Classification and measurement of financial assets – business model

Reporting update
28 June 2023, 23RU-08

KPMG

Highlights

- Business model assessment for financial assets
- The implications when financial assets are managed differently from expectations
- The accounting when there is a change in business model
- Fair value considerations

What's the issue

Uncertainty in global and domestic economies with rising interest rates and inflation is expected to continue.

Entities are taking actions to manage their exposures to these risks. These actions may differ from the entity's previous expectations regarding how it was going to manage its financial assets. These may have implications on the measurement and classification of financial assets.

ASIC's 30 June 2023 focus areas for financial reporting feature financial assets classification as one of the areas that may be impacted by the current environment. That is, whether they are appropriately measured at amortised cost, fair value through other comprehensive income, or fair value through profit and loss.

What you need to know

Classification

The business model for managing financial assets impacts the classification and measurement of financial assets. Judgement is required to determine whether an entity's actions give rise to a change in business model for existing assets, a new business model for newly acquired or originated assets or no change at all. Changes in business model are infrequent under AASB 9.

Fair value

Volatility in local and global markets may impact assumptions underlying valuations of financial instruments. This includes the impact of increasing interest rates on fair value measurement, including for those financial instruments measured at amortised cost as their fair value is disclosed in the financial statements.

KPMG

Classification and measurement of financial assets – Business model

June 2023

Classification and measurement of financial assets – business model

What's the issue

- Uncertainty in global and domestic economies with rising interest rates and inflation is expected to continue.
- Entities are taking actions to manage their exposures to these risks. These actions may differ from the entity's previous expectations regarding how it was going to manage its financial assets. These may have implications on the measurement and classification of financial assets.
- ASIC's 30 June 2023 focus areas for financial reporting feature financial assets classification as one of the areas that may be impacted by the current environment. That is, whether they are appropriately measured at amortised cost, fair value through other comprehensive income, or fair value through profit or loss.
- ASIC also continues to highlight the importance of disclosing information about key judgements made in relation to estimates including the fair value of financial instruments. This includes disclosure of uncertainties, key assumptions, how they have changed period to period, and sensitivity analysis.

What is the impact

- The business model for managing financial assets impacts the classification and measurement of financial assets.
  - ✓ Judgement is required to determine whether an entity's actions give rise to a change in business model for existing assets, a new business model for newly acquired or originated assets, or no change.
  - ✓ Changes in business models are infrequent under AASB 9 *Financial instruments*.
- Volatility in local and global markets may impact financial instrument valuation assumptions.
  - ✓ Entities may have to consider the impact of rising interest rates and inflation on fair value measurement.

In summary

- Assess the potential accounting implications when cash flows from financial assets are realised differently from expectations.
- Where there is a change in business model, reclassification is effective from the next reporting period. Consider the disclosures that will apply to both current and subsequent reporting periods.
- Fair value of financial instruments is expected to be lower than amortised cost for fixed rate securities in an increasing interest rate environment.
- Fair value hierarchy for financial instruments may have changed compared to prior periods. Disclosures apply when there are transfers between fair value hierarchy levels.
- Additional information may be required about assumptions applied, including significant changes during the period, and judgements made in fair value estimates or expected credit loss calculations.

What's in this publication

01 What is the nature of cash flows?

One of the two factors that impact the classification and measurement of financial assets is the nature of the instrument's cash flows.

Nature of cash flows

Only financial assets with cash flows that are solely payments of principal and interest on the principal amount outstanding (**SPPI**) can qualify for an **amortised cost** measurement basis subsequent to initial recognition.

Broadly, contractual cash flows arising from a financial instrument that meet the SPPI criterion are consistent with a basic lending arrangement. The cash flows would compensate a holder for time value of money consistent with the currency of the cash flows and credit risk of the issuer (interest rate).

SPPI assessment can be complex. If it is not SPPI, the financial asset must be measured at fair value, with changes either through other comprehensive income or through profit or loss, depending on the nature of the asset and the business model.

Examples of SPPI assets

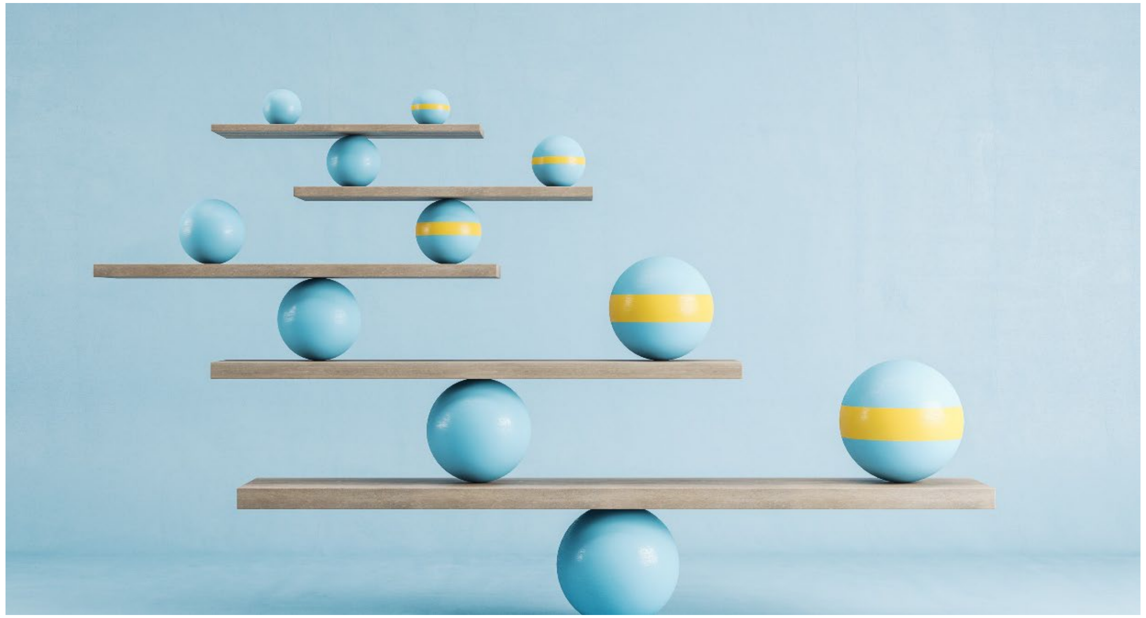
Typically such financial assets are mortgage receivables, credit card receivables, trade receivables, government bonds, semi-government bonds and corporate bonds.

Depending on the terms, financial assets that have features such as prepayable prior to maturity date or extendable beyond the contractual term may not qualify as SPPI.

May not be SPPI assets

For example, an entity bought a perpetual instrument that is callable at any time by the issuer at par plus accrued interest. Interest is payable only if the issuer remains solvent after payment. Any deferred interest does not accrue additional interest.

The SPPI criterion is not met because the issuer may defer payments and additional interest does not accrue on the amounts deferred. Therefore, the holder is not entitled to consideration for the time value of money on the principal amount outstanding.



02 What is a business model?

The second factor that determines the classification and measurement of financial assets is the **business model**.

For example, SPPI assets are measured at amortised cost, fair value through other comprehensive income (FVOCI), or fair value through profit or loss (FVTPL) depending on how they are managed. That is, how key management personnel expects to realise the cash flows from the assets governs the measurement basis of the financial assets.

A business model refers to how an entity manages its financial assets in order to generate / collect the cash flows including:

- holding the asset to collect contractual cash flows (‘held to collect’), or
- by collecting contractual cash flows and selling financial assets (‘held to collect and for sale”), or
- If it is neither held to collect or held to collect and for sale, under AASB 9, the financial assets fall under Other.

Business model is…

- Determined by key management personnel (e.g. for certain organisations, this could be the Risk Committee)
- Forward looking (expectations of how financial assets will be managed to realise cash flows)
- Matter of fact, not an assertion
- Observable through activities undertaken to manage the financial assets
  - ✓ How performance of financial assets is evaluated and reported to key management personnel
  - ✓ How risks affecting the financial assets are being managed
  - ✓ How managers of the financial assets are being compensated

Business model is not…

- Voluntary designation or matter of choice
- Management’s intention
- An instrument-by-instrument approach
- Based on ‘worst case' or 'stress case' scenarios

03 What are the types of business models?

Held to collect

Where key management personnel determines that the objective for a portfolio of SPPI assets is to collect the payments of principal and interest over the life of the instrument, the financial assets are in a held to collect business model.

SPPI assets are the only type of financial assets that could be managed under a held to collect model.

A portfolio of financial assets may be in a held to collect business model even if some sales are expected. Depending on frequency, value, timing and reasons, the objective for the financial assets may still be consistent with a held to collect model as long as any expected sales are considered incidental to the held to collect objective. There is no 'bright line' test in AASB 9 and therefore judgement is required.

Financial assets in a held to collect business model are measured at amortised cost.

Held to collect and for sale

Financial assets are in a held to collect and for sale business model where key management personnel's objective is to realise the cash flows from the assets by both collecting contractual cash flows and selling the financial asset. In this business model, sale of financial assets is integral (not just incidental) to the business model.

Financial assets in a held to collect and for sale model are measured at fair value with changes in fair value recognised in other comprehensive income.

Other

Financial assets that are not in a held to collect or held to collect and for sale business model are in the Other business model. This includes financial assets managed and performance evaluated on a fair value basis whereby, fair value is used to assess performance and to make decisions such as to hold or sell. This includes financial assets held for trading, managing assets on a fair value basis, or maximising cash flows through sale.

Financial assets under this model are measured and classified at fair value through profit or loss, with changes in fair value recognised in the profit or loss.

Examples of expected sales consistent with held to collect model

- Deterioration in credit risk of the issuer
- Sales occur close to the maturity of the financial assets
- Once off significant sale
- Frequent sales but value is not significant (individually and in aggregate)

Examples of management's objective consistent with held to collect and for sale model

- Managing financial assets for everyday liquidity needs
- Maintaining a net interest margin profile or an interest yield profile
- Matching duration of assets to those of liabilities

04 What if outcomes differ from expectations?

Scenario 1: business model – held to collect

At initial recognition/assessment

On adoption of AASB 9, 1 July 2018, the key management personnel of a bank approved the business model for a portfolio of financial assets as held to collect. This decision was made after considering all relevant information at assessment date which included:

- how the cash flows from the portfolio will be realised, which is to primarily collect payment of principal and interest over the life of the instruments;
- any sales have historically been, and expected to continue to be, incidental; and
- the assets are not considered to be held for everyday liquidity needs.

Subsequently

During the year ending 30 June 2023, there has been an increase in sales activities. Management has been managing interest rate risk actively lately due to the rapidly increasing interest rate environment and this is evidenced by frequent and the significant value of asset sales.

Accounting considerations

As there has been a change in the day to day management of the financial assets, given the increased value and frequency of sales which is not attributable to changes in credit risk, there should be an analysis of the potential accounting implications.

1. Does this give rise to a prior period error?

Generally, no, on the basis that all relevant information was considered at the time the business model was initially approved.

However, an analysis should be performed to determine whether this gives rise to:

- a change in business model, that is, a reclassification of the (existing financial assets) in the portfolio,
- a new business model for newly acquired financial assets, or
- no change in the business model.

04 What if outcomes differ from expectations?

Accounting considerations (continued)

2. Does the change in how cash flows are realised result in a change in business model?

AASB 9 has a high hurdle on whether there is a change in business model. A change in business model is expected to be infrequent.

For there to be a change in business model, key management personnel determines there is a change in how the financial assets are managed, and it is a direct result of:

- An external or internal change that is significant to the operations of the entity (for example cessation or commencement of a business activity), and
- The change is demonstrable to external parties.

The following does not result in a change in business model

- Realisation of financial assets is different from the expectation at initial recognition
- Change in intention
- Temporary disappearance of a particular market
- Transfers of financial assets between parts of an entity with different business models

Examples of significant changes that are evident to external parties

The following are examples when conditions for a change in business model are met:

- ***Scenario 2**:* Public announcement of an acquisition of an entity, and existing financial assets in a held to collect model will be transferred to the held to collect and for sale portfolio of the acquiree. The existing financial assets in the held to collect model will be reclassified and measured at FVOCI.

  However, consider an entity with two portfolios, held to collect and held to collect and for sale. Under AASB 9, there is no change in business model if the entity announces it will transfer the financial assets from the held to collect portfolio to the held to collect and for sale portfolio. This is because it is not due to an internal change that is significant to its operations nor demonstrable to external parties.

- ***Scenario 3***: The regulator makes an announcement that requires entities to make regular sales to demonstrate the liquidity of the financial assets. The value of sales will be significant. Management assesses that the business model changes from held to collect to held to collect and for sale on the basis that it will now manage the financial assets in that portfolio where selling is an integral part of their model, there is an external change that is significant to the operations of the entity, and it is demonstrable to external parties. The existing financial assets in the held to collect model will be reclassified and measured at FVOCI.

05 When is reclassification effective?

If the conditions for a change in business model are met, reclassification for existing financial assets in that portfolio occurs from the beginning of the next reporting period. Reclassification occurs prospectively. Prior periods are not restated.

Scenario 4

Continuing on from Scenario 3, key management personnel of a bank with a 30 June year end approve a change in business model on 1 March 2023. The change is from held to collect to held to collect and for sale. The conditions for a change in business model are met at that date.

The financial assets in the held to collect portfolio on 1 March 2023 will continue to be measured at amortised cost on 30 June 2023. The financial assets are only reclassified to held to collect and for sale from 1 July 2023.

Any new financial assets acquired after the date of change in business model (1 March 2023) should be classified and measured based on the new business model.

Now assume the bank reports on a quarterly basis. The bank will reclassify the financial assets from 1 April 2023, the beginning of the next reporting period.

Disclosure requirements when there is a reclassification

The following disclosure requirements apply when reclassification occurs during the reporting period:

Type of reclassification	Periods when disclosures required	Disclosures required
All reclassifications in the current or previous reporting period	Period of reclassification and the periods following reclassification	▪ Date of reclassification ▪ Detailed explanation of the change in business model and a qualitative description of its effect on the entity's financial statements ▪ Amount reclassified into and out of each category
FVTPL to amortised cost or FVOCI	Each reporting period following reclassification until derecognition	▪ Effective interest rate determined on the date of reclassification ▪ Interest revenue recognised
FVOCI to amortised cost FVTPL to amortised cost or FVOCI	Current reporting period	▪ Fair value of the financial assets at the reporting date ▪ Fair value gain or loss that would have been recognised in profit or loss or OCI during the reporting period if the financial assets had not been reclassified

06 Is there a new business model?

Is there a new business model?

Looking at the situation of **Scenario 1**, as noted in Section 4, during the year ending 30 June 2023, there has been an increase in sales activities from the held to collect portfolio due to the rapidly increasing interest rate environment.

As there has not been any significant change to its operations as a result of internal or external factors that are demonstrable to third parties, there is no change in the business model for the existing financial assets in the held to collect portfolio.

Where the conditions for a change in business model are not met, the classification and measurement of the remaining financial assets in the business model do not change. However, an entity should assess whether there is a new business model for new financial assets.

The factors outlined in Section 2 for determining a business model apply. The new business model for newly acquired financial assets should be approved by key management personnel, which depending on the entity, could include the Risk Committee.

When does the new business model start?

The new business model for new financial assets will start from the date the key management personnel approved the new business model.

07 What are the fair value considerations?

Volatility in local and global markets may impact financial instrument valuation assumptions. This includes the impact of increasing interest rates on fair value measurement, including for those financial instruments measured at amortised cost as their fair value is required to be disclosed in the financial statements in accordance with AASB 7 *Financial instruments: disclosures*.

Considerations for fair value measurement and disclosures include:

Measurement

- The rebuttable assumption that amortised cost approximates fair value for shorter term financial instruments may no longer hold.
- Fair value is generally lower than amortised cost for fixed interest rate securities in a rising interest rate environment.
- For floating rate financial instruments, amortised cost may not represent fair value if repricing is not frequent.
- Credit valuation adjustment and debit valuation adjustment on derivative instruments could be material. If an entity applies hedge accounting, this may impact hedge effective testing. This may result in hedge ineffectiveness.

Disclosure

- Unobservable inputs may become more significant. This may result in a transfer from Level 1 to Level 2 or Level 2 to Level 3 under the fair value hierarchy. Additional disclosures may apply when there are transfers between fair value hierarchy levels.
- Given the variability and range of reasonable assumptions and inputs, consider whether additional information about assumptions and judgements applied in fair value estimates may provide relevant information, including sensitivity analysis.

KPMG

Contact us

Patricia Stebbens
Partner
T: +61 3 9288 6261
E: pstebbens@kpmg.com.au

Febby Sumael
Senior Manager
T: +61 7 3233 9791
E: fsumael@kpmg.com.au

KPMG.com.au