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To the Point

FASB —final guidance

FASB makes targeted amendments to guidance on classifying and measuring financial instruments

Entities will have to measure many equity investments at fair value and recognize changes in fair value in net income unless they qualify for the new practicability exception.

What you need to know

- The FASB issued final guidance that will require entities to measure equity investments that do not result in consolidation and are not accounted for under the equity method at fair value and recognize any changes in fair value in net income unless the investments qualify for the new practicability exception.
- The standard doesn't change the guidance for classifying and measuring investments in debt securities and loans.
- Entities will have to record changes in instrument-specific credit risk for financial liabilities measured under the fair value option in other comprehensive income.
- Entities that are not public business entities (PBEs) will no longer have to disclose the fair value of financial instruments measured at amortized cost.
- The guidance is effective for calendar-year PBEs beginning in 2018. For all other calendar-year entities, it is effective for annual periods beginning in 2019 and interim periods beginning in 2020. Non-PBEs can adopt the standard at the same time as PBEs, and both PBEs and non-PBEs can early adopt certain provisions.

Overview

The Financial Accounting Standards Board (FASB) issued final guidance[1] that will change how entities measure certain equity investments and present changes in the fair value of financial liabilities measured under the fair value option (FVO) that are attributable to their own credit.

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The new guidance also changes certain disclosure requirements and other aspects of current US GAAP. It does not change the guidance for classifying and measuring investments in debt securities and loans.

Under the new guidance, entities will have to measure many equity investments at fair value and recognize any changes in fair value in net income unless the investments qualify for the new practicability exception. For financial liabilities measured using the FVO in Accounting Standards Codification (ASC) 825, *Financial Instruments*, entities will need to present any change in fair value caused by a change in instrument-specific credit risk (own credit risk) separately in other comprehensive income (OCI).

The new standard differs significantly from the model the FASB developed jointly with the International Accounting Standards Board (IASB) and from IFRS 9, *Financial Instruments*, which the IASB issued in July 2014. The FASB plans to issue a separate standard on credit losses later this quarter with requirements that will also differ from those in IFRS 9. Entities that invest in debt securities should monitor that project because the guidance will affect the measurement, presentation and disclosure of impairment related to these securities.

This publication summarizes the key provisions of the new guidance and includes a summary of changes in presentation and disclosure requirements in the appendix.

Summary of key amendments

Equity investments

The new guidance requires the fair value measurement of investments in equity securities and other ownership interests in an entity, including investments in partnerships, unincorporated joint ventures and limited liability companies (collectively, equity investments) that do not result in consolidation and are not accounted for under the equity method. Entities will have to measure these investments at the end of each reporting period and recognize changes in fair value in net income (FV-NI). Entities will no longer be able to recognize unrealized holding gains and losses on equity securities they classify today as available for sale (AFS) in OCI. They also will no longer be able to use the cost method of accounting for equity securities that do not have readily determinable fair values.

The guidance applies to all entities except those in certain industries that are required to account for substantially all of their investments at fair value with changes in fair value recognized in net income or in the change in net assets (e.g., broker-dealers in securities, investment companies, defined benefit pension and other postretirement plans). It also does not apply to (1) derivative instruments that are subject to the requirements of ASC 815, *Derivatives and Hedging*, (2) Federal Home Loan Bank and Federal Reserve Bank stock and (3) an exchange membership that has the characteristics of an ownership interest specified in ASC 940-340-25-1(b).

A practicability exception will be available for equity investments that do not have readily determinable fair values and do not qualify for the practical expedient to estimate fair value under ASC 820, *Fair Value Measurement* (i.e., the net asset value practical expedient). These investments may be measured at cost, less any impairment, plus or minus changes resulting from observable price changes in orderly transactions for an identical or similar investment of the same issuer. Entities will have to reassess at each reporting period whether an investment qualifies for this practicability exception.

To identify observable price changes, entities should consider relevant transactions that occurred on or before the balance sheet date that are known or can reasonably be known. To identify price changes that can be reasonably known, entities will be expected to make a reasonable effort (without expending undue cost and effort) to identify any observable

transactions. However, they will not be required to perform exhaustive searches. In addition, when determining whether an equity instrument issued by the same issuer is similar to the equity investment it holds, an entity should consider the different rights and obligations associated with the instruments. Differences in rights and obligations could include characteristics such as voting rights, distribution rights and preferences, and conversion features. Entities should adjust the observable price of the similar instrument for the different rights and obligations to determine the amount that should be recorded as an adjustment in the carrying value of the instrument being measured.

How we see it

An entity will have to exercise judgment and consider its facts and circumstances to determine whether an equity instrument issued by the same issuer is similar to the equity investment it holds and to apply the concepts of "undue cost and effort," and "reasonably known" under the new practicability exception.

For each reporting period, an entity that uses the practicability exception to measure an equity investment will be required to make a qualitative assessment of whether the investment is impaired. If an impairment exists, the entity will have to estimate the investment's fair value in accordance with ASC 820 and recognize an impairment loss in net income equal to the difference between the investment's carrying value and its fair value. The entity will no longer be able to consider whether the decline is other than temporary, as is required under current US GAAP. This single-step model for assessing impairment is expected to accelerate the recognition of losses in investments without readily determinable fair values.

The guidance is expected to accelerate recognition of impairment losses in equity investments without readily determinable fair values.

Financial liabilities measured under the fair value option

For financial liabilities measured using the FVO in ASC 825, the change in fair value caused by a change in instrument-specific credit risk (own credit risk) will be presented separately in OCI. An entity may consider this amount to be the difference between the total change in fair value and the amount resulting from a change in a base market rate (e.g., a risk-free interest rate). This is a significant change from current US GAAP, which requires the instrument's entire change in fair value to be recognized through earnings. An entity may use another method that it believes results in a faithful measurement of the fair value change attributable to instrument-specific credit risk. However, it will have to apply the method consistently to each financial liability from period to period.

Upon derecognition of the financial liability, the accumulated gains and losses due to changes in the instrument-specific credit risk will be reclassified from OCI to net income.

How we see it

The only own-credit relief the guidance provides is for financial liabilities measured using the FVO. The effect of an entity's own credit risk for other financial liabilities measured at FV-NI, including derivatives, will continue to be reported in net income, resulting in continued earnings volatility due to changes in an entity's nonperformance risk.

Deferred tax assets

The remeasurement of a financial instrument at fair value generally creates a temporary difference between the 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 (DTAs), which must be assessed for realizability. Under the new guidance, entities will have to assess the realizability of a DTA related to an AFS debt security in combination with the entity's other DTAs.

How we see it

The new guidance eliminates one method that is currently acceptable for assessing the realizability of DTAs related to AFS debt securities. That is, an entity will no longer be able to consider its intent and ability to hold debt securities with unrealized losses until recovery, which may not be until maturity, akin to a tax planning strategy. Under this method, a valuation allowance currently wouldn't be necessary for DTAs on unrealized losses, even when there is significant negative evidence (e.g., recent cumulative losses) related to the realizability of other DTAs because the specific DTAs are expected to reverse as time passes.

Presentation and disclosure

The new guidance requires entities to present financial assets and financial liabilities separately, grouped by measurement category and form of financial asset in the statement of financial position or in the accompanying notes to the financial statements. Entities that are not PBEs will no longer have to disclose the fair value of financial instruments measured at amortized cost. PBEs will no longer have to disclose the method(s) and significant assumptions they use to estimate the fair value of financial instruments measured at amortized cost. In addition, PBEs will have to use the exit price notion when measuring the fair value of financial instruments measured at amortized cost for disclosure purposes.

Non-PBEs can early adopt a provision that eliminates the fair value disclosures for financial instruments not recognized at fair value.

Transition and effective date

The guidance is effective for PBEs for annual periods beginning after 15 December 2017, and interim periods therein. For all other entities, it is effective for annual periods beginning after 15 December 2018, and interim periods within annual periods beginning after 15 December 2019. Non-PBEs can early adopt the standard as of the effective date for PBEs. All entities can early adopt a provision requiring them to recognize the fair value change from own credit in OCI for financial liabilities measured using the FVO in ASC 825. Non-PBEs can early adopt a provision that eliminates the fair value disclosures for financial instruments not recognized at fair value. Both of these provisions can be early adopted for financial statements of annual or interim periods that have not yet been issued or made available for issuance, including those for periods in 2015.

An entity will record a cumulative-effect adjustment to beginning retained earnings as of the beginning of the first reporting period in which the guidance is adopted, with two exceptions. The amendments related to equity investments without readily determinable fair values (including disclosure requirements) will be effective prospectively. The requirement to use the exit price notion to measure the fair value of financial instruments for disclosure purposes will also be applied prospectively.

Endnote:

[1] Accounting Standards Update 2016-01, *Financial Instruments — Overall — Recognition and Measurement of Financial Assets and Financial Liabilities.*

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Appendix: Summary of key presentation and disclosure requirements

Instruments and features affected	Presentation and disclosure requirements
Financial assets and financial liabilities	Entities will separately present financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables) in the statement of financial position or in the notes to the financial statements.
Financial instruments, with certain exceptions (such as equity method investments, equity investments without readily determinable fair values, receivables and payables due in less than one year and demand deposit liabilities)	A PBE will be required to disclose, either in the body of the financial statements or in the accompanying notes, the fair value of financial instruments and the level of the fair value hierarchy within which the measurements are categorized in their entirety (i.e., Level 1, 2 or 3). ‣ A PBE won't be required to disclose: ‣ The methods and significant assumptions used to estimate the fair value of financial instruments consistent with the requirements of ASC 820-10-50-2(bbb). ‣ A description of the changes in the methods and significant assumptions used to estimate the fair value of financial instruments, if any, during the period. Non-PBEs will no longer be required to disclose the fair value of financial instruments measured at amortized cost.
Fair value measurements only for disclosure purposes	The new guidance eliminates the exception in ASC 825 that allows entities to calculate fair values of certain financial instruments (e.g., loans) using an entry price notion rather than the exit price notion of ASC 820.
Equity investments without readily determinable fair values measured using the new practicability exception	An entity that applies the practicability exception for measuring equity investments without readily determinable fair values will disclose all of the following: ‣ 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 ‣ As of the date of the most recent statement of financial position, 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
Financial liabilities measured under the fair value option	Entities will disclose the following information about the effects of the instrument-specific credit risk and changes in it for financial liabilities measured under the FVO: ‣ The amount of change, during the period and cumulatively, of the fair value of the liability that is attributable to changes in the instrument-specific credit risk ‣ How the unrealized gains and losses attributable to changes in instrument-specific credit risk (and recorded in OCI) were determined ‣ If a liability is settled during the period, the amount, if any, recognized in OCI that was recognized in net income at settlement
Fair value option	In annual periods only, an entity will need to disclose the methods and significant assumptions used to estimate the fair value of items measured under the FVO, consistent with the requirements of ASC 820-10-50-2(bbb), except that an entity is not required to provide the quantitative disclosures about significant unobservable inputs used in measurements categorized in Level 3 of the fair value hierarchy.