Project	**Financial Instruments: Recognition and Measurement**
Topic	**Transition: retrospective application – hybrid contracts**

Introduction

1. Agenda paper 3C does not address the proposed transition to the proposed new classification and measurement guidance for hybrid contracts containing one or more embedded derivative(s) that are separated from the financial host for accounting purposes under current IAS 39. This addendum addresses that issue.

2. Agenda paper 3A1 proposes the elimination of current embedded derivative accounting for financial hosts.

3. As a reminder, at the last meeting the Board tentatively decided to require retrospective application of the new guidance unless specific transition relief is provided.

Transition for hybrid contracts with financial hosts

4. If the Board agrees with staff recommendation on embedded derivatives as set out in agenda paper 3A1, there are two possible outcomes of applying the new classification model to hybrid contracts for which embedded derivatives have been separated under the current guidance in IAS 39:[1]

   (a) the entire contract is accounted for at fair value; or

[1] The transition to the new classification model is set out in the main paper (agenda paper 3C).

(b) the entire contract is accounted for at amortised cost.

5. In both cases, the items being accounted for are reduced from two (or more) units to one unit - the entire hybrid contract.

6. Retrospective application would be as follows:

   (a) For separated hybrid contracts measured at fair value under the new guidance:

      (i) reverse the effects of applying amortised cost measurement to the host contract and FVTPL accounting to the embedded derivative(s); and

      (ii) restate the opening retained earnings of the earliest period presented, any comparative information and the current period to reflect fair value measurement of the entire hybrid contract since inception.

   (b) For separated hybrid contracts measured at amortised cost under the new guidance:

      (i) reverse the effects of applying amortised cost measurement to the host contract and FVTPL accounting to the embedded derivative(s); and

      (ii) restate the opening retained earnings of the earliest period presented, any comparative information and the current period to reflect amortised cost measurement (including any effects of applying the guidance in IAS 39.AG8 on re-estimates of cash flows) of the entire hybrid contract since inception.

7. Alternatively, the Board could require applying the new guidance only to hybrid contracts that are entered into on or after the transition date (ie *prospective application*).[2]

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[2] As the proposals would involve a change in the unit of account the staff believes prospective application for existing contracts is not a feasible way forward.

Staff analysis

8. The staff wishes to highlight that the accounting items measured after the bifurcation of an embedded derivative form part of a contract but are not themselves a contract.

9. One of the consequences of this is that for embedded derivative(s) (for measurement and disclosure purposes) and the host contract (disclosure purposes, since it likely would have been measured at amortised cost under IAS 39), the fair value has been determined on a components basis. That is, the fair value for each separate part of the contract would have been determined separately.

10. As a consequence, the sum of the fair values of the components may not equal the fair value of the entire hybrid contract (for example, because of the structuring margin that is inherent in any complex product would not be considered when valuing a separated embedded derivative as if it was a standalone derivative).

11. This means that an entity might have to determine retrospectively the fair value of the entire hybrid contract, possibly using hindsight, if the fair value of the entire hybrid contract was not determined in the past. This would be contrary to the requirements of IAS 8 *Accounting Policies, changes in Accounting Estimates and Errors* that does not permit retrospective application if this would involve hindsight.

12. One practical expedient could be to allow the sum of the components to be deemed as the fair value of the hybrid contract at the date of transition. However, in particular for contracts measured at fair value through profit or loss, any existing difference will be unwound at the next measurement date.

13. The staff wants to emphasise again the importance of transition requirements that provide useful and comparable information to users. As highlighted in other papers, retrospective application ensures comparability of the information reported in financial statements.

Staff recommendation

14. **The staff recommends requiring retrospective application of the proposed changes to accounting for hybrid contracts. Further, the Board should require in cases where the fair value of the entire hybrid contract has not been determined in the past to use the sum of the fair values of the components reported in financial statements as a proxy at the date of transition.**

15. The staff believes that in many cases the required information is already available. The staff believes that the benefit of comparable information outweighs the cost involved for preparers, particularly in the light of the practical expedient for a deemed fair value on transition if fair value information for the entire hybrid contract was not determined in the past. However, the staff acknowledges the potential impact on profit or loss in subsequent periods when the fair value of the entire hybrid contract is used for measurement purposes, but believes the benefits of retrospective application outweigh this effect.

Question to the Board
Does the Board agree with the staff recommendation in paragraph 14? If not, what approach do Board members want to require, and why?