

Heads Up

In This Issue

- Introduction
- Summary of Changes to U.S. GAAP on Classification and Measurement
- Appendix — Comparison of Classification and Measurement Models

Targeted Therapy

FASB Amends Guidance on Classification and Measurement of Financial Instruments

by Jamie Davis and Shahid Shah, Deloitte & Touche LLP

Introduction

On January 5, 2016, the FASB issued [ASU 2016-01](#),¹ which amends the guidance in U.S. GAAP on the classification and measurement of financial instruments. Although the ASU retains many current requirements, it significantly revises an entity's accounting related to (1) the classification and measurement of investments in equity securities and (2) the presentation of certain fair value changes for financial liabilities measured at fair value. The ASU also amends certain disclosure requirements associated with the fair value of financial instruments.

This *Heads Up* provides a comprehensive summary of the FASB's changes to its classification and measurement model for financial instruments. In addition, the [appendix](#) to this *Heads Up* compares the classification and measurement models under current U.S. GAAP, the ASU, and IFRS 9 (2014).²

Editor's Note: Although the FASB and IASB had been working to converge their respective classification and measurement models (see the FASB's February 2013 [exposure draft](#)), after performing stakeholder outreach and a cost-benefit analysis, the FASB ultimately decided to make only limited changes to existing U.S. GAAP. Consequently, the ASU's amendments do not achieve convergence with IFRSs. The IASB's final guidance on this topic was issued in July 2014 in the form of amendments to IFRS 9 (see Deloitte's August 8, 2014, [Heads Up](#) for more information about the amendments to IFRS 9 (2014)).

Summary of Changes to U.S. GAAP on Classification and Measurement

Key changes as a result of the ASU are discussed below.

Classification and Measurement of Equity Investments

The ASU requires entities to carry all investments in equity securities, including other ownership interests such as partnerships, unincorporated joint ventures, and limited liability companies, at fair value through net income (FVTNI). This requirement does not apply to investments that qualify for the equity method

¹ FASB Accounting Standards Update No. 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities*.

² IFRS 9, *Financial Instruments* (revised 2014).

of accounting or to those that result in consolidation of the investee or for which the entity has elected the practicability exception to fair value measurement (as discussed below).

Editor's Note: Under current U.S. GAAP, marketable equity securities other than (1) equity method investments (those for which the investor has significant influence over the investee) or (2) those that result in consolidation of the investee are classified as either held for trading or available for sale (AFS). For AFS equity securities, any amounts in accumulated other comprehensive income (OCI) are recycled to net income upon sale or an other-than-temporary impairment. Investments in nonmarketable equity securities other than equity method investments or those that result in consolidation of the investee are measured at cost (less impairment) unless the fair value option has been elected. Because equity securities would no longer be accounted for as AFS securities or by using the cost method, entities that hold such equity investments could see significant volatility in earnings. For instance, this new requirement would significantly affect certain types of mutual funds (e.g., bond funds and fixed-income funds) that are currently accounted for as AFS securities. According to ASC 320-10-55-9,³ a mutual fund is considered an equity security even if it invests only in U.S. government debt securities. Consequently, investments in bond funds and fixed-income mutual funds are considered equity securities and must be accounted for at FVTNI under the ASU.

For investments in equity securities without a readily determinable fair value that do not qualify for the net asset value (NAV) practical expedient in ASC 820-10-35-59, an entity is permitted to elect a practicability exception to fair value measurement, under which the investment will be measured at cost, less impairment, plus or minus observable price changes (in orderly transactions) of an identical or similar investment of the same issuer. The ASU clarifies that when identifying observable price changes, an entity should consider relevant transactions "that are known or can reasonably be known" and that an entity is not required to spend undue cost and effort to identify such transactions. The ASU also indicates that an entity should consider a security's rights and obligations, such as voting rights, distribution rights and preferences, and conversion features, when evaluating whether the security issued by the same issuer is similar to the equity security held by the entity.

The practicability exception is not available to (1) reporting entities that are investment companies, (2) broker-dealers in securities, or (3) postretirement benefit plans.

Editor's Note: Entities that elect the practicability exception would still need to assess the equity investment for impairment (see discussion below).

Furthermore, investments in Federal Home Loan Bank (FHLB) and Federal Reserve Bank (FRB) stock issued to member financial institutions are not subject to this guidance. Instead, FHLB and FRB stock would continue to be accounted for at cost less impairment under ASC 942-325-35-3. The ASU's impairment guidance on equity investments for which fair value is not readily determinable also does not apply to FHLB or FRB stock.

³ For titles of *FASB Accounting Standards Codification (ASC)* references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

Impairment Assessment of Equity Investments Without Readily Determinable Fair Values That Are Measured by Using the Practicability Exception

In an effort to simplify the impairment model for equity securities for which an entity has elected the practicability exception, the FASB eliminated the requirement in U.S. GAAP to assess whether an impairment of such an investment is other than temporary. Under the new guidance, as of each reporting period, an entity will qualitatively consider the following indicators (from ASC 321-10-35-3, which was added by the ASU) to determine whether the investment is impaired:

- a. A significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee
- b. A significant adverse change in the regulatory, economic, or technological environment of the investee
- c. A significant adverse change in the general market condition of either the geographical area or the industry in which the investee operates
- d. A bona fide offer to purchase, 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
- e. Factors that raise significant concerns about the investee's ability to continue as a going concern, such as negative cash flows from operations, working capital deficiencies, or noncompliance with statutory capital requirements or debt covenants.

If it determines that the equity security is impaired on the basis of the qualitative assessment, the entity will recognize an impairment loss equal to the amount by which the security's carrying amount exceeds its fair value. By contrast, the current guidance in ASC 320-10-35-30 requires an entity to perform a two-step assessment under which it first determines whether an equity security is impaired and then evaluates whether any impairment is other than temporary.

Presentation of Fair Value Changes Attributable to Instrument-Specific Credit Risk for Fair Value Option Liabilities

The ASU establishes an incremental recognition and disclosure requirement related to the presentation of fair value changes of financial liabilities for which the fair value option has been elected. Under this guidance, an entity would be required to separately present in OCI the portion of the total fair value change attributable to instrument-specific credit risk as opposed to reflecting the entire amount in earnings. For derivative liabilities, however, any changes in fair value attributable to instrument-specific credit risk would continue to be presented in net income, which is consistent with current U.S. GAAP. This new requirement to separately present in OCI the portion of the total fair value change attributable to instrument-specific credit risk does not apply to financial liabilities of consolidated collateralized financing entities that are measured in accordance with ASC 810-10-30-10 through 30-15 and ASC 810-10-35-6 through 35-8.

An entity would measure the portion of the change in fair value attributable to instrument-specific credit risk as the excess of total change in fair value over the change in fair value that results from a change in a base market risk, such as a risk-free interest rate or a benchmark interest rate. Alternatively, an entity would be permitted to use another method that it considers to more faithfully represent the portion of the total change in fair value resulting from a change in instrument-specific credit risk. In either case, the entity would disclose the method it used to determine the gains and losses attributable to instrument-specific credit risk and would be required to apply the method consistently from period to period.

Any accumulated gains or losses reflected in OCI as a result of this provision would be recognized through earnings once the financial liability is derecognized.

Editor’s Note: During the financial crisis of 2008, many stakeholders expressed concerns about the counterintuitive impact on earnings of recording changes in the fair value of financial liabilities when such changes are related to an entity’s own debt for which the fair value option had been elected.

Under U.S. GAAP today, for financial liabilities measured at fair value, an entity would recognize a gain in earnings when there is an increase in instrument-specific credit risk or a loss when there is a decrease in instrument-specific credit risk. The new guidance aims to eliminate this counterintuitive result by requiring entities to present in OCI changes in fair value that result from changes in an entity’s own credit risk.

As discussed in more detail below in the [Effective Date and Early Adoption](#) section, entities are permitted to early adopt this provision of the ASU for financial statements that have not yet been issued.

Valuation Allowance on a Deferred Tax Asset Related to an AFS Debt Security

The new guidance eliminates the diversity in practice related to the evaluation of the need for a valuation allowance for deferred tax assets (DTAs) related to debt securities that are classified as AFS. Under current U.S. GAAP, entities may perform this evaluation either separately from their other DTAs or in combination with them. The new guidance clarifies that an entity should “evaluate the need for a valuation allowance on a [DTA] related to [AFS] securities in combination with the entity’s other [DTAs].”

Editor’s Note: When a financial instrument is measured at fair value, the tax basis of that instrument is not usually affected. This causes a temporary difference between the tax basis and financial reporting basis of an investment, thereby creating a DTA or DTL pursuant to ASC 740. Historically, some entities have evaluated the need for a valuation allowance on DTAs associated with AFS debt securities separately from other DTAs. The revised guidance clarifies that such separate evaluation is not permitted.

Disclosure Requirements

Summarized below are some of the ASU’s notable changes related to disclosures.

Amendments to Disclosures in ASC 825

For financial instruments not recognized at fair value in the statement of financial position, the ASU specifies that:

- Entities that do not meet the definition of a public business entity (PBE) are no longer required to provide the disclosures⁴ in ASC 825-10-50 about fair value.
- PBEs are no longer required to disclose the information in ASC 825-10-50-10(b) and (c) related to (1) the methods and significant assumptions they used to estimate fair value or (2) a description of the changes in the methods and significant assumptions they used to estimate fair value.

⁴ Before ASU 2016-01’s amendments, ASC 825-10-50-10 states that “a reporting entity shall disclose all of the following:
a. Either in the body of the financial statements or in the accompanying notes, the fair value of financial instruments for which it is practicable to estimate that value
b. The method(s) and significant assumptions used to estimate the fair value of financial instruments consistent with the requirements of paragraph 820-10-50-2(bbb) except that a reporting entity is not required to provide the quantitative disclosures . . . by that paragraph
c. A description of the changes in the method(s) and significant assumptions used to estimate the fair value of financial instruments, if any, during the period
d. The level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (Level 1, 2, or 3).”

However, the ASU retains the current requirements in U.S. GAAP for PBEs to provide fair value information about (1) financial instruments not recognized at fair value in the statement of financial position either in the body of the financial statement or in accompanying notes and (2) the level of the fair value measurement hierarchy in which financial instruments are classified (i.e., Level 1, Level 2, or Level 3).

Editor's Note: The option permitting entities to omit ASC 825-10-50 fair value disclosures if it is not "practicable to estimate fair value" has been eliminated.

The ASU also clarifies U.S. GAAP by eliminating the guidance in ASC 825 that had been interpreted to permit an "entry" price notion for estimating the fair value of loans for disclosure purposes. The amendments instead require a PBE to disclose the fair value, in accordance with the "exit" price notion in ASC 820, of financial assets and financial liabilities measured at amortized cost, except for (1) receivables and payables due within one year or less; (2) equity investments for which the practicability exception is applied; and (3) deposit liabilities with no defined or contractual maturities.

Editor's Note: Practitioners may have interpreted the current illustrative guidance in ASC 825-10-55-3 to allow entities to disclose the fair value of loans on the basis of an "entry" price notion. The ASU's requirement to disclose fair value on the basis of an "exit" price notion may represent a major shift for some entities that have continued to disclose the fair value of loans on the basis of entry price. The new guidance was intended to achieve greater consistency and comparability related to fair value measurements for financial statement users.

The ASU also requires all entities to disclose either on the balance sheet or in the notes to the financial statements all financial assets and financial liabilities grouped by (1) measurement category (i.e., amortized cost or fair value — net income or OCI) and (2) form of financial asset (i.e., securities and loans/receivables).

Equity Investments Without Readily Determinable Fair Values

The new guidance requires entities that have elected the practicability exception to fair value measurement (discussed above) to disclose (1) the carrying amount of investments without readily determinable fair values, (2) the amount of the adjustment (either upward or downward) made to the carrying amount due to observable price changes, (3) any impairment charge during the reporting period, and (4) additional information to help users understand the information the entity considered in determining the quantitative information disclosed in items (1) through (3).

Effective Date and Early Adoption

For PBEs, the new standard is effective for fiscal years and interim periods within those fiscal years beginning after December 15, 2017. For all other entities, including not-for-profit entities and employee benefit plans within the scope of ASC 960 through ASC 965 on plan accounting, the effective date is in line with the recommendation of the private-company decision-making framework — that is, the guidance is effective for fiscal years beginning one year after the effective date for PBEs (i.e., December 15, 2018) and interim reporting periods within fiscal years beginning two years after the PBE effective date (i.e., December 15, 2019).

Early adoption is permitted for all entities whose financial statements have not yet been issued or have not been made available for issuance with respect to the following changes made to ASC 825:

- For financial liabilities measured under the fair value option, fair value changes resulting from a change in instrument-specific credit risk would be presented separately in other comprehensive income.
- The fair value disclosure requirements for financial instruments not recognized at fair value would be eliminated for non-PBEs.

Early adoption of other provisions is not permitted for PBEs. Non-PBEs are permitted to early adopt the new standard when it becomes effective for PBEs (i.e., fiscal years beginning after December 15, 2017, including interim periods therein).

To adopt the amendments, entities will be required to make a cumulative-effect adjustment to beginning retained earnings as of the beginning of the fiscal year in which the guidance is effective, with the exception of the following:

- 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.
- Guidance consistent with ASC 820 on using the exit price notion to measure the fair value of financial instruments for disclosure purposes will be applied prospectively. If information is no longer comparable as a result of adopting the guidance, entities will be required to disclose that fact.

Appendix — Comparison of Classification and Measurement Models

The table below compares the classification and measurement models under current U.S. GAAP, the ASU, and IFRS 9 (2014).

Subject	Current U.S. GAAP	ASU 2016-01	IFRS 9 (2014)
Classification and measurement categories for financial assets other than equity investments	<p>Under ASC 320, three categories are used to classify and measure investments in securities:</p> <ul style="list-style-type: none"> • Trading (FVTNI). • AFS (FVTOCI). • Held to maturity (amortized cost). <p>Under ASC 310, two categories are used to classify and measure loans:</p> <ul style="list-style-type: none"> • Held for investment (amortized cost). • Held for sale (lower of cost or fair value). 	No changes.	<p>Three categories are used:</p> <ul style="list-style-type: none"> • Amortized cost. • Fair value through other comprehensive income (FVTOCI). • Fair value through profit or loss (FVTPL).
Classification and measurement categories for equity investments	<p>Under ASC 320, marketable equity securities other than equity method investments (those for which the investor has significant influence over the investee) or those that result in consolidation of the investee are classified as either held for trading (FVTNI) or AFS (FVTOCI).</p> <p>For AFS equity securities, any amounts in accumulated OCI are recycled to net income upon sale or when the security becomes other than temporarily impaired. Investments in nonmarketable equity securities other than equity method investments are measured at cost (less impairment) unless the fair value option has been elected.</p>	<p>Under ASC 321, entities will carry all investments in equity securities that do not qualify for equity method accounting or result in consolidation of the investee at FVTNI. For equity investments that do not have a readily determinable fair value, entities are permitted to elect a practicability exception and measure the investment at cost less impairment plus or minus observable price changes (in orderly transactions).</p> <p>The exception would not be available to investment companies, broker-dealers, defined benefit plans, and investors in equity investments that apply the NAV practical expedient under ASC 820-10-35-59.</p>	<p>Equity investments other than equity method investments or those that result in consolidation of the investee are accounted for at FVTPL with an option to irrevocably designate equity investments that are not held for trading at FVTOCI at initial recognition. For FVTOCI equity investments, any amounts in accumulated OCI are not transferred to profit or loss, even if the investment is sold or impaired. In limited circumstances, "cost may be an appropriate estimate of fair value."</p>
Classification and measurement categories for financial liabilities	<p>Nonderivative financial liabilities (primarily an entity's own debt) are accounted for at amortized cost unless the fair value option is elected. Derivative financial liabilities and short-sale obligations are measured at fair value.</p>	No changes, except for the presentation of certain fair value changes for fair value option liabilities (see below).	<p>Financial liabilities are carried at amortized cost, except for derivative and trading liabilities and those designated under the fair value option (see below).</p>
Method for classifying financial assets	<p>For securities, the classification depends on whether the entity holds the security for trading or has the intent and ability to hold it to maturity.</p> <p>For loans, the classification depends on whether the entity intends to hold the loan to maturity or for the foreseeable future.</p>	No changes.	<p>The classification is based on both the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial asset.</p>
Criteria for carrying financial assets at amortized cost	<p>The following financial assets are carried at amortized cost:</p> <ul style="list-style-type: none"> • Debt securities that the entity has the positive intent and ability to hold to maturity. • Loans that the entity has the intent and ability to hold to maturity or for the foreseeable future. 	No changes.	<p>Financial assets are carried at amortized cost if they satisfy both of the following criteria:</p> <ul style="list-style-type: none"> • They meet the cash flow characteristics criterion (i.e., solely payments of principal and interest). • They are held in a business model whose objective is to hold assets for the collection of contractual cash.

Subject	Current U.S. GAAP	ASU 2016-01	IFRS 9 (2014)
Criteria for measuring financial assets other than equity investments at FVTOCI	The following financial assets other than equity investments are measured at FVTOCI: <ul style="list-style-type: none"> Investments in debt securities that are not classified as either trading or held to maturity. Loans not classified as held for trading if the investor is contractually at risk of not recovering substantially all of its initially recorded investment. 	No changes.	Financial assets other than equity investments are measured at FVTOCI if they satisfy both of the following criteria: <ul style="list-style-type: none"> They meet the cash flow characteristics criterion. They are held in a business model in which assets are managed both to collect contractual cash flows and for sale.
Criteria for measuring financial assets other than equity investments at FVTNI (or FVTPL)	The following financial assets other than equity investments are measured at FVTNI: <ul style="list-style-type: none"> Debt securities bought and held principally for trading. Loans bought and held principally for trading if the investor is contractually at risk of not recovering substantially all of its initially recorded investment. Financial assets elected under the fair value option (see below). 	No changes.	The following financial assets other than equity investments are measured at FVTPL: <ul style="list-style-type: none"> Financial assets that fail to qualify for either amortized cost or FVTOCI. Financial assets designated under the fair value option (see below).
Criteria for measuring financial assets at the lower of cost or fair value	Loans held for sale.	No changes.	Not applicable.
Unrealized foreign currency gains and losses on financial assets accounted for at FVTOCI	For AFS debt securities, unrealized foreign currency gains and losses are deferred in OCI in a manner similar to how other unrealized gains and losses are deferred.	No changes.	Unrealized foreign currency gains and losses on nonequity investments accounted for at FVTOCI are recognized in profit or loss.
Hybrid financial assets	Embedded derivatives in hybrid financial assets are bifurcated and accounted for separately at FVTNI when certain conditions are met.	No changes.	Measured and classified in their entirety in accordance with their contractual cash flow characteristics and the business model under which they are managed. Bifurcation of embedded derivatives in hybrid financial assets is prohibited.
Fair value option — qualifying conditions	For financial instruments within the scope of the guidance, qualifying conditions need not be met before the fair value option may be elected.	No changes.	The fair value option may be elected only if qualifying conditions are met. For a financial asset, the option may be elected if exercising it would eliminate or significantly reduce an accounting mismatch. For a financial liability, the option may be elected if either of the following applies: <ul style="list-style-type: none"> Exercising the option would eliminate or significantly reduce an accounting mismatch. A “group of financial liabilities or [a group of] financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity’s key management personnel.” In addition, the fair value option may be elected for a hybrid financial liability unless either of the following applies: <ul style="list-style-type: none"> The embedded derivative or derivatives do not “significantly modify the cash flows that otherwise would be required by the contract.” “(I)t is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative(s) is prohibited.”

Subject	Current U.S. GAAP	ASU 2016-01	IFRS 9 (2014)
Presentation of fair value changes attributable to instrument-specific credit risk for financial liabilities designated under the fair value option	There are no similar requirements under current U.S. GAAP.	The portion of the total fair value change caused by a change in instrument-specific credit risk is recognized in OCI. Any accumulated amount remaining in OCI is reclassified to earnings when the liability is extinguished.	The portion of the total fair value change caused by a change in the liability's credit risk is recognized in OCI unless such treatment would create or enlarge an accounting mismatch in profit or loss. This amount is not subsequently transferred to profit or loss.
Reclassification of financial assets other than equity investments	Reclassification is permitted in certain circumstances. Transfers from the held-to-maturity category and transfers into or out of the trading category are expected to be rare.	No changes.	Reclassification is required if the business model changes and would be recorded as of the first day of the period after the period in which the business model changes.

Subscriptions

If you wish to subscribe to *Heads Up* and other Deloitte accounting publications, please register at www.deloitte.com/us/subscriptions.

Dbriefs for Financial Executives

We invite you to participate in *Dbriefs*, Deloitte's webcast series that delivers practical strategies you need to stay on top of important issues. Gain access to valuable ideas and critical information from webcasts in the "Financial Executives" series on the following topics:

- Business strategy and tax.
- Driving enterprise value.
- Financial reporting.
- Financial reporting for taxes.
- Governance, risk, and compliance.
- Technology.
- Transactions and business events.

Dbriefs also provides a convenient and flexible way to earn CPE credit — right at your desk. [Subscribe](#) to *Dbriefs* to receive notifications about future webcasts at www.deloitte.com/us/dbriefs.

Technical Library and US GAAP Plus

Deloitte makes available, on a subscription basis, access to its online library of accounting and financial disclosure literature. Called Technical Library: The Deloitte Accounting Research Tool, the library includes material from the FASB, EITF, AICPA, PCAOB, IASB, and SEC, in addition to Deloitte's own accounting and SEC manuals and other interpretive accounting and SEC guidance.

Updated every business day, Technical Library has an intuitive design and navigation system that, together with its powerful search features, enable users to quickly locate information anytime, from any computer. Technical Library subscribers also receive *Technically Speaking*, the weekly publication that highlights recent additions to the library. For more information, including subscription details and an online demonstration, visit www.deloitte.com/us/techlibrary.

In addition, be sure to visit [US GAAP Plus](#), our free Web site that features accounting news, information, and publications with a U.S. GAAP focus. It contains articles on FASB activities and updates to the *FASB Accounting Standards Codification*[™] as well as developments of other U.S. and international standard setters and regulators, such as the PCAOB, AICPA, SEC, IASB, and IFRS Interpretations Committee. Check it out today!

Heads Up is prepared by members of Deloitte's National Office as developments warrant. This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor.

Deloitte shall not be responsible for any loss sustained by any person who relies on this publication.

As used in this document, "Deloitte" means Deloitte & Touche LLP, a subsidiary of Deloitte LLP. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.