In depth

A look at current financial reporting issues

No. US2016-01
January 29, 2016

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New guidance on recognition and measurement to impact financial instruments

At a glance

The FASB issued the new recognition and measurement guidance on January 5, 2016. The changes to the current US GAAP financial instruments model primarily affect the accounting for equity investments, financial liabilities under the fair value option, and the presentation and disclosure requirements for financial instruments.

No significant changes were made to the recognition and measurement guidance for investments in loans and debt securities.

The standard is effective for public business entities for annual periods (and interim periods within those annual periods) beginning after December 15, 2017. All other entities will need to apply the standard for annual periods beginning after December 15, 2018, and for interim periods beginning after December 15, 2019.

Background

.1 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"). Once effective, the ASU will apply to the recognition and measurement of certain financial instruments for all entities.

.2 The recognition and measurement project started as a joint project with the IASB, with an objective of improving the decision usefulness of financial statements by simplifying and harmonizing the accounting for financial instruments. The recognition 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 upcoming months. An exposure draft of the new hedging guidance is expected in the first half of 2016.

.3 The most recent exposure draft for the recognition and measurement project (issued in February 2013) proposed significant changes to current US GAAP guidance, including an accounting model that linked the measurement of an entity's financial assets to its cash flow characteristics and the manner in which the entity expected to benefit from the related cash flows. The measurement of financial liabilities also would have taken into account whether the entity expected to pay the contractual cash flows or to settle the liability at its fair value.

.4 The FASB noted that while the current accounting for the subsequent measurement of financial instruments is complex, stakeholders have learned how to navigate that complexity to obtain the information they need. The FASB also noted that the 2013 proposed ASU (which was more consistent with IFRS 9) would simply have replaced the

known complexities under current US GAAP with an unknown amount and type of complexity. As a result, the FASB discarded many of the proposals in the 2013 exposure draft and instead decided to make targeted improvements while retaining much of today's recognition and measurement model for financial instruments.

Key provisions

.5 The new guidance will impact 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 the need for a valuation allowance on 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 not under the fair value option is largely unchanged.

Accounting for equity investments

.6 The ASU makes significant changes to the accounting for equity investments. The ASU's accounting model will apply to all types of equity investments, including equity instruments that meet the definition of a security (as provided under current US GAAP) and those that would not be considered securities (e.g., limited partnership interests). Equity investments included in the scope of the new guidance may include investments in the equity of investment companies that hold nothing but debt securities, as the ASU does not permit an investor to "look through" the investment to determine the appropriate recognition and measurement model.

.7 The guidance also applies to forwards and options to acquire and dispose of ownership interests that are not accounted for as derivative instruments under ASC 815, *Derivatives and Hedging*. For example, the ASU applies to a gross physically-settled forward contract to purchase equity shares that are not deemed to be readily convertible to cash.

Equity investments with readily determinable fair values

.8 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.

.9 Equity securities have no maturity date, and therefore the primary way an entity realizes the value of their investment (aside from dividends) is through sale. As such, the FASB believes that "fair value through earnings" is the most appropriate measurement and recognition method for equity investments in unconsolidated entities not accounted for under the equity method.

PwC observation:

The FASB considered providing an exception to the fair value through earnings measurement model for equity securities deemed to be strategic investments, as entities may be able to realize the value from these types of investments by means other than sale or collecting dividends. Developing a definition of a strategic investment proved difficult, and the FASB concluded that providing an exception would add complexity to the accounting model that would not be worth the perceived benefits.

Equity investments without readily determinable fair values

.10 Under current US GAAP, an unconsolidated investment in an equity security without a readily determinable fair value that is not accounted for by the equity method is measured at cost, less any impairment determined to be other than temporary.

.11 The ASU generally eliminates the cost method for these investments. 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, adjusted for subsequent observable price changes. Entities that elect this measurement alternative will report changes in the carrying value of the equity investments in current earnings.

.12 If this measurement alternative is elected, changes in the carrying value of the equity investment will be required to be made whenever there are observable price changes in orderly transactions for the identical or similar investment of the same issuer. The implementation guidance notes that an entity should make a "reasonable effort" to identify price changes that are known or that can reasonably be known. The implementation guidance also indicates that in determining whether a security issued by the same issuer is similar, an entity should consider differences in the rights and obligations of the securities. Differences in rights and obligations may indicate that the security is not similar (and thus the observable price would not be used to adjust the carrying value of the equity investment held) or may indicate that the observable price should be adjusted to reflect such differences.

.13 The measurement alternative may be elected separately on an investment by investment basis for each equity investment without a readily determinable fair value. Once elected, it should be applied consistently as long as the investment meets the qualifying criteria. The standard requires that the entity reassess whether the investment continues to qualify for the measurement alternative each reporting period. If, for example, the investee subsequently undergoes an initial public offering such that there is now a readily determinable fair value, the measurement alternative would no longer be permitted, and the investment would be prospectively measured at fair value in accordance with ASC 820, *Fair Value Measurement*.

PwC observation:

The application of the measurement alternative will require new processes, controls, and procedures and will require the exercise of significant professional judgment. For example, entities will need to establish procedures to identify observable prices for the same or similar securities and to adopt policies for determining what types of securities would be considered similar for the purposes of determining whether an observable price of a different security should be utilized to adjust the basis of the security owned. Entities will also have to establish internal controls to ensure that each equity investment subject to the measurement alternative is evaluated each reporting period to ensure that it continues to meet the qualifying criteria (i.e., the equity security does not have a readily determinable fair value).

While there is no explicit requirement in the ASU for the preparation of contemporaneous documentation of the election of the measurement alternative, we believe entities should consider establishing procedures to evidence the election at the time an investment is made.

.14 If the election is not made, equity investments without readily determinable fair values should be reported at fair value in accordance with the provisions of ASC 820, with all subsequent changes in fair value recorded in earnings.

PwC observation:

Obtaining the necessary information to support a valuation prepared in accordance with ASC 820 for investments without readily determinable fair values can be time consuming and may require the assistance of third-party valuation professionals. Given the potential amount of time and expense involved with obtaining valuations for each equity investment for each reporting period, entities should carefully evaluate the costs and benefits associated with electing full fair value versus the measurement alternative.

Impairment model for equity investments without readily determinable fair values

.15 The ASU includes a new impairment model for equity investments without readily determinable fair values. The new model is a single-step, unlike today's two-step approach.

.16 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 that an impairment exists, the entity will need to 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.

.17 The single-step model is intended to reduce subjectivity, improve comparability, and increase representation faithfulness of the financial statements. In addition, the FASB looked to reduce the burden on preparers of financial statements by eliminating the need to forecast whether an equity investment will eventually recover value.

.18 The measurement alternative was established, in part, to provide entities with relief from having to get a valuation prepared each reporting period for equity investments without readily determinable fair values. The use of a qualitative impairment model is consistent with that objective. A quantitative impairment analysis does not need to be prepared, unless the qualitative assessment indicates that the fair value of the investment is less than its carrying value. The ASU provides a representative, but not all inclusive list of impairment indicators, which includes a "significant" deterioration or "significant" adverse change, or "significant" concerns about the investee's ability to continue as a going concern. The significance of these factors should be evaluated relative to the conditions that existed at the time of the investment's acquisition or last adjustment for either an impairment or an observable price. Considerable judgment will need to be applied in determining when an impairment indicator is significant enough to warrant preparation of a full quantitative valuation.

PwC observation:

The ASU does not include a threshold to be met in order for an equity investment to be evaluated for impairment (i.e., the model does not consider whether an impairment is "probable" or "more likely than not"). Rather, the qualitative assessment is used to identify the presence of significant impairment indicators. The presence of one or more indicators does not necessarily mean an equity investment is impaired. However, it does mean the entity is required to perform a valuation to determine whether an impairment exists (i.e., whether fair value is below the carrying value of the equity investment).

Financial liabilities and the fair value option

.19 The impact of changes in instrument-specific credit risk on liabilities for which the fair value option has been elected is reported in current earnings under current US GAAP. This resulted in gains when the entity's credit deteriorated and losses when it improved. While preparers and users understood the theory behind these counterintuitive outcomes, some questioned the value of this reporting given that such impacts may not be realizable. Many entities removed this amount from earnings in non-GAAP measures, because they believed the amount was not useful in analyzing an entity's financial performance.

.20 Under the ASU, 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 (OCI). This provision does not apply to financial liabilities required to be measured at fair value with changes in fair value recognized in current earnings. For example, this guidance would not apply to derivative instruments.

.21 The accumulated gains and losses due to changes in instrument-specific credit risk will be recycled from accumulated other comprehensive income and recognized in earnings if the financial liability is settled before maturity.

.22 In 2014, the FASB provided an alternative measurement for collateralized financing entities (CFEs) that eliminated the measurement difference that may exist when financial assets and financial liabilities of the CFE are measured independently at fair value. A requirement for CFEs to record changes in fair value due to instrument-specific credit risk in OCI would have generated a new measurement difference for these entities, as changes in credit risk related to financial assets would continue to impact earnings. As a result, the final ASU specifies that the guidance related to instrument-specific credit risk does not apply to financial liabilities of a CFE measured using the alternative measurement.

PwC observation:

During its deliberations, the Board also discussed other instances when preparers elected the fair value option on non-recourse liabilities to avoid a mismatch in recognition from the assets that support them. They noted that some entities do not disclose changes in instrument-specific credit risk for nonrecourse liabilities. The Board explains in the basis of conclusion that they did not intend to change how entities were identifying and measuring changes in instrument-specific credit risk from what is currently disclosed under US GAAP. While no guidance was formally included in the codification, we understand that the Board believes that entities can continue their current disclosure practices in this area both with respect to disclosure and what is included in OCI.

.23 The ASU allows, but does not require, preparers to measure the change in instrument-specific credit risk as the portion of the periodic change in fair value that is not due to changes in a base market rate, such as a risk-free interest rate. A reporting entity will be able to use an alternative method if it believes it to be a more faithful measurement of the change in credit risk for the entity. The selected methodology is a policy election and will need to be disclosed and consistently applied to each financial liability from period to period.

.24 No significant changes were made to the recognition and measurement of liabilities for which the fair value option has not been elected.

Loans and debt securities

.25 With the exception of those instruments for which the fair value option has been elected, the ASU does not make significant changes to the recognition and measurement guidance for investments in loans and debt securities.

PwC observation:

The FASB's project on credit losses will have a significant impact on how credit losses will be measured on loans and debt securities. That guidance is expected to be issued in the upcoming months.

Deferred tax assets

.26 Unrealized losses on available-for-sale debt securities are recognized in other comprehensive income and typically give rise to deferred tax assets. A valuation allowance is required to the extent it is more likely than not that a deferred tax asset is not realizable. Historically, entities applied one of two views. The need for a valuation allowance on a deferred tax asset related to available-for-sale securities was assessed either (1) in combination with the entity's other deferred tax assets, or (2) separately from other deferred tax assets and considered to be inherently recoverable so long as the related debt securities were expected to be held until they recovered in value (i.e., maturity, if necessary). The second view was supportable even if a valuation allowance was required on other deferred tax assets of a company.

.27 Although the latter approach was accepted by the SEC, the Board ultimately saw no conceptual basis for separately analyzing deferred tax assets for available-for-sale debt securities.

.28 The ASU requires that these deferred tax assets be evaluated for realizability in combination with other deferred tax assets of an entity. This approach is consistent with IFRS.

Presentation and disclosure

.29 The ASU makes targeted changes to the presentation requirements for financial instruments under current US GAAP. In addition to the change discussed above related to instrument-specific credit risk, the ASU requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (e.g., securities or loans and receivables) on the balance sheet or in the accompanying notes to the financial statements.

.30 With regard to disclosure, the ASU eliminates the requirement for entities that are not public business entities (PBEs) to present fair value information for financial assets and liabilities measured at amortized cost. PBEs will continue to be required to present this information either parenthetically on the face of the balance sheet or in the notes to the financial statements. PBEs do not need to provide fair value information for receivables and payables due within one year and demand deposit liabilities. The board concluded that the benefit to financial statement users of disclosing such information did not justify the likely cost for non-PBEs.

.31 PBEs will be required to determine fair value for financial assets and liabilities based on the exit price notion in ASC 820, *Fair Value Measurement*. This may represent a change in practice for some entities that had previously provided fair value information for loans carried at amortized cost using an entry price based on their interpretation of the illustrative examples in ASC 825, *Financial Instruments*.

.32 All entities will be required to disclose financial assets and financial liabilities separately, grouped by measurement category (e.g., fair value, amortized cost, lower of cost or market) and form of financial asset (e.g., loans, securities).

.33 For equity investments without readily determinable fair values measured under the measurement alternative, the ASU requires disclosures of:

- the carrying value of such investments;
- the total amount of adjustments resulting from impairment; and
- the total amount of adjustments for observable prices.

Transition

.34 In general, the new guidance will require modified retrospective application to all outstanding instruments, with a cumulative effect adjustment recorded to opening retained earnings as of the beginning of the first period in which the guidance becomes effective. However, changes to the accounting for equity securities without a readily determinable fair value will be applied prospectively.

PwC observation:

The ASU requires that the changes to the accounting for equity securities without readily determinable fair values to be applied prospectively. The Board made this decision. principally to eliminate the need for preparers to retrospectively identify impairments using the new single-step model and observable price changes for the same or similar instruments that may have occurred in prior periods for entities that elect to apply the measurement alternative.

This means that any impact from the adoption of this ASU on equity securities without readily determinable fair values will not be reported as part of the transition adjustment. Instead, these impacts will be recorded after the transition date and will impact that period’s current earnings.

What’s next?

.35 The new guidance will be effective for PBEs 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 PBE effective date. For these entities, the guidance will be effective in fiscal years beginning after December 15, 2018 and interim periods within fiscal years beginning after December 15, 2019.

.36 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 PBEs can early adopt the provision permitting the omission of fair value disclosures for financial instruments reported 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 or that have not yet been made available for issuance.

Questions?

PwC clients who have questions about this *In depth* 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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