Additional Reading Materials for Financial Instruments

01. ‘Hold-to-collect’ business model

This is a business model in which the entity’s objective is to hold the financial asset to collect the contractual cash flows from the financial asset rather than with a view to selling the asset to realize a profit or loss.

- For example, trade receivables held by a manufacturing entity are likely to fall within the hold to collect business model if the trade receivables do not contain a significant financing component in accordance with SLFRS 15, as the manufacturing entity is likely to have the intention to collect the cash flows from those trade receivables.

The hold to collect business model does not require that financial assets are always held until their maturity. An entity’s business model can still be to hold financial assets to collect contractual cash flows, even when sales of financial assets occur.

There is a specific exception where financial assets are sold as a result of **an increase in the assets’ credit risk**. IFRS 9.B4.1.3A notes that sales, irrespective of their frequency and value due to an increase in the assets’ credit risk, are not inconsistent with the hold to collect business model because the credit quality of financial assets is relevant to the entity’s ability to collect contractual cash flows.

In addition, although there is a **presumption** that the **hold to collect requirements will not be met** when there are sales that are more than infrequent or more than insignificant it is necessary to consider why sales occurred and whether or not they are ‘one off’. However, if more than an infrequent number of sales or a more than insignificant value of sales are made out of a portfolio, the entity should assess whether and how the sales are consistent with the hold to collect objective. This assessment should **include the reason(s)** why the sales do not represent a change in the entity’s business model as well as the expected frequency of sales, and whether the assets that are sold are held for an extended period of time relative to their contractual maturities.

Examples of sales that would not contradict holding financial assets to collect contractual cash flows include:

- Selling the financial asset close to its maturity (meaning that there is little difference between the fair value of the remaining contractual cash flows and the cash flows arising from the sale),
- Selling the financial asset to realize cash to deal with an unforeseen need for liquidity,
- Selling the financial asset as a result of changes in tax laws,
- Selling the financial asset due to significant internal restructuring or business combinations; or

- Selling the financial asset due to concerns about the collectability of the contractual cash flows (i.e. increase in credit risk).

Example 1 – Is the hold to collect business model test met?
Entity A sold one of its diverse business operations and currently has CU10 million of cash. It has not yet found another suitable investment opportunity in which to invest those funds, so it buys short dated (6 month maturity) high quality government bonds in order to generate interest income. It is not considered likely but, if a suitable investment opportunity arises before the maturity date, the entity will sell the bonds and use the proceeds for the acquisition of a business operation. Otherwise it will hold the bonds to their maturity date.
Answer
Consideration of the facts and circumstances are required. It is likely that the government bonds would meet the hold to collect business model test, as the entity's objective appears to be holding the government bonds and collecting the contractual cash flows which consist of the contractual interest payments and, on maturity, the principal amount. If the bond were to be sold prior to its maturity date, the fair value of the cash flows arising would be similar to those which would be collected by continuing to hold the bonds

02. The SPPI contractual cash flow characteristics test

Contractual cash flows are considered to be SPPI if the contractual terms of the financial asset only give rise to cash flows that are **solely payments of principal and interest** on the principal amount outstanding on specified dates (i.e. the contractual cash flows are consistent with a basic lending arrangement)

Principal is the fair value of the financial asset at initial recognition, which may be different from the contractually stated principal (e.g. a bond that is purchased or originated at a premium or discount)

Whilst the consideration for the time value of money and credit risk are typically the most significant elements of '**interest**', IFRS 9 acknowledges that it can also contain other elements such as consideration for liquidity risk, profit margin and service or administrative costs.

Example 2 – SPPI test for loan with zero interest and no fixed repayment terms
Parent A provides a loan to Subsidiary B. The loan is classified as a current liability in Subsidiary B's financial statements and has the following terms:– No interest; – Repayable on demand of Parent A **Question: Does the loan meet the SPPI contractual cash flows characteristic test?**
Answer

Yes. The terms provide for the repayment of the principal amount of the loan on demand.

Example 3 – SPPI test for loan with zero interest repayable in five years
Parent A provides a loan of Rs. 10 million to Subsidiary B. The loan is classified as a current liability in Subsidiary B's financial statements and has the following terms:– No interest; – Repayable on in 5 years **Question: Does the loan meet the SPPI contractual cash flows characteristic test?**
Answer
Yes. The principal (fair value) is Rs10 million discounted to its present value using the market interest rate at initial recognition. The final repayment of Rs.10 million represents a payment of principal and accrued interest.

Example 4 – SPPI test for loan with profit linked element
Entity D lends Entity E CU500 million for five years at an interest rate of 5%. Entity E is a property developer that will use the funds to buy a piece of land and construct residential apartments for sale. In addition to the 5% interest, Entity D will be entitled to an additional 10% of the final net profits from the project. **Question: Does the loan meet the SPPI contractual cash flows characteristic test?**
Answer
No. The profit linked element means that the contractual cash flows do not reflect only payments of principal and interest that consist of only the time value of money and credit risk. Therefore, the loan will fail the requirements for amortized cost classification. Entity D will account for the loan at fair value through profit or loss.

Example 5 – SPPI test for convertible note
Does an investment in a convertible note that converts into equity instruments of the issuer meet the SPPI contractual cash flows characteristic test?
Answer
No. SLFRS 9 requires analysis of the terms of the convertible note in its entirety. The interest rate in a convertible note does not reflect the consideration for the time value of money and the credit risk (except when the shares are used as a currency, with a variable number of shares being issued that are equal in value to the unpaid principal and interest). The interest rate is usually set lower than the market interest rate. The

overall return is also linked to the value of the equity of the issuer such that the conversion feature would potentially enhance the overall return.

03. 'Hold-to-collect' business model

This business model typically involves greater frequency and volume of sales than the hold to collect business model. Integral to this business model is an intention to sell the instrument before the investment matures.

Example 6 – Hold to collect or hold to collect and sell business model test
Entity A sold one of its diverse business operations and currently has CU10 million of cash. It has not yet found another suitable investment opportunity in which to invest its funds, so it buys medium dated (3 year maturity) high quality government bonds in order to generate interest income. It is considered likely that a suitable investment opportunity will be found before the maturity date, and in that case Entity A will sell the bonds and use the proceeds for the acquisition of a business operation. Otherwise, Entity A plans to hold the bonds to their contractual maturity. **Question: Are the criteria for a hold to collect or hold to collect and sell business model met?**
Answer
It is likely that the government bonds would not meet the hold to collect business model test because it is considered likely that the bonds will be sold well before their contractual maturity. However, **it is likely** that the investment would meet the **hold to collect and sell** business model test.

04. Trade receivables

SLFRS 9 includes an exception for the measurement on initial recognition of trade receivables without a significant financing component. These are required to be recognised at the transaction price (as defined in SLFRS 15 Revenue from Contracts with Customers) instead of fair value.

For trade receivables with a significant financing component, any differences arising between the amount of revenue recognised in accordance with SLFRS 15 – which is measured at the transaction price in accordance with SLFRS 15 - and the fair value of the trade receivable is recognised as an expense in profit or loss. The existence of a significant financing component is determined in accordance with the guidance set out in Paragraphs 60-65 of SLFRS 15 Revenue from Contracts with Customers