Project	**Financial instruments: classification and measurement of financial liabilities**
Topic	**Bifurcation methodology**

Purpose of this paper

1. At the joint meeting on 10 February the IASB tentatively decided that liabilities in Category B should be bifurcated. However, the Board did not discuss **the methodology** for that bifurcation. Liabilities in Category B are held to pay contractual cash flows and have "non-vanilla" (structured) contractual cash flow characteristics

2. In agenda paper 2 for the 10 February 2010 meeting, we described two possible alternatives:

   (a) maintain the existing bifurcation requirements in IAS 39 *Financial Instruments: Recognition and Measurement;* or

   (b) use a bifurcation approach that is based on the classification conditions in IFRS 9 *Financial Instruments* (that is, bifurcation would be based on the liability's contractual cash flow characteristics).

Alternatives for bifurcation

3. The bifurcation methodologies (and their respective criticisms and benefits) are discussed below. Agenda paper 8A for this meeting asks the IASB how liabilities in Category C should be measured. For simplicity, the discussion below assumes that the IASB confirms that they should be measured at amortized cost.

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Alternative 1: Maintain the existing bifurcation requirements

4. Under this alternative, the requirements in IAS 39 on embedded derivatives for financial liabilities would be retained to respond to issues raised about recognizing gains or losses arising from changes in an entity's own credit risk. That is, an embedded derivative would be separated from the host if, and only if:

   (a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics of the host;

   (b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and

   (c) the entire (hybrid) contract is not measured at fair value through profit or loss.

5. Paragraphs AG30 and AG33 of IAS 39 provide examples of when the condition described above in paragraph 4(a) **is met** and **is not met**.

6. If the conditions described in paragraph 4 **are met**, the separated derivative would be measured at fair value through profit or loss and the host would be measured at amortized cost (unless the entity elects the fair value option (FVO), which is discussed in agenda paper 8C).

7. If the conditions described in paragraph 4 **are not met**, the entire hybrid contract would be measured at amortized cost (unless the entity elects the FVO, which is discussed in agenda paper 8C). That is consistent with existing IFRSs.

Alternative 2: Use the classification conditions in IFRS 9 as bifurcation criteria

8. Under this alternative, an instrument would be bifurcated if a component (the host) of the structured liability has cash flow characteristics that are solely payments of principal and interest on the principal amount outstanding (ie a component meets the condition in paragraph 4.2(b) of IFRS 9).

9. If the instrument is bifurcated, the host would be measured at amortized cost and the other contractual feature(s) would be measured at fair value through profit or loss.

10. If the host does **not** have cash flow characteristics that are solely payments of principal and interest, the entire instrument would be measured at fair value

through profit or loss. That is because neither the entire liability **nor any component of it** meets the condition in paragraph 4.2(b) of IFRS 9.

Comparison of Alternative 1 and Alternative 2

11. In many cases, the two alternatives would have the same results. However, there would be some differences. We think those differences are primarily the result of the following two factors:

    (a) Alternative 1 uses the definition of a *derivative* – that is, the contractual feature that is separated from the host **must** meet the definition of a derivative in IAS 39. In contrast, Alternative 2 does **not** use that definition and, as a result, the contractual feature that is separated from the host may not be a derivative.

    (b) Alternative 1 uses the notion of *closely related* but Alternative 2 does not. Rather Alternative 2 looks to whether a component of the liability has contractual cash flows that are solely payments of principal and interest.

12. To summarize the abovementioned two points, Alternative 1 focuses on the characteristics of the **embedded feature** (ie, is it a derivative and, if so, is it closely related to the host?). Alternative 2 focuses on the characteristics of the **host** (ie does it have contractual cash flows that are solely payments principal and interest?).

13. As mentioned above, we think that the two alternatives would have the same results in many cases—but Alternative 2 would probably bifurcate more instruments than Alternative 1.

Examples

14. The following table illustrates the outcomes of Alternatives 1 and 2.

15. For simplicity, we have used the following abbreviations:

    (a) EF—embedded feature

    (b) FVTPL—fair value through profit or loss

    (c) AC—amortized cost

16. In some cases, the requirements under Alternative 1 (IAS 39) are summarized. The objective of this table is not to replicate or interpret the requirements in IAS 39—but rather to summarize some of the differences between the two alternatives.

	Instrument	**Measurement under Alternative 1**	**Measurement under Alternative 2**
1	Liability with interest or principal payments linked to an equity or commodity index	Bifurcated Host: AC EF: FVTPL	Bifurcated Host: AC EF: FVTPL
2	Liability with an extension option (ie option to extend the contractual term of the instrument)	Not bifurcated and measured at AC if there is a concurrent adjustment to the approximate current market rate of interest at the time of extension.	Not bifurcated and measured at AC if the contractual cash flows the entire term of the instrument (original term + extension term) are solely principal and interest.
3	Liability with a prepayment option	Not bifurcated and measured at AC if the prepayment amount is approximately equal on each prepayment date to the amortized cost of the host debt contract or reimburses the lender for an amount up to the approximate present value of lost interest.	Not bifurcated and measured at AC if the contractual cash flows over the term of the instrument are solely principal and interest, which may include reasonable compensation for the early termination of the contract.
4	Liability that pays a variable interest rate that is capped.	Not bifurcated and measured at AC if the cap is unleveraged and is at or above the market rate at inception.	Not bifurcated and measured at AC the variable rate is a market rate and the cap is unleveraged.

	Instrument	Measurement under Alternative 1	Measurement under Alternative 2
5	Liability that pays a market interest rate but payment of interest cannot be made unless the issuer is able to remain solvent immediately afterwards. Deferred interest does not accrue additional interest	Not bifurcated and measured at AC	Bifurcated Host: AC EF: FVTPL
6	A liability that pays interest that might increase, but not double, the holder's initial rate of return.	Not bifurcated and measured at AC	Bifurcated Host: AC EF: FVTPL
7	An embedded prepayment option in an interest-only or principal-only strip	Not bifurcated and measured at AC if the host (a) initially resulted from separating the right to receive contractual cash flows of an instrument that does not contain embedded derivatives and (b) does not contain any terms not present in the original host debt contract.	Bifurcated Host: AC ED: FVTPL

Staff recommendation

17. At this point we recommend that the IASB pursue Alternative 1. Some have criticized these requirements for being complex and rules-based. However, others (in the context of financial liabilities) have told us that practice has developed and is generally working well. In fact, many constituents (including respondents to the exposure draft *Financial Instruments: Classification and Measurement*) noted that there is not a need to change the existing requirements for financial liabilities because the criticisms of (and complexity arising from) financial instrument accounting are primarily related to financial assets.

18. We do not think that Alternative 2 will be any less complex to apply than the existing requirements—and will have the same results in most cases. In fact, in some ways, it may create additional complexity for little additional useful information.

Measurement challenges

19. For example we think that Alternative 2 would increase the measurement challenges that an entity would face. Consider a liability whose interest payments must be deferred if the issuer is unable to remain solvent immediately afterwards (and deferred interest does not accrue additional interest).

20. As noted above, practice has concluded that under IAS 39 the interest deferral feature does not need to be accounted for separately; therefore, the entire liability is measured at amortized cost.

21. However, under Alternative 2, the interest deferral feature would be bifurcated and be required to be measured at fair value. It is clear from the outreach discussions we have had, that valuation of such a feature would be very challenging.

Identifying the components

22. Moreover, while the bifurcation principal in Alternative 2 would be based on whether a component has cash flows that are solely principal and interest, we

think additional application guidance would be required. For example, consider a liability whose payments of principal and interest have a link to a leveraged inflation index (eg the link results in payments of 2 X the inflation index). Paragraph B4.13 of IFRS 9 notes that linking payments of principal and interest to an **unleveraged** inflation index would not in itself disqualify the instrument from being measured at amortized cost. However, because the example above is linked to a **leveraged** inflation index, it would not be eligible for amortized cost in its entirety – and would be bifurcated. The question is – what would the components be? Would the host be a liability with a link to an unleveraged inflation index (and the embedded feature would be the feature that creates leverage)? Or would the host be a liability that is not linked to inflation at all (and the embedded feature would be the link to the leveraged inflation index)?[1]

23. Given that existing accounting of financial liabilities appears to generally be working well, we think any possible benefits of those few differences do not outweigh the costs associated with changing the methodology and disrupting existing practice (eg systems changes, etc) at this point.

Question 1 : bifurcation methodology
Does the Board agree with our recommendation that the bifurcation requirements in IAS 39 should be carried forward for financial liabilities? If not, what does the Board want to do instead and why?

[1] The Implementation Guidance in IAS 39 (C.1) notes that when bifurcating a hybrid contract an entity may not create a cash flow that does not exist. That is, the entity cannot identify a component that is not specified in the contract—and may not establish terms of the host that would result in the separation of an embedded derivative that is not already clearly present in the hybrid instrument.