New Measurement & Classification Guidance for Financial Instruments

On January 5, 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-01, *Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*. FASB has backed away from the sweeping overhauls proposed in its 2013 exposure draft, opting instead to make targeted improvements to current guidance. More importantly for financial institutions, FASB has retained the separate models in existing U.S. generally accepted accounting principles (GAAP) for determining classification and measurement of loans and debt securities, as noted in the table below.

U.S. GAAP – Financial Instruments Classifications – Debt Instruments & Loans			
Balance sheet category			
Held-to-maturity	Available-for-sale (AFS)	Trading	Held-for-sale
Income statement measurement			
Amortized cost	Fair Value – Other Comprehensive Income (FV-OCI)	Fair Value – Net Income (FV-NI)	Lower of cost or FV

These changes do not supersede existing specialized accounting guidance for broker dealers, investment companies and defined benefit and other postretirement plans.

What Is Changing?

Equity Securities

The ASU requires most equity securities to be measured at FV-NI. Equity securities previously classified as available for sale with changes in fair value recognized in other comprehensive income (FV-OCI) would be measured at FV-NI.

The ASU's scope covers all entities not covered by specialized guidance, including credit unions, mutual insurance companies and trusts not reporting substantially all their assets at fair value. It's not applicable to investment companies, broker-dealers or postretirement benefit plans, all of which are covered by specialized guidance. These changes would not apply to derivatives, consolidated investments, investments accounted for under the equity method, certain exchange memberships or Federal Home Loan Bank (FHLB) and Federal Reserve Bank (FRB) stock issued to member financial institutions.

Practicability Exception for Equity Securities Without Readily Determinable Fair Values

The ASU creates a new practical exception for nonmarketable equity securities, *i.e.*, cost method investments under current U.S GAAP. Securities that qualify for the existing net asset value practical expedient in ASC 820-10-35-59 are not eligible. If elected, entities would record those securities at cost adjusted for impairment and increases or decreases in observable prices (for orderly transactions for a similar investment of the same issuer). Entities should consider relevant transactions on or before the balance sheet date that are known or can reasonably be known to identify observable price changes. Entities are required only to make a reasonable effort, not an exhaustive search, to identify observable transactions. An entity should adjust the observable price of a similar security to reflect structural differences, such as voting rights, distributions rights and preferences and conversion features.

Impairment of Equity Securities Without Readily Determinable Fair Values

For equity securities where the "cost+" practical expedient has been elected, the ASU eliminates the other-than-temporary impairment model; entities would apply a single-step impairment test. At each reporting date, an entity electing this practicability exception would be required to evaluate impairment. If there's an indication the investment is impaired (without considering whether the decline is other-than-temporary under current U.S. GAAP), the investment should be measured in accordance with ASC 820, *Fair Value Measurement.* The impairment loss would be recognized in net income as the difference between the carrying value and fair value. Impairment indicators an entity should consider include, but are not limited to:

- A significant deterioration in earnings performance, credit rating, asset quality or business prospects of the investee
- A significant adverse change in the investee's regulatory, economic or technological environment
- A significant adverse change in general market condition of either the geographic area or the industry in which the investee operates
- A bona fide purchase offer, an offer by the investee to sell or a completed auction process for the same or similar investment for an amount less than the carrying amount of that investment
- Significant going concern issues, such as negative cash flows from operations, working capital deficiencies or noncompliance with statutory capital requirements or debt covenants

FASB plans to issue a final standard on credit losses for all other instruments later this quarter.

Measurement of Gains & Losses – Equity Securities						
Current		FV-OCI	FV-NI	Lower of cost or FV	Cost	Equity method
ASU 2016-01	Cost – Impairment & observable price changes		FV-NI			Equity method

Financial Liabilities "Own Credit"

Under current GAAP, companies can elect to measure certain debt instruments at fair value and recognize changes in fair value related to those debt instruments in earnings. If the debt decreases in price on the market, the liability associated with the debt would decrease (because a company could buy back the debt at a lower price). That decrease currently would be reported as a gain in the income statement. This guidance has been widely criticized for causing undue earnings volatility.

Under the new standard, fair value changes resulting from own credit for financial liabilities measured under the fair value option will be recognized through other comprehensive income (OCI) instead of net income. An entity can measure the effect of instrument-specific credit risk "own" credit using any method that faithfully represents such changes. The entity must disclose the method chosen and apply it consistently from period to period. Upon derecognition of the financial liability, the accumulated gains and losses due to changes in the instrument-specific credit risk would be reclassified from OCI to net income.

Deferred Tax Assets

The remeasurement of a financial instrument at fair value generally creates a temporary difference between the financial reporting basis and the tax basis of the instrument under ASC 740, *Income Taxes*, because the tax basis generally remains unchanged. This difference requires recognition of deferred taxes. Unrealized losses can give rise to deferred tax assets (DTA), which must be assessed for realizability. There is diversity in practice as some entities evaluate the need for a valuation allowance on a DTA related to AFS securities separately from their other deferred tax assets. The ASU clarifies entities would assess the realizability of a DTA related to an AFS debt security in combination with the entity's other DTAs.

Disclosures

The ASU retains many current U.S. GAAP balance sheet presentation requirements. Entities would separately present all financial assets and liabilities grouped by both measurement category and form, *e.g.*, securities, loans and receivables, on the balance sheet or in financial statement notes. For example, financial assets measured at FV-NI are presented separately from assets measured at fair value through OCI.

Public business entities will continue to disclose the FV of financial assets and liabilities measured at amortized cost. In a change from the exposure draft, current trade receivables and payables and demand deposit liabilities would not require fair value measurement. This can be done either parenthetically on the face of the balance sheet or in the financial statement notes. However, the ASU provides relief for public business entities by eliminating required disclosure of the method(s) and significant assumptions used in FV estimates for financial instruments measured at amortized cost.

In a significant change from current practice, nonpublic entities no longer would be required to disclose the FV of financial instruments measured at amortized cost.

Entities would have additional disclosure requirements when the cost+ practicability exception has been elected for equity investments without readily determinable fair values, as follows:

- The carrying amount of investments without readily determinable fair values
- The amount of impairments and downward adjustments, if any, both annual and cumulative
- The amount of upward adjustments, if any, both annual and cumulative
- For the current reporting date, additional information (in narrative form) that is sufficient to permit financial statement users to understand the quantitative disclosures and the information that the entity considered in reaching the carrying amounts and upward or downward adjustments resulting from observable price changes

GAAP currently allows entities an option to measure FV in two different ways for disclosure for certain financial assets. The exception in ASC 825 allowing entities to use an entry price notion rather than the exit price notion of ASC 820 no longer would be allowed.

Effective Date & Transition

Transition will require a cumulative effect adjustment to the statement of financial position as of the beginning of the first reporting period in which the guidance is effective, with two exceptions:

- Guidance (including disclosure requirements) on equity securities without readily determinable fair values will be applied prospectively to all equity investments that exist as of the date of adoption
- Changes related to the use of an exit price for disclosures also would be on a prospective basis with disclosure that prior-year data is not comparable, as applicable

In the year of adoption, the entity would make the normal accounting change disclosure, including the nature and reason for the change in accounting principle, the method of applying the change, the effects on each financial statement line item (if material) and the cumulative effect on retained earnings.

This standard is effective for public business entities for fiscal years beginning after December 15, 2017, including interim periods, *i.e.*, 2018 for calendar year-end companies. All other entities will have an additional year to adopt for annual financial statements and two years for interim financial statements; however, they could early adopt as of the effective date for public business entities.

Early application will be permitted for any interim or annual financial statements that have not been issued or not made available for issuance upon issuance of the final standard **only** for the following items:

- FV changes resulting from own credit for financial liabilities measured under FV option will be recognized through other comprehensive income
- FV disclosure requirements will be eliminated for financial instruments not recognized at FV for nonpublic business entities, including not-for-profit entities and employee benefit plans

Appendix A, below, summarizes the effective dates for this ASU and several other major projects.

For additional information, contact your BKD advisor or visit BKD’s Hot Topic page.

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Appendix A

Implementation Dates								
		Effective Date (for entities with calendar year-ends)						
Standard Issue Date	Type	2015*	2016	2017	2018	2019	2020	2021
Classification & Measurement Jan. 2016	Public business entity (PBE)	*Early adopt (partial – own credit)*			Interim & annual			
	All others	*Early adopt (partial – own credit & certain fair value disclosure)*			*Early adopt*	Annual	Interim	
** If financial statements have not been issued or available for issue*								
Impairment (CECL) 1Q 2016 (?)	PBE – SEC filers					Interim & annual		
	PBE – small						Interim & annual	
	All others						Annual	Interim
Leases 1Q 2016	PBE		*Early adopt*	*Early adopt*	*Early adopt*	Interim & annual		
	All others		*Early adopt*	*Early adopt*	*Early adopt*	*Early adopt*	Annual	Interim
Revenue Recognition May 2014	PBE			*Early adopt*	Interim & annual			
	All others			*Early adopt*	*Early adopt*	Annual	Interim	