Ref: #763316

Educational material 10

APPLICATION OF IFRS STANDARDS IN LIGHT OF THE CORONAVIRUS DISEASE (COVID-19) UNCERTAINTY

IFRS 9 *Financial Instruments* – Change in held-to-collect business models

Issued 4 May 2020

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1. Introduction

This educational material issued by SAICA's Accounting Practices Committee (APC) is prepared for educational purposes, highlighting the requirements within IFRS that are relevant for entities considering how the pandemic affects their accounting, for financial periods ending after 31 December 2019 with a focus on IFRS 9 *Financial Instruments* (IFRS 9) and specifically the requirements related to a change in held-to-collect business models for corporate entities.

Entities are reminded to consider the impact of events related to COVID-19 on both interim and annual financial statements. This guidance does not change, remove nor add to, the requirements in IFRS. It is intended to support the sound, consistent and robust application of requirements in IFRS. It is of importance that IFRS is applied consistently on the basis of the most robust reasonable and supportable assumptions in the current environment.

2. Change in held-to-collect business models

Paragraph 4.1.1(a) of IFRS 9 requires an entity to classify financial assets on the basis of the entity's business model for managing the financial assets as determined by the entity's key management personnel (as defined in IAS 24 *Related Party Disclosures*).

An entity's business model refers to how an entity manages its financial assets in order to generate cash flows and is determined at a level that reflects how groups of financial assets are managed together to achieve a particular business objective. The business model determines whether cash flows will result from collecting contractual cash flows (i.e. a held-to-collect business model), selling financial assets or both (IFRS 9.B4.1.2-B4.1.2A).

In light of the impact of COVID-19 on current and forecasted economic conditions, some entities may take a decision to sell some or all of their financial assets (for example trade receivables) that are part of a held-to-collect business model in line with their updated risk management strategy to manage their credit and liquidity risks. A question arises as to whether there has been a change in the business model for these financial assets.

Paragraph B4.4.1 of IFRS 9 requires an entity to reclassify financial assets if, and only if, the entity changes its business model for managing those financial assets. Such changes are expected to be very infrequent and are determined by the entity's senior management as a result of external or internal changes and must be significant to the entity's operations and demonstrable to external parties. 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. (IFRS 9 B4.4.1). An entity shall not reclassify financial liabilities (IFRS 9.4.4.2).

Entities should also consider paragraph B4.4.3 of IFRS 9 when assessing the impact of COVID-19 on held-to-collect business models for financial assets such as trade receivables. This paragraph outlines the following events and actions that would not result in a change in business model:

- a change in intention related to particular financial assets, even in circumstances of significant changes in market conditions;
- a temporary disappearance of a particular market for financial assets; or
- a transfer of financial assets between parts of the entity with different business models.

In general, taking into account the above factors and the specific requirements of paragraph B4.4.1 and B4.4.3 of IFRS 9, the reclassification of trade receivables and other similar financial assets because of a change in the held-to collect business model due to COVID-19 is expected to be rare.

There may however be a few instances where the COVID-19 related event or action does result in a change in business model such as when an entity begins or ceases to perform an activity that is significant to its operations. For example, as a result of the COVID-19 pandemic, a corporate entity with a proportion of its sales undertaken on credit and has a retail lending business, takes a decision to close down its retail lending business. The retail lending business no longer accepts new business and the entity is actively marketing the portfolio of assets in that business for sale. (IFRS 9. B4.4.3)

A change in the objective of the entity's business model must be effected before the reclassification date. For example, if an entity with a year-end of 31 March decides on 15 February to shut down its lending business and hence must reclassify all affected financial assets on 1 April (i.e. the first day of the entity's next reporting period), the entity must not accept new lending business or otherwise engage in activities consistent with its former business model after 15 February (IFRS 9.B4.4.2). Where a reclassification as a result of a change in business model is considered appropriate, IFRS 9.5.6.2-5.6.7 provides guidance on accounting for the change.

In the context of sales of trade receivables as a result of COVID-19, an entity may also consider the following factors:

- Expectations of sales actively:
    - An entity should consider the frequency and value of sales and whether these will be temporary in nature or continue into the future (for example, due to ongoing liquidity constraints). (IFRS 9.B4.1.2C)
    - Sales may be consistent with a 'hold-to-collect' business model if those sales are infrequent (even if significant in value) or insignificant in value both individually and in aggregate (even if frequent). (IFRS 9.B4.1.3B)
    - An increase in the frequency or value of sales in a particular period is not necessarily inconsistent with a 'hold-to-collect' business model if an entity can

explain the reasons for those sales and demonstrate why those sales do not reflect a change in the entity's business model. (IFRS 9. B4.1.3B)

— Reasons for the sales:
  - Irrespective of their frequency and value, sales due to an increase in the assets' credit risk are generally not inconsistent with a business model whose objective is to hold financial assets to collect contractual cash flows because the credit quality of financial assets is relevant to the entity's ability to collect contractual cash flows. (IFRS 9.B.4.1.3.A)

— Whether cash flows were realised differently from expectations:
  - Cash flows may also be realised in a way that is different from the entity's expectations at the date that the entity assessed the business model, such as more sales of trade receivables than expected at the point when they were initially classified. This does not change the classification of the remaining trade receivables held in that business model (i.e. those assets that the entity recognised in prior periods and still holds) as long as the entity considered all relevant information that was available at the time that it made the business model assessment.
  - Sales should, however, be considered when assessing the business model for newly originated trade receivables by taking into account how cash flows were realised in the past along with other relevant information.

3. Disclosures

Entities should consider the disclosure requirements in paragraph 12B (a)-(c) of IFRS 7 *Financial Instruments: Disclosures* relating to reclassifications and changes in business model. More specifically, if an entity has, in the current or previous reporting periods, reclassified trade receivables in accordance with the requirements of paragraph 4.4.1 of IFRS 9, it should disclose the following:
— the date of reclassification;
— a detailed explanation of the change in business model and a qualitative description of its effect on the entity's financial statements; and
— the amount reclassified into and out of each category.