constituents asked the boards to provide additional guidance on this point. We believe that the application guidance in both IFRS 9 and the FASB's proposed ASU could be supplemented by explaining that when financial assets are either held for trading[11] or managed and evaluated on a fair value basis, the entity makes

[10] IASB Agenda paper 6B. FASB memo 152

[11] FASB's proposed ASU defines trading purposes as "The determination of what constitutes trading purposes is based on the intent of the issuer or holder. Trading involves financial instruments that are bought and held principally for the purpose of selling them in the near term and, therefore, held for only a short period of time. Trading generally reflects active and frequent buying and selling. Trading securities generally are used with the objective of generating profits on short-term differences in price.

decisions (ie whether to hold or sell the asset) based on changes in—and with the objective of realising—the assets' fair value. That is, the activities an entity undertakes to achieve these objectives are primarily focused on fair value information and key management personnel uses that fair value information to assess the assets' performance and to make decisions accordingly. In contrast, an entity may be monitoring fair value information and reporting such information to management; for example to show that particular liquidity portfolios have a sufficient fair value to be in compliance with regulatory requirements. But the objective of such portfolios is not to realise fair values and thus will not be required to be measured at FVPL.

Staff recommendation

51. Based on the boards' previous deliberations and the feedback received on the exposure drafts, the staff recommend that the boards confirm the proposals to define the business model that results in measurement at FVOCI and retain the FVPL measurement category as the residual category.

52. The staff also recommend that in order to assist in differentiating the business models, the application guidance states that financial instruments that are managed on a fair value basis must be measured at FVPL. However, to supplement the guidance related to the FVPL measurement category, we recommend that the boards provide application guidance to explain the meaning of managing financial assets and evaluating their performance on a fair value basis. We believe that could be accomplished by supplementing the application guidance to clarify that when financial assets are either held for trading or managed and evaluated on a fair value basis, the entity makes decisions (ie whether to hold or sell the asset) based on changes in—and with the objective of

---

IFRS 9 defines held for trading as a financial asset that (a) is acquired or incurred principally for the purpose of selling or repurchasing it in the near term; (b) on initial recognition is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or (c) is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

realising—the assets' fair value. The activities the entity undertakes are primarily focused on fair value information and key management personnel uses that fair value information to assess the assets' performance and to make decisions accordingly. In addition, another indicator is that the users of the financial statements are primarily interested in fair value information in order to assess the entity's performance.

Clarification of the proposed application guidance for the FVOCI measurement category

53. The staff believe that an entity needs to apply judgement in assessing whether financial assets are managed both to collect the contractual cash flows and for sale. However, we believe that clarification of the application guidance would assist entities in making the assessment. In clarifying the proposed FVOCI guidance, we have identified the following areas for the boards to consider:

    (a) articulation of the 'hold to collect and sell' business model; and

    (b) how the hold to collect and sell business model is different from other business models.

Articulation of the hold to collect and sell business model

54. As stated in paragraph 12 of this paper, the FASB's proposed ASU said that the objective of the business model for the FVOCI measurement category is managing financial assets for both the collection of contractual cash flows and for sale. However, the IASB's Limited Amendments ED implied that collecting contractual cash flows and selling is the outcome of the business model.

55. We think that managing financial assets both to collect contractual cash flows and for sale is the outcome of the way in which financial assets are managed to achieve a particular objective. That is, collecting cash flows and selling is not in itself the objective of the business model

Staff recommendation

56. We recommend that the boards clarify the articulation of the FVOCI measurement category to make it clear that managing financial assets both to collect contractual cash flows and for sale, is the outcome of the way in which financial assets are managed to achieve a particular objective rather than the objective in itself.

57. The staff also recommends removing the guidance in the FASB's proposed ASU that require financial assets for which an entity has at initial recognition not yet determined whether it will hold the financial assets to collect contractual cash flows or sell, to be measured at FVOCI. This is because such guidance is inconsistent with the hold to collect and sell business model being a defined, rather than the residual, business model.

How the business model for FVOCI is different from other business models

58. The staff think that the concerns about how to distinguish the FVOCI measurement category from the other measurement categories could be addressed by clarifying the following three key issues;

    (a) when FVOCI provides relevant and useful information;

    (b) the activities that are commonly associated with the FVOCI measurement category; and

    (c) the role of sales in classifying financial assets in the FVOCI measurement category.

When FVOCI provides relevant and useful information

59. As discussed in IASB agenda paper 6A/FASB Memo 249, the objective of the business model assessment (consistent with the overall objective of IFRS 9 and the FASB's proposed ASU), is to ensure that financial assets are measured in a way that provides relevant and useful information to users of financial statements. In other words, the business model assessment allocates financial assets to the measurement attribute that will provide information about how the asset holder

manages activities and risks to realise cash flows and create value (ie generate income and profit), with the result that users of financial statements can predict the timing, amount and uncertainty of future cash flows.

60. For a business model in which financial assets are managed both in order to collect contractual cash flows and for sale, **performance will be affected by both contractual cash flows and the realisation of fair values**. As such, amortised cost information in the income statement reflects the decision to hold the assets to collect contractual cash flows unless, and until, they are sold in order to achieve the objective of the business model. Fair value information in the balance sheet reflects the cash flows that would be realised, if, and when, the assets are sold.

61. FVOCI as a measurement basis therefore only provides relevant and useful information to the users of the financial statements when **both** the collection of contractual cash flows and the realisation of cash flows through selling **are integral** to the performance of the business model. This is different from the amortised cost measurement category where only the collection of contractual cash flows is integral (and the realisation of cash flows through sales are only incidental)—and from the FVPL measurement category where collection of contractual cash flows is only incidental.

Staff recommendation

62. We recommend that the application guidance for the FVOCI measurement category more clearly articulates that FVOCI as a measurement category provides relevant and useful information to users of financial statements only when **both** the collection of contractual cash flows and the realisation of cash flows through selling are **integral** to the performance of the business model.

The activities that evidence the hold to collect and sell business model

63. As noted in Agenda paper 6A/FASB Memo 249, each of an entity's business models is usually observable by particular activities that are undertaken to achieve the objective of the business model.

64. The staff believe that the articulation of the business model should be supplemented by a description of the activities that the boards believe are typically associated with managing financial assets both to collect contractual cash flows and for sale.

65. Both the IASB's Limited Amendments ED and the FASB's proposed ASU provided illustrative examples of activities that they believe are consistent with the business model for FVOCI measurement. The staff believe that those examples could be supplemented by describing the activities that could also be consistent with the business model:

    (a) Financial assets are held in a liquidity portfolio and significant portions of the portfolio are frequently sold to meet everyday liquidity needs;

    (b) The duration of the financial assets are matched to that of the liabilities they are funding by regularly rebalancing the portfolio of financial assets by undertaking significant buying and selling activity;

    (c) The entity seeks to maintain a particular yield profile or to manage its exposure to interest rate risk by holding and selling financial assets in accordance with a stated risk management policy[12].

66. We think the key performance indicators for such financial assets include **both** the contractual interest yield and impairment charges **and** the fair value changes.

67. The staff also believes that an important differentiating factor between the amortised cost measurement category and the FVOCI measurement category are the risks that an entity generally manages under each of these measurement categories. For assets that are held in the amortised measurement cost category, the entity's activities are primarily directed towards managing the credit risk of those assets (refer to Agenda paper 6B/FASB Memo 250 for this meeting). However, for assets held under the FVOCI measurement category the entity's

[12] We note that even in a hold to collect business model (refer to Agenda paper 6B/FASB Memo 250) banks may manage interest rate risk and use interest rate swaps to manage the risk because of the effect on net interest margin. We believe that this would not be inconsistent with a held to collect business model.

activities are also directed towards managing other market risks, such as liquidity risk and achieving a particular yield profile.

Staff recommendation

68. The staff recommend expanding the application guidance for the FVOCI measurement category to supplement the description of the business model for FVOCI with a description of the information that is typically considered and activities that are typically associated with a business model where financial assets are managed both to collect the contractual cash flows and for sale, which may include, but is not limited to:

   (a) The key performance indicators for such financial assets include the contractual interest yield and impairment charges and the fair value changes.

   (b) Financial assets are held in a liquidity portfolio and significant portions of the portfolio are frequently sold to meet everyday liquidity needs;

   (c) The entity seeks to maintain a particular yield profile or to manage its exposure to interest rate risk by holding and selling financial assets in accordance with a stated risk management policy

The role of sales in classifying financial assets as measured at FVOCI

69. As stated in paragraph 33, many respondents questioned the role of sales in the business model assessment for measuring financial assets at FVOCI. In particular, they questioned whether there is a level (ie frequency or amount) of sales that is too much—or too little—and thus will result in financial assets not satisfying the business model assessment to be measured at FVOCI.

70. We think that there is no threshold for the frequency or amount of sales that are permitted out of the FVOCI measurement category, as long as the financial assets are managed in way that is consistent with this business model. That is, assets should be measured at FVOCI when both the collection of contractual cash flows and sales are integral to achieving the objective of the business model.

Staff recommendation

71. The staff recommend that the boards clarify the application guidance to note that there is no 'threshold' for the frequency or amount of sales in the FVOCI measurement category. Rather the entity will need to determine whether **both** the collection of contractual cash flows and sales are **integral** to achieving the objective of the business model.

Summary of staff recommendations

Two fair value measurement categories

72. We recommend that:

(a) the boards retain two fair value measurement categories—FVOCI and FVPL.

(b) the boards confirm the proposals to define the business model that results in measurement at FVOCI and retain the FVPL measurement category as the residual category.

(c) the boards provide application guidance to explain the meaning of managing financial assets and evaluating their performance on a fair value basis. We believe that could be accomplished by supplementing the application guidance to clarify that when financial assets are either held for trading or managed and evaluated on a fair value basis, the entity makes decisions (ie whether to hold or sell the asset) based on changes in—and with the objective of realising—the assets' fair value. The activities the entity undertakes are primarily focused on fair value information and key management personnel uses that fair value information to assess the assets' performance and to make decisions accordingly.

Clarification of proposed FVOCI guidance

73. The staff believe that an entity needs to apply judgement in assessing whether financial assets are managed both to collect the contractual cash flows and ofr sale. However, we believe that clarification of the application guidance would assist in making the assessment. Therefore, we recommend that

    (a) the boards clarify the articulation of the FVOCI measurement category to make it clear that managing financial assets both to collect contractual cash flows and for sale, is the **outcome** of the way in which financial assets are managed to achieve a particular objective rather than the objective in itself.

    (b) the FASB remove the guidance from the proposed ASU that require assets for which an entity has at initial recognition not yet determined whether it will hold the financial assets to collect contractual cash flows or sell to be measured at FVOCI. In the staff's view, such guidance is inconsistent with the hold to collect and sell business model being a defined, rather than the residual, business model.

    (c) the application guidance for the FVOCI measurement category more clearly articulates that FVOCI as a measurement category provides relevant and useful information to users of financial statements only when **both** the collection of contractual cash flows and the realisation of cash flows through selling are **integral** to the performance of the business model.

    (d) the application guidance for the FVOCI measurement category supplement the requirements for the hold to collect and sell business model with a description of the information that is typically considered and activities that are typically associated with a business model where financial assets are managed both to collect the contractual cash flows and for sale. Such activities may include, but are not limited to:

(i) The key performance indicators for such financial assets include the contractual interest yield and impairment charges and fair value changes.

(ii) Financial assets are held in a liquidity portfolio and significant portions of the portfolio are frequently sold to meet everyday liquidity needs;

(iii) The duration of the financial assets are matched to that of the liabilities they are funding by regularly rebalancing the portfolio of financial assets by undertaking significant buying and selling activity;

(iv) The entity seeks to maintain a particular yield profile or to manage its exposure to interest rate risk by holding and selling financial assets in accordance with a stated risk management policy

(e) the boards clarify the application guidance to state that there is no 'threshold' for the frequency or amount of sales in the FVOCI measurement category. Rather the entity will need to determine whether both the collection of contractual cash flows and sales are integral to achieving the objective of the business model.

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

Appendix A

Examples of FVOCI category in FASB's proposed ASU and IASB's Limited Amendments ED

Example 1

1. A nonfinancial entity anticipates capital expenditure in a few years. The entity invests its excess cash in financial assets to fund the expenditure when the need arises. The entity's objective for managing the financial assets is to maximize the return on those financial assets. Accordingly, the entity would sell financial assets and reinvest the cash in financial assets with a higher yield when an opportunity arises. Furthermore, the managers responsible for the portfolio would be remunerated on the basis of the return generated by the financial assets.
2. The entity's business model is to manage assets both to collect contractual cash flows and to sell them. The entity makes the decision on an ongoing basis about whether collecting cash flows or selling financial assets will maximize the return on those financial assets until the need for the invested cash arises. That strategy is consistent with a fair value through other comprehensive income classification.
3. In contrast, consider an entity that anticipates a cash outflow in five years to fund capital expenditure and invests excess cash in short-term financial assets with the objective of holding the assets to collect contractual cash flows. When the investments mature, the entity would reinvest the cash into new short-term financial assets. The entity would follow this strategy until the funds are needed, at which time it would use the proceeds from the maturing financial assets to fund most of the capital expenditures. *[The guidance in the IASB'S Limited Amendments ED further states that: Only insignificant sales occur before maturity.]* That strategy is consistent with the objective of holding financial assets to collect contractual cash flows.

Example 2

4. A financial entity holds financial assets to meet its everyday liquidity needs. The entity seeks to minimize the costs of managing its liquidity needs and, therefore,

actively manages the contractual yield on the financial assets. The entity monitors the contractual yield and holds some financial assets to collect contractual cash flows and sell other financial assets to reinvest in higher yielding financial assets or to better match the duration of its liabilities. *[The guidance in the IASB'S Limited Amendments ED further states that: This strategy has resulted in significant recurring sales activity in the past, which is expected to continue.]*

5. The entity's business model is to manage assets both to collect contractual cash flows and to sell them. Both holding and selling are integral to the objective of maximizing the yield on the financial assets while meeting the liquidity needs of the entity.

Example 3

6. An insurer holds financial assets to fund insurance contracts liabilities. The insurer uses proceeds from the contractual cash flows on the financial assets to settle insurance contracts liabilities as they come due. The insurer also undertakes significant buying and selling activity to rebalance the portfolio of financial assets on a regular basis as estimates of the expected cash flows needed to fulfil the changes in the insurance contracts liabilities to ensure that the contractual cash flows from the financial assets are sufficient to settle those liabilities.

7. The insurer's objective is to fund insurance contract liabilities. Both collecting contractual cash flows to fund liabilities as they become due and selling financial assets to maintain the desired profile of the asset portfolio are integral to achieving that objective. Accordingly, the insurer's business model is to manage financial assets both to collect contractual cash flows and to sell them.