Ready for New Classification & Measurement Rules for Financial Instruments?

While the effective date has arrived for public business entities (PBE) to implement Accounting Standards Update (ASU) 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, the Financial Accounting Standards Board (FASB) only has recently finalized a set of technical corrections in ASU 2018-03. The technical corrections are not expected to have a significant effect on current accounting practice or create significant administrative cost for most entities. They address when and how to apply the measurement alternative to equity securities without a readily determinable fair value (RDFV) and presentation when the fair value option (FVO) is elected. To allow entities to continue their current adoption plans for ASU 2016-01, the effective dates for the technical corrections include relief for interim reporting for PBEs.

This paper reviews key aspects of the standard and includes the recent technical updates.

Effective Dates
ASU 2016-01

PBEs
Annual and interim reporting periods beginning after December 15, 2017

All Others
Annual reporting periods beginning after December 15, 2018
Interim periods beginning after December 15, 2019

Effective Dates
ASU 2018-03

PBEs
Annual reporting periods beginning after December 15, 2017
Interim periods beginning after June 15, 2018

All Others
Annual reporting periods beginning after December 15, 2018
Interim periods beginning after December 15, 2019

Equity Securities Measurement

Most equity securities will now be measured at fair value through net income (FV-NI). Equity securities previously classified as available-for-sale (AFS) with changes in fair value recognized in other comprehensive income (FV-OCI) would be measured at FV-NI.

ASU 2016-01'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 (FV). The ASU is **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 and Federal Reserve Bank stock issued to member financial institutions.

Practicability Exception for Equity Securities Without RDFVs

The ASU creates a new practical exception for nonmarketable equity securities, *i.e.*, cost method investments under current U.S generally accepted accounting principles (GAAP). Securities that qualify for the existing net asset value practical expedient in Accounting Standards Codification (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 only are required 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, *e.g.*, voting rights, distributions, rights and preferences and conversion features.

FASB's intent was not to prohibit the use of a more precise measurement method; an entity could apply a more precise measurement method in the future if market conditions change. An entity measuring an equity security using the measurement alternative may change its measurement approach to an FV method in accordance with Topic 820, *Fair Value Measurement*, by electing an initial accounting policy that would apply to that security and all identical or similar investments of the same issuer. The technical corrections clarify that the election would be irrevocable and apply to all future purchases of identical or similar investments of the same issuer. An entity should not measure the same equity security differently based on when the security was purchased. Any resulting gains or losses on the securities for which that election is made shall be recorded in earnings at the time of the election.

Adjustments made under the measurement alternative should reflect the FV of the security as of the date that the observable transaction for a similar security took place. No other adjustments should be made to reflect events or other circumstances through the reporting date.

The remeasurement of forward contracts and purchased options on equity securities should be performed when observable transactions occur or impairment occurs on the underlying equity securities. Remeasuring the entire value of forward contracts and purchased options is required when observable transactions occur on the underlying equity securities. An entity must update all valuation inputs, not just the input related to the change in the underlying security's value.

Impairment of Equity Securities Without RDFV

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. If elected, an entity is required to evaluate impairment at each reporting date. If impairment is indicated (without considering whether the decline is other-than-temporary under current U.S. GAAP), the investment should be measured in accordance with Topic 820. The impairment loss would be recognized in net income as the difference between the carrying value and FV. 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

Measurement of Gains & Losses – Equity Securities						
Current	n.a.	FV-OCI	FV-NI	Lower of cost or FV	Cost	Equity method
ASU 2016-01	Cost + NI	n.a.	FV-NI	n.a.	n.a.	Equity method

Financial Liabilities "Own Credit"

Under current GAAP, companies can elect to measure certain debt instruments at FV and recognize changes in FV related to those debt instruments in earnings; this is known as the FVO. If the market price of debt decreases, the liability associated with the debt also 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 ASU 2016-01, FV changes resulting from "own credit" for financial liabilities measured under the FVO will be recognized through 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.

FVO Liabilities Presentation

Current guidance requires separate presentation of the portion of the total change in the FV of a liability attributable to a change in instrument-specific credit risk (ISCR) within OCI. FASB never intended to amend practice on how ISCR should be measured. The technical corrections clarify that when the FVO is elected for a financial liability, the liability should be considered to have ISCR if it is a general obligation of the entity, regardless of whether the FVO was elected under Subtopic 815-15, *Derivatives and Hedging—Embedded Derivatives*, or Subtopic 825-10, *Financial Instruments—Overall*.

Presentation of FVO Liabilities Denominated in a Foreign Currency

ASU 2016-01 was not intended to amend practice on how ISCR or FVO liabilities should be measured. The technical corrections update Topic 825 and Topic 830, *Foreign Currency Matters*, to clarify that for FVO liabilities, the change in FV that relates to ISCR should first be measured in the currency of denomination when presented separately from the total change in the financial liability's FV. Then, both components of the change in the liability's FV should be remeasured into the functional currency of the reporting entity using end-of-period spot rates.

Deferred Tax Assets (DTA)

The remeasurement of a financial instrument at FV generally creates a temporary difference between the instrument's financial reporting and tax basis 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 DTAs, 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 DTAs. 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

ASU 2016-01 retains many current 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 FV-OCI.

PBEs will continue to disclose the FV of financial assets and liabilities measured at amortized cost—either parenthetically on the face of the balance sheet or in the financial statement notes. However, the ASU provides relief for PBEs 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 an RDFV, as follows:

- The carrying amount of investments without an RDFV
- 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.

Transition

Transition is on a retrospective basis with 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 several exceptions:

- Guidance (including disclosure requirements) on equity securities without RDFV will be applied **prospectively** to all equity investments that exist as of the date of adoption. The technical corrections clarify the prospective approach only is meant for instances in which the measurement alternative is actually applied. An entity could choose to measure some equity securities without an RDFV at FV under ASC 820 and would then use a modified retrospective transition with a cumulative adjustment to opening retained earnings.
    - ASU 2018-03 further clarifies that insurance entities subject to ASC 944 electing the expedient for equity securities without RDFV would use a prospective approach that would be applied consistently to the entity's entire population of equity securities for which the measurement alternative is selected.
- 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, an 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.

Effective Dates

ASU 2016-01

ASU 2016-01 is effective for PBEs 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 PBEs.

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 FVO liabilities will be recognized through OCI
- 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

ASU 2018-03

The technical corrections are effective for PBEs for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years beginning after June 15, 2018. PBEs with fiscal years beginning in the period between December 15, 2017, and June 15, 2018, would not be required to adopt ASU 2018-03 until the interim period beginning after June 15, 2018. PBEs are required to use a retrospective transition approach and make a cumulative-effect adjustment back to the effective date of ASU 2016-01.

For all other entities, the amendments would have the same effective date and transition requirements as ASU 2016-01. Entities that have adopted ASU 2016-01 would be allowed to early adopt.

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

Contributor

Anne Coughlan
Director
317.383.4000
acoughlan@bkd.com