

Using business models to drive classification: The case of debt instruments in the financial services sector

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Declaration of own work

I, Dominique Holmes (student number: 1555849), hereby declare that this thesis is my own unaided work. It is submitted in partial fulfillment of the degree of Master of Commerce in Accounting at the University of the Witwatersrand, Johannesburg. It has not been submitted elsewhere for the purpose of being awarded another degree or for examination purposes.

Signed

Dominique Holmes

7 November 2018

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II. Abstract

Faithfully representing financial instruments in financial statements is critical to the sustainable functioning of the global economy. This was highlighted in the aftermath of the Global Financial Crisis (GFC) where the relative financialisation of the global economy was implicated as contributing to the crisis (Barth and Landsman, 2010; Laux, 2012; Zhang and Andrew, 2014). Following the GFC, efforts to develop an improved accounting standard for reporting financial instruments were accelerated (IASB, 2014). This culminated in the release of IFRS 9 which uses the business model to determine the accounting treatment of financial assets. The standards' predecessor, IAS 39, used the concept of management's intention to determine accounting classification. This was perceived as being unnecessarily complex (IASB, 2008).

Accounting commentators question whether the move to a business model basis is in substance different from management's intention (Leisenring et al., 2012). Arguing that representing a contractually identical asset differently, based on its use, potentially undermines faithful representation and impairs comparability. This has led to questioning whether the use of a financial asset has the ability to alter its economic substance (Leisenring et al., 2012; Barth, 2013).

This thesis explores IFRS 9's logic of using the business model to determine the classification of financial assets in the financial services sector. Initial insights are obtained by conducting detailed interviews with some of South Africa's leading practical and technical minds. These insights pertain to differences between management's intention and the business model, whether a financial asset can be 'used' and how this may impact the economics of the financial.

This research finds that financial assets can be used by financial institutions for various purposes. These are consistent with the business models of IFRS 9. Further, this thesis finds that communicating these alternate 'uses' is important to represent the differing economics of those assets. Participants also indicate that the business model enhances comparability through enabling comparison between similar *business models*, as opposed to accounting for identical financial assets in the same way.

This thesis contributes to the growing calls for research into business models in financial reporting (EFRAG, 2010; Nielsen and Roslender, 2015). This thesis is also the first to provide the perceptions of South African experts on IFRS 9's logic of using the business model as a method for classifying, measuring and presenting financial instruments.

Keywords: *business models, IFRS 9, management intention, IAS 39, financial assets, economic substance*

III. List of defined terms

Abbreviation	Full term
BC	Basis for conclusions
CA (SA)	Chartered Accountant (South Africa)
CF	Conceptual Framework for Financial Reporting
EFrag	European Financial Reporting Advisory Group
EU	European Union
FASB	Financial Accounting Standards Board
FS	Financial Service
GFC	Global Financial Crisis
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
ICAEW	Institute of Chartered Accountants in England and Wales
IFRS	International Financial Reporting Standards
OCI	Other comprehensive income
SPPI	Solely payments of principle and interest
US GAAP	United States Generally Accepted Accounting Principles

IV. List of referenced accounting standards

Abbreviation	Full term
IAS 2	Inventories
IAS 12	Income taxes
IAS 16	Property, plant and equipment
IAS 38	Intangible assets
IAS 39	Financial instruments: recognition and measurement
IAS 40	Investment property
IFRS 3	Business combinations
IFRS 8	Operating segments
IFRS 9	Financial instruments
IFRS 13	Fair value measurement
IFRS 17	Insurance contracts

1. Introduction

1.1. Background and context

The recently released financial reporting standard IFRS 9 introduces IFRS users to the concept of using the entity's specific business model to determine the accounting treatment of financial assets. This is the first time the IASB has explicitly referred to the use of a business model to inform the accounting classification, measurement and presentation of an asset. The concept of the business model has been used in financial reporting to determine accounting treatment inconsistently (Leisenring et al., 2012). Further, the existing CF does not define business models or provide the conceptual basis for its use. The IASB's exposure draft on the new CF refers to the term business activities, which similarly is not well defined and references the business model concept used in IFRS 9, which likewise is not defined in IFRS 9.

There has been debate regarding the use of the term *business model* in financial reporting around whether, and in what respects, it differs from management's intention (seen previously under IAS 39) (EFRAG, 2010; Leisenring et al., 2012). There is no consensus on whether a financial asset can be 'used' for different purposes as with a non-financial asset and if the use impacts its economics (or resultant economics experienced by the entity). Consequently, there is no agreement on how the financial asset should be faithfully depicted in the financial statements (EFRAG, 2010; Leisenring et al., 2012; Barth, 2013).

1.2. Statement of the problem

IFRS 9 is the first standard which explicitly discusses the business model in accounting (IASB, 2017i) while the scope limitations of various other accounting standards implicitly incorporate a business model effect without specifically referring to the term. The business model in financial reporting is not thoroughly defined, although guidance is provided in IFRS 9 on how it should be determined (IASB, 2017i). This creates opportunities for subjectivity in determining accounting policies and the potential for opportunistic accounting behaviour. Further, despite IFRS 9 unequivocally stating that the business model is not management's intention, some commentators argue these concepts are substantially the same (Leisenring et al., 2012; IASB, 2017i).

Financial statements are concerned with reporting the economic phenomena of transactions and events. IFRS 9 provides that an identical financial asset may be measured and presented differently based on the entity's business model objective for that financial asset. The business model in this context is understood

as the manner in which the entity will realise the asset, either through holding to collect contractual cash flows or through sale. This is referred to as being the uses of financial assets.

The accounting profession is divided about what achieves faithful representation. For example, some feel that contractually identical financial assets must be presented in the same manner, irrespective of the business model. I.e. the use of a financial asset does not alter its economic substance and resultant accounting treatment. On the other hand, some feel that the use of a financial asset does alter its economic substance so it should be represented differently. It can then be argued that reflecting business models in financial reports is a more faithful representation and promotes comparability among similar economic phenomena and reflects dissimilar economic phenomena differently.

Interestingly, for a non-financial asset, it is taken for granted that the use of the asset is an important factor when determining accounting treatment. Take the case of a building: if an entity's business model is to occupy that building, it should be accounted for under the cost or revaluation models under IAS 16 (IASB, 2017d). If, however, an entity's specific business model is to hold the building for rental and capital appreciation, it must be accounted for under the cost model or the fair value model under IAS 40 (IASB, 2017d). There is not consensus regarding financial assets (Brougham, 2012; Leisenring et al., 2012; Barth, 2013; IASB, 2017i).

With financial assets in terms of IFRS 9, if an entity's business model is to hold a bond for the collection of contractual cash flows, it should account for it under the amortised cost model (IASB, 2017i). However, if an entity's business model is to hold that bond for trading purposes, it should account for it under the fair value model to reflect the strategy of profiting from fluctuations in the financial asset's value (IASB, 2017i).

Opponents of the business model in financial reporting argue that financial assets can only be held or sold and cannot be used exclusively for one purpose or, that one use does not preclude the other (Leisenring et al., 2012). For FS entities a financial asset could be used in different ways and for different and specific purposes. To illustrate, FS entities take on liabilities from customers, in return for cash. The FS entity is expected to invest amounts received in an appropriate manner to discharge the liability. I.e. the nature of the financial liability incurred will inform the nature of assets purchased or the way a financial asset is used to derive economic benefits for the FS entity.

In addition, the FS industry is strictly regulated. This is due to the FS industry's integral role in managing risk and holding funds in a fiduciary capacity¹. Regulators develop capital and solvency requirements which specify the types of financial and other assets which must be held. This is necessary to ensure appropriate assets are held and are matched to related liabilities. Mismatches or the use of inappropriate assets compromise the regulated solvency position of the FS entity which is primarily measured in terms of IFRS audited financial statements. Furthermore, in pursuit of profitability, financial assets need to have appropriate risk and duration profiles to the related liabilities as mismatches can result in losses. Whilst the 'use' of a financial asset may not be as clearly observable as for a non-financial asset, an FS entity will hold financial assets in different portfolios based on liability profiles. This would be the case for both internal management purposes and external prudential regulation requirements.

1.3. Purpose

The purpose of this study is to explore the business model in financial reporting for financial assets in the FS sector to obtain initial insights about using business models to drive accounting treatment and, consequently, measurement.

1.4. Significance of the study

This study answers calls for more research on business models in financial reporting (see EFRAG, 2010; ICAEW, 2010; Nielsen and Roslender, 2015). It will add a qualitative aspect through in-depth, open-ended interviews with some of South Africa's leading financial reporting academic and practice minds. This will assist practitioners to understand this change and to contribute to the acceptance or rejection of this addition to the IFRS. In this way, this study can stimulate further debate with the aim of continuous improvement of financial reporting standards.

The latest exposure draft of the *Conceptual Framework* refers to business activities in various areas of financial reporting (business models). The exposure draft proposes that an entity's business activities inform key issues such as measurement and the unit of account. Consequently, this study will not only be applicable to IFRS 9 but also has the potential to form the conceptual base for future standard setting (IASB, 2015).

This study examines the business models in the context of the FS sector. This sector is important as most FS entities manage funds in a fiduciary capacity and are high public accountability entities (Companies Act

¹ See the effects of the GFC resulting from failures of certain entities in the FS sector.

No. 71 of 2008). Accounting for financial assets is relevant not only to generic investors and creditors, but also to the public whose funds are invested and whose risks are managed.

In light of the IASB's recent activities as part of its *Better communication in financial reporting* project, focus has been drawn on better representing transactions and events to users of financial information. This study provides insights into the manner of representing debt instruments in the financial statements, and therefore contributes to this debate.

1.5. Research question

The research question:

To explore the use of business models to drive the classification of debt instruments within the financial services sector in a South African context.

In order to explore the research question, the following sub-questions will need to be answered in the context of the South African financial services sector:

- 1) Is there a difference between management intention in IAS 39 and the business model determination in IFRS 9?
- 2) Does the use of a debt instrument alter its economic substance and, therefore, drive classification?
- 3) Does the use of business models to drive an entity's accounting policy for debt instruments result in a better representation of the economics of the transaction in financial statements?

1.6. Assumptions, limitations and delimitations

This study does not explore the full complement of IFRS 9 changes from IAS 39. Only perceptions related to the business model in financial reporting of financial assets are examined.

Although fair value is mentioned in its relevance to the measurement of financial assets, detailed analysis on the merits or disadvantages of fair value is not within the scope of this thesis.

This study reviews the business model concept in the South African FS sector because this sector has extensive experience with financial instruments and can provide depth and understanding of the implications of the business model in reporting financial assets.

This study concentrates on financial assets which can be held under either the amortised cost or fair value models, namely debt instruments. This is because these assets are affected by the use of the business model to determine the classification. This study does not consider the appropriateness of the measurement basis as it relates to the assigned business model but rather aims to investigate the classification of these financial assets.

The reasons for the change from management intention to business models are also not explored.

2. Literature review

Financial instruments are present in all major companies' financial statements. Due to the pervasive nature of financial instruments, the classification and consequently measurements and disclosure is of paramount importance. This thesis utilised debt financial instruments to explore the change by the IASB to using an entity's business model to drive classification under IFRS 9.

The literature review begins with an overview of financial instruments and the business model, thereafter discussing the development of the standards to account for financial instruments. This is followed by a discussion of the relevant content of IFRS 9 used to classify financial instruments in order to provide context and introduce relevant prior literature. Business models are explored in more detail in their broader context. The controversial concept of management intention, its relation to business models and both terms existing use in IFRS is discussed next. Lastly the use and economic substance of a financial asset is discussed.

2.1. Financial instruments and the business model

Financial instruments encompass a broad spectrum of financial assets and liabilities which ultimately represent a right or obligation to receive or pay an amount of cash or other financial instruments (IASB, 2017i). Financial instruments present various complexities in accounting: of particular concern is the difficulty in measurement and in communicating the economics of these transactions in a coherent manner (IASB, 2008). Financial instruments' popularity and complexity present a challenge for standard setters to develop standards to meet the needs of users in understanding and predicting future cash flows of the entity.

This section presents a background of standard setting for financial instruments, and the context for the development of IFRS 9. Some of the main requirements and contents of IFRS 9 are also discussed. Lastly, the concept of the business model is set out.

2.1.1. Standard setting for financial instruments

The development of a global accounting standard for financial instruments is a constantly evolving and iterative process. The IASB began work on a financial reporting standard for financial instruments as early as 1988 (IASB, 2008). Further exposure drafts and discussion papers were issued, culminating in the issuing of IAS 39 related to recognition and measurement in 1999 (IASB, 2008). Two related standards were issued pertaining to presentation of financial instruments (IAS 32) in 1995 and disclosure of financial instruments (IFRS 7) in 2005 (IASB, 2008). IAS 39 has been amended numerous times in the succeeding years, subsequently being replaced by IFRS 9 in 2014.

IAS 39 required that financial assets be classified using a variety of definitions, as well as, for debt-type instruments, management's intention and ability to hold a financial asset to maturity (IASB, 2016). These requirements were seen to be rule based (IASB, 2008).

In early 2008, the IASB released a discussion paper entitled "Reducing complexity in reporting financial instruments" aimed at looking at measurement and classification (IASB, 2008). IAS 39 was seen to be a complex standard, containing too many rules-based tests and bright line guidance² (IASB, 2008).

The 2008 discussion paper dealt with the primary concern of measurement of financial instruments, defining the long-term solution as a single measurement approach for all financial instruments (IASB, 2008). The discussion paper highlighted that fair value measurement (rather than historic cost) was the only measurement method which could be applicable to *all* financial instruments (IASB, 2008). A single measurement approach would do away with the numerous accounting classifications, reduce complexity and result in optimal comparability (IASB, 2008). The discussion paper also suggests that in the medium

² Bright line guidance refers to rules based guidance in IFRS, where something can only have one of two or more outcomes based on the display of specified characteristics or quantum. This does not consider all the facts and circumstances which are characteristic of more principles based guidance which is the standard setting objective of the IASB. An example of these bright line tests in relation to the accounting for financial assets is the "tainting" provisions in IAS 39, where if an entity sells more than an insignificant portion of its investments classified as held-to-maturity, the entire class is tainted and no items may be classified as such for the 2 years thereafter (IASB, 2016a).

term, a single measure may not be achievable and consequently, an amortised cost-based method to measure debt-type financial assets is appropriate as an interim solution (IASB, 2008).

Measurement in financial reporting has always been controversial, with fair value, historical cost, and mixed measurement bases each enjoying episodic popularity (Georgiou and Jack, 2011). For financial instruments the debates contained in the 2008 discussion paper emphasise that measurement of financial instruments is a contentious issue (IASB, 2008). It is argued that fair value provides the most relevant information compared to historical cost based information (Georgiou and Jack, 2011; Linsmeier, 2011; Leisenring et al., 2012; Barth, 2013). Conversely, there are arguments that presenting fair value for certain interest yielding financial instruments may result in a loss of useful financial information (IASB, 2017i, BC4.7). In instances in which the financial asset is held to collect contractual cash flows, the amortised cost model better communicates the expected future cash flows from the asset (IASB, 2017i, BC4.7).

IAS 39 and IFRS 7 were amended in October 2008 because of the adverse effects of the GFC, political interference and lobbying from banks and other stakeholders (Bengtsson, 2011). Prior to the amendment, an entity was not permitted to reclassify financial assets out of the held for trading category (IASB, 2016, BC11E). This was in contrast to the US GAAP reporting standard equivalent which permitted reclassification in rare circumstances (IASB, 2016, BC11E). Companies applying US GAAP were able to reclassify interest bearing assets held at fair value to the held-to-maturity classification measured at amortised cost. In the absence of the amendment, entities applying IFRS would be disadvantaged by being unable to reclassify their financial assets similarly.

For banks, in particular, this amendment provided significant relief. A banking entity would typically have a banking book where loans would be originated, and held to collect cash flows. Profit would be made on the interest margin between the cost of funding (finance costs) and the income received on loans advanced (interest income). These originated loans would be held-to-maturity and measured at amortised cost. In other instances, a bank would have a trading book where either originated or purchased loans would be held for trading purposes either through securitisation transactions or outright sale. The loans in the trading portfolios would typically be held and measured at fair value.

A loss of liquidity during the GFC and decline in fair value prices on the trading book resulted in rapid declines in reported fair values. These market value declines could trigger “fire sales” to meet regulatory requirements further suppressing prices (Bengtsson, 2011). Because of these declines banks no longer wanted to trade these loans, preferring to hold these to maturity. As a result of the 2008 amendment,

banks were able to reclassify interest bearing instruments held for trade measured at fair value to held-to-maturity measured at amortised cost. The impairment requirements of IAS 39 would be applied to the loans measured at amortised cost. However, these requirements would be based on the incurred loss model in IAS 39, rather than on the more severe declines in fair values in the trading book.

The reclassification election was widely adopted. One third of European banks opted to reclassify financial assets, resulting in the avoidance of fair value losses (Fiechter, 2011). South African banks also used the reclassification to avoid significant fair value losses – see Standard Bank of South Africa Limited and Investec Bank Limited (de Jager, 2014). The amendment to reclassify attracted criticism due to asymmetric treatment of the option to reclassify in a market downturn, violating the premise of faithful representation and neutrality (de Jager, 2014).

In the wake of the GFC, IFRS 9 was developed in a series of tranches to hasten release while some sections were still being developed. These tranches relate to classification and measurement of financial instruments, hedge accounting and impairment of financial instruments (IASB, 2017i). The standard was finally completed in July 2014 with an effective date of 1 January 2018 (IASB, 2017i). Consensus on issuing the standard was not reached, with the initial standard and subsequent amendments attracting 5 dissenting opinions (IASB, 2017i).

Fair value accounting and financial instruments were both vilified and vindicated by commentators as being the cause or as having amplified the GFC (Barth and Landsman, 2010; Fiechter, 2011; Laux, 2012). The complexity of financial instruments and the alleged inability of standard setters to enforce transparent accounting has also been implicated (Laux, 2012). So, too, has the instability of fair value measures in illiquid markets, and the procyclicality of fire-sales provoked by declining values of balance sheets and the imposition of financial institutions' capital requirements (Bengtsson, 2011; Fiechter, 2011; Laux, 2012). On the contrary, fair value is thought to have made the declines in value visible earlier than financial assets accounted for at amortised cost (Linsmeier, 2011).

Despite not viewed as the cause of the GFC, it appears that standard setters have lost their appetite for the full fair value accounting model. IFRS 9 still requires a mixed measurement approach³, which is tacit acknowledgement that the financial reporting environment may not be ready for fair value accounting for

³ See IFRS 9 para 4.1.1 permitting measurement at amortised cost, or at fair value (after meeting both the business model test and the contractual cash flows test). See also James Leisenring's dissenting opinion to IFRS 9 (IASB, 2017i)

all financial instruments. The retention of the mixed measurement model has attracted criticism in the perceived reduction in comparability of financial statements (Leisenring et al., 2012; Barth, 2013).

The press release accompanying the publication of IFRS 9 stated that the development of IFRS 9 improved upon the requirements in IAS 39 and was in response to the GFC (IASB, 2014). However, some commentators challenge whether IFRS 9 actually represents a significant improvement on IAS 39 (Leisenring et al., 2012), particularly in the alleged reduction of complexity of classification and perpetuating management intention⁴. The issuing of a similar standard in the guise of an improved standard in response to the financial crisis is characteristic of a legitimising scheme (for more, see Suchman, 1995).

2.1.2. Content of IFRS 9 related to classification

The objective of IFRS 9:

“[I]s to establish principles for the financial reporting of financial assets and financial liabilities that will present relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of an entity’s future cash flows” (IASB, 2017i, para 1)

From the objective above, two things are clear: the IASB seeks to continue to pursue more principles based accounting standards - in contrast to the FASB’s exceedingly rules based standards (WÜStemann and WÜStemann, 2010); and the persistence of the relevance and decision useful paradigms (see Whittington, 2008; Ravenscroft and Williams, 2009).

According to the IASB’s CF, the objective of general purpose financial statements is to enable users to make decisions about whether to invest or lend to the entity, based on an assessment of the entity’s ability to generate future cash flows (IASB, 2017a). The September 2010 version of the CF also removed the references to stewardship or accountability. These two concepts, decision usefulness and stewardship, are considered to be divergent paradigms in relation to the purpose of financial reporting (Whittington, 2008; Murphy et al., 2013).

On the one hand, those advocating stewardship seek to hold management accountable for the manner in which they have performed their duties (Whittington, 2008; Ravenscroft and Williams, 2009). On this basis, financial reports enable investors to decide whether to retain or remove management. Proponents

⁴ See, for example, the dissent of Patricia McConnell and dissent of James Leisenring from IFRS 9 Financial Instruments (2009) (IASB, 2017i)

of this view advocate the use of entity specific information in financial statements. They are considered cautious of fair value measurements, as market factors may not be under management's control. These supporters of the stewardship view prefer the reliability of predominately cost-based measures (Whittington, 2008; Ravenscroft and Williams, 2009; Botosan and Huffman, 2015; Maroun, 2017a).

On the other hand, those who advocate decision usefulness rank the ability of financial information to assist in predicting future cash flows as the primary objective, with the stewardship objective being ancillary (Whittington, 2008; Murphy et al., 2013). The decision usefulness objective is closely aligned with the preference of fair value measurement methods (Whittington, 2008; Zhang and Andrew, 2014).

The IASB asserts that stewardship is subsumed into the decision usefulness objective. Further, these concepts are not different but are complementary and can most likely be met collectively (IASB, 2017a). However, there is still debate on whether these are entirely different objectives or whether stewardship is subsumed into decision usefulness or whether these concepts function in parallel (Lennard, 2007).

The business model in financial reporting can be argued to display characteristics of both the decision usefulness and the stewardship paradigm. In relation to the stewardship paradigm, business models reflect how an *entity's* management has used or will use an asset to create value over the period, communicating entity specific information (Whittington, 2008; EFRAG, 2010; Yong et al., 2016; Maroun, 2017a). The use of entity specific information ignores the so-called market perspective, cited as the antithesis of the stewardship view (Whittington, 2008). This view is contrasted to the fair value view where the use of market based information from the perspective of a market participant is seen as superior (Whittington, 2008). Using the business models in reporting financial assets may provide information on how the entity's management created value serving the stewardship objective (Yong et al., 2016).

The business model may also provide decision useful information to predict future cash flows. The business model shows how the entity will realise the value from an asset, through a sale transaction or continued collection of the contractual cash flows. Different business models will have different cash flow characteristics which can be more accurately modelled by users in estimating future cash flows. The business model conflicts with the fair value accounting view in that an entity specific consideration of the use of the asset drives the accounting treatment, rather than an objective market view of the use. Further, as a result of using the business model, a hold to collect model retains a cost based measurement.

IFRS 9 requires that an entity classify a financial asset on the basis of both the business model in which the asset is held and the nature of the associated cash flows. An entity determines whether the financial asset is held in a portfolio to collect contractual cash flows, or held to realise through a sale transaction (IASB, 2017i). In determining an entity's business model for managing financial instrument, the IFRS considers how performance of the financial assets is evaluated; the nature of the risks impacting the performance of the business model and the manner of managing those risks and the manner of remunerating management based on the performance of the financial assets.

In July 2014, the IASB introduced a third business model for financial assets, namely, those which are held in a business model the objectives of which are achieved both through collection of contractual cash flows *and* realisation through sales (IASB, 2017i). This third category has caused confusion in what was originally seen as a straightforward classification requirement where there were distinct uses i.e. held for sale or held to collect⁵. By implication contractually identical financial assets may be classified and measured either as held to collect at amortised cost, or held for trading at fair value, or a combination of purposes at fair value through OCI⁶. As a result, three identical financial assets can be held in three different business models within the same entity, and reported and measured using three different methods.

In delineating these business models, IFRS 9 Appendix B provides application guidance, requiring assessment of the significance and frequency of sales. This requires reviewing prior sales activity in determining the boundaries of the portfolio (IASB, 2017i, B4.1.2C).

The standard provides that *a significant value of frequent sales* requires the entity to assess how such activity remains consistent with the held to collect business model and classification (IASB, 2017i, B4.1.3B). This assessment requires qualitative consideration of the surrounding circumstances leading up to and causing the sale (IASB, 2017i, B4.1.2C). Being a principle based standard, IFRS 9 does not provide a rule⁷ indicating a specific percentage of sales to be considered significant nor a specified frequency as the threshold.

⁵ Refer to the dissenting opinion of Stephen Cooper and Jan Engström from the issue in July 2014 of IFRS 9 (IASB, 2017i).

⁶ The fair value through OCI option provides for a business model where the objectives are achieved both through collecting contractual cash flows and through selling activities. This classification results in the income statement measured as if the assets were held at amortised cost with the balance sheet financial asset value at fair value. The difference between the amortised cost and fair value measurements is recorded in OCI.

⁷ For example, a 10% turnover in the portfolio through sales before maturity or 5 times a year.

IFRS 9 does not contain the same restrictive provisions of IAS 39 related to tainting (see footnote 2). IAS 39 requires that, unless sales activities are insignificant, sales of financial assets classified as held-to-maturity can require reclassification of the entire category of held-to-maturity investments of the entity. The tainting provisions of IAS 39 are relevant to this study as this was a key “rule-based” provision which was, on the surface, changed by IFRS 9, however commentators have questioned whether the tainting provisions differ from the significance and frequency of sales concepts in IFRS 9. These tainting provisions may have resulted in punitive accounting consequences. Under IFRS 9 the ‘intention’ can change for an individual asset, provided the tests above are not exceeded. IFRS 9 also provides for the ability to change the business model for a portfolio resulting in reclassifications: these are expected to be rare (IASB, 2017i).

Views are polarised about whether the business model in IFRS 9 is linked to the concept of management intention which was used in IAS 39 to differentiate held for sale and held-to-maturity investments (IASB, 2017i). IFRS 9 categorically denies this, indicating that the business model is an observable matter-of-fact (IASB, 2017i). Despite the statements of the IASB, the use of the terms management intention and the business models remain a contentious issue and were included in three dissenting opinions to the issuing of IFRS 9 (and subsequent amendments)⁸. These dissenting opinions argue that fair value accounting for all financial assets would provide the most useful information and that the business model distinction is in essence arbitrary and does not provide relevant information (IASB, 2017i).

IFRS 9 retains the mixed measurement method. The standard requires that if an entity holds a financial asset to collect contractual cash flows it is measured at amortised cost (a historical cost based measure) (IASB, 2017i). Alternately, if the financial asset is held to sell, it is measured at fair value (IASB, 2017i). The perpetuating of the mixed measurement model also received mixed reviews, with many fair value supporters opposed to the continued amortised cost treatment of debt instruments (Trott, 2009; Linsmeier, 2011; Leisenring et al., 2012). Once an entity has evaluated the business model for which a financial asset is held, it is also required to pass the SPPI test. This effectively ensures that only “pure” debt instruments can be classified as held to collect and consequently measured at amortised cost.

The following section discusses business models in the broader business environment and summarises some of the definitions and meanings ascribed to business models.

⁸ See section 2.2 where the business model management intention debate is discussed.

2.1.3. Business models in context

Drawing from Teece (2010) Beattie and Smith (2013) describe the business model as follows:

“A business model articulates how the company will convert resources and capabilities into economic value (Teece, 2010). This model makes visible how the company acquires and uses different forms of capital (physical, financial and intellectual) to create value” (Beattie and Smith, 2013, p. 243).

A business model describes the manner in which an entity organises inputs or capitals, processes them and creates outputs and outcomes for a range of stakeholders, including shareholders, employees, regulators and society. Teece (2010) describes business models in terms of the mechanisms of delivering value to customers and that all decisions and structures are focused on the customer. The integrated reporting framework (IIRC, 2013) emphasises that the business model is fundamental to an organisation, using inputs in the form of capitals, processing them and creating value for stakeholders.

Many authors criticise this absence of a clear definition and framework for business models (EFRAG, 2010; Zott et al., 2011; Leisenring et al., 2012; Barth, 2013; Page, 2014). Teece (2010) contends that the reason for this lack of definition is that research in the economic space is premised on theoretically constructed markets, where there is no need for business models. Business models are created to solve “real world” (Teece, 2010, p. 175) problems of innovating product, organisation of supply and distribution channels to diverse markets, eliciting demand and interacting with geographically and culturally diverse customers. Page (2014) argues that providing a definition brings about further complexity in the potential for more ambiguity and creates further undefined terms, which has the tendency to create circular reasoning.

There is increasing popularity of business models in various disciplines in both academia and practice (EFRAG, 2010; ICAEW, 2010; Zott et al., 2011; Lassini et al., 2016). Industry associations such as the EFRAG and the ICAEW have published exploratory documents on the role of business models in financial reporting (EFRAG, 2010; ICAEW, 2010). This increasing popularity in the literature is moving into the financial reporting standard setting process more formally through the publication of IFRS 9 and the references to business activities in the CF exposure draft (IASB, 2015; IASB, 2017i).

There are increasing calls for more use of and support for business models in financial reporting (EFRAG, 2010; ICAEW, 2010; Nielsen and Roslender, 2015; Yong et al., 2016; Maroun, 2017a). Financial reporting is at present, a value capture story rather than a value creation story (Nielsen and Roslender, 2015). This is because financial reports capture historical transactions and events rather than describe how the entity has created value over the period (Nielsen and Roslender, 2015). In contrast to calls for more prevalence

of business models in financial reporting, a study of 103 EU listed entities finds that there is no correlation between accounting policy choices made by the entity and its business model (Lassini et al., 2016). Consequently, this results in questions about whether financial reporting based on business models can appropriately convey the way entities are managed to create value. It appears that users of financial statements concur with increasing use of the business model in financial reporting. In its outreach activities as part of the development of IFRS 9, almost all respondents agreed with reflecting the way an entity manages financial assets in the financial statements (IASB, 2017i, BC4.16).

IFRS 9 refers to business models as follows:

“An entity’s business model refers to how an entity manages its financial assets [or financial liabilities] in order to generate cash flows” (IASB, 2017i, B4.1.2A).

The standard also does not attempt to define a business model but describes some considerations, in addition to the assessment of the method of generating cash flows (IASB, 2017i). Key factors considered in determining the business models for financial assets include how performance is measured for financial assets and the basis upon which managers are remunerated, as well as the risks impacting performance (IASB, 2017i, B4.1.2B).

Recently, the IASB/FASB CF exposure draft included the business model, or business activities, as it is referred to (IASB, 2015). The exposure draft does not define business activities (IASB, 2015). The IASB proposes using an entity’s business activities to determine the unit of account, measurement basis, as well as presentation, disclosure and classification (IASB, 2015). These are contentious and long debated issues which will now rely on the business model in determining the outcome. This further emphasises the institutionalisation and importance accorded to the business model in financial reporting.

2.2. Management intention and business models

IFRS 9 introduces the business model to determine the classification and, consequently, measurement of financial assets. The previous accounting standard on financial instruments, IAS 39, includes the requirement for management to have the “positive intention and ability” to hold a financial asset to maturity to classify it as measured at amortised cost (IASB, 2016, para 9). These concepts generated disagreement, even amongst IASB board members (IASB, 2017i). The contention is that management’s intention is undesirable in financial reporting, due to subjectivity in using “management choice” to

determine accounting treatment, resulting in a loss of neutrality⁹. Further, the dissenters assert that there is a loss of comparability. Items may not be faithfully represented, owing to the reporting the same item differently based on management's intention. There is a further argument that there is no difference in substance between management intention and the entity's business model. By implication, business models may be equally undesirable under IFRS, for similar reasons to management intention.

This section is structured as follows. Firstly, the debates are contextualised in terms of the issued standard and the related dissenting opinions. Secondly, the implicit existence of business models in the existing body of the IFRS is reviewed. Finally, the use of management intention in various accounting standards is discussed, highlighting the disparate views of the IASB regarding management intention and its place in IFRS.

The IASB states:

“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 *entity's business model does not depend on management's intentions* for an individual instrument” (IASB, 2017i, B4.1.2, emphasis added).

The IASB asserts that the primary differentiator between business models in IFRS 9 and management intention in IAS 39 is the later functions at an instrument level (IASB, 2017i). However, in IAS 39, where tainting occurs, the entire portfolio of instruments in the held-to-maturity classification is reclassified (see footnote 2). The inability to hold one instrument to maturity under IAS 39 causes the intention for the entire portfolio to be challenged and subsequently changed. Consequently, the tainting provisions function at a portfolio level and not necessarily at an individual instrument level. This requirement may contradict the assertion that a key differentiator is the unit of account.

Despite the formal views of the IASB on the distinction between the business model in IFRS 9 and management intention in IAS 39, there was disagreement at the Board level regarding the use of the business model and its relation to management intention. The criticism of one of the dissenters - Mr Leisenring - focused on the inability of a business model based approach to preserve neutrality, and the inability of the IASB to demonstrate convincingly that the business model is not management choice (IASB, 2017i, DO11 - DO12). This is couched in the preference to adopt fair value accounting for all financial instruments (IASB, 2017i, DO1). It is unclear whether Mr Leisenring's criticism of business models rests

⁹ See dissenting opinions of James Leisenring and Patricia McConnell to the issuing of IFRS 9 (IASB, 2017i).

with its measurement outcomes, namely, the persistence of mixed measurement basis rather than fair value accounting for all financial instruments. Alternately, whether on a standalone basis business models in financial reporting are viewed as equally as undesirable as management intention.

Beyond the boundaries of formal standard setting, there is debate around management intention and its relation to the business model concept in IFRS 9.

Leisenring et al. (2012) contend that the distinction between an entity's business model and management intent in financial reporting is "both artificial and unnecessary" (Leisenring et al., 2012, p. 331). They reason that it is inconceivable that management would formulate a business model which they do not intend to carry out (Leisenring et al., 2012). The objectives set by an entity's business strategy result in the various business models which are formulated in pursuit of the profit motive (Leisenring et al., 2012). For management to act against these objectives will be counter intuitive. They also challenge the IASB's assertion that a differentiator is that management intention functions at an instrument level whereas the business model is at a portfolio level (Leisenring et al., 2012). They contend that financial reporting is concerned with reporting individual transactions as a result, the unit of account¹⁰ for reporting financial assets should be at a transaction level (Leisenring et al., 2012).

The EFRAG acknowledges the assertions of Leisenring et al. (2012). The EFRAG argues that management intent differs fundamentally from an entity's business model in that management intent is volatile and susceptible to change. In contrast, an entity's business model is likely to remain more static and less transitory (EFRAG, 2010). An entity's business model follows the strategic focus of the organisation and is unlikely to change unless the entity's underlying strategic objectives are modified. A change of these objectives will entail more than merely a change in accounting treatment but a change in the underlying processes and manner of managing the operations. Furthermore, a change in business model will be a significant event which would be well documented and communicated to users (EFRAG, 2010).

2.2.1. Business models existing use in IFRS

Business models are used in IFRS in the following ways. The IASB issues standards which apply to specific types of activities or contracts. In addition, business models are evident through the scoping requirements of standards. Some accounting standards use definitions or titles which differentiate

¹⁰ Per IFRS 13 the unit of account is "The level at which an asset or a liability is aggregated or disaggregated in an IFRS for recognition purposes" (IASB, 2017j, Appendix A). The definition, objective and use of the unit of account in IFRS is currently part of the IASB's CF project.

between business models. The business model is also apparent in certain presentation and disclosure requirements of standards.

Activity or contract specific standards are used by the IASB to specify the accounting treatment for entities whose business models are similar and so should have different or more detailed guidance concerning accounting treatment, for example, IFRS 17 for insurance contracts (IASB, 2017k).

The scoping requirements of certain standards encapsulate elements of the business model and are used to drive accounting outcomes. For example, the scope of IAS 2 on inventories excludes items held by commodity broker-traders (EFRAG, 2010; IASB, 2017b). The result is that the inventory standard does not apply where commodity items are held to trade rather than to be *used* otherwise in the entity's operations.

The definitions contained within certain standards result in the application of the standard to a particular business model. For example, the definitions of property plant and equipment and investment property are based on the intended *uses* of the asset (EFRAG, 2010; Leisenring et al., 2012; IASB, 2017d; IASB, 2017f). The purpose for which an item of property is held (i.e., either own use or rental), informs the way cash flows are generated and, as a result, is reflective of the business model. Interestingly, there are no dissenting opinions to the issuing of these standards related to the differing accounting treatments for the same asset.

In certain instances, the IASB has incorporated the business model in the manner of presenting and disclosing items (EFRAG, 2010; Leisenring et al., 2012). IFRS 8 requires that a segment report is presented on the basis of discrete business activities in the manner reported to an entity's chief operating decision maker (IASB, 2017h). IFRS 8 differentiates into operating segments those portions of the business which generate revenue and incur expenses in a similar manner, this is referred to in the standard as the management approach (IASB, 2017h, BC9 - 17).

2.2.2. Management intention and existing use in IFRS

Table 1 presents references to and discussion of instances where management's intention is referred to in IFRS. This is not intended to be a comprehensive list but highlights some of the different views of the IASB on management's intention.

Table 1: Management intention in existing IFRS

Description	IFRS requirement	Discussion
Intangible assets recognised as part of a business combination (Leisenring et al., 2012; IASB, 2017g, para 57; IASB, 2017e, BC169)	IFRS 3 requires the recognition of intangible assets separately from goodwill on recognition of a business combination. In specifying the recognition criteria in IFRS 3 B31 – B34, the separability criteria are met, even if an entity does not intend selling or otherwise exchanging and transacting with the intangible. The BC emphasises this point in indicating that: “... management’s intentions are <i>not</i> a characteristic of an asset” (IASB, 2017g, BC169, emphasis added)¹¹. In contrast, the recognition requirements for an internally generated intangible asset under IAS 38 require that an entity demonstrate “... its intention to complete the intangible asset and use or sell it” (IASB, 2017e, para 57).	Both references relate to the recognition criteria for intangible assets. In the first instance, the entity disregards management’s intention in determining the recognition as part of a business combination. This is important as the BC categorically refutes the statement that management intention is a characteristic of an asset. In contrast, in the second instance, an entity’s management needs to demonstrate its intention to use the asset prior to qualifying for recognition. The unit of account in the above examples is not explicitly stated but this is presumed to be the individual item.
Fair value of non-financial ¹² assets relating to highest and best use (IASB, 2017j, para 29)	IFRS 13 indicates that fair value of a non-financial asset is the highest and best use to a market participant, regardless of the manner in which the entity intends using the item (IASB, 2017j, para 29). However, IFRS 13 permits an entity to measure the fair value of a non-financial asset to assume that the current use is its highest and best use unless there are indicators to the contrary.	The principle in IFRS 13 is to reflect the highest and best use to which a market participant can put the asset. IFRS 13 includes the presumption that current use is highest and best use, in order to limit an exhaustive search for all possible uses. This does not detract from the principle that highest and best use is the preferable base upon which to determine fair value. This would imply that the manner of use by an entity should not be used to determine fair value and rather emphasise non-entity specific use. This contradicts the principles of IFRS 9 in using the business model to reflect a differing use in the financial statements.

¹¹ This inconsistency was noted by Leisenring et al. (2012).

¹² For a discussion on the IASB’s view on highest and best use as it relates to financial assets see the discussion in section 2.3.2 and IFRS 13 (IASB, 2017j, BC63).

Description	IFRS requirement	Discussion
Designation of hedging relationship – IAS 39 (IASB, 2016, 88(a))	In order to qualify for hedge accounting five criteria need to be met, including the following: “At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity’s risk management objective and strategy for undertaking the hedge” (IASB, 2016, 88(a)).	The term designation means the action of choosing. IAS 39 requires that in order to qualify for hedge accounting the entity’s management must formally “choose” to do so. This requires a more formal documentation of management’s objectives for engaging in this strategy. This requirement, based on management choice (albeit documented) drives the accounting and measurement outcomes for hedges.
Deferred tax treatment (IASB, 2017c, para 51 - 51E & BC23)	In terms of IAS 12.51, an entity is required to measure a deferred tax asset or liability based on the manner in which an entity expects to recover the asset’s carrying amount (IASB, 2017c). This is owing to the differential tax rates which apply in certain jurisdictions, dependent on the manner of realising the underlying asset.	This relates to the treatment of investment property, where an item is presumed to be held to sell in the future and when measured at fair value. An explicit reference was made to an alternate business model ¹³ where an item of investment property can be held to consume the benefits over time (e.g., through earning rentals) rather than through sale (IASB, 2017f, para 51C). The result is management’s intended use of the underlying asset drives the measurement of the deferred tax liability or asset. The unit of account for this determination is the individual asset level.
Cessation of capitalisation and commencement of depreciation or amortisation (IASB, 2017d, para 20 & 55; IASB, 2017e, para 30 & 97)	Both IAS 16 on property plant and equipment and IAS 38 on intangible assets include the principles that an entity is able to capitalise amounts to the cost of the asset until the asset is operating as <i>intended</i> by management. This point is also when depreciation or amortisation commences.	In this instance, management constructs or develops an asset based on the use for which management intends the asset. The entity assesses when the asset is fit for purpose. This will impact both the extent to which costs are recognised in the carrying amount, as well as the measurement (at initial recognition and subsequently through depreciation or amortisation).
Transfers of investment property (IASB, 2017f, para 57 & BC27)	IAS 40.57 indicates that a transfer to or from investment property can only occur when there is a change in the property’s use. It further indicates that a change in management’s intention alone is not sufficient evidence that there has been a change in use.	Two important points are drawn from this requirement, namely, that management intention is a factor in determining use for an individual item of property. Further, that a change in management intention is not the predominant factor to consider in evaluating use. Further factors considered in this paragraph relate to actions taken by the entity. This can be related back to the business model in that commentators view the business model as the implemented actions required to achieve the entity’s objectives.

¹³ This reference to the business model was only documented in IAS 12 as a result of the explicit use of the business model in IFRS 9 (IASB, 2017c, BC23). These amendments to IAS 12 were made in 2010 after issuing the chapters of IFRS 9 relating to classification and measurement in November 2009.

From the examples provided the IASB incorporates management's intention into accounting standards inconsistently. Understandably, there is contention as to the desirability of the role of management intention in financial reporting.

2.3. The use and economic substance of a financial asset

For financial reports to be useful for decision making, information must display the fundamental qualitative characteristics of relevance and faithful representation (IASB, 2017a). Relevance is described as the ability of financial information to make an impact on the decision making of users. Information can portray this characteristic by having predicative or confirmatory value (IASB, 2017a). The CF describes faithful representation as a complete, neutral and free from error depiction of an economic phenomenon (IASB, 2017a).

Unfortunately, the CF does not explain what is meant by economic phenomenon, nor what the economic characteristics of assets and liabilities are (Lee, 2006). Nor does the CF indicate how the use of an item should impact the underlying economics and on the accounting treatment (Barth, 2013). The CF also defines an asset in terms of the future economic benefits which it represents, which similarly requires an understanding of *economic* benefits (IASB, 2017a). The CF states that the substance of a transaction, including economic reality, is more important than its legal form. This means that transactions need to be considered more broadly than only from a legal rights and obligations perspective (IASB, 2017a).

There are debates about the ability of business model concept in IFRS 9 to display these characteristics of decision useful information appropriately. Leisenring et al. (2012) contend that a single measurement approach based on fair value would better achieve the objective of financial reporting, regardless of the assets use. Conversely, Botosan and Huffman (2015) argue that the representation of assets based on the manner of value realisation provides the most decision useful information.

Leisenring et al. (2012) conclude that the only way the use of the business model or management intention is conceptually sound is if the *use* of a financial asset through its manner of value realisation, does, in fact, change the economic reality of the financial asset. If it does not, then comparability is impaired to a degree of incoherence and items are not faithfully represented by the financial reports. These authors recommend that an entity account for a financial asset based on the contractual terms, namely, based on the rights and obligations specified in the contract. However in the CF, IFRS requires that "... attention needs to be given to its [a transaction's] underlying substance and economic reality and

not merely its legal form” (IASB, 2017a, 4.6). This implies that the substance of a transaction or event is not only defined by its legal form or contractual terms but also includes other ‘economic’ characteristics. In contrast, whilst discussing financial and non-financial assets IFRS 13 states that the characteristics of a financial asset are its contractual terms (IASB, 2017j, B63(a))¹⁴.

Of particular contention, is whether the manner of value realisation impacts or changes the economic reality or phenomenon being reported (Leisenring et al., 2012; Barth, 2013). Firstly, the nature of economic reality is examined. Secondly, whether the method of value realisation is an economic characteristic of a financial asset is explored, consequently, considering whether different accounting treatment is justified on this basis.

2.3.1. Economic reality

Accounting purports to provide a faithful representation of economic reality as an objective fact (Hines, 1991; Lee, 2006). However, accounting is not concerned with the reporting of natural phenomenon (Lee, 2006). Rather, it is a subjectively constructed set of rules to present a series of transactions and events to users, in a fashion which conforms to current society’s thinking and philosophy. Accounting merely “... rests on the elaboration of different images of reality ...” (Davis et al., 1982, p. 307). Arguably, once a set of reporting standards is formulated, it is possible to evaluate the compliance with those principles from an objective perspective (Shapiro, 1997). In the same way, an actual accounting number may be an objective concept but the manner of reporting this is subjective and socially constructed (Davis et al., 1982). The complexities in determining an agreed upon conceptual framework for financial reporting are, in part, due to the difficulty in reconciling financial reporting to a single economic reality (Hines, 1991).

Not only are the phenomenon and the rules created to report these phenomena a subjective and human construction but the communication or representation of this reality in itself informs and further creates reality (Hines, 1988; Hines, 1991; Shapiro, 1997). In this way, accounting has “power” in its ability to create and communicate reality in a circular manner (Hines, 1988). In the context of accounting, reality can be created on the basis of “collective intentionality” (Lee, 2006, p. 12) by “sharing intentional states” (Alexander and Archer, 2003, p. 5). This change in states further perpetuates complexity in defining an appropriate CF. What is deemed to be appropriate in any given set of circumstances is based on the prevailing belief rather than an objective fact grounded in scientific determinism (see Ravenscroft and

¹⁴ See also section 2.3.2.

Williams, 2009). In this way, if financial reporting communicates value realisation as an economic characteristic based on the prevailing IASB view, users and other market participants may, over time, build this into their interpretation of economic reality.

The IASB seeks to preserve the ideal of objectivity in financial reporting (Hines, 1991). Particularly as the perception of objectivity is one of the key elements to maintain the institutional legitimacy of the profession (Shapiro, 1997). For example, the assertion that an entity's business model is an observable matter-of-fact highlights this pursuit of objectivity (IASB, 2017i). This implies that the business model exists as an objective and naturally occurring phenomenon, when in reality it could be the subjective articulation of what is considered an entity's value creation process. Being able to view the business model becomes an objective observation but the manner in which and the 'how' of creating the business model and its meaning in differing contexts are subjective.

Whether or not value realisation impacts the economic phenomenon being reported depends on the prevailing accepted view. The economic reality of a transaction or event cannot be separated from its subjective interpretation. In the strict standard setting context, value realisation can be seen to be an economic characteristic¹⁵. Through communicating the idea that value realisation best reflects the economics, value realisation can become an economic characteristic of an asset. Various commentators have aligned themselves with the view that illustrating the manner of value realisation is a critical component of reporting transactions and events (EFRAG, 2010; Botosan and Huffman, 2015): this infers that value realisation is perceived to be economic reality.

2.3.2. The use of a financial asset

"A question relating to comparability to which we do not have a good answer is whether two assets that seem the same (e.g., computers) are economically the same if they are *used differently* (e.g., as inventory or property, plant and equipment)" (Barth, 2013, p. 7, emphasis added).

This raises the question whether the use of an asset alters its economic features, in this way justifying the use of an alternate accounting method to reflect the different economics (Leisenring et al., 2012; Barth, 2013). This has implications not only for comparability but also for faithful representation. Seemingly this is assumed or accepted to be true in the case of a non-financial asset but contention arises for financial

¹⁵ For example, as demonstrated by the use of different models to account for investment property vs property plant and equipment – these requirements would not have been included in the relevant standards if standard setters were of the view that this financial reporting did not reflect the economics. Also, consider the use of business models in IFRS 9 and business activities in the IASB's CF project.

assets. Botosan and Huffman (2015) emphasize that the terms *value in use* and *value in exchange* are not synonymous with the concepts of *non-financial* and *financial assets* respectively. They also acknowledge that a non-financial asset can be held for exchange or a financial asset can be held for use (e.g. trade receivables).

In discussing the concept of value realisation and its impact on the economic substance of a financial asset, the scope to 'use' a financial asset has been challenged. This is because the idea of value realisation suggests that there are differing manners of realising value from an asset through the way the asset is used. There are divergent views on whether a financial asset can be used both within the issued IFRS and in the academic literature (EFRAG, 2010; Brougham, 2012; Leisenring et al., 2012). IFRS 9 provides (primarily) two uses for financial assets: either they are held in a business model to collect contractual cash flows or to sell (IASB, 2017i). This is at odds with the guidance in IFRS 13:

"Financial assets *do not have alternative uses* because a financial asset has specific contractual terms and can have a different use only if the characteristics of the financial asset (ie (sic) the contractual terms) are changed. However, a change in characteristics causes that particular asset to become a different asset. The objective of a fair value measurement is to measure the asset that exists at the measurement date" (IASB, 2017j, BC63(a), emphasis added).

The context set by IFRS 13 is that financial assets cannot be used in different ways and, consequently, there is no "highest and best use" for financial assets (IASB, 2017j, BC63). Paradoxically, in determining *which* financial assets are subject to fair value measurement requirements (i.e. through the business model assessment in IFRS 9) the *use* of a financial asset (i.e. held to collect or held for sale) drives the accounting treatment. As shown in section 2.1.3, the term business model is not defined but the common understanding is that this term relates to the manner of value creation or value realisation. This implies that there can be different ways to create value from the same financial asset.

Leisenring et al. (2012) argue that the characteristics of physical assets, i.e., that they can only be used for one purpose at a given time, differentiates them from financial assets (Leisenring et al., 2012). It is also more difficult to demonstrate the use of financial assets, with their characteristics meaning that changes in use can be made with relative ease and negligible cost. It is argued that financial assets have characteristics which render the single use, to the exclusion of other uses, impossible (Leisenring et al., 2012). Financial assets are considered fungible and can easily be converted to cash (Leisenring et al., 2012), and hence can be substituted for other financial assets. However Brougham (2012) argues that the use of the business model for a financial asset is important because of a financial asset's fungible

nature. The business model should communicate to users how cash flows will be generated because of a financial asset's potential for multiple uses.

Transacting in financial instruments can be seen as a passive activity where the only actions or uses are to hold the asset or to sell. At a reporting date, an entity could hold a financial asset with both the intention to collect and sell. In this instance until the asset is actually sold, using the asset in one way it does not preclude use in the alternate manner (Leisenring et al., 2012). A financial asset can be held to collect contractual cash flows *and* be held for subsequent sale, as highlighted by the controversial¹⁶ July 2014 amendment to IFRS 9 which permits a third business model, a combination of hold to sell and to collect (IASB, 2017i).

Leisenring et al. (2012) further indicate that all decisions or intentions in respect of holding or selling assets are in pursuit of the profit motive. An entity's management will follow the course of action which will lead to the greater profits.

However, for financial institutions a financial asset may be held for several purposes: asset liability management, risk management and prudential regulation purposes (Brougham, 2012). Asset liability management refers to purchasing or holding suitable assets to satisfy specific liabilities which an entity holds. This assists in financial solvency and profitability, in ensuring that liabilities are matched by assets returning, at least, the same or more cash flows than the obligations under the liability. For prudential supervision purposes, Insurance entities, Banks, Pension funds and Collective Investment Scheme regulations¹⁷ requires that certain levels of specified assets are held to protect clients from losses associated with reckless conduct.

For an insurance company, a long-term life policy should not be matched with short-term bonds, or primarily with equity shares. It would be prudentially sound and in the interests of profitability if these liabilities be backed by a low risk, long duration asset such as a government bond, supplemented with listed equities. However, the same entity may hold the same dated government bond in another business

¹⁶ This amendment was approved by 14 of the 16 members of the IASB. Two members dissented on the basis that the distinction of this business model was unclear and viewed the requirement as introducing complexity in application – see IFRS 9 Dissent of Stephen Cooper and Jan Engström from the issue in July 2014 of IFRS 9 Financial Instruments (IASB, 2017i)

¹⁷ See the Long Term Insurance Act, 1998 (Act No. 52 of 1998) section 31, Banks Act, 1990 (Act No. 94 of 1990) section 73, Pension Funds Act, 1956 (Act No 24 of 1956) regulations Part VII 28 and Collective Investment Schemes Control Act, 2002 (Act No. 45 of 2002) section 46.

model whose objective is to trade, based on expected changes to interest rates or fair values of the bond (i.e. for speculative purposes). Solvency and profitability factors will determine the business models, consequently driving the investment strategy and purpose for purchase of the financial asset in different departments of the same insurance company.

The example illustrates that the same bond can be used in two differing business models with two completely different uses within the same entity. If these business models are established, it is unlikely for an entity to use the instrument in a different manner, although it is conceivable that they could do so in exceptional circumstances¹⁸. In a financial institution there is a relationship between the financial assets bought and the financial liabilities entered into. Both the asset and liability parts of these transactions are considered *inter alia* in developing and selling FS products. A sale contrary to the stated business model to take advantage of a market opportunity could result in a gap in the asset liability matching profile. This could require the purchase of a replacement asset with similar, if not identical, characteristics as the one disposed of.

The different uses in the example above can be communicated by measuring both financial assets (bonds) using a single fair value measure (Linsmeier, 2011; Leisenring et al., 2012). Alternately, in terms of IFRS 9, the financial assets should be reported under two different models with one at amortised cost (hold to collect)¹⁹ and the other at fair value (hold to trade). As a result of the different uses, the entity could be exposed to different risks, in the first instance market and liquidity risk as well as market behaviours. In the second instance, the risk exposures may be different, with a hold to collect model exposing the entity to credit risk and long-term interest rate risk. The timing of cash flows is also impacted, depending on whether the entity will hold the financial asset to collect or sell. As a result of the different uses, the variation in risk, return and the manner of collecting cash flows, it could be misleading for both assets to be reported in the same way.

¹⁸ For example, a run on the banks could result in liquidity requirements in excess of the statutory liquidity portfolio. It is complex to anticipate a similar example in the insurance context owing to their stringent requirements to hold cash type assets, as well as that in many instances unexpected and unlikely loss events such as catastrophes are routinely covered by reinsurance treaties.

¹⁹ Note that this thesis does not consider the potential practice of insurance companies of designating financial assets as fair value through profit and loss in order to eliminate accounting mismatches that could arise as the insurance liabilities could be measured on a current value basis.

3. Methodology

3.1. Justification for use of a qualitative method

This study assumes that accounting is a social construct resulting in no single correct view (see Section 2.3.1). In light of this, this study adopts an interpretive qualitative methodology as it aims to understand how current accounting experts view using the business model to drive classification. IFRS 9 is a relatively new standard, with complex requirements and broad implications. A qualitative approach is considered more appropriate to capture the perceptions, ideas and reasoning related to the use of the business model in financial reporting (O'Dwyer et al., 2011). Moreover, interviews allow for more rich and detailed data to be collected than might otherwise have been collected through quantitative methods.

A positivist approach was considered but rejected as the purpose of this research is not to produce generalizable results but understand a new accounting prescription. A quantitative method would not yield the same rich and detailed data based on interviewees' experience (Rowley, 2012).

3.2. Sample size and selection of sample

The interviewees are: preparers, users, auditors, academics or analysts of financial statements. The selection of interviewees with experience in financial reporting, with the appropriate qualifications and experience in FS, assisted in ensuring that relevant data of good quality was obtained and is applicable to the research (O'Dwyer et al., 2011).

Purposive sampling was used to ensure that the interviewees selected are highly knowledgeable, qualified and experienced in the subject matter. This has enhanced the validity of the study by ensuring interviewees have relevant and applicable insights to offer the research due to their high technical abilities. This also reduces the risk of uninformed responses distorting the results (Creswell, 2009). Other factors such as availability of interviewees (from both a geographical and scheduling perspective) also affected the sample selection.

Twelve interviews were planned with additional interviewees available if saturation was not achieved by the 12th interview (Rowley, 2012). Saturation was reached (where no further themes or new responses emerged) after interview 10. This was supported by the remaining two planned interviews not providing additional themes or insights. Some pragmatism is required as although a sense of saturation was obtained, it is possible that had a very large number of people been interviewed some additional insights

could have been discovered (O'Dwyer et al., 2011; van Zijl and Maroun, 2016). The breakdown of interviewees is provided below in table 2, more detail, including the length of the interviews are included in Annexure I.

Table 2 – breakdown of interviewees

Respondent code	Background	Sector
A1	Academic	Accounting education
A2	Academic	Accounting education
I1	Analyst	Banking
P1	Preparer	Banking and insurance
P2	Preparer	Insurance
P3	Preparer	Banking
P4	Preparer	Banking
P5	Preparer	Banking
P6	Preparer	Banking
T1	Auditor - technical	Financial services
T2	Auditor - technical	Financial services
T3	Auditor - technical	Insurance

3.3. Detailed interviews

A research agenda was designed based on the prior literature (see detailed interview agenda in Annexure II). Open-ended questions were used to enable new concepts and ideas to emerge from the interviews free from rehearsed responses (Qu and Dumay, 2011). Sub-questions were developed and served as prompts in the event that a particular question had not been explored fully by a participant (Rowley, 2012). These interview questions were piloted to ensure that they are not leading interviewees to specific responses, contain no ambiguities or repetition and that the concepts are completely explored.

Interviews were performed between August 2017 and February 2018 in Johannesburg. All interviews were conducted in person and lasted between 45 to 120 minutes. This provided adequate time for the interview agenda to be fully explored (see Annexure II) (Leedy and Ormrod, 2013).

3.4. Collection of data

Potential interviewees were contacted by phone or e-mail to invite them to participate in the study. Interested participants were then contacted to arrange a mutually convenient location, date and time for the interview to take place (Leedy and Ormrod, 2013). Interviewees were provided with background documentation which introduced the research topic and explained the purpose of the research (O'Dwyer et al., 2011).

Interviewees were assured of their anonymity. At the beginning of each interview the researcher spent a few moments building a rapport with the interviewee (Alvesson, 2003; O'Dwyer et al., 2011; Leedy and Ormrod, 2013) to enable an environment where the interviewee felt free to be open and candid. The researcher requested permission to record the interviews so that there were no interruptions or distractions for taking notes (this also promotes accuracy of the final transcriptions). The interviewee was advised of his/her right to withdraw at any time without prejudice.

The order of questions posed differed among interviews in order to preserve the flow and conversational manner of the interview but all questions were covered in each interview. The interviewees were afforded the opportunity to review their transcript for completeness and accuracy if they so wished (Alvesson, 2003).

Interviews were recorded on a dictaphone (O'Dwyer et al., 2011). The researcher transcribed the interviews using Microsoft Excel and stored these on a password protected computer. The transcribed record of the interviews was saved, with backups routinely made. Each transcript did not contain the interviewees' personal details. A separate password protected master spreadsheet was maintained to link a transcript with the interviewee.

3.5. Data Analysis

The data analysis is an iterative process. Firstly, each interview was transcribed by the researcher. During transcription responses were categorized and notes summarizing each transcript were made. The initial issues, ideas, similarities and contradictions were used to form open codes (Leedy and Ormrod, 2013; Maroun, 2017b). As additional interviews were conducted and transcribed, so the open codes were

refined and re-grouped as necessary. This resulted in each interview being read, and the open codes revised, several times throughout this phase of the data analysis (O'Dwyer et al., 2011; Leedy and Ormrod, 2013). Examples of open codes include: business model, management intention, the economic substance of financial assets and the use and faithful representation of financial assets.

Within each of the open codes, various sub-themes emerged and were used to identify and develop axial codes. This resulted in a data reduction process that involved re-reading transcripts and reviewing the prior literature to ensure completeness and consistency was achieved. This process was employed until a sense of saturation was achieved and no new axial codes emerged (O'Dwyer et al., 2011). Examples of axial codes include: the unit of account for the business model, the significance and frequency of sales and changes in business models, these were derived from the prior literature, and ensured that focus on the research question was maintained. The axial codes were used to structure the findings in Section 4.

3.6. Validity and reliability

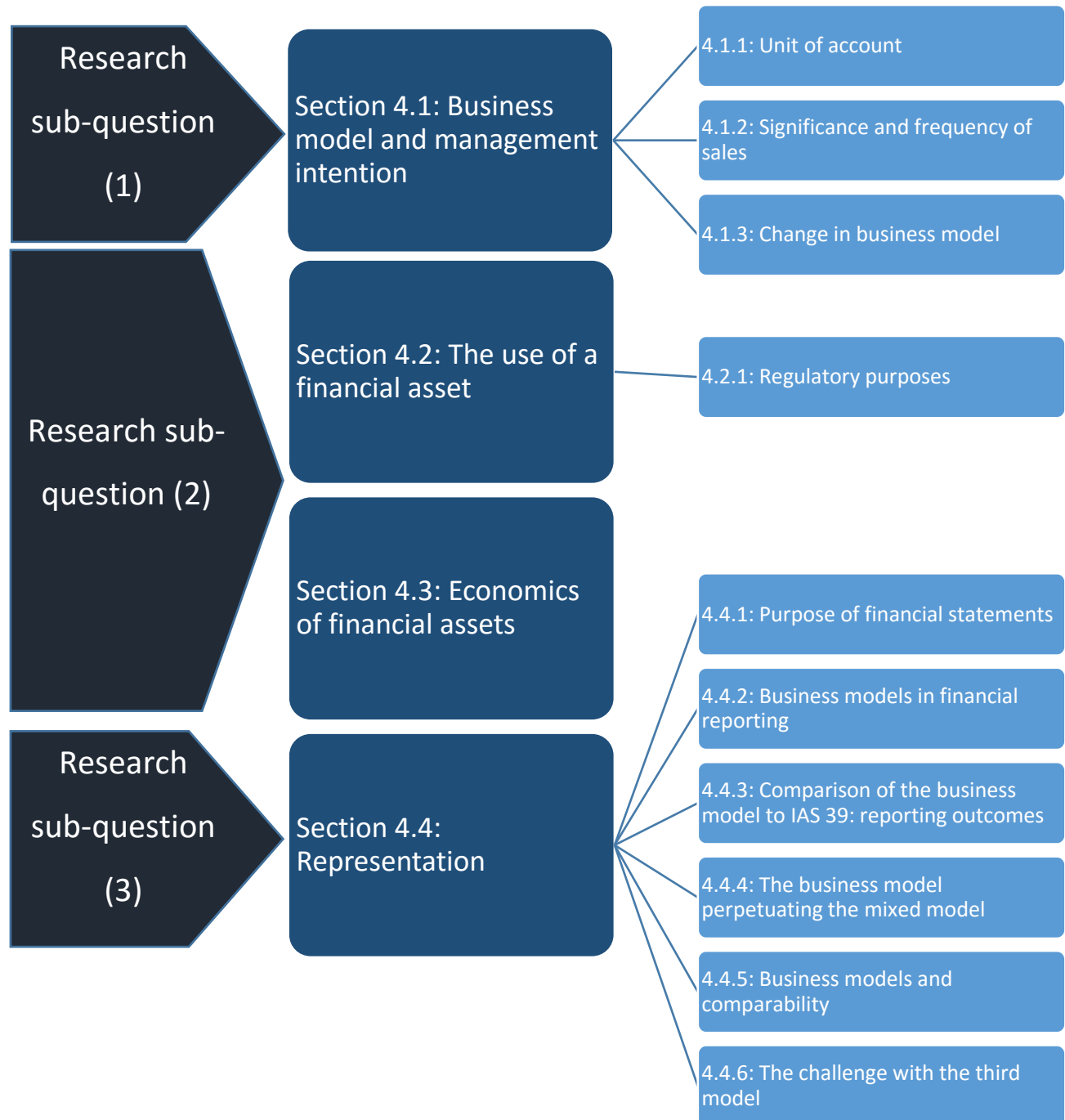
Several limitations exist in respect of qualitative methods. These include that the researcher is an integral part of the research being both the instrument used to ask the interview questions and to analyse and synthesise the data. The following steps were taken to address validity and reliability of the research conducted.

- Interviewees were informed of, and reminded, that their anonymity is guaranteed. This is important to encourage honest and complete responses even where these are controversial (Alvesson, 2003; Leedy and Ormrod, 2013).
- The interview questions were piloted with two academics with at least 10 years' experience to ensure that questions are objective, do not display any bias on the part of the researcher and relate to the research question and sub-questions identified (Rowley, 2012).
- Respondents were not provided with detailed questions in advanced to reduce the risk of rehearsed responses. In addition, interviewees were sometimes requested to rephrase their responses to eliminate any ambiguity and to address rehearsed responses (Alvesson, 2003).
- During the interview process, interviewees were allowed to respond in an open-ended manner, with the researcher being cognisant of not leading the interviewee (Rowley, 2012). Participants were carefully selected based on both years' experience in the financial services sector and detailed knowledge of IFRS requirements, particularly IFRS 9.

- As with all qualitative studies, the research is inherently involved in the data collection and interpretation process (Creswell and Plano Clark, 2011). To reduce the risk of incorrect coding, the researcher's supervisor reviewed transcripts and coding as a review control (O'Dwyer et al., 2011).

4. Findings and analysis

The following section presents the findings of this thesis. The list of participants and their related background information is presented in Appendix I while the interview agenda is set out in Appendix II (pages 67 and 68 respectively). The findings have been laid out as follows:



4.1. Business models and management intention

Section 2.2 considers the relationship between management intention and the business model. Participant's responses were split when asked to differentiate between management intention under IAS 39 and the business model under IFRS 9. Half the respondents concluded that these are different terms with different meanings and operational effects (A1, A2, P3, T1, T2, T3), while the others did not perceive such a distinction (I1, P1, P3, P4, P5, P6).

The participants who did not see a distinction did not associate the classification model in IAS 39 with management intention as described in the literature (see section 2.2). This view was especially prevalent with preparers (P1, P3, P4, P5, P6). Rather, the classification process employed was based on a type of 'negative test' where their objective was not to be compliant with IAS 39 but was dependent on avoiding the punitive tainting requirements²⁰. By way of illustration, an entity may have the intention to hold a bond to maturity, but can potentially sell it if a liquidity need arises. The entity would classify the bond as held for trading despite not actually having that intention, to pre-empt possible future tainting and avoid its negative accounting consequences.

Management intention is not expressly mentioned and defined in IAS 39. Rather, the definitions of financial assets are worded to incorporate the action of management intention²¹ (P1). There is no challenge to management intention and no real proof of the intention required (P1, T3). This can result in compliance with IAS 39, but not in the manner envisaged by the standard.

On the other hand, despite indicating that there is a difference between business models and management intention, T1 argues that even the *management intention* concept contained in IAS 39 might not actually align with the common interpretation of intention:

"To me when you don't cater for changes in intention, I'm not sure you are going down an intention route. You are going down a 'make a decision at a point in time and that's it', stick with it" (T1).

²⁰ Financial assets can only be classified as held-to-maturity if in the current and two preceding financial years the entity has not sold financial assets (not more than insignificant) in this classification (see IAS 39 para 9).

²¹ For example, the definition of held-to-maturity: "Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the *positive intention and ability* to hold to maturity ..." (IASB, 2016, para 9, emphasis added).

This is further supported by participants using the term ‘intention’ instead of ‘business model’ when discussing the IFRS 9 requirements (P3, P4, P6, T1, T2). The term ‘intention’ in these participants’ view is not synonymous with management intention in IAS 39. The use of ‘intention’ interchangeably with other terms reflects the difficulty experienced by participants in drawing such a distinction. Where participants perceive a difference in the terms, these were found to relate to (a) the *level* at which the assessment is performed and (b) the ease with which management intention or the business model can change.

In summary, participants appear divided into two groups: those who see a distinction between business model and management intention and those who see no such distinction. An important finding is that preparers appear to be utilising a strategy of classification which on paper conforms to IAS 39 prescriptions but when in reality are being applied in a defensive manner to avoid onerous tainting provisions. The following sections set out the key areas where there was perceived to be a difference between management intention and the business model.

4.1.1. Unit of account

Participants expressed diverse views on the level at which the business model should be determined (unit of account²²). The level at which the business model was defined functioned as a hierarchy, with different levels of aggregation interpreted to be the appropriate unit of account (see table 2).

Relationship between the levels

Most participants discussed the business model in relation to strategy. However, they did not view the business model as being at the strategic level but rather as an operationalisation of the business’ strategy (A1, I1, P4, T1).

“Well, the strategy informs the business model. So, the company has a strategy where it decides how do I actually want to achieve whatever I want to achieve. So, what do I want to achieve, how do I want to achieve it? The business model gives effect to that. You put the business model in place in order to achieve whatever your strategic objectives are” (A1).

“I think the business model is probably the result of the strategy. So, the intention, to me, the strategy is the intention and then it drives the business model” (T1).

²² The exposure draft for revisions to the CF includes for the first time a section describing the concept of the unit of account and its use in financial reporting and standard setting (IASB, 2015).

"So how do you get to [the] business model? You start off with your strategy, your strategy is then translated into a business model...then we take that and translate it into an operating model" (I1).

In one instance the participant viewed the business model as a term more encompassing than for the classification of financial assets, but the use of "business model" was a necessary simplification in determining a relatable term:

"A business model for a business is something that is far greater than whether you hold financial assets to collect principle and interest or if you think you might realise value at some point. But it was a way of describing part of the way that a financial institution conducted its business" (A2).

There is also a lack of consensus or clear definition of strategy, intention and the business model, with these terms being used interchangeably (I1, P3, T1, T2).

Despite disagreeing that the business model was at a segment level, participants viewed the alignment of the business model to segmental reporting as imperative for effective communication (A1, P2, T1).

"I think if you can align the business model principles in [IFRS] 9 to your [IFRS 8] segmental reporting, to what you communicate to the market and to your shareholders and analyst community, I think that cuts out a lot [of] inconsistencies and it just makes stuff much easier" (P2).

There was also a view from one participant that:

"The more granular, the more flexibility you have" (P4).

A very small portfolio has the disadvantage of making sales activities of the portfolio more material and can leading to questioning or reassessment of the business model. This could further undermine the entity's ability to determine its business model adequately (see section 4.1.3). In a smaller portfolio with fewer assets, just a few sales transactions could trigger the *significant and frequent sales activity* threshold and, as a result, "bring your business model into question" (P6). This is explored further in section 4.1.2.

Table 3 – Unit of account for classification of financial assets

Level	Description	Considerations/implications	Quotes
Strategic (P2)	When different legal entities operate different businesses (retail banking, insurance, corporate banking).	Allows a one-to-one mapping of entity-to-business model (P2). Board-level strategic decisions are reflected in business model (P2). Practically presents audit challenges as a single entity level business model is not commonly used in FS entities.	“I mean we've got our business, we've got two businesses, three should I say... The businesses are managed through an EXCO but ultimately reportable to board, so it's definitely at a strategic level” (P2).
Segmental reporting (A1)	Direct alignment between the segments disclosed under IFRS 8 and the business models used for IFRS 9.	Aligns communication in the financial statements with the way the business is managed (A1). Segment reporting is related to business models prior to the issuing of IFRS 9 (A1).	“In my mind the business model will be at the level of segmentation. Because if you think about your segments, they are the different parts of the business that get managed separately internally for management purposes. Now the only reason why you would have different parts of your business managed separately and internally is because the underlying risks and operations and the cash flows are fundamentally different” (A1).
Portfolio (A2, I1, P1, P3, P4, P5, T1, T2, T3)	Lower than the segment level, groups of financial instruments managed together with similar risks.	Portfolios are undefined by the IFRS and dependent on the entity's management. Aligns with mandates created to give effect to the entity's strategy (P4, P5). Further aligns with product design where economies of scale at a portfolio level are critical to make products viable (P1).	“If it's done at a higher level or a different level, you can have your model but your model can be changed without you knowing in advance, and being able to advise that person [of] the financial impact of that decision” (P5).
Asset or portion of an asset (P6)	At the asset level or portion of the asset level for very large assets.	Large asset exposures in a wholesale bank may be held in multiple business models.	“[For example] we originate R1b of a loan, we only actually intend to hold and collect [R800m] of this and [R200m] we are originating to sell. So, it's one asset but we are using it for two different things and then we put it into two different [business models]” (P6).

Most participants held the view that the level would require careful consideration to be compliant with the standard, auditable *and* practically operational. The definition of portfolios is a critical first step in the implementation of IFRS 9's classification requirements (P1, P3, P4, P6, P5, T2).

Despite the various views on the appropriate level to determine the business model, most participants described the business model as aligned to the way the business is managed (A1, A2, I1, P2, P3, P5, P6, T1, T2, T3).

"I think that the business model needs to be at the economic level, at the level that the business gets managed by management..." (A1).

"So, we've gone through quite [an] extensive exercise with the various functions across the group to articulate what we actually do and how we manage the business" (P2).

IFRS 9 envisaged the possibility of more than one business model within an entity (IASB, 2017i, B4.1.2). There are varying interpretations of whether there should be a single business model at the reporting entity level (P2) or multiple business models per entity (A2, I1, P1, P3, P4, P5, P6, T1, T3).

It is clear that there needs to be evidence of multiple business models within a single reporting entity, should this be required. These require substance and not manipulation in order to achieve a particular accounting measurement outcome (A1). In a banking environment, this is said to be achieved by the "Chinese walls" imposed by regulation between the trading and funding desks²³ (A1, P1). The observable nature also differentiates the business model from management intention (P1).

"So yes, if you've got two business models, fantastic but the chances are you've also got two different management systems, you've got different controls in place, different governance systems in place, different key performance indicators, different risks, different targets for the different management groups, different criteria according to which you hold them accountable. Now what we are saying is that the two models that you're explaining to me have substance, they're genuine" (A1).

The level was understood as a key differentiator for some participants (A1, A2, P2, T1, T2, T3). This is in line with the IASB's justification of the difference in terminology. It is unclear whether participants were

²³ As the funding desks have access to management accounts, this function needs to be completely separated from the trading desk to prevent trading on *insider information*.

led to this view through IFRS 9 or whether respondents would identify the level as a differentiator in the absence of the IASB's assertions.

Management intention is seen to function at an individual financial asset level (A1, A2, P2, P3, T1, T2) and is seen as static at a point in time (T1).

“Management's intention is something that gets applied on a case by case basis” (A1).

The business model is seen to function at various levels, depending on the way the business is managed.

Other participants from the banking industry did not view management intention to be at an instrument level vs the business model at a higher portfolio level. Again, these participants did not see a difference in these terms. This can be attributable to their disassociating intention from IAS 39 in the context of classifying financial assets (P3, P4, P5, P6)

4.1.2. Significance and frequency of sales

The significance and frequency of sales is important when delineating business models or portfolios, as well as for determining whether there has been a change in business model. Consequently, if there are significant and/or frequent sales, the financial assets are unlikely to be classified in a held to collect model (see section 2.1.2). Most participants discussed the significance and frequency test, however, there were diverse views on how this would be implemented and audited.

Participants commented that fixed percentages for significance and frequent occurrences were unlikely to emerge as 'rules of thumb' or be required by auditors (P1, P2, T2, T3). A characteristic of principles based accounting standards is the ability of the reporting entity to use judgement. This judgement is required in determining the appropriate frequency and significance of sales for the entity to provide a faithful and neutral representation of financial assets. One participant viewed the creation of fixed percentages as a contravention of the principles based approach required by IFRS 9, although acknowledging that there would be pressures from auditors to have an “arbitrary line” (A2).

“So, I don't think we will get there for IFRS, and to be honest I think again that becomes too rules based as well; I don't think that's the intent as well” (P2).

“So again, I think *just if* IFRS was driving consistency you would want bright lines, you would want 10% for everybody” (T2, emphasis added).

This area requires specific consideration by auditors as it is an area of significant judgement (A1, A2, P3, T1, T2, T3). One of the auditor participants concurred with the view that judgement needs to be applied by the entity's management in defining the business models (T2). The audit would be performed on the basis of the client determined ranges (once considered in line with the principles in IFRS 9) (T2). Further, diversity amongst entities regarding the percentage and frequency of sales is acceptable and in line with IFRS' principles-based philosophy (T2).

The significance and frequency test are considered to be an area of contention with auditors, resulting in debates and compromise (A2, P3, P4, P5, P6). In one case there was reluctance from auditors to commit to fixed percentages and thresholds:

"My sense of it at the time was, in a normal audit fashion, until industry benchmarks [are established] they didn't really want to make a call one way or the other" (P3).

Conversely, other participants noted that there would be a set of unwritten rules formulated, both practically for internal use, to establish boundaries of portfolios, and as thresholds for a change in business model (P4, P5, P6). These rules might be necessary from an audit perspective to counter the risk of abuse (T1).

"And that's where we are going to end up I think, with just a bunch of rules. Not in the standard, but they'll be, call it, society's rules. ... the society of banks and banks' auditors around the globe will decide what the thresholds are" (T1).

The significance and frequency of sales activity is also a key factor in determining whether there has been a change in business model. This would trigger a reclassification per IFRS 9 with relatively punitive income statement implications²⁴.

4.1.3. Change in business model

The relevance of a change in business model is twofold. Firstly, the ease with which management intention could be changed when compared to the 'rigour' of the business model in IFRS 9 is seen to be a differentiator of these two terms. Secondly, the rigour around the changes in business model are key in

²⁴ A reclassification is only recognised prospectively from the first day of the reporting period following the reclassification (IASB, 2017i). This is to deter opportunistic reclassifications as both income statement and balance sheet impacts will be delayed to the next reporting period.

limiting opportunistic behaviour. The potential for abuse is a concern in relation to the use of intention or the business model in financial reporting.

On the one hand, the ease of change in use of a financial asset is compared to the relative difficulty of change in respect of a non-financial asset (Leisenring et al., 2012). This argument continues that because of this ease of change, the underlying uses lack substance. As a result, it is not appropriate to differentiate intention for financial assets because of the fluid nature of these assets.

On the other hand, T2 argued that for non-financial assets the intention can also change relatively quickly. The execution may take longer and, hence, is a consideration in that decision but it would not inhibit the choice:

“Then if we want to differentiate on that basis, non-listed financial assets vs listed financial assets would get [you into] the same trouble. So, I would still see in my mind [that] assets are the same, decisions about assets are the same. The ease at which you could liquidate something could *inform* the decision that you have made but, once the decision is made, it’s made and your measurement should change” (T2, emphasis added).

The IASB and EFRAG argue that management intention can be changed more easily – perhaps as the time factor is less important - whereas the business model is stable particularly when linked with an entity’s strategy (see section 4.1.1) (EFRAG, 2010; IASB, 2017i).

The transitory nature of intention compared to business model is illustrated below. A business model is a higher strategic direction within which intentions for individual items can change but on an overall basis the objective of the business model is preserved:

“So, a nice way of illustrating this is to say my business model is to be a vegetarian. My intention, I might have a quinoa salad today, and I might have a quinoa salad tomorrow and maybe on the third opportunity, I actually decide to go with a normal Greek salad. Now there has been a change of intention there, I went from quinoa salad to Greek salad, but the fundamentals didn’t change. I [am] sticking in line with my original principle of I am a vegetarian” (A1).

"Management intent can be changed even more frequently than management itself can be changed" (A2).

Certain sales activities are also not seen to be acting contrary to one's business model (A1, P4, P5, P6). IFRS 9 is seen to accommodate such changes through the significance and frequency of sales tests (P4, P5, P6). Financial institutions' businesses are also constructed in such a way that fluidly in responding to changes in environment is required:

"I mean there's the treasury environment and the global markets environment where it's frequent and you are changing your mind ... the instruments themselves are of such a nature that you are changing your mind all the time. Whereas if you are in a retail space or an investment banking space, even if in a corporate bank space, the type of assets you are using are different in nature, there you are not changing your mind all the time" (P4).

An additional consideration in assessing change in intention for an individual asset within a business model is the practical need to purchase a replacement asset (A1, A2, P1, P5, T1, T2). For example, if a cash flow yielding asset is sold to make a short-term profit or for short-term liquidity needs, it is likely that a replacement asset will be required to maintain the business model's overall cash flow collection objective. The replacement asset would likely be very similar to the asset disposed of and in a similar market transaction could be purchased at the higher market price (T1, T2). IFRS would require accounting for a gain on disposal of the original asset but economically the entity would be in the same position (T1).

A change in business model is permitted by IFRS 9, although it is expected to be rare (A1, A2, P1, T1, T3). Various anti-abuse mechanisms are in place to ensure that the change in model has substance and is not done to manipulate the accounting outcomes. This prevents flip-flops (A1, T1) in the business model. Real changes in business models are expected to be infrequent with a purported change more likely to be initiated to manipulate the accounting outcome:

"As much as [management] believe things are changing and [they] want to prove their numbers... people want to get to a different accounting answer, it's normally a bit of smoke and mirrors" (T3).

A change in business model is considered to be a reclassification for the purposes of IFRS 9. The accounting procedures on reclassification result in the income statement impact of the change coming into effect prospectively from the *next* reporting period (usually annually or half-yearly) (T1). An entity may be constrained from making opportunistic changes in business models, as the profit impact is delayed

and somewhat unpredictable for the next period (T1). This is considered to be an effective anti-abuse mechanism (T1).

A further element discussed by participants is the significant and infrequent assessments which can act as an anti-abuse mechanism (P4, P5, P6, T1, T2). This is because once an entity decides on its business models as being held to collect or held to sell, opportunistic behaviour contrary to these models will be clearly observable (P1, P4, P5, P6, T2, T3). The significant and frequency test and assessment of the surrounding circumstances, will either justify the sales as legitimate, or bring the entire business model assessment into question (P4, P5, P6). This is similar to the tainting provision in IAS 39 (P4, P5, P6, T2), due to the tests largely being seen as a rule (T2).

One participant strongly disagreed that neither intention nor a business model could be changed easily in a sophisticated financial institution context. Portfolios and products are set up with the related systems infrastructure, people, processes and in some cases regulatory approvals. Consequently, changing the business model from holding to collect to holding to trade would require dismantling this infrastructure and potentially require regulatory approvals in order to manage risk holistically. This is seen to be an effective anti-abuse mechanism (I1):

"No, you don't just sell things to get liquidity. Your business runs in a particular way... you have entire teams involved, you've got lawyers involved, you've got regulatory experts involved because there is a regulatory cost to each of these types of assets... so you don't *just* decide" (I1, emphasis added).

Summary

Participants did not fully regard the classification model in IAS 39 to be intention driven; rather it was based on the tainting requirements to avoid, seemingly, punitive treatment. This does comply with management intention as following this 'punitive-avoidance' logic does indirectly result in the 'true' management intention being realised. Only where management were certain that they would be able to hold to maturity would they classify the financial asset as such. A downside of the management intention model is if management is anything less than certain an element of prudence could arise resulting in defaulting the classification to hold for trade. The business model in IFRS 9 is seen as different from the approach in IAS 39. The primary two differences are (a) the level at which the classification is performed and (b) the rigour around the changes in business model. The interpretation of the business model as

principle-based; the alignment to the way the business is managed; the demonstration of the significance and frequency of sales and the reclassification requirements are seen to be key enhancements to IFRS 9, reducing the opportunities for manipulation of accounting.

Consequently, it appears that there is a difference in the classification approach and operational effects of the business model under IFRS 9 compared to management intention in IAS 39. However, this thesis, also finds that the term *management intention* is not consistently understood and its use in the context of IAS 39 is unclear.

4.2. The use of an asset

A critical point of departure in the literature is the assertion that financial assets differ from non-financial assets in that a financial asset cannot be ‘used’ in different ways. This is both in the sense that it cannot be consumed and the use of a financial asset in one way does not preclude use in another way. The ‘use’ is also arguably not demonstrable in the sense that if an entity currently owns a bond, that does not in itself objectively demonstrate whether they will hold it to collect contractual cash flows or will sell it. Holding a financial asset can only be a passive activity: the only decisions are to hold or to sell today, and these are not be considered ‘uses’ (Leisenring et al., 2012). Even the IASB has asserted in IFRS 13 that a financial asset cannot be used (see section 2.3.2). Paradoxically, the concept of ‘use’ is important in the development of the business model argument in IFRS 9. This section presents participants’ views.

Participants were unanimous in their views that a financial asset can be used (A1, A2, I1, P1, P2, P3, P4, P5, P6, T1, T2, T3,). In some instances, participants did not initially understand the question (P1, P2, P4, P5, P6, T2). This disbelief in having been asked such an obvious question indicates, at least at face value, that there does appear to be a ‘use’ for financial assets. One participant remarked incredulously:

“Absolutely you use it in many varied different ways!” (P4).

The activities of a financial institution are such that financial instruments are the primary assets and liabilities which produce their return, rather than productive physical assets as with non-financial institutions (A2, P3, T1, T3).

“So, I mean just as simple as holding onto it or selling it is a decision, and that is with any asset” (T2).

All participants identified the ability to hold an asset to collect contractual cash flows as a ‘use’ of a financial asset. Participants also identified the hold to sell model as another ‘use’ of a financial asset (A1, A2, I1, P1, P2, P3, P4, P5, P6, T1, T2, T3). In some cases, there is scepticism regarding the held to trade model, which is seen as ‘gambling’.

“I think in some cases [there is] a certain amount of gambling that goes on. So, I think that must be made clear. I think that some of the guys do take a position on what they think whatever the asset is going to do and then decide whether to hold or not to hold that particular type of asset” (A1).

This model functions primarily on the basis of identifying a potentially under-priced asset, purchasing when the price is relatively low and selling the asset at a profit when prices increase (A1).

Only one participant explicitly mentioned the hold to collect *and* sell as a use of a financial asset (P1), although many participants discussed this business model more generally (explored in section 4.4.6). This portfolio can exist to cater for assets which can be held to collect contractual cash flows and to sell when required. For example, in line with IFRS 9, participants related this model to the liquidity portfolio of a bank. The quantum of this portfolio is rebalanced continually (in line with banking regulations) and although held to collect, they can be sold at any point if liquidity requirements decrease (P1, P4, P5, P6). A further application of this model is for financial assets in an insurance entity. However, this is not common in South Africa as most financial assets are already held at fair value to match policyholder liabilities (P2).

4.2.1. Regulatory purposes

Financial institutions are strictly regulated on account of holding client funds in a fiduciary capacity. As part of maintaining a financially sound condition, the regulators²⁵ require certain minimum value of assets to be held in low risk (and consequently low yielding) assets.

The liquidity portfolio in a banking environment is held to ensure that, in adverse conditions, appropriate assets, which can be quickly liquidated to meet demands for cash, are held. For example, a run on the banks or unexpected significant withdrawals. Participants viewed this regulatory-liquid-asset portfolio as

²⁵ E.g., the South African Reserve Bank and, until recently, the Financial Services Board.

a ‘use’ of a financial asset. I.e. the assets are being held for *liquidity purposes* and cannot be used to sell or to generate better returns (A1, P1, P4, P5, P6, T1).

“It’s actually quite punitive, so if I were to buy a bond from the reserve bank, it’s because I *must* hold it as regulatory capital and I’m actually not allowed to use that to necessarily generate [a better return]” (P1, emphasis added).

Related to the use of financial assets to meet regulatory capital requirements, asset-liability management is necessary for both the solvency and profitability of financial institutions (A1, A2, I1, P1, P3, P2, P4, P5, P6, T1, T2). To support financial soundness for customers and shareholders, a financial institution needs appropriate assets to service commitments to customers and policyholders (A1, P2, T2). Even for internal management purposes, asset-liability management is required to manage the business effectively.

“I think it’s back to talking about your strength of your balance sheet. It’s represented by, in a financial institution, financial assets to meet various liabilities or obligations that you have on the balance sheet” (P2).

Profitability in a financial institution depends on the margin between the return on assets and the cost of funding those assets. P1 illustrates this as follows:

“So, we’ll get money in from customers [who] put [in] deposits, but that’s a liability to us. Then we will *use* that to generate assets, which [are] loans to customers. So, from our side, it’s optimising that asset yield to give the returns to your liability holders and your shareholders but together with optimising that margin for us for profit. So, it’s how do we make that asset sweat best relative to what it cost us, to make a profit” (P1, emphasis added).

Summary

Participants are unanimous in their views that a financial asset can be ‘used’ for various different purposes, and see no distinction between financial and non-financial assets in this regard. This partially answers research sub-question 2, and supports that financial assets can be ‘used’.

4.3. Economics of financial assets

The literature describes identical bonds held by different entities or even different divisions within an entity, to illustrate the impact of different accounting treatment required by IFRS 9 (EFRAG, 2010; Leisenring et al., 2012; Barth, 2013). Questions arise as to whether these are economically the same

financial asset or whether the use (hold to collect or hold to sell) will impact the economics of those bonds. If that is so, Leisenring et al. (2012) and Barth (2013) argue there is justification in using the business model to differentiate accounting treatment because the economic substance of the bond differs.

Most participants viewed the two bonds with different uses as being economically different (A1, I1, P2, P4, P5, T1, T2). Some participants initially appeared confused about why there would be an economic difference and argued that there is an identical bond and the same set of contractual risks and cash flows (P3, P6, T3). When asked to explain themselves in more depth, they subsequently justified that, using these financial assets could create differences which should be accounted for differently (P3, P6). In one instance participant T3 indicated that intuitively the bonds are the same but T3 could “rationalise” them being economically different. The convergence around the formalised views of the IASB underscore accounting’s ability to inform economic reality (Hines, 1988). This illustrates that participants may view these transactions as different on the basis of the guidance in IFRS 9 and may be biased towards agreement with the standard while intuitively experiencing a disconnect from their own intuition and experience. This highlights the complex conceptual nature of using the business model to drive accounting treatment. Another participant acknowledged this potential for bias owing to long exposure to financial instruments:

“Yes, I might have been brainwashed being too long in financial instruments, but it works for me” (P1).

Participants considered the cash flows associated with the financial asset and the various risks to which the financial asset is exposed, as the primary characteristics (A1, A2, I1, P1, P2, P4, P5, P6, T1, T2). However, there were variations in how this was contextualised.

The underlying cash flow characteristics of a financial asset are irrelevant; only the intended manner of value realisation is a relevant economic reality (A1). In this instance, the contractual characteristics of the instrument are ignored.

“I think [a financial asset] only has two economic characteristics. Its value is either derived through subsequent realisation, i.e., hold to sell, and that holding period might be short-term or long-term, or it’s held to realise the coupons in it i.e., to strip out the contractual cash flows. I think those are the only two economics you get” (A1).

Another nuance on disregarding the underlying contractual characteristics is the creation of different risks based on the use of the asset (I1, P4, P5, P6, T2).

“Well, I wouldn’t necessarily say the characteristics inherent *in* the bond [are] different because a bond by itself has got interest rate risk and credit risk. My decision of how I’m going to use it, how can I say this, *decide which risk I’m exposed to or I am exposing myself to*” (T2, emphasis added).

“The underlying fundamentals of a government bond are the same but your behaviour in the realisation of those fundamentals is going to be different” (P4).

The basic characteristics inherent in a financial asset can be altered through the manner of intended use by the characteristics the entity *chooses* to expose itself to. This ‘choice’ of risk exposures is seen to be a deliberate process, critical to the operations of a financial institution (I1). In this way, the use of an asset becomes an economic characteristic of the asset which should be reflected in classification and subsequent measurement in accordance with the CF’s *faithful representation* of the economic phenomenon (T1).

“So, my intention with it can change the base economic characteristics of that item. The intention becomes part of those economic characteristics. *Or maybe, more correctly, override some of those economic characteristics or changes them*” (T1, emphasis added).

A further subtlety is viewing the underlying characteristics and the use as two interconnected economic events – both of which should be communicated by IFRS:

"The instrument itself is static, it has characteristics, the way in which it is used is the dynamic part of it, so that then converts it into some other form of economic energy and it’s the two parts that financial statements should be portraying" (A2).

To be recognised as a financial asset, an item needs to meet the definition of an asset and then the definition of a financial asset (P1, P2, P4, P5, P6). Inherent in the definition of an asset in the CF is the existence of future economic benefits flowing to the entity. This is seen to be the cash flows associated with *the use* of the asset (P2). Building on the definition of an asset, the definition of a financial asset is the contractual right to receive cash. Consequently, the cash flows of a financial asset are seen to be a key element or characteristic of these definitions (P1).

One participant held very strong views that all financial instruments should be held at fair value through profit and loss (P1). This participant also ascribed to the decision usefulness and valuation paradigms (see section 4.4.1). Interestingly P1 supported the idea that the use of an asset should be an economic characteristic of the asset:

“It’s that, intuitively, the value of an asset should consider its use, embedded within the rights and obligations but [also be] an objective market view. I think I should just say that” (P1).

P1 would prefer the highest and best use being considered when valuing a financial asset. This is contrary to the requirements of IFRS 13 where the highest and best use principle only applies to non-financial assets, as financial assets do not have alternate uses (see section 2.3.2).

Another expansion of the economic characteristics being changed by the intended use is that these views hold for financial and non-financial assets. The underlying characteristics of any asset should not be the sole factor in looking at the assets’ economic reality, rather the intended use of the asset should also drive the accounting treatment. This is demonstrated by the different uses and consequential accounting treatment for the same building as property, plant and equipment or investment property (A2, T2).

Summary

Participants viewed the use of a financial asset to alter the economic characteristics *the entity chooses to expose itself to*. Another view was that the use does not change the fundamental economic characteristics. Rather the underlying financial asset is one static economic event and the use is another dynamic interlinked economic event, both of which need to be communicated to users. These are the economic phenomena on which the CF requires reporting in the financial statements.

This section together, with the use of a financial asset in section 4.2, supports research sub question 2. This research finds that a financial asset can be used and this use alters its economic characteristics.

4.4. Representation

This section explores whether using the business model to drive accounting treatment results in a faithful representation of the economics of financial assets (discussed in the previous section). In section 4.3 the conclusion was reached that a financial asset can be used in different ways and that the use of a financial asset changes the economics of that asset. This section explores the manner in which the business model and its related measurement outcomes represent these different economics.

4.4.1. Purpose of financial statements

IFRS financial statements are primarily used as a means to communicate with stakeholders (A1, A2, I1, P1, P2, P3, P4, P5, P6, T1, T2, T3). This includes communication about the entity's past performance and future prospects (A1, A2, P1, P2, T1, T3), as well as management's stewardship of the business (A2, P3, P4, P5, P6, T2, T1). The financial statements also need to communicate the risk inherent in the business (A1, I1, P1, T1). Further, participants view the financial statements as communicating the economic activities of an entity (A2, P1, P4, P5, P6). One participant expressly questions whether these objectives were achieved by the IFRS (P4). The nature of this communication is viewed as dynamic as it is required to change as "society develops" (T1).

One participant interprets the objective as best served through maximising fair value information. If an entity's balance sheet were at fair value, it would better enable the direct determination of the value of an entity rather, than relying on models.

"I think what, probably, it intuitively does in my mind, if everything were to be at fair value, is you will get to what the fair value of your business should be" (P1).

The conceptual preference for fair value is important because IFRS 9, through the business model, perpetuates a mixed measurement basis. Others opposed this view, countering that the financial statements are not a standalone valuation of an entity but provide inputs which can be used in valuation models so users can make economic decisions (A1, T1):

"They [management] will tell you where their plans are, but then users need to say, okay but how does that fit in with what I believe? You know clearly then you make your decisions" (T1).

The primary users of financial statements per the CF are potential investors and creditors (IASB, 2017a, OB2). However, some consider a broader scope of users other than providers of capital (A1, P1, P2, P4, P5, P6). Particularly in a financial institution context, the relevant regulator and the clients of the financial institution are considered users (P1, P2, P4, P5, P6). This broader public accountability seems to align with stewardship. Even a participant with strong neoliberal fair value views acknowledged that:

"Everything is driven around what's the risk that we pose, because we are dealing with just money. So, risk and how we manage that [risk] and our liquidity is vital [for] anybody to understand [our business]" (P1).

The use of the financial statements as a management tool further emphasises the usefulness of the business model (I1, P1, P3, P5). There are noted limitations of IFRS as a management tool, particularly when the financial statements do not appropriately reflect the economics of transactions (P1, P3, P5, P6). Despite these limitations, IFRS is used in some cases as the base for budgeting, determining and measuring key performance indicators and determining capital and funding needs (P1, P3, P5, P6).

4.4.2. Business models in financial reporting

Contrary to the literature and the dissenting opinions to IFRS 9, the business model is not viewed as controversial and is supported as one of the areas in IFRS 9 which make sense (A1, I1, P1, P3, P4, P5, P6, T1, T2, T3). The business model is seen to be easy to implement, and intuitive for users to understand (A1). The business model should correspond with the way the entity manages its business and should be aligned with other public reporting (A1, P2). Despite the arguments in the literature (see section 2.2) participants theoretically viewed management intention as a key driver of financial reporting (A1, I1, P5, T1, T2).

From an audit perspective, significant work has been carried out on the classification and measurement requirements of IFRS 9 in financial institutions (P2, P3, P4, P5, P6, T1, T3). There is a concern that the business model is an area of significant judgement which provides the opportunity for manipulation of results and challenges in auditing (A1, A2, T1, T2, T3). A perceived challenge is the qualitative nature of the assessment, compared to the relative rigour for the assessment of a quantitative judgement:

“The difficulty is not the judgemental nature of [the business model assessment]. The difficulty is the appearance of a scientific approach [when compared to quantitative methods]. When it comes to defining the business model in the accounting, it’s a qualitative discussion that takes place and a qualitative conceptual link which occurs” (A1).

The business model classification assessment was not seen as an area where there is potential to manipulate results (I1, P1). This is owing to the alignment with how the business is managed:

“So now I have to prepare that, I have to tell my auditor okay so we have these loans, this is where it is, this is what their purpose is, these are the terms and conditions evaluated, and this is how we got to the conclusion. So, and they will replicate some of that to make sure that we didn't lie in [the assessment] so I don't think this is necessarily an area where you can hide” (P1).

4.4.3. Comparison of the business model to IAS 39: reporting outcomes

In considering whether the business model results in a better representation of the economics of a transaction, a useful base is the representation under IAS 39. Most participants viewed the classification and measurement requirements of IFRS 9 to be an improvement over IAS 39 (A1, A2, P1, P2, P3, P4, P5, P6, T2). The business model in IFRS 9 “makes sense” (A1, P4). As criticism of IAS 39:

“I can’t say I ever really understood the classification under IAS 39” (P3).

“... IAS 39 is so rules-based and so restrictive that it’s generally hated by everybody except auditors who use it as an objective to a) discipline their clients and b) to develop an additional source of revenue by providing information that isn’t actually needed to run a business” (A2).

Despite conceding that the business model principle works and does provide an element of anti-abuse, one participant remarked:

“Was IAS 39 broken so much that this really solves it? I would say no. But that’s my own personal view” (T2).

The business model assessment to determine the classification of financial assets is considered less complicated and rigid than is IAS 39 (A1, A2, P2). This is due in part, to the complex subsequent measurement requirements in IAS 39 related to various impairments methodologies and reversals (A1, A2). IFRS 9 has simplified the measurement choices:

“So, there’s too many different permutations that are available [in IAS 39]: it’s complicating everything. But if you put business model logic in place it, at least, makes the fundamental measurement choice binary. It’s either fair value or it’s at cost/amortised cost” (A1).

The IAS 39 assessment was also premised on arbitrary rules (A1, A2). The existence of rules in financial reporting presents a challenge, as some entities structure their products to fit the definitions (A2, P1, P3). On transition to IFRS 9, there may be consequences and difficulties in properly evaluating the substance of these transactions.

“I think there was more structuring and the risk of manipulating things [in IAS 39] because I can write a contract to tick a box to meet a definition. Where with business models what makes it a little bit more difficult from a hurdle perspective is [that] you can’t tell me that it meets amortised cost but yet all you do within your business is measure and report on fair value” (P1).

An improvement on IAS 39 has been the removal of the concept of tainting (P2, P5, T1, T2) (see section 2.1.2). The tainting provisions were seen to be too “harsh” (P2), and could result in unintended and unfairly restrictive consequences for legitimate business changes (P5), for example, in the consolidated financial statements where a sale of a financial asset classified as held-to-maturity in a subsidiary may cause group wide tainting. This can result in reclassifications of all financial assets of the group out of the held-to-maturity category (P5).

“So, due to the option that policyholders have in terms of switching investment base, we could never keep to the tainting or stay out of the tainting requirements because we would be forced there because holding for a long duration is very difficult for us to predict” (P2).

Conversely, the level at which the business model is set is considered to be a similar “stick”, and participants viewed the significant and frequency assessments to be a similar anti-abuse mechanism (P5, P6, T2).

“But how they then ended up slotting it [the business model assessment] into the decision tree and at the level that they are putting it, makes it, just in my personal view, a stick, a rule, a tainting provision, just at a different level and again you are going to get hit by the stick if you do something. If you say you're doing something and you are not doing it” (T2).

The business model in IFRS 9 is seen to be more substantive than the concept of management intention in IAS 39 (A1, P1, P3, P4, P5, P6). This could be as a result of the assertion of the IASB that the business model is principles based and the test is how the business is managed:

“Internally, when I've had discussions with our treasury department, I've blatantly said to them it's fine if you do this but if what we actually do is different, the auditors will never accept it. There is too much evidence against amortised cost. So, either we do need to change our business model or we need to accept that the accounting has to change. ... you can't have both and you can't force it per se in that way” (P1).

What is interesting to note is the view that you cannot force the business model (P1). This supports greater congruency with a principles based approach, as well as its appropriateness as a mechanism for anti-abuse. It also lends to the view that there is substance behind the business models reported on, something which reflects economic reality.

4.4.4. The business model perpetuating the mixed model

A criticism of IFRS 9 in the literature and in the dissenting opinions to IFRS 9 is the persistence of a mixed measurement basis. Namely, one which permits the use of both amortised cost and fair value, dependent on the entity's business model. There are divergent views on whether a mixed model or a full fair value model would best represent financial assets in the financial statements, especially from a comparability perspective. Most participants were in favour of the persistence of the mixed measurement model, and considered a full fair value model as inappropriate because of its inability to communicate the entity's strategy for groups of financial assets (A1, I1, P2, P4, P5, P6, T1, T2, T3). In response to the persistence of the mixed measurement base, one participant noted:

“The numbers are a mix because your business is a mix. But I'm only saying that because you've now got supporting explanation that goes along with it” (A1).

Fair value was advocated by some as the theoretical preference for all financial instruments (A2, P1), but significant implementation challenges were acknowledged. The proponents conceded that a full fair value approach may not be possible yet but IFRS 9 represented progress towards this goal (P1). A challenge in measuring all financial assets at fair value is the difficulty, cost and effort in determining the amount for certain assets, for example, a mortgage book (A2, T1). For banks, the challenge in moving traditional amortised cost loans and advances to a fair value model using existing legacy systems, models and capabilities means that fair value is not an attractive option and in some cases, is actively avoided (P3). Even a strong proponent of fair value for all assets, not only financial assets, acknowledged the complexity with a full fair value approach:

“But having said that, to get to a consensus of what those values will be, the difficulty of it, your perspective vs my perspective and consistency in a market is exceptionally difficult. Whether amortised cost achieves that, [I] don't know, but I think there's more certain cash flows, and I think that's why that's an easier method” (P1).

One of the benefits of the business model, and consequently the retention of the mixed measurement basis, is that the financial statements differentiate between the different manners of realising assets (again, as a strategy of the business) and, as a result, representing the expected future cash flows. This information is seen to be valuable to users of financial statements for both stewardship and decision usefulness purposes. Enabling an understanding of the expected cash flows or returns and the risks

inherent in those cash flows satisfies a variety of users' information needs (A1, A2, I1, T1, T2). There is a certainty or reliability when measuring items at amortised cost (P1). Amortised cost reflects less volatility and reduces the potential for disposals because of adverse regulatory requirements (T2).

A challenge of the amortised cost model is the use of historic information and the inability to reflect true declines in value (P1). However, this challenge is thought to be largely solved by the impairment model²⁶ for financial assets at amortised cost in IFRS 9. This model takes the expected lifetime credit losses, rather than considering incurred losses as under IAS 39. The resultant value is closer to a fair value than has previously been reported and is seen as an important step towards full fair value (P1).

The full fair value approach is said to incorporate all relevant market factors in determining market price. The market price is seen to be reflective of the timing and the risks inherent in the cash flows (P1). Both models, hold to collect and hold to sell, would seek to maximise the fair value and in perfect market conditions those fair values would be equal (P1).

“I feel that if both could have just been at fair value you would have actually seen the total value you are exposed to with the counterparty, including credit risk, without having to wonder about anything else. The one just said ‘well I think I can maximise and can realise that fair value through cash’ and the other one said ‘well I think through sale’. But they are ultimately both trying to get to the same fair value being realised” (P1).

However, fair value is not seen to be appropriate in all instances: it is criticised as not incorporating management intention (I1, T1, T2). Aligned with IFRS 9 and the business model, fair value is not appropriate when there is no intention to sell or dispose of a financial asset:

“Is fair value accounting the holy grail, end result where accounting should go? I don't think so. It's appropriate where it's appropriate, based on your intention, or your business model or your strategy. The whole balance sheet should not be at fair value” (T2).

Surprisingly from an analyst perspective, the persistence of the mixed measurement model for financial assets particularly in a banking context is the preferable option (I1). Profit and operations of a banking entity focus largely on two primary sources of revenue. Firstly, an interest margin obtained through maximising the spread between the cost of funding and loans advanced to customers. Secondly, financial

²⁶ Most participants discussed the complexity related to the IFRS 9 impairment model. This is outside of the scope of this thesis.

assets are purchased to trade, where profits arise from the bid offer spreads on these purchases, as well as commissions charged on these transactions and financial assets (A2, I1). Critically, a key performance metric on the first revenue stream relates to interest margin on interest earning assets. Through the held to collect model the interest income is reported in the income statement with the balance sheet showing the amortised cost value. In this light, holding these interest-earning assets at fair value would distort the key ratios and metrics used to evaluate and model performance and income generating capacity of banks, by removing the interest income from the income statement and representing only fair value gains and losses (I1).

The different representation through amortised cost or fair value also has implications for understanding the income statement and balance sheet of a FS entity (I1). ‘Interest income’ (or net interest earned for a banking entity) in the context of IFRS 9 provides a clear view of management’s strategy which is to generate return through the time value of money and credit risk. The absence of interest income communicates that the entity’s strategy is to derive income from actively managing financial assets to make short-term profits. Similarly, the differentiating hold to collect and hold to sell financial assets on the balance sheet can communicate the relative size and mix of financial assets with different strategies.

When asked if all financial assets should be accounted for at fair value participant T1 argued:

“You see I’m not comfortable with that [full fair value] because I think that intention comes into it. I don’t like all [financial assets] at fair value because [I might not be] exposed to fair value. So, if your business model says ‘I’m never going to sell this’, it means nothing to me. It’s an interesting number, and you might say, but [you] should have sold [it] but if they [management] are saying we aren’t going to sell this, there are other reasons that we need to keep it”.

T2 argued that the financial statements should not be reflective of the various opportunities that management did not take up. The potential penalties for comparatively lower performance based on the opportunity cost of not realising the asset is seen to be inappropriate and better dealt with by investors selecting an alternative investment. Further, in a financial institution context, the security of assets in meeting obligations may be more important than a short-term gain. The ability to compare entities is better facilitated by the business model classification and measurement as the users can predict the actual future cash flows and risk exposure (A1, I1, P4, P5, P6, T2).

Some participants viewed IFRS 9 as moving away from a fair value model or, at least, that the fair value preference had lost popularity (P3, P4, P5, P6).

“You know the pendulum goes; at one stage [it was] fair value. That’s how it’s managed, it’s a wholesale book, as opposed to a retail book and now the pendulum has started moving the other way. ... the volatility and the complexity [are too high] and actually you [are] just collecting cash flows. So, I think it’s just sort of evolved over time” (P4).

Other participants viewed IFRS 9 as an opportunity to fair value more of their existing financial assets (A2, P2).

“So, we are in [a] more beneficial position in implementing [IFRS] 9, where we are actually using the business model approach required by [IFRS] 9 to look at fair valuing our entire balance sheet” (P2).

In both examples above, the entities have used the business model to better align the accounting classification and measurement with the way the businesses are managed and their business strategy.

4.4.5. Business models and comparability

A consideration is whether reporting an identical financial asset differently according to the business model compromises comparability. Participants generally aligned with the view that reporting the same asset in the same manner would *not* be an appropriate representation of the economics if the assets are used differently. Consequently, comparability would be achieved by representing these assets differently, based on the entity’s business model. The business model, therefore, provides a better base for comparing entities by making their similarities and differences clear – especially their different strategies (A1, I1, P4, P5, P6).

A financial asset used to collect cash flows is economically different from the same contractual asset which an entity holds to sell (see section 4.2 on the use of a financial asset and section 4.3 economics of a financial asset).

“In fact, making the financial information look the same actually distorts the economic reality. They are not the same, yet you are trying to create an accounting environment where everything gets recorded in the same way because of comparability. But you are trying to create

comparability between things which are not comparable in the first place. You want to pretend that they are comparable because it makes it easier, I suppose” (A1).

The risk and return inherent in an entity’s cash flows is the primary point of comparison for users of financial statements. The business model communicates this information through illustrating to which risks the entity is exposed, based on its use of the asset. For example, interest rate risk or credit risk in a hold to sell and hold to collect model respectively (A1, I1, P4, P5, T1, T2). Further, the business model communicates the expected return on the financial asset by indicating the method of realising cash flows. This communication enables comparison and selection of a target investment aligned with the investor’s strategy. The business model classification is also critical in discerning underlying differences within, for example, a bank and for providing investors an indication of how to model cash flows (I1).

The business model indicates that items are not comparable and reflects similar models in similar ways. This enables better comparison between different entities. Participant (P6) indicates that the primary reason for certain financial assets from fair value to amortised cost is to enable comparison to similar entities. Even within the banking sector, activities are not comparable, and it is more appropriate to compare, based on the business model.

“If you have a certain bank that’s only running fair value trading activities vs one that has got a mixed model vs one that’s got only a banking activity you can’t compare these” (P5).

The business model in financial reporting is seen to be typical of principle based accounting standards. An entity is required to reflect the economic substance of transactions, rather than represent transactions and events in line with an accounting rule, disparate from the economics.

“So that’s the beauty of principle based [accounting standards], it allows the financial statements to reflect what management, what the preparer, believe the right message is and now I [as a user] can *compare the messages*” (T2, emphasis added).

Conversely, participant P1’s view aligns with strong fair value and decision usefulness views. Comparability is best achieved by reflecting the same financial asset with the same contractual rights and obligations in the same manner (P1). Other participants could not reconcile the IASB’s pursuit of comparability with the explicit allowance to treat contractually identical instruments differently (P3, T3). They argue that using the business model can decrease comparability; these participants also present

contradictory arguments regarding whether identical instruments are economically different based on use (P3, T3). Again, this highlights the conceptual complexity in understanding the business model.

4.4.6. The challenge with the third model

The third model of fair value through OCI was not well supported (A1, A2, P1, P2, P3, P4, T3), nor well understood²⁷ (P3, T2, T3). It is not seen to be connected to an actual business model (A1, P3, T1), as conceptually holding both to collect *and* sell confuses the normally distinct uses.

“It’s like saying you are either dead or alive but now [the IASB] have created this in-between transitory zone that you’re in. Whenever they put something through OCI, it’s because they can’t figure out what to do with it... That thing [the OCI option] is absolute rubbish” (A1).

This model also presents challenges from an audit perspective in terms of a model the objectives of which are met both by sale and collecting cash flows (A2, T2, T3).

“I think it’s complicated and messy and I hope my clients don’t get there because I don’t know how on earth you are going to mechanically do it” (T2).

Several preparers in the banking and insurance industry indicated that the third model could be used in their entities. The third model can be used for the bank’s liquidity portfolio²⁸, the objectives of which are achieved both through collecting cash flows and through sale (P1, P4, P5, P6). Participant (P4) explains this requirement:

“You have to hold [R100] then suddenly you are only required to hold [R80] so then you are going to want to sell those. And then again, now you need to hold [R120] again and so you build it up and so it goes” (P4).

Another participant would simplify the approach to a single fair value model, removing the need for the OCI option.

²⁷ Many participants discussed and had mixed views on the concept of recycling related to the fair value through OCI option. However, the prohibition on recycling pertains only to equity instruments where the entity has elected this presentation option. The prohibition on recycling does not apply to debt instruments in the third model. (These discussions were outside of the scope of this thesis).

²⁸ This portfolio is a statutory requirement and comprises of liquid low risk low yielding assets.

“... I would have actually wanted everything from the beginning in profit and loss and never had the OCI option” (P1).

Participants feel that there are better solutions as alternatives to the third model (P1, T1, T2, T3). Accounting for the change in use when the change occurs seems more appealing, more practical to implement *and* more in line with existing accounting principles (T1, T2).

“From a conceptual perspective I can see that you have mixed measurements but I would rather see it as I'm holding [until I] make a decision to sell, boom I sell, or I am looking to sell, IFRS 5²⁹ type thing. I'm changing my measurement model. It's not [that] I am pre-empting my sale because then it actually means that for all other assets, I should do the same. Have [fair] value on the balance sheet [and] cost accounting on the income statement. So, it's conceptually in my mind not the best thing, [but] I can understand why it's there” (T2).

Summary

Participants hold primarily stewardship-orientated views as they relate to the purpose of financial statements. Decision usefulness is also important for a range of users but in a regulated environment the accountability to the regulator and customers is particularly important.

The business model is seen to make sense, with the intention driving accounting treatment as a desirable outcome in facilitating consistent and effective communication to stakeholders. Another improvement on IAS 39 is the removal of the tainting rules: participants agreed that this rule was not practical. The business model was also seen as more substantive and observable, a concept the application of which can be evidenced through the way the business is managed.

Participants are comfortable with the retention of the mixed measurement model in IFRS 9. In addition, they are in favour of the way the business model represents economically different financial assets based on their use. This better enables communication, especially of their strategy. The use of the business model is seen to enhance comparability by differentiating business models through use. The third model remains contentious, and possibly does not best represent the nature of the financial asset.

In addressing research sub-question 3, participants view the business model to be a better representation of the economics.

²⁹ IFRS 5 is the accounting standard relating to non-current assets held for sale and discontinued operations.

5. Conclusions

This section provides a summary of the key debates of the research sub questions identified as part of the research question and concludes on the research sub-questions.

5.1. Concluding remarks and contribution

IFRS 9 provides the first opportunity to examine the business model in a formal standard. Given the effective date of the standard, this study is able to capture participants' views at the point where implementation activities are still underway and are most topical. This study is also able to examine the critical points of dissent in relation to the business model and its use in IFRS 9.

Leisenring et al. (2012) present arguments that there is no difference between the business model in IFRS 9 and the concept of management intention in the standard's predecessor IAS 39. This research finds that some participants disagree that these terms are the same. Alternately, some participants do not view management intention in IAS 39 as substantive, relying on negative tests (see section 4.1) to avoid punitive accounting outcomes.

Leisenring et al. (2012) argue that the level at which the two terms operate is not a sufficient differentiator, owing to IFRS applying to the reporting of transactions, not portfolios. This research finds that the business model concept operates at different levels or units of account in different businesses but is aligned to the way the business is managed. Participants further acknowledged that management intention functions at an individual asset level and that the level is a differentiator of these terms.

A further argument presented by the literature is that the ease with which the business model can change effectively makes it the same as management intention. In a financial institution context, participants do not agree: a change in business model will be a significant strategic endeavour. This will require fundamental structural alterations to change a business model between held to collect and held to sell. Changes in use of financial assets in a financial institution also give rise to possibly needing to purchase a replacement asset, given the asset's specific use in the entity's operations (see below).

In answering research sub-question 1, this research concludes that there is a difference between management intention in IAS 39 and the business model in IFRS 9.

A second critical point of departure in determining whether the business model is appropriate is whether a financial asset can be used. The literature argues that if financial assets can be used, and this 'use'

changes the economics then differentiating accounting treatment on the basis of the business model can result in a more faithful representation. Leisenring et al. (2012) contend that a financial asset cannot be used. This assertion is rebutted by this research. Aside from the uses mentioned by IFRS 9 i.e., hold to sell and hold to collect, the regulatory purposes and asset-liability matching for both solvency and profitability have been identified as additional uses. From a regulatory perspective, a financial institution is required to hold certain assets as regulatory capital; this is seen as a distinct 'use' of a financial asset. Further, financial institutions use financial assets and financial liabilities as the base of their operations, and these instruments are core in generating margin for profitability through matching assets and liabilities. This sourcing and holding very specific assets to match obligations is seen as another use of a financial asset.

The logical progression is whether the use of an asset alters its economic substance. Barth (2013) argues that, if this is the case, a different accounting treatment is necessary to faithfully represent the economics in the financial statements.

Primary economic characteristics of financial assets are cash flows and risks, both of which were found to be influenced or altered by the use of a financial asset. Key findings of this research are that critical to understanding the economics of a financial asset are the risks and cash flows which an entity *elects* to expose itself to through the financial asset's use. Despite not being an underlying contractual characteristic of the financial asset, the 'use' influencing the risk and cash flows is seen as an economic event which requires reporting for the financial asset to be faithfully represented.

In concluding research sub-questions 2, this research finds that a financial asset can be used and that these 'uses' can be distinct and that the use of a financial asset is an economic characteristic – either through changing the risks and cash flows, or as an economic event linked with the financial asset.

Lastly, this research examines how the business model faithfully represents these economics. Financial statements are seen as a tool to communicate risk and return information to users. The business model is seen as intuitive and easy to implement. This is viewed as an improvement from IAS 39, both from a conceptual understanding perspective, and in a more principles based approach. The business model in IFRS 9 perpetuates the mixed model of accounting for financial assets at amortised cost *and* at fair value. There is some preference for a full fair value model, however, most participants view this mix itself as an important tool in communicating the business models of areas within a financial institution. This enables a differentiation of the entity's strategy. Differentiating use based on the business model enable users to

understand the underlying cash flows and risks better, enabling evaluation of past performance and predicting future cash flows. Even participants who consider fair value for all financial instruments the ultimate goal, feel that IFRS 9 is a step in that direction and hence support the business model concept. This research finds that using the business model to drive accounting treatment enables users to identify and differentiate between business models easily.

Two areas of concern are the impact of the business model and the resultant differing accounting treatment on comparability and the so-called third model where financial assets can be held both to collect contractual cash flows and for sale.

In answering research sub-question 3, this research finds that using the business model to drive accounting treatment results in a better representation of the economics, particularly when compared to IAS 39.

5.2. Recommendations and areas for future research

The following issues raised in this research fell outside the scope, and are recommended as areas for future research.

The impact of the business model on comparability is identified as a conceptual issue when evaluating an area where preparers are provided alternate accounting treatments. More work can be done on understanding the practical application and empirical implications of accounting alternatives on comparability.

A key finding in the results is that, the business model is seen as providing additional value in communicating an entity's strategy. Given the IASB's focus on better communication, future research could explore how the business model can be used to further improve financial reporting.

This research only considers the impact of the business model assessment to classify debt instruments as required by IFRS 9. Further research can expand the business model in accounting for other financial instruments.

The third model of fair value through OCI is particularly contentious. Conceptually holding both to collect and to sell is not in many instances seen as a business model. Further research can examine this duality of purpose and how best this should be faithfully represented in the financial statements.

Appendix I: List of participants

Respondent code	Background	Sector	Years of experience	Approximate length of interview (in minutes)
A1	Academic	Accounting education	11	50
A2	Academic	Accounting education	41	80
I1	Analyst	Banking	6	45
P1	Preparer	Banking and insurance	11	105
P2	Preparer	Insurance	19	45
P3	Preparer	Banking	12	60
P4	Preparer	Banking	16	75
P5	Preparer	Banking	24	75
P6	Preparer	Banking	16	75
T1	Auditor - technical	Financial services	30	60
T2	Auditor - technical	Financial services	17	120
T3	Auditor - technical	Insurance	19	70

Appendix II: Interview agenda

Agenda item	Description
1.	What are the objectives of financial reporting?
2.	How can a financial asset be used in a financial institution context?
3.	What do you consider to be the economic substance of a financial asset?
4.	In what way does this use alter or change the economic characteristics, if any?
5.	What do you understand by the term business model in the context of financial reporting?
6.	What do you understand by the term management intention as used in IAS 39?
7.	What do you think the differences and similarities are between management intention in IAS 39 and business model requirement in IFRS 9?
8.	What do you think the benefits and challenges are in using the business model to determine the accounting policy for financial assets?
9.	How does using the business model as a base provide a better or worse representation of the economics compared to a situation where all financial assets are reported in the way same, or on the basis of the rights and obligations of the actual asset?
10.	In what way should the AFS reflect this differing use?

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