STAFF PAPER

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Project	**Financial instruments: classification and measurement**		
Paper topic	Bifurcation: principal and interest bifurcation methodology		
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Introduction

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

2. This paper discusses a principle-based bifurcation methodology based on an instrument's contractual cash flow characteristics. This paper focuses on the **application** of the principle-based bifurcation approach to financial assets and financial liabilities (ie the mechanics of how it would work). It also discusses specific issues that arise from the holder's or the issuer's perspective and how they could be addressed if the boards pursue this approach. This paper **does not** discuss the arguments for and against bifurcation or our analysis of whether bifurcation should be required[2]. Nor does this paper address the advantages and disadvantages of this approach to bifurcation. These arguments and the arguments for and against bifurcation are set out in IASB AP6B/FASB Memo

[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.

140. Staff analysis and recommendation and questions for the boards are provided in IASB AP 6F/FASB Memo 140D.

3. **Financial assets –** IFRS 9 does not bifurcate financial assets. Therefore, for the IASB, this alternative would introduce bifurcation for financial assets. The FASB's tentative model already bifurcates financial assets but uses the 'closely related' criteria existing in current US GAAP. Hence, this approach would introduce a bifurcation methodology that is consistent with the assessment of the contractual cash flows characteristics of financial assets discussed by the boards in February 2012.

4. **Financial liabilities –** Introduction of the principle and interest (P&I) bifurcation methodology would be a change for both the IASB and the FASB. Both boards' C&M models currently bifurcate hybrid financial liabilities but use their respective closely related criteria. To apply a P&I bifurcation methodology to financial liabilities, the staff think that the boards would need to adjust the overall C&M model for liabilities and use the cash flow characteristics assessment that was discussed for financial assets in February 2012. The application of the cash flow characteristics assessment to financial liabilities is discussed in IASB AP 6C/FASB Memo 140A. That assessment would determine which financial liabilities would be assessed for bifurcation. This would result in greater symmetry in the accounting for financial assets and financial liabilities because both models would use the same contractual cash flow characteristics assessment.

5. This approach does not include separation of an equity component, as discussed in IASB AP 6B/FASB Memo 140. For IFRS, that would be determined under IAS 32 *Financial Instruments: Presentation*. For the FASB, it would be determined outside the scope of this project and would be determined under current applicable Topics in US GAAP.

Explanation of the approach

6. Under the P&I bifurcation approach, if an instrument has cash flows that are not solely payments of principal and interest, the instrument would be assessed to determine whether it should be bifurcated into:

   (a) a host contract with cash flows that are solely payments of P&I and

   (b) an embedded feature[3].

   The host contract could qualify for a measurement category other than at fair value through profit or loss (FVPL) depending on the business model within which it is held[4]. The embedded feature would be measured at FVPL.

7. An entity may not identify a component that is not specified or may not establish terms of the host P&I component in a manner that would result in separation of an embedded feature that is not already clearly present in the hybrid instrument. If there is no identifiable P&I component, the entire contract would be measured at FVPL.

Considerations for financial assets and financial liabilities

8. The current bifurcation requirements address the accounting for hybrid instruments with embedded *derivatives*. Absent the election of the fair value option for the instrument in its entirety, bifurcation is required if the following criteria are met:

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

   (b) The entire hybrid instrument is not remeasured at FVPL under otherwise applicable accounting requirements.

[3] Whether the embedded feature should be required to be a derivative is discussed in paragraphs 12-13.

[4] If relevant, the staff will prepare an analysis of the application of a business model assessment for financial liabilities at a future session. Currently, IFRS 9 does not have a business model assessment for financial liabilities. The FASB's tentative model has different business model assessments for financial assets and financial liabilities. However, the classification and measurement for held-for-trading liabilities and derivatives are similar under both models.

(c) A separate instrument with the same terms as the embedded derivative instrument would meet the definition of a derivative.

9. In IFRS 9 and the FASB's tentative model, derivatives are measured at FVPL. In the P&I bifurcation methodology, the embedded feature would likely be a derivative. If not, the staff believe that the embedded feature should be similarly measured at FVPL (subject to possible constraints discussed later in the paper).

10. The staff believe that the P&I bifurcation methodology risks introducing inappropriate flexibility in identifying the P&I host and embedded feature and may at best result in components being recognised that do not provide useful information and at worst, could create structuring opportunities. The staff think additional criteria is need to impose more discipline around bifurcation:

    (a) require that the embedded feature meet the definition of a derivative[5] or

    (b) require that the components are separately managed.

11. The staff believe that requiring the embedded feature to meet the definition of a derivative will provide sufficient discipline around the P&I bifurcation methodology. However, including an additional requirement that the components be separately managed – according to a standalone management assessment – would create a higher threshold for bifurcation.

Require the embedded feature to be a derivative

12. With this requirement, an instrument that contained a non-derivative embedded feature would not be bifurcated and the hybrid instrument would be measured at FVPL in its entirety. An instrument that contained an embedded feature that met the definition of a derivative would be bifurcated as described above.

13. The staff believe that in many cases the embedded feature would meet the definition of a derivative and that it would often result in bifurcation of components similar to those that are bifurcated under current requirements. If the embedded feature were required to be a derivative, it would provide greater

[5] The staff notes that the definition of a derivative under U.S. GAAP and IFRSs is different.

comparability in the application of the bifurcation guidance and limit opportunities for entities to achieve particular accounting outcomes.

Separate management of the embedded derivative

14. Feedback from some constituents indicates that a hybrid instrument can be managed as a single unit of account or as more than one unit of account. (Some challenge this assertion and believe that a single contract cannot be managed as separate components because all the components of the contract must be settled together.) They believe that bifurcation based on separate management of components would result in more useful information being provided. Some who hold this view believe that a hybrid contract should be bifurcated *only* if the components are separately managed. When a hybrid instrument is managed in its entirety, it represents a single unit of account and, therefore, bifurcation may not provide the most relevant information to users.

15. The staff note that how *components* are managed is an instrument-specific consideration, which would be in addition to and different from the business model assessment that would be applied at a higher level of aggregation under the C&M models being developed by the boards. Such an approach would also be akin to an intent-based model.

16. If the boards require that the components must be separately managed to be bifurcated, then:

    (a) Hybrid instruments with separately managed components would be bifurcated with the host P&I component classified and measured based on the business model within which it is held and the embedded feature would be classified and measured at FVPL.

    (b) Hybrid instruments in which the components are managed together will not be bifurcated and the instrument will be measured in entirety at FVPL.

Considerations specific to financial liabilities – FASB only

17. If the boards decide to pursue a P&I bifurcation methodology, the FASB would need to consider the accounting for particular convertible debt instruments from the issuer's perspective that would not meet the P&I cash flow characteristics assessment but that do not have a separation model and are generally measured at amortised cost under current U.S. GAAP. This issue was previously discussed in IASB AP 6C/FASB memo 140B.

Key points in this paper

18. If the boards pursue a P&I bifurcation approach, they must consider:

    (a) whether the host contract or the embedded feature should be the residual when measuring the host contract;

    (b) whether the embedded feature should meet the definition of a derivative for the financial instrument to be eligible for bifurcation; and

    (c) whether the components of the hybrid contract should be separately managed for the financial instrument to be eligible for bifurcation.