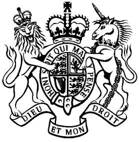

HM TREASURY

Financial Reporting Advisory Board Paper

IFRS 9 *Financial Instruments* implementation: Discussion on the business model assessment in the public sector context

Issue:	At the last meeting (FRAB 125) HM Treasury noted that central government entities often hold financial instruments primarily for policy reasons, rather than with a business model objective in mind. The Board requested HM Treasury to provide a paper further discussing and interpreting the business model assessment. This paper considers the business model assessment and its applicability in the public sector context.
Impact on guidance:	To be considered in a later paper to the Board before issuing an Exposure Draft in 2016.
IAS/IFRS adaptation?	None proposed.
Impact on WGA?	The business model assessment can result in different outcomes at different levels (group vs subsidiary).
IPSAS compliant?	Prior to IFRS 9 the recognition and measurement of financial instruments were similar under IFRS and IPSAS. Changes to IPSAS in response to IFRS 9 are not yet known.
Interpretation for the public sector context?	None proposed.
Impact on budgetary regime? Impact on Estimates?	Not from this specific issue.
Alignment with National Accounts:	No misalignment identified at this stage. Initial discussions with the ONS indicate that IFRS 9 is broadly aligned with the National Accounts.
Timing:	No changes are expected to be made to the FReM until the 2018/19 financial year.

Recommendation:	That the Board consider the analysis of the application of the IFRS 9 business model assessment in the public sector and provide comment on the questions raised in this paper.

DETAIL

Background

1. At the last meeting (FRAB 125) HM Treasury noted that central government entities often hold financial instruments primarily for policy reasons, rather than with a business model objective in mind. The Board requested HM Treasury to provide a paper further discussing and interpreting the business model assessment. This paper considers the business model assessment and its applicability in the public sector context.

Approach to classification and measurement under IFRS 9 Financial Instruments

2. Under IFRS 9 *Financial Instruments* an entity should classify its financial assets into two primary measurement categories, based on:

    a. the contractual cash flow characteristics of a financial asset; and

    b. the entity's business model for managing the financial assets.[1]

3. A financial asset can only be measured at **amortised cost** if two conditions are met:

    a. the financial asset has the features of a basic lending arrangement; and

    b. the financial asset is managed on a contractual cash flow basis.

4. A financial asset that does not meet both conditions above should be measured at **fair value**.

5. The International Accounting Standards Board (IASB) intended for IFRS 9 to help users understand the financial reporting of financial assets by aligning the measurement attribute of financial assets with the way that the entity manages its financial assets ('business model') and their contractual cash flow characteristics. The intention being to provide relevant and useful information to users for their assessment of the amounts, timing and uncertainty of the entity's future cash flows.

6. The business model of the entity is not considered in isolation to the contractual cash flow characteristics when determining how to measure financial assets. Following responses

1 IFRS 9, paragraph 4.1.1

to the 2009 Exposure Draft (Classification and Measurement)[2], the IASB concluded that it would be more efficient for an entity to consider the business model condition first but to assess the contractual cash flow characteristics as well, if the model is collecting contractual cash flows, to ensure that amortised cost provides relevant information to users.

The business model assessment

7. **An entity's business model refers to how an entity manages its financial assets in order to generate cash flows**[3]. The business model determines whether cash flows will result from collecting contractual cash flows, selling financial assets or both.

8. An entity will make the assessment of its business model on the basis of circumstances that it reasonably expects to occur and should exclude 'worst case' or 'stress case' situations. For example, if an entity expects it will sell a particular portfolio of financial assets only in a 'stress case' scenario, then this would not affect the entity's assessment of the business model for those assets if the entity does not reasonably expect it to occur.

9. All relevant evidence that is available at the date of the assessment needs to be considered. Such relevant evidence includes, but is not limited to:

    a. how the performance of the business model and the financial assets held within that business model are evaluated and reported to the entity's key management personnel (per IAS 24 *Related Party Disclosures*);

    b. the risks that affect the performance of the business model (and the financial assets held within that business model) and, in particular, the way in which those risks are managed; and

    c. how managers of the business are compensated (for example, whether the compensation is based on the fair value of the assets managed or on the contractual cash flows collected). [4]

10. In order to assess whether the business model is to hold financial assets to collect contractual cash flows, an entity needs to consider the frequency and significance of past sales activity (and the reason for those sales) as well as expectations about future sales activity.

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2 http://www.ifrs.org/Current-Projects/IASB-Projects/Financial-Instruments-A-Replacement-of-IAS-39-Financial-Instruments-Recognitio/Exposure-Draft-and-Comment-Letters/Pages/Exposure-Draft-and-Comment-Letters.aspx

3 IFRS 9, Appendix B application guidance, paragraph B4.1.2A

4 IFRS 9, Appendix B application guidance, paragraph B4.1.2B

11. For newly originated or newly acquired financial assets, the entity needs to consider information about how cash flows were realised in the past as this will then affect the classification of new assets recognised in the future.

12. The business model is a matter of fact and not merely an assertion[5]. It is based on an assessment of the facts that can be observed through the activities that the entity undertakes to achieve the objective of the business model. An entity's business model (for the purposes of IFRS 9) is not merely an elective choice and does not depend on management's intentions for an individual instrument.

Determining the level at which the business model is assessed

13. An entity's business model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular business objective. The business model does not depend on management's intentions for an individual instrument[6].

14. An entity's management needs to apply judgement to determine at what level the business model condition is applied. For example, it may be assessed on a portfolio basis or a business unit basis. The determination should be made on the basis of how an entity manages its business and not made at the level of an individual asset – i.e. on an instrument-by-instrument basis.

15. Ultimately the level at which the business model assessment is made is the level at which decisions are taken about how an entity manages its financial assets. The business model assessment may result in different objectives at different levels within the same consolidation group.

16. For example, if an entity has a business model with the objective of originating loans to customers and subsequently selling those loans to a securitisation vehicle. The securitisation vehicle issues instruments to investors. The originating entity controls the securitisation vehicle and thus consolidates it. The securitisation vehicle collects the contractual cash flows from the loans and passes them on to its investors. The consolidated group originated the loans with the objective of holding them to collect the contractual cash flows. However, the originating entity has an objective of realising cash flows on the loan portfolio by selling the loans to the securitisation vehicle, so for the purposes of its separate financial statements it would not be considered to be managing this portfolio in order to collect the contractual cash flows.[7]

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5 IFRS 9, Appendix B application guidance, paragraph B4.1.2B

6 IFRS 9, Appendix B application guidance, paragraph B4.1.2

7 IFRS 9, Appendix B application guidance, paragraph B4.1.4A, Example 3

Reclassification of financial assets under IFRS 9 Financial Instruments

17. If cash flows are realised in a manner that is different than expected at the date the business model was assessed then this will not give rise to a prior period error (under IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*), nor will it change the classification of the remaining financial assets held in the extant business model, provided all relevant information was considered at the time of the business model assessment.

18. Reclassification of financial assets is not prohibited under IFRS 9, however, changes in the business model are expected to be very infrequent, determined by the entity's senior management as a result of external or internal change and must be significant to the entity's operations and demonstrable to external parties. Accordingly, a change in an entity's business model will occur only when an entity either begins or ceases to perform an activity that is significant to its operations; for example, when the entity has acquired, disposed of or terminated a business line[8].

19. The standard mandates that reclassifications should take effect from the beginning of the following reporting period. This is to prevent entities from choosing a reclassification date to achieve specific accounting effects and also to faithfully represent how the entity's financial assets are managed at a specific reporting date.

Applying the business model in the public sector

20. A respondent to the initial central government impact assessment in 2015 questioned whether the business model is always directly applicable in a public sector context, as an entity's objectives are likely to be linked to the delivery of policy objectives rather than the realisation of cash flows or fair value gains.

21. The Government's policy position is to ensure the effective and efficient management of publicly owned assets and keeps ownership of all assets under review. Where there is no longer a strong policy reason for continued public ownership or where there is potential for an asset to operate more sensibly and efficiently in the private sector, the government will continue to look into the potential sale of public sector assets.

22. The classification approach under IFRS 9 is based on how an entity manages its financial assets. The business decision for originating or acquiring financial assets in the first instance is not relevant to the ongoing management of these financial assets.

23. Likewise in the public sector the business motivation or policy intention for originating or acquiring financial assets is not relevant to the IFRS 9 assessment of the business model. This is because the assessment is based around the management of the financial assets - i.e. holding to collect contractual cash flows, selling financial assets or both - and not the rationale for originating or acquiring the financial assets. The business motivation or policy

8 IFRS 9, Appendix B application guidance, paragraph B4.4.1

intention is only ever relevant to the extent that it impacts upon the management of the financial assets.

24. Do the Board agree that policy intention in the public sector context is not relevant to the assessment of the business model unless it directly impacts upon the management of the financial assets?

Determining the level at which the business model is assessed in the public sector

25. Establishing the appropriate level at which the business model is determined for a particular group of financial assets is unlikely to be an issue unique to the public sector. Entities will need to consider who is taking meaningful decisions about how financial assets are managed and not how and why assets are originated in the first instance.

26. In the public sector this should not be assumed to be at the Whole of Government Accounts (WGA) level or even at the level of the individual reporting entities. Therefore, public sector entities will need to determine where the decisions are being made in order to assess the business model for classification and measurement purposes.

27. Where the public sector is likely to differ from the private sector is with regards to consistency of approaches taken to assessing the business model under common control – i.e. within the same consolidation group. In the private sector it may be expected that the approach across a consolidation group would need to be consistent. By analogy this might imply a consistent approach to the assessment of the business model should be taken across, say, the central government sector.

28. However, in central government each entity, specifically each Accounting Officer, is separately accountable to Parliament. The public sector context therefore differs to the 'parent-subsidiary' relationship that exists in the private sector.

Applying changes to the business model in the public sector

29. If there is a change in government policy which affects the underlying entity's business model for holding financial assets then a reclassification may be justified to the extent that it affects how those financial assets are managed. It is probable that this will be a similar issue in the private sector – i.e. if a private sector entity makes a significant policy change. The standard is clear that when, and only when, an entity changes its business model for managing financial assets it shall reclassify all affected financial assets[9].

30. Changing the business model is likely to be a significant event and it would be expected that decision makers engage in substantive discussions and investigations into alternatives before a decision is finalised. No disclosures would be required in the entity's financial

9 IFRS 9, paragraph 4.4.1

statements until the decision has been made by senior management, committed to and communicated internally. This is consistent with IFRS 7 *Financial Instruments: Disclosures* which requires the relevant disclosures to be made after the reclassification has occurred. Even from an IAS 1 *Presentation of Financial Statements* perspective, the business model would still need to have actually changed.

31. IFRS 9's application guidance provides the following example of a change in business model:

    a. An entity has a portfolio of commercial loans that it holds to sell in the short term. The entity acquires a company that manages commercial loans and has a business model that holds the loans in order to collect the contractual cash flows. The portfolio of commercial loans is no longer for sale, and the portfolio is now managed together with the acquired commercial loans and all are held to collect the contractual cash flows.

32. The above example illustrates that where an entity is acquiring a new business, and therefore would have to put a significant amount of planning and resources into the acquisition, the entity probably knew as a result of the planning it would change its business model following the acquisition. Consequently, the business model would not change until the new business was actually acquired.

33. Applying the above to a public sector context, it is only likely that an entity's business model should be re-examined after an announcement of a significant change in policy has been made publicly and there is evidence of a resulting influence on the way a class of financial assets is managed. The standard could be applied in such cases without adaptation or interpretation for the public sector context. The public sector should not be reporting on the basis of anticipated future changes in policy and any anticipated changes in regulatory approach should also not be taken into account in the assessment.

34. **Do the Board agree that no adaptation or interpretation of the business model assessment is needed for the public sector context?**

35. **Do the Board agree that the business model should only be impacted once there are clear facts and evidence that a change in policy will impact on the management of the underlying financial assets?**

Interpreting 'contractual cash flows' in the public sector context

36. In the public sector, not all arrangements pertaining to a financial asset at origination will be clearly contractual in nature.[10] For example, student loans provided through the

10 Statutory obligations are not financial liabilities and are therefore outside the scope of IAS 39 or IFRS 9 – International GAAP 2016

student loan support system or when interest-free loans are provided to benefit recipients with repayments made as deductions from future benefit entitlement.

37. IFRS 9 does not define what 'contractual' means within the scope of the standard. A definition is provided in IAS 32 *Financial Instruments: Presentation*, and this continues to apply under IFRS 9.

38. The definition of a financial instrument under IAS 32 is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity[11]. **It clarifies that 'contract' and 'contractual' refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing**[12].

39. Under IAS 39 *Financial Instruments: Recognition and Measurement*, if a debt instrument has been accounted for at amortised cost, or as an available-for-sale financial asset, then entities are already required to consider the contractual cash flows to apply the effective interest rate method and to establish if there are any embedded derivatives.

40. The IFRS 9 classification assessment should not unduly impact public sector entities when determining whether contractual cash flow characteristics exist within the scope of the standard. IFRS 9 does necessitate the need for entities to think differently about the information they already have; there is likely to be some form of a contract or other relevant documentation, such as the terms and conditions of a loan, which can be utilised in considering the contractual cash flows.

41. **Do the Board agree that no adaptation or interpretation of 'contractual cash flows' is needed for the public sector context?**

Recommendation

42. That the Board consider the analysis of the application of the IFRS 9 business model assessment in the public sector and provide comment on the questions raised in this paper.

HM Treasury
17th March 2016

11 IAS 32, paragraphs 11

12 IAS 32, paragraphs 13