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Introduction

1. This series of papers discusses whether bifurcation should be pursued and, if so, the basis for bifurcation for financial assets that do not qualify in their entirety for a measurement category other than fair value through profit or loss (FVPL) due to their contractual cash flow characteristics (ie contractual cash flows are not solely principal and interest (P&I))[1].

2. Some believe that symmetry in bifurcating financial assets and financial liabilities is important, therefore this series also discusses bifurcating financial liabilities. Because bifurcation is inextricably linked to the general classification and measurement (C&M) model, this series also discusses the C&M model for financial liabilities more broadly. (The C&M model for financial assets was discussed at the February 2012 joint board meeting.)

[1] Not all financial assets within the scope of this series would be eligible for bifurcation even if bifurcation is pursued. For example, freestanding derivatives would not be eligible for bifurcation under either bifurcation methodology discussed in this series.

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The Financial Accounting Standards Board (FASB), is the national standard-setter of the United States, responsible for establishing standards of financial accounting that govern the preparation of financial reports by nongovernmental entities. For more information visit www.fasb.org

3. There are five papers in this series. The purpose of this paper is to provide some general considerations and structure for the discussion about bifurcation before introducing the detailed topics in the subsequent papers. The next three papers describe approaches for bifurcating financial assets and financial liabilities:

   (a) IASB AP 6C/FASB Memo 140A – No bifurcation

   (b) IASB AP 6D/FASB Memo 140B – Principle-based bifurcation methodology based on the instrument's cash flow characteristics

   (c) IASB AP 6E/FASB Memo 140C – Bifurcation methodology based on the "closely related"[2] criteria in IAS 39/IFRS 9[3] and Topic 815

   Issues discussed in these papers are interrelated, so the final paper in the series—IASB AP 6F/FASB Memo 140D—addresses the papers' interaction and contains the staff analysis and recommendations.

4. There are two primary themes to this series:

   (a) Whether eligible financial assets and/or financial liabilities should be bifurcated; and

   (b) If bifurcation is required[4], which methodology should be used?

   The conclusions for financial liabilities and financial assets may differ.

5. This paper provides relevant background and an overall framework for thinking about bifurcation. The structure of this paper is as follows:

   (a) Background – explains the boards' rationales for their current positions on bifurcation in IFRS 9 and the FASB's tentative model.

   (b) Symmetry – discusses considerations related to symmetry in the accounting for financial assets and financial liabilities.

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[2] US GAAP uses the terminology "clearly and closely related", but for purposes of this series, "closely related" will be used.

[3] IFRS 9 carries forward IAS 39 bifurcation requirements for financial liabilities.

[4] 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.

(c) Bifurcation – discusses, at a high level, the benefits and criticisms of bifurcating financial instruments.

Background

6. This section provides an overview of the development of the aspects of the IASB's and FASB's respective C&M models regarding bifurcation. Additional background regarding the cash flow characteristics assessment is included in IASB AP 6C/FASB Memo 140A. A more detailed explanation of how the IASB and the FASB arrived at their current positions, including the alternatives that the boards considered and the arguments that the boards found most persuasive, is included in the appendices.

   (a) Appendix A – detailed IASB background

   (b) Appendix B – detailed FASB background

IASB background

7. In the July 2009 exposure draft *Financial Instruments: Classification and Measurement* (IASB 2009 ED), the IASB proposed a symmetrical C&M model for financial assets and financial liabilities that prohibited bifurcation. The IASB took the view that accounting for hybrid contracts as a single unit of account would reduce complexity in the accounting for financial instruments and provide useful information for assessing the timing, amount and uncertainty of future cash flows.

8. **Financial assets** – The IASB subsequently confirmed the proposals in the IASB 2009 ED to not bifurcate financial assets and issued IFRS 9 *Financial Instruments*. Many constituents support this position and find IFRS 9 to be operational. Other constituents disagreed with the proposals to eliminate bifurcation for financial assets and have continued to express disagreement for the following reasons:

(a) Components of some hybrid contracts are managed separately. Bifurcation may therefore provide more relevant information to users.

(b) A C&M model without bifurcation results in some financial assets being measured at FVPL even if an entity holds the assets to collect contractual cash flows. This leads to increased volatility in profit or loss (P&L) that is not meaningful. Amortised cost measurement of the host contract would provide more useful information to users.

(c) Symmetry in bifurcating financial assets and financial liabilities is of primary importance because the contractual terms of the instrument are the same from the holder and issuer perspective, and thus, the accounting should be the same. Some also thought that hybrid financial instruments may be managed together and believe symmetrical accounting would reduce the effect of mismatches. Therefore, since the IASB retained bifurcation for financial liabilities, financial assets should be bifurcated.

(d) A relatively insignificant feature could result in a hybrid instrument being measured at FVPL in its entirety instead of amortised cost.

9. **Financial liabilities** – When redeliberating the IASB 2009 ED, the IASB decided that additional time was necessary to determine how best to address the effects of changes in a financial liability's credit risk (often referred to as 'own credit risk') when the liability is measured at fair value.[5] The issue already existed under IAS 39 *Financial Instruments: Recognition and Measurement*. However, the proposals for financial liabilities in the IASB 2009 ED would exacerbate the issue because the population of financial liabilities measured at FVPL would have been expanded to include hybrid financial liabilities.

10. The IASB performed an extensive outreach programme, including a user questionnaire, and subsequently published the exposure draft *Fair Value Option for Financial Liabilities* (IASB 2010 ED) in May 2010.

[5] This issue is discussed in further detail in IASB AP 6C/FASB Memo 140A.

11. The feedback from constituents, including users, received in the outreach programme indicated that a symmetrical C&M model for financial assets and financial liabilities is not necessary and often does not result in the most useful information. Also, the feedback indicated that the C&M requirements for financial liabilities in IAS 39, including bifurcation, generally work well. 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.

12. For financial liabilities designated under the fair value option, the IASB decided to finalise the proposals included in the IASB 2010 ED, with minor modifications that were supported by constituents requiring separate presentation in other comprehensive income (OCI) of the effects of changes in a liability's credit risk.

FASB background

13. In the May 2010 proposed Accounting Standards Update *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815)* (proposed Update), the FASB proposed a C&M model with two main classification and measurement categories: FVPL and FVOCI. The proposed Update did not include bifurcation for financial assets or financial liabilities but used the bifurcation guidance in Subtopic 815-15 to determine the classification of hybrid financial instruments. The measurement model under the proposed Update would have required a hybrid financial instrument to be classified and measured at FVPL if the hybrid instrument contained an embedded derivative that would require bifurcation and separate accounting based on current US GAAP; whereas, a hybrid instrument that did not require bifurcation and separate accounting under current US GAAP would be eligible for measurement at FVOCI. The FASB believed that eliminating bifurcation for hybrid financial instruments would simplify the accounting for financial instruments. Rather than creating a new set of criteria to assess whether the cash flow variability of a

hybrid financial instrument was incompatible with the concepts for FVOCI measurement, the FASB decided to use the bifurcation guidance in Subtopic 815-15 to determine classification because that guidance was well understood in practice.

14. **Financial liabilities** – In response to the proposed Update, many constituents (mainly preparers) stated that an entity should continue to be allowed to bifurcate embedded derivatives from hybrid financial liabilities. These respondents noted that bifurcation would allow the entity to classify and measure the host contract based on the overall C&M model for financial instruments, including management's business strategy. These respondents believe that once the embedded derivative is bifurcated from the hybrid financial liability, amortised cost measurement is the most relevant measurement attribute for the host contract for the same reasons they believe amortised cost measurement generally is the most relevant measurement attribute for financial liabilities. That is, these respondents were especially concerned about recognising fair value changes related to an entity's own credit risk and measurement of a financial liability at an amount that is different than its settlement amount. To address these concerns and others interrelated with the pending project on financial instruments with characteristics of equity, the FASB decided to retain bifurcation for financial liabilities during the redeliberations of its tentative C&M model.

15. **Financial assets** – The FASB believed that asymmetry in accounting for financial assets and financial liabilities would increase complexity and, therefore, decided to also bifurcate financial assets during the redeliberations of its tentative C&M model. To avoid disruption to practice and changing the guidance for embedded derivatives before the boards had an opportunity to jointly discuss their respective C&M models, the FASB decided to use the existing embedded derivative requirements in Subtopic 815-15 for both hybrid financial assets and financial liabilities.

Symmetry in accounting for financial assets and financial liabilities

16. As noted in the background sections above, the notion of 'symmetry' is often used when discussing the accounting for financial assets and financial liabilities, notably bifurcation, but is used with different meanings. Symmetry may refer to:
    (a) Symmetry in bifurcation methodology (eg both financial assets and liabilities are bifurcated using the 'closely related' criteria);
    (b) Symmetry in whether bifurcation is required (or prohibited) for both financial assets and financial liabilities; or
    (c) Symmetry in the overall C&M model (ie the same C&M criteria are applied to both financial assets and financial liabilities, including the same bifurcation requirements, if any).
17. The staff note that the overall C&M models for financial assets and financial liabilities are not symmetrical under either IFRS 9 or the FASB's model (and are not symmetrical under existing IFRSs and US GAAP). However, the FASB's tentative model, unlike IFRS 9, contains symmetrical requirements for bifurcation. That is, under the FASB's tentative model, both financial assets and liabilities are bifurcated using the 'closely related' criteria whereas under IFRS 9 only financial liabilities are bifurcated. This difference is because the boards have placed different emphasis in their respective models on the importance of symmetry in bifurcation.

General considerations for symmetry

18. Those who prefer a symmetrical C&M model and/or symmetry in bifurcating financial assets and financial liabilities argue that symmetry reduces the complexity in financial reporting because users and prepares would only have to learn one set of requirements. Additionally, these constituents argue that a financial instrument should be accounted for in the same way by the holder and the issuer. Some IASB constituents note that since bifurcation has been deemed

appropriate for hybrid financial liabilities under IFRS 9, it would also be appropriate to bifurcate from the holder perspective.

19. Those who support an asymmetrical C&M model and/or bifurcation of financial assets and financial liabilities argue that the differences between financial assets and financial liabilities (discussed below) necessitate different accounting models. This view is reflected in the feedback[6] the IASB received regarding how to deal with own credit risk in financial liabilities—that symmetry in accounting for financial assets and financial liabilities is not necessary and does not result in useful information.

Specific considerations for symmetry

20. In assessing the relevance of symmetry in bifurcating financial assets and financial liabilities, the boards need to be aware of considerations that apply only to either financial assets or financial liabilities or that apply to both financial assets and financial liabilities but may lead to different conclusions. These considerations are summarised below to help the boards analyse the issues discussed in IASB AP 6C-6E/FASB Memos 140A-140C.

21. **Equity conversion features from the issuer's perspective** – Equity instruments (from an issuer's perspective) are not within the scope of IFRS 9 and the FASB's tentative model and, therefore, would continue to be accounted for under current IFRS and US GAAP. The staff believe that if the application of IAS 32 *Financial Instruments: Presentation* and 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 IFRS 9 or the FASB's final C&M model. The staff highlights that the project on financial instruments with characteristics of equity, when completed, could change the classification of debt-

[6] See paragraph A10 of the appendix.

equity hybrid instruments. The staff do not plan to address the classification of debt-equity hybrid instruments in this project.

22. **Own credit risk** – One of the key accounting issues highlighted by the financial crisis was the counter-intuitive effect of recognising changes in a financial liability's credit risk in P&L when the liability is measured at fair value. This issue is unique to the liability side of the balance sheet. Constituents believe that this effect ought to be recognised in P&L (or for some, at a minimum, separately presented in P&L) only if the financial liability is held for trading or is a derivative liability (ie, in circumstances where the entire change in the fair value of the financial liability may be realised through a transaction). The boards were urged to address this issue in their projects on financial instruments. Bifurcating financial liabilities resulted in a narrower population of financial liabilities affected by this issue because only bifurcated derivative features (or items considered to be held for trading) would be measured at FVPL. The issue is discussed in further detail in IASB AP 6C/FASB Memo 140A.

23. **Overall C&M model** – At the February 2012 joint board meeting, the boards agreed on a contractual cash flow characteristics assessment for financial assets based on the notion of solely P&I. However, this assessment does not currently apply to financial liabilities. Additionally, both IFRS 9 and the FASB's tentative model require an assessment of the business model within which financial assets are managed[7]. The FASB's model also requires a business model assessment for financial liabilities. IFRS 9 does not have a business model assessment for financial liabilities. However, the outcome is similar to the business model assessment under for financial assets in IFRS 9 (a similarity noted in the IASB's original deliberations). The outcome is also similar to the FASB's tentative model in that IFRS 9 requires that all held-for-trading financial liabilities, including derivatives, be measured at FVPL. Potential bifurcation methodologies

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[7] The alignment of the business model criterion for financial assets measured at amortised cost under IFRS 9 and the FASB's tentative model is discussed in IASB AP 6A/FASB Memo 139. The alignment of the business model criterion for financial assets at the FVOCI and FVPL measurement categories will be discussed at a future meeting.

therefore need to be considered in the light of the differing C&M requirements for financial assets and financial liabilities unless the boards decide to align the broader C&M models[8].

24. **Economic purpose of financial instruments** – Many constituents believe that bifurcation is appropriate for the issuer of structured financial instruments (ie financial liabilities with embedded derivatives) but not for the holder of such instruments (ie financial assets with embedded derivatives). Financial liabilities are often issued in the normal course of business with the view to finance operations and may be settled only through payment of the contractual amounts due. Entities may include embedded derivatives in financial liabilities in order to achieve a better interest rate but these features do not change the entity's underlying purpose for issuing and holding the liability (ie the features are generally not included for trading purposes). While some believe that amortised cost is generally the most appropriate measurement attribute for structured financial liabilities (because it reflects the issuer's legal obligation to pay the contractual amounts in the normal course of business), they acknowledge that amortised cost would be difficult to apply and understand that the cash flows can be highly variable if a financial liability has structured features (eg embedded derivatives). Therefore, many believe that bifurcating structured financial liabilities is the most appropriate measurement methodology because it results in the most useful measurement (ie amortised cost without the cash flow variability caused by the embedded derivative that would be measured separately at FVPL).

25. In contrast, financial assets are generally entered into with the view to earn a return (realised through interest income or capital appreciation or both). Therefore, the most appropriate measurement attribute for financial assets other than those that have simple cash flow characteristics and are held to collect contractual cash flows is fair value. This view is widely held by constituents, including users.

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[8] IASB AP 6C/FASB Memo 140A discusses whether and, if so how, the contractual cash flow characteristics assessment that is required for financial assets should apply to financial liabilities.

General discussion of bifurcation

26. This section sets forth the general arguments for and against bifurcation without regard to a specific bifurcation methodology. The staff's objective is to help the boards analyse the issues discussed in IASB APs 6C-6E/FASB Memos 140A-140C and form views about the first primary question in this series: whether financial assets and/or financial liabilities should be bifurcated.

Arguments for bifurcation

27. **Two units of account** – Some believe that hybrid financial instruments represent two units of account and therefore should be classified and measured separately. One argument commonly cited to support this point of view is that components of a hybrid instrument can be separately managed. Hence accounting for the instrument as more than one unit of account would provide the most relevant information about the timing, amount, and uncertainty of cash flows from the instrument.

28. **Inappropriate P&L volatility** – Some argue that a C&M model without bifurcation results in inappropriate P&L volatility because hybrid financial assets are measured at FVPL (which includes the effect of measuring the host at fair value) even if they are held with an objective of collecting the contractual cash flows. Proponents of this viewpoint believe that a different measurement attribute (ie amortised cost) would be more appropriate for the host contract in such cases.

29. **Structuring opportunities** – Some believe that bifurcation reduces structuring opportunities because an entity cannot structure an instrument as one or two contracts to achieve a desired accounting outcome.

30. **Own credit risk** – Bifurcation addresses the issue of own credit risk in liability measurement (discussed in paragraph 22 in this paper) for many financial liabilities.

31. **Hedge accounting –** Bifurcating a hybrid instrument may enable an entity to use the embedded derivative as a hedging instrument in a qualifying hedging relationship[9].

Arguments against bifurcation

32. **One unit of account** – Some believe that a hybrid instrument represents one unit of account because it is a single contract and will eventually be settled as such. Hence accounting for the instrument as a whole would provide the most relevant information about the timing, amount, and uncertainty of cash flows from the instrument. Bifurcating the instrument into separate components would create 'artificial' instruments for accounting purposes.

33. **Complexity** – Bifurcation introduces additional complexity to financial reporting by creating an exception to the underlying C&M model[10]. Besides, particular bifurcation methodologies may lead to additional measurement complexities and/or exceptions in the context of the overall C&M model for financial instruments. This will be further discussed in IASB AP 6D and AP 6E/FASB Memo 140B and Memo 140C.

34. **FVO option** – Some are concerned that bifurcation may necessitate or broaden the fair value option to allow entities to avoid the complexity of bifurcation and the fair value option will reduce comparability among entities. If the boards choose an alternative that includes bifurcation, the staff will bring further analysis of the knock-on effects to the fair value option.

35. ***De minimis* features** – The P&I contractual cash flow characteristics assessment decreases the need to bifurcate financial assets because insignificant features that modify the relationship between principal and interest (while still being consistent

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[9] This issue is still relevant but slightly less critical for the IASB as the new general hedge accounting model (which has yet to be finalised) allows non-derivatives measured at FVPL to be designated as hedging instruments.

[10] Historically, bifurcation has been viewed as an anti-abuse exception to the general C&M model to prevent entities circumventing the requirements to measure derivatives at other than FVPL.

with this notion) will no longer cause the instrument in its entirety to be measured at FVPL.

36. These arguments are further discussed in AP 6F/FASB Memo 140D (Staff analysis and recommendation).

Appendix A: Detailed IASB background

A1. IAS 39, which has been superseded by IFRS 9, contains requirements for the bifurcation of financial assets and financial liabilities. IAS 39 requires that an embedded derivative be separated from a non-derivative host contract for measurement purposes if (IAS 39 paragraph 11):

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

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

(c) the hybrid instrument is not measured at FVPL.

The embedded derivative would be measured at FVPL while the host contract would be accounted for separately under IAS 39 if it is a financial instrument and under another appropriate standard if it is not a financial instrument.

Exposure draft

A2. In July 2009 the IASB issued the exposure draft *Financial Instruments: Classification and Measurement* (IASB ED), which proposed to eliminate bifurcation for financial assets and financial liabilities. In developing the proposals, the IASB considered and rejected using the 'closely related' bifurcation requirements in IAS 39, which had been criticised as being rule-based, complex and internally inconsistent. The IASB believed that bifurcation requirements based on the closely related criterion would not provide useful information for users, and decided not to include bifurcation in the proposals.

A3. Besides, a closely related methodology would result in hybrid contracts being classified using conditions different from those that would be applied to all non-hybrid financial instruments (ie the assessment of contractual cash flow characteristics). As a result, some hybrid contracts that do not qualify for a

measurement category other than FVPL due to their contractual cash flow characteristics might still qualify for amortised cost under the closely related requirements. The IASB therefore concluded that a single classification approach (ie the contractual cash flow characteristics assessment with no bifurcation) for all financial instruments, including hybrid contracts with financial hosts, was the only approach that responded adequately to the criticisms described above. A single classification approach would improve comparability by ensuring consistency in classification, and hence makes it easier for users to understand the information that financial statements present about financial instruments.

A4. In the responses to the IASB ED, some respondents, mainly preparers, stated their preference for keeping or modifying the closely related bifurcation model that was in IAS 39 for the following reasons (IFRS 9 paragraph BC4.88):

(a) Eliminating the requirement to account for embedded derivatives as stand-alone derivatives would lead to increased volatility in profit or loss and, in the view of those respondents, result in accounting that did not reflect the underlying economics and risk management or business model considerations in a transaction. That would be the case, for example, where the components of a hybrid financial asset are managed separately.

(b) Structuring opportunities would be created, for example if an entity entered into two transactions that have the same economic effect as entering into a single hybrid contract.

However, most respondents agreed that elimination of bifurcation reduces the complexity in financial reporting of financial assets and improves the reporting for financial instruments.

Redeliberations on the IASB ED for financial assets

A5. During the redeliberations on the IASB ED, the IASB decided to first publish a revised standard for financial assets—resulting in IFRS 9 being issued in November 2009—and then complete the redeliberations for financial liabilities.

This was in part because many were of the view that fundamental changes to financial liability accounting were not warranted. However, it was primarily because additional consultation was necessary to find an appropriate solution to the accounting for the effects of changes in own credit risk in financial liabilities which could not be completed in the timeline the IASB had undertaken to publish a revised standard for financial assets. Thus, the final requirements for financial liabilities were postponed until after the requirements for financial assets had been published.

A6. The IASB confirmed the proposals in the IASB ED for financial assets for the following reasons (IFRS 9 paragraph BC 4.89):

(a) Eliminating the embedded derivatives guidance for hybrid contracts reduces the complexity in financial reporting by eliminating another classification approach and improves the reporting for financial instruments. The majority of constituents agreed with this conclusion.

(b) In the IASB's view, the underlying rationale for separate accounting for embedded derivatives is not to reflect risk management activities, but to avoid entities circumventing the recognition and measurement requirements for derivatives. Accordingly it is an exception to the definition of the unit of account (the contract) motivated by a wish to avoid abuse. It would reduce complexity to eliminate and anti-abuse exception.

(c) The IASB noted the concerns about structuring opportunities referred to in paragraph BC4.88(b) (reproduced in paragraph A4(b)). However, two contracts represent two units of account. Reconsideration of the unit of account forms part of a far broader issue for financial reporting that is outside the scope of the Board's considerations in IFRS 9. In addition, embedded derivative features often do not have contractual cash flows that represent payments of P&I and thus the entire hybrid contract would not be eligible to be measured at amortised cost. The IASB noted that C&M of a hybrid contract in its entirety would provide

more relevant information because the embedded derivative feature affects the cash flows ultimately arising from the entire hybrid contract. Thus, applying the classification approach to the hybrid contract in its entirety would depict more faithfully the amount, timing and uncertainty of future cash flows.

(d) In the IASB's view, accounting for the hybrid contract as one unit of account is consistent with the project's objective—to improve the usefulness for users in their assessment of the timing, amount and uncertainty of future cash flows of financial instruments and to reduce the complexity in reporting financial instruments.

Redeliberations on the IASB ED for financial liabilities

A7. To address the issue of own credit risk in fair value measurement of financial liabilities, the IASB began an extensive outreach programme (which included a user questionnaire) immediately after issuing the requirements for financial assets in IFRS 9.

A8. During the outreach programme, the Board explored several approaches for classification and subsequent measurement of financial liabilities that would exclude the effects of changes in a liability's credit risk from profit or loss, including (IFRS 9 paragraph BC4.47):

(a) measuring liabilities at fair value and presenting in other comprehensive income the portion of the change in fair value that is attributable to changes in the liability's credit risk. A variant of this alternative would be to present in other comprehensive income the entire change in fair value.

(b) measuring liabilities at an 'adjusted' fair value whereby the liability would be remeasured for all changes in fair value except for the effects of changes in its credit risk (ie 'the frozen credit spread method'). In other words, the effects of changes in its credit risk would be ignored in the primary financial statements.

(c) measuring liabilities at amortised cost. This would require estimating the cash flows over the life of the instrument, including those cash flows associated with any embedded derivative features.

(d) bifurcating liabilities into hosts and embedded features. The host contract would be measured at amortised cost and the embedded features (eg embedded derivatives) would be measured at fair value through profit or loss. The Board discussed either carrying forward the bifurcation requirements in IAS 39 for financial liabilities or developing new requirements.

A9. The primary message that the IASB received from users of financial statements and other constituents was that the effects of changes in a liability's credit risk ought not to affect profit or loss unless the liability is held for trading (including if it is a derivative). That is because an entity generally will not realise the effects of changes in the liability's credit risk unless the liability is held for trading.

A10. In addition to that view, there were several other themes in the feedback that the Board received (IFRS 9 paragraph BC4.49):

(a) Symmetry between how an entity classifies and measures its financial assets and its financial liabilities is not necessary and often does not result in useful information. Most constituents said that in its deliberations on financial liabilities the IASB should not be constrained or biased by the requirements in IFRS 9 for financial assets.

(b) Amortised cost is the most appropriate measurement attribute for many financial liabilities because it reflects the issuer's legal obligation to pay the contractual amounts in the normal course of business (ie on a going concern basis) and in many cases, the issuer will hold liabilities to maturity and pay the contractual amounts. However, if a liability has structured features (eg embedded derivatives), amortised cost is difficult to apply and understand because the cash flows can be highly variable.

(c) The bifurcation methodology in IAS 39 is generally working well and practice has developed since those requirements were issued. For many entities, bifurcation avoids the issue of own credit risk because the host is measured at amortised cost and only the derivative is measured at FVPL. For this reason, many constituents, including users of financial statements, favoured retaining bifurcation for financial liabilities even though they supported eliminating it for financial assets. Users preferred structured assets to be measured at fair value in their entirety. Many constituents were sceptical that a new bifurcation methodology could be developed that was less complex and provided more useful information than using the bifurcation methodology in IAS 39. Moreover, a new bifurcation methodology would be likely to have the same classification and measurement outcomes as the existing methodology in most cases.

(d) The Board should not develop a new measurement attribute. The almost unanimous view was that a 'full' fair value amount is more understandable and useful than an 'adjusted' fair value amount (such as the frozen credit spread approach) that ignores the effects of changes in the liability's credit risk.

(e) Even for preparers with sophisticated valuation expertise, it is difficult to determine the amount of change in the fair value of a liability that is attributable to changes in its credit risk. Under existing IFRSs, only entities that elect to designate liabilities under the fair value option are required to determine that amount. If the IASB were to extend the requirement to determine the own credit amount to more entities and to more financial liabilities, many entities would have significant difficulty determining that amount and could incur significant costs in doing so.

A11. Many constituents said that none of the alternatives being discussed to address own credit was less complex or would result in more useful information than the existing bifurcation requirements.

A12. As a result of the feedback received, the IASB decided to retain almost all of the existing requirements for the C&M of financial liabilities. The IASB decided that the benefits of changing practice did not outweigh the costs of the disruption that such a change would cause. Accordingly, in October 2010 the IASB carried forward almost all of the requirements for financial liabilities unchanged from IAS 39 to IFRS 9 (IFRS 9 paragraph BC4.51).

A13. By retaining almost all of the existing requirements, notably bifurcation, the issue of credit risk is addressed for most financial liabilities because they would continue to be subsequently measured at amortised cost or would be bifurcated into a host, which would be measured at amortised cost, and an embedded derivative, which would be measured at fair value. Financial liabilities that are held for trading (including all derivative liabilities) would continue to be subsequently measured at FVPL in their entirety, which is consistent with the widespread view that all fair value changes for those liabilities ought to affect profit or loss (IFRS 9 paragraph BC4.52).

A14. The issue of credit risk of concern to users (ie for items not held for trading) would remain only in the context of financial liabilities designated under the fair value option. Thus, in May 2010 the IASB published the exposure draft *Fair Value Option for Financial Liabilities*, which proposed that the effects of changes in the credit risk of liabilities designated under the fair value option would be presented in OCI. The IASB considered the responses to that exposure draft and finalised the proposals as an amendment to IFRS 9 in October 2010 (IFRS 9 paragraph BC 4.53).

A15. Subsequent feedback on the requirements has been positive—the requirements are seen as operational and effectively address the issue of measuring the effects of changes in own credit risk for financial liabilities.

Appendix B: Detailed FASB background

B1. Subtopic 815-15 requires bifurcation and separate accounting of certain embedded derivative features. Paragraph 815-15-25-1 (originally issued as paragraph 12 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*) states:

> An embedded derivative shall be separated from the host contract and accounted for as a derivative instrument pursuant to Subtopic 815-10 if and only if all of the following criteria are met:
>
> a. The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.
>
> b. The hybrid instrument is not remeasured at fair value under otherwise applicable generally accepted accounting principles (GAAP) with changes in fair value reported in earnings as they occur.
>
> c. A separate instrument with the same terms as the embedded derivative would, pursuant to Section 815-10-15, be a derivative instrument subject to the requirements of this Subtopic. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

B2. The embedded derivative would be measured at FVPL while the host contract would be accounted for separately under the FASB's tentative C&M model if it is a financial instrument and under another appropriate standard if it is not a financial instrument.

Proposed Update

B3. The FASB issued a comprehensive proposed Accounting Standards Update *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815)* (proposed Update) in May 2010. The proposed Update would have required most financial instruments to be measured at fair value. Qualifying fair value changes could be recognised in OCI if the financial instrument qualified based on the characteristics of the instrument

and an entity's business strategy. Additionally, the proposed Update would have eliminated the current US GAAP requirement to bifurcate and separately account for embedded derivatives in a hybrid financial instrument to reduce complexity and increase comparability among entities. However, the Board decided that rather than creating a new set of criteria to assess whether the cash flow variability of a hybrid financial instrument was incompatible with the concepts for FVOCI measurement, the FASB decided to use the bifurcation guidance in Subtopic 815-15 to determine classification of the hybrid instrument because that guidance was well understood in practice. Therefore, an entity would have been required to measure a hybrid financial instrument for which an embedded derivative feature would otherwise be required to be accounted for separately from the host contract under Subtopic 815-15 to be measured in its entirety at FVPL in each reporting period.

B4. Most users did not provide feedback on the proposed changes to the accounting for hybrid financial instruments because of technical complexity and their unfamiliarity with current bifurcation guidance for embedded derivatives. The users that provided feedback on this aspect of the proposed Update generally believe measuring hybrid financial assets and hybrid financial liabilities at FVPL in their entirety provides better information about the current economic and interest rate environment, cash flow variability, and risks inherent in these instruments. These users also believe that eliminating the requirement to bifurcate embedded derivatives from the host contract will improve comparability among entities.

B5. Most non-users did not support measuring hybrid financial assets and hybrid financial liabilities at fair value in their entirety. They believe that an entity should continue to be allowed to bifurcate embedded derivatives from the host contract based on the bifurcation rules in Subtopic 815-15. This would allow the entity to classify and measure the host contract based on the overall C&M model for financial instruments, including management's business strategy.

B6. Some non-users agreed with the elimination of bifurcation and separate accounting of the embedded derivative for hybrid financial assets but believe that

bifurcation should be allowed for hybrid financial liabilities. These constituents believe that once the embedded derivative is removed from the hybrid financial liability, amortised cost measurement is the most relevant measurement attribute for the host contract for the same reasons they believe amortised cost measurement is the most relevant measurement attribute for financial liabilities in general such as own debt. They also believe that it is not appropriate to measure financial liabilities at any amount other than the face amount as they argue this is the amount at which the liability will most likely be settled. They also believe that measuring liabilities at fair value results in counter-intuitive gains on financial liabilities that may result from deterioration of an entity's own credit. In most cases, these gains will never be realised. They believe that the gains are theoretical in nature and not representative of an entity's actual financial position.

B7. Many non-users were concerned that elimination of bifurcation would require hybrid financial instruments with *de minimis* embedded derivatives to be measured at FVPL. If bifurcation for hybrid financial instruments were ultimately eliminated, these constituents recommend that an entity be allowed to evaluate the potential significance of an embedded derivative to the overall cash flows of the instrument as part of the C&M model[11].

B8. Some non-users believe that recognising all fair value changes in net income for hybrid financial instruments that are currently bifurcated will improve consistency among entities and will ease operational issues.

Considerations specific to financial liabilities

B9. **Equity conversion features** – 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

[11] The staff believe this concern is addressed for financial assets by the decisions at the February 2012 joint board meeting.

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.

B10. **Own credit risk** – The proposed Update required separate presentation of significant changes in the fair value of financial liabilities attributable to changes in the entity's own credit standing (excluding the change in the price of credit). The FASB believed that this would address the needs of differing financial statement users and would provide users with the ability to include or exclude those amounts when analysing the financial statements of different entities.

B11. Constituents recommended that changes in fair value that are attributable to own credit risk should be separately presented, unless the liabilities are held for trading or are derivative liabilities, which most agreed should be recorded within P&L. In addition, most constituents recommended that such changes in fair value should be recognised in other comprehensive income. Further, most disagreed that the change in the price of credit should be excluded from the measurement of fair value changes attributable to own credit risk.

Redeliberations on proposed Update

B12. In redeliberations subsequent to the proposed Update, the FASB tentatively decided to retain bifurcation and separate accounting for embedded derivative features in hybrid financial instruments as currently required under Subtopic 815-15 on embedded derivatives for the following reasons:

(a) concerns related to measuring financial liabilities in general at fair value such as own credit risk, settlement amount, etc.

(b) concerns about the interrelated issues with the pending project on financial instruments with characteristics of equity;

(c) preference to have a symmetrical bifurcation model for hybrid financial assets and hybrid financial liabilities;

(d) to avoid changing the guidance for embedded derivatives before the boards had an opportunity to jointly discuss their respective C&M models.

B13. Consequently, embedded derivatives would be bifurcated using the closely related criteria and measured at FVPL under the FASB's tentative model for hybrid financial assets and financial liabilities. An entity would apply the C&M model separately to the host contract, which would require C&M based on both the characteristics of the host contract and the entity's business strategy.