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STAFF PAPER

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Paper topic	Bifurcation: a 'no-bifurcation' approach		
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Introduction

1. This paper is the second in a series of papers considering the bifurcation of financial assets and financial liabilities[1].

2. This paper discusses a classification and measurement (C&M) model for financial instruments that does **not** include bifurcation. This paper focuses on the **application** of the 'no-bifurcation approach' to financial assets and financial liabilities (ie the mechanics of how this approach would work). It also discusses a few issues that arise only from the issuer's perspective and how they could be addressed if the boards decide to pursue this approach for financial liabilities. This paper **does not** discuss the arguments for and against bifurcation or our analysis of whether bifurcation should be required[2]. The arguments for and against bifurcation are set out in IASB AP6B/FASB Memo 140. The staff's

[1] For an explanation of how this paper fits in the series, see IASB AP 6B/FASB Memo 140.

[2] If the boards decide to pursue bifurcation, the need for the fair value option (FVO) for hybrid financial instruments will be discussed at a future meeting.

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analysis and recommendation—as well as the questions for the boards— are set out in IASB AP 6F/FASB Memo 140D.

Financial assets

3. If bifurcation is not included in the C&M model for financial assets, financial assets would be classified on the basis of their contractual cash flow characteristics and the business model within which they are held. Financial assets with contractual cash flows that are not solely payments of principal and interest (P&I) will be classified and measured in their entirety at fair value through profit or loss (FVPL)[3]. Financial assets with contractual cash flows that are solely P&I will be classified and measured in their entirety in accordance with the business model within which they are held[4].

4. This approach is consistent with IFRS 9 *Financial Instruments.* However, a minor adjustment was made to the notion of solely P&I in IFRS 9 in February 2012. As noted in the agenda paper for that meeting[5], the staff believes that while this adjustment to the assessment of contractual cash flows is small, it addresses many of the issues raised with the IASB on the application of that assessment to particular instruments. The staff are of the view that by addressing these issues, the concerns of many that resulted in requests for the reintroduction of bifurcation of financial assets should have been addressed.

5. From the FASB's perspective, a no-bifurcation approach would eliminate the requirements for embedded derivatives in Subtopic 815-15 for financial assets. Instead, a financial asset with an embedded derivative (a hybrid financial asset) would be classified and measured in its entirety in accordance with the general

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[3] The appendix to IASB AP 6/FASB Memo 138 provides an extract from the February 2012 IASB Update/FASB Summary of Decisions Reached, which discusses the boards' tentative decisions related to the assessment of a financial asset's contractual cash flows.

[4] The staff discuss what business model would qualify for amortised cost in IASB AP 6A/FASB Memo 139.

[5] The February 2012 IASB AP 5A/FASB Memo 133.

C&M criteria. Hybrid financial assets with contractual cash flows that are not solely P&I would be classified and measured in their entirety at FVPL. Hybrid financial assets with contractual cash flows that are solely P&I would be classified and measured in their entirety in accordance with the business model within which they are held.

6. **Example 1 –** A debt investment with a stated interest rate of LIBOR x 1.5 does not contain cash flows that are solely P&I. This is because the relationship between principal, the time value of money and the credit risk of the instrument is modified more than insignificantly. Consequently, the instrument would be classified at FVPL in its entirety under the no-bifurcation approach.

7. However, a debt instrument that pays interest at LIBOR with insignificant leverage would meet the cash flow characteristics assessment and could qualify in its entirety for a measurement category other than FVPL under the no-bifurcation approach depending on the business model within which it is held.

Financial liabilities

8. Currently, a financial liability with an embedded derivative (a hybrid financial liability) is bifurcated under both IFRS 9 and the FASB's tentative C&M model using the 'closely related' criteria.

9. If bifurcation is not included in the C&M model for financial liabilities, the boards would need to consider more broadly how financial liabilities should be classified and measured, including the need for any exceptions to the model. The staff believe that in developing a no-bifurcation C&M model for financial liabilities the boards should consider their current decisions on contractual cash flow characteristics for the overall C&M model and leverage as much as possible their prior deliberations and the feedback received to date rather than develop a new set of C&M criteria for financial liabilities. Developing a new set of C&M criteria solely for financial liabilities would be inconsistent with the boards' objective to reduce the key differences in their **existing** models. It also would be inconsistent

with the IASB's objective to minimise the changes to IFRS 9 and to complete the limited modifications project expeditiously.

IASB background on C&M of financial liabilities

10. The IASB's exposure draft *Financial Instruments: Classification and Measurement*, which was published in July 2009 (IASB 2009 ED), proposed a symmetrical C&M model for financial instruments that did not include bifurcation. Under the proposed model, both financial assets and financial liabilities would be classified based on:

    (a) their contractual cash flow characteristics; and

    (b) the business model within which they are held.

11. The respondents to the IASB 2009 ED generally supported the proposed C&M criteria; however many raised a concern **specific to hybrid financial liabilities**. They noted that many hybrid financial liabilities would be measured at FVPL and, as a result, changes in the liability's credit risk would affect profit or loss (P&L) which does not result in useful information (this is often referred to as the own credit risk issue). While commenting on bifurcation in general, respondents also stated that 'immaterial' embedded derivatives should not affect classification.

12. The respondents to the IASB 2009 ED proposed the following alternatives to address the own credit risk issue:

    (a) Retain bifurcation—Some respondents supported retaining the existing bifurcation requirements in IAS 39 *Financial Instruments: Recognition and Measurement* while others suggested new bifurcation requirements (for example, using the contractual cash flows characteristics (ie P&I) assessment).

    (b) Do not retain bifurcation but address 'own credit'—Some respondents stated that they would support the proposals if the re-measurement of the liability did not reflect changes in own credit in P&L.

13. Consequently, the IASB decided that additional consultation was needed to determine how best to address the effects of changes in a financial liability's credit risk when the liability is measured at fair value. The IASB performed an extensive outreach programme, including a user questionnaire. The feedback from constituents, including users, received in that outreach programme indicated that the C&M requirements for financial liabilities in IAS 39, including bifurcation, generally work well[6]. The IASB therefore decided to carry forward the C&M model for financial liabilities, including bifurcation, from IAS 39 to IFRS 9. This addressed the issue of own credit risk for non-derivative financial liabilities, except for those designated under the fair value option (FVO).

14. In May 2010 the IASB published the exposure draft *Fair Value Option for Financial Liabilities* (IASB 2010 ED), which proposed that the effects of changes in the credit risk of liabilities designated under the FVO would be presented in other comprehensive income (OCI). The proposals were supported by constituents and the IASB finalised the C&M model for financial liabilities accordingly.

15. Consequently, under IFRS 9, financial liabilities are measured at amortised cost except for[7]:

    (a) financial liabilities designated under the FVO; and

    (b) financial liabilities held for trading, which includes derivative liabilities.

16. Hybrid financial liabilities are bifurcated according to the closely related criteria that have been carried forward from IAS 39. Financial liabilities designated under

[6] A detailed discussion of the feedback received by the IASB in the outreach programme is provided in IASB AP 6B/FASB Memo 140.

[7] IFRS 9 provides specific requirements for financial guarantee contracts, loan commitments and financial liabilities that arise as a result of the derecognition guidance. Those requirements are outside of the scope of this paper and thus are not described.

the FVO are remeasured through P&L except for the effects of changes in the own credit risk; which are recorded in OCI[8].

FASB background on C&M of financial liabilities

17. The FASB proposed Update would have generally required financial liabilities to be measured at fair value except for financial liabilities that qualified for the amortised cost option[9]. The FASB proposed Update included two main classification and measurement categories: FVPL and FVOCI. For a financial liability to be eligible for the FVOCI, it would need to meet the cash flow characteristics test and the business model test in the proposed Update. As part of the cash flow characteristics test in the proposed Update, a hybrid financial liability for which the guidance on embedded derivatives in Subtopic 815-15 would otherwise have required bifurcation and separate accounting would not meet the cash flow characteristics test and, therefore, would be measured at FVPL in its entirety.

18. The FASB received mixed feedback on the proposals to eliminate bifurcation for hybrid financial liabilities and to account for them in entirety at FVPL. Most users did not comment on these proposals; however, those who did support the proposal to measure hybrid financial instruments in their entirety at fair value also recommended separately presenting changes in fair value related to changes in own credit risk.

19. Most non-users did not support measuring hybrid financial liabilities at fair value in their entirety. They believed that an entity should continue to be allowed to bifurcate embedded derivatives from the host contract based on the bifurcation guidance in Subtopic 815-15. These non-users noted that amortised cost is the most relevant measurement attribute for the host contract in a hybrid financial liability. Many of these constituents also were concerned that the proposals

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[8] A limited exception to address accounting mismatches exists, which is described in paragraph 33.

[9] The FASB proposed Update also required core deposit liabilities to be measured using a remeasurement approach and provided an exception for short-term trade payables.

would result in hybrid financial instruments (assets and liabilities) with *de minimis* embedded derivative features being measured at fair value. However, some non-users supported eliminating bifurcation because it would improve consistency among entities and ease operational issues.

20. The FASB considered the feedback received on the proposed Update and subsequently decided that (1) amortised cost would be the primary C&M category for financial liabilities and (2) bifurcation of financial liabilities would be retained consistent with the guidance in Subtopic 815-15. The FASB made these decisions to address the following concerns by constituents:

    (a) Measuring financial liabilities at an amount other than the amount that the liability would be settled;

    (b) The counterintuitive results of recognising in P&L the effects of changes in own credit risk; and

    (c) The potential for structuring opportunities, ie an entity should not be able to avoid accounting for derivatives at FVPL by embedding a derivative in a non-derivative instrument.

21. Under the FASB's tentative model, derivative financial liabilities (including embedded derivatives that are bifurcated) are measured at FVPL. Bifurcated host contracts and non-hybrid financial liabilities are classified on the basis of their contractual cash flow characteristics and the business model assessment. The contractual cash flow characteristic assessment that is applied to financial liabilities under the FASB's tentative model is identical to the assessment that would have been applied to financial assets **prior to** the tentative decisions made in February 2012.

22. However, the business model assessment that is applied to financial assets and financial liabilities is different. That is, a bifurcated host or a non-hybrid financial liability (this would include financial liabilities that are specifically excluded from the bifurcation guidance in Subtopic 815-15) could qualify for amortised cost if it is a debt instrument that has all of the following characteristics:

    (a) It is not a financial derivative contract;

(b) An amount transferred to the issuer at inception will be returned to the creditor at maturity or settlement; and

(c) It cannot contractually be prepaid or settled in such a way that the investor would not recover substantially all of its initial investment, other than through his own choice.

23. Financial liabilities that meet the conditions set out above would be measured at amortised cost unless:

    (a) The entity's strategy for financial liabilities at inception is to subsequently transact at fair value. (These liabilities would be measured at FVPL.)

    (b) Financial liabilities are short sales. (These liabilities would be measured at FVPL.)

    (c) Financial liabilities are nonrecourse. (These liabilities would be measured consistently with the measure of the related financial assets.)

24. Additionally, the FASB's model contains specific guidance for particular issued convertible debt instruments that are not currently required to be separated for an equity component under current US GAAP. These instruments would be measured at amortised cost in their entirety (similar to current US GAAP).

C&M model for financial liabilities under the no-bifurcation approach

25. As noted earlier in this paper, if the boards decide to pursue a no-bifurcation approach, the staff believe that the boards would need to consider more broadly how financial liabilities should be classified and measured. The staff note that both boards have already considered C&M models for financial liabilities that do not permit bifurcation and received feedback on those proposals. There are three consistent messages in the feedback, particularly from non-users:

    (a) Financial instruments should be classified on the basis of their contractual cash flow characteristics and an entity's business model.

    (b) Bifurcation should be retained for financial liabilities because:

(i) they believe that amortised cost is the most relevant measurement attribute for the host contract in a hybrid financial liability; and

(ii) it generally avoids the issue of recognising the effects of changes in own credit risk in P&L for non-derivatives (with the exception of financial liabilities designated under the FVO).

26. Consistent with this feedback, the staff believe that a no-bifurcation C&M model for financial liabilities should consider:

(a) the contractual cash flow characteristics of the financial liability;

(b) the business model within which the financial liability is held;

(c) the measurement attribute that would result under a no-bifurcation approach (ie when amortised cost would be permissible); and

(d) concerns about recognising in P&L the effects of changes in own credit risk when a financial liability is measured at fair value.

27. **Contractual cash flow characteristics** – In February 2012, the boards decided to pursue an assessment of a financial asset's contractual cash flows that is based on whether the cash flows are solely P&I. The staff think that the same assessment of P&I could be applied to financial liabilities for the following reasons:

(a) The assessment is generally consistent with the proposals in the IASB 2009 ED, which applied to both financial assets and financial liabilities and were generally supported by constituents **except for** concerns about recognising the effects of changes in a liability's credit risk in P&L.

(b) The assessment is directionally consistent with the assessment of contractual cash flows for financial liabilities that is **currently** included in the FASB's C&M model (ie only financial liabilities with 'simple' cash flows could qualify in their entirety for amortised cost measurement), which used to be aligned with the assessment for financial assets. However, the assessment for financial liabilities is no

longer aligned with the assessment for financial assets because the assessment for financial assets was amended by the tentative decisions taken by the FASB in February 2012.

(c) The assessment would increase alignment with the **newly agreed** assessment for financial assets and would result in greater symmetry in how financial assets and financial liabilities are classified and measured.

28. Under this approach, financial liabilities (including hybrid financial liabilities) could qualify in their entirety for amortised cost measurement, dependent on the business model, if the contractual cash flows are solely P&I. Financial liabilities (including hybrid financial liabilities) would be measured at FVPL if the contractual cash flows are not solely P&I (except for those cases where the boards decide to provide a specific exception, if any).

29. The staff note that the tentative decisions made by the boards in February 2012 alleviate some concerns previously raised by constituents about *de minimis* embedded derivative features that modify insignificantly the economic relationship between principal, the time value of money and the credit risk.

30. **Example 2 –** An issued bond with a stated interest rate that is computed based on the performance of a third party's equity would be measured at FVPL in its entirety because its cash flows are not solely P&I.

31. **Business model** – The staff will bring a paper that discusses the assessment of the business model for financial liabilities at a future meeting depending on the tentative decisions made by the boards on this series of papers.

32. **Own credit risk**[10] – The boards have already considered alternative approaches to address the concerns about recognising in P&L the changes in the fair value of a financial liability attributable to changes in its credit risk. To address that issue, both boards have decided to retain bifurcation for financial liabilities, which

[10] The boards have different requirements for how to measure credit risk. The staff do not propose trying to address these differences in this project.

reduced the population of items affected—ie the issue remained only for financial liabilities designated under the FVO.

33. To address the issue for liabilities designated under the FVO, IFRS 9 includes specific presentation provisions that require the effects of changes in own credit risk to be recognised in OCI except for the unusual case for which recognising the effects of the changes in the financial liabilities' credit risk in OCI would create or enlarge an accounting mismatch in P&L. If so, an entity is required to present all changes in fair value (including the effects of changes in the credit risk of the liability) in profit or loss[11]. In developing this approach, the IASB has considered and rejected other alternatives (discussed in paragraph A8 in IASB AP 6B/FASB Memo 140).

34. The FASB's model originally did not include a FVO for financial liabilities; however, it was subsequently introduced during re-deliberations. Consequently the FASB's current model does not address the issue of own credit risk for those financial liabilities; however, the FASB staff plans to discuss this issue with the FASB prior to finalising the overall C&M model.

35. The staff do not believe that the boards should re-consider the approaches that have been considered and rejected in the past.

36. Consequently, if the boards decide to pursue a no-bifurcation approach, the staff believe that the boards could either:

    (a) Address the issue of own credit risk by extending the presentation requirements in IFRS 9 for financial liabilities designated under the FVO to all financial liabilities measured at FVPL (other than those held-for-trading, including derivatives)—that is, the effects of changes in the financial liability's credit risk would be recognised in OCI[12]; or

[11] This is expected to be rare. The example brought to the IASB's attention was the unusual case where a financial institution funds mortgages by issuing bonds in the market and the borrower is able to satisfy their obligation either by repaying in cash or by delivering the related bond to the bank.

[12] Except for situations for which an accounting mismatch would result (under IFRS 9).

(b) Require that the entire fair value change is presented in P&L if the financial liability has cash flows that are not solely P&I, which is consistent with the FASB's tentative model (ie there would be no special treatment for the effects of changes in own credit risk). Under this approach, the boards could consider requiring separate presentation of changes in own credit risk on the face of P&L (eg either as a separate line item or parenthetically, which would be consistent with the approach in the FASB's proposed Update).

37. IASB AP 6F/FASB Memo 140D provides an analysis of these alternatives, the staff recommendation and a question to the boards.

One final issue: a FASB-only consideration

38. Equity instruments (from an issuer's perspective) are not within the scope of the FASB's project and, therefore, would continue to be accounted for under current US GAAP. The FASB staff believes that if the application of US GAAP results in a debt-equity hybrid instrument recognised as a financial liability in its entirety or as having a separately reportable financial liability component, that financial liability or component would be subsequently measured under the final guidance issued for this project. The staff highlights that the project on financial instruments with characteristics of equity, when completed, could change the classification of debt-equity hybrid instruments under current US GAAP. The FASB staff does not plan to address the classification of debt-equity hybrid instruments in this project.

39. However, there are particular issued convertible debt instruments that qualify for an exception in Topic 815 and are not subject to special separation models under current US GAAP. These instruments generally are measured at amortised cost, unless the fair value option under US GAAP is elected. If the boards decide to pursue a no-bifurcation approach, the FASB would need to consider the accounting for these issued convertible debt instruments. This issue was raised by constituents as in response to the proposed Update. If the proposed P&I cash flow characteristics approach decided for financial assets at the February 2012 joint

meetings was also applied to financial liabilities, these issued convertible debt instruments generally would be required to be measured at FVPL in their entirety.[13] As noted earlier in this paper, the FASB's tentative model provides specific guidance for these instruments that allows an issuer to measure these instruments at amortised cost. In IASB AP 6F/FASB Memo 140D the staff will ask the FASB whether they would like to carry forward this guidance to the proposed P&I model or would they prefer that the FASB staff return with additional analysis and alternatives.

Key points

40. The key considerations under a no-bifurcation approach are summarised below:

    (a) If the boards pursue a no-bifurcation approach to C&M of financial liabilities, that staff believe that the assessment should be based on whether the contractual cash flows are solely P&I and the business model. That approach would be symmetrical with financial assets. If the boards pursue this approach, the staff will bring a paper at a future date that discusses a business model assessment for financial liabilities.

    (b) If the boards pursue a no-bifurcation approach, they must consider whether, and if so how, the concerns about recognising in P&L the effects of changes in own credit risk when a financial liability is measured at fair value should be addressed. The staff believe that these concerns could be addressed either by requiring separate recognition of the changes in fair value attributable to own credit in OCI or through separate presentation in P&L.

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[13] This would not necessarily be the case in the context of IFRS literature. As discussed in IASB AP 6B/FASB memo 140, under IAS 32, an equity conversion feature that meets the definition of an equity instrument (in accordance with the 'fixed-for-fixed' condition) would be bifurcated and accounted for separately. The host debt instrument would be within the scope of IFRS 9. Absent other embedded features that are not solely P&I, the debt host would qualify for a measurement category other than at FVPL on the basis of its contractual cash flow characteristics.

(c) If the boards decide to pursue a no-bifurcation C&M approach for financial liabilities, the FASB would need to decide whether they would like to carry forward the guidance for particular issued convertible debt instruments currently included in the FASB's tentative model that permits such instruments to be measured in their entirety at amortised cost.