# In brief

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**At a glance**

*The FASB has issued the classification and measurement standard. The standard principally affects accounting for equity investments and financial liabilities where the fair value option has been elected.*

# *Classification and measurement – FASB issues final standard*

## What happened?

On January 5, 2016, the FASB issued Accounting Standards Update 2016-01, *Financial Instruments–Overall: Recognition and Measurement of Financial Assets and Financial Liabilities* (the ASU). Changes to the current GAAP model primarily affects the accounting for equity investments, financial liabilities under the fair value option, and the presentation and disclosure requirements for financial instruments. In addition, the FASB clarified guidance related to the valuation allowance assessment when recognizing deferred tax assets resulting from unrealized losses on available-for-sale debt securities. The accounting for other financial instruments, such as loans, investments in debt securities, and financial liabilities is largely unchanged. The more significant amendments are summarized below.

### *Equity investments*

All equity investments in unconsolidated entities (other than those accounted for using the equity method of accounting) will generally be measured at fair value through earnings. There will no longer be an available-for-sale classification (changes in fair value reported in other comprehensive income) for equity securities with readily determinable fair values.

For equity investments without readily determinable fair values, the cost method is also eliminated. However, entities (other than those following "specialized" accounting models, such as investment companies and broker-dealers) will be able to elect to record equity investments without readily determinable fair values at cost, less impairment, and plus or minus subsequent adjustments for observable price changes. Changes in the basis of these equity investments will be reported in current earnings. This election only applies to equity investments that do not qualify for the NAV practical expedient.

The impairment model for equity investments subject to this election is a single-step model (unlike today's two-step approach). Under the single-step model, an entity is required to perform a qualitative assessment each reporting period to identify impairment. When a qualitative assessment indicates an impairment exists, the entity would estimate the fair value of the investment and recognize in current earnings an impairment loss equal to the difference between the fair value and the carrying amount of the equity investment.

### *Financial liabilities and the fair value option*

When the fair value option has been elected for financial liabilities, changes in fair value due to instrument-specific credit risk will be recognized separately in other comprehensive income. The accumulated gains and losses due to these changes will be reclassified from accumulated other comprehensive income to earnings if the financial liability is settled before maturity.

The ASU will allow, but not require, preparers to measure the change in fair value due to instrument-specific credit risk based on the portion of the total change in fair value that does not result from a change in a base market risk, such as a risk-free rate or a benchmark interest rate.

### *Disclosure*

Entities that are not public business entities will no longer be required to disclose the fair value of financial instruments carried at amortized cost. While public business entities will continue to be required to make this disclosure, the ASU eliminates the requirement to disclose the methods and significant assumptions used to estimate the fair value.

Public business entities will be required to use the exit price when measuring the fair value of financial instruments measured at amortized cost for disclosure purposes. In addition, the new guidance requires financial assets and financial liabilities to be presented separately in the notes to the financial statements, grouped by measurement category (e.g., fair value, amortized cost, lower of cost or market) and form of financial asset (e.g., loans, securities).

## Why is this important?

Certain financial institutions, such as retail and commercial banks and insurance companies, are likely to be most affected by the new guidance. Companies with large equity investment portfolios that are not currently being measured at fair value through net income may also be significantly impacted.

## What's next?

The classification and measurement guidance will be effective for public business entities in fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. All other entities, including certain not-for-profit entities and employee benefit plans, will have an additional year, or may early adopt coincident with the public business entity effective date.

All entities can early adopt the provision to record fair value changes for financial liabilities under the fair value option resulting from instrument-specific credit risk in other comprehensive income. Entities that are not public business entities can early adopt the provision permitting the omission of fair value disclosures for financial instruments at amortized cost. Early adoption of these provisions can be elected for all financial statements of fiscal years and interim periods that have not yet been issued (for public business entities) or that have not yet been made available for issuance.

The classification and measurement guidance is the first ASU issued under the FASB's financial instruments project. The ASU for the new impairment guidance is expected in the first quarter of 2016. An exposure draft of the new hedging guidance is expected in the first half of 2016.

## Questions?

PwC clients who have questions about this *In brief* should contact their engagement partner. Engagement teams who have questions should contact the Financial Instruments team in the National Professional Services Group (1-973-236-7803).

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