

# Technical Line

FASB – final guidance

## A closer look at the new guidance on recognizing and measuring financial instruments

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### What you need to know

- ▶ The new recognition and measurement guidance requires entities to measure equity investments (except those accounted for under the equity method, those that result in consolidation of the investee and certain other investments) at fair value and recognize any changes in fair value in net income.
- ▶ The standard doesn't change the guidance for classifying and measuring investments in debt securities or loans.
- ▶ Entities have to record changes in instrument-specific credit risk for financial liabilities measured under the fair value option (FVO) in other comprehensive income.
- ▶ This publication has been updated to address clarifications the FASB issued on transition, application of the measurement alternative and presentation of financial liabilities measured using the FVO. Answers to questions companies have raised have also been updated.
- ▶ The guidance is effective for calendar-year public business entities beginning in 2018. For all other calendar-year entities, it is effective for annual periods beginning in 2019 and interim periods beginning in 2020.

### Overview

The [final guidance](#)<sup>1</sup> the Financial Accounting Standards Board (FASB or the Board) issued in 2016 changes how public and private companies, not-for-profit entities and employee benefit plans recognize, measure, present and make disclosures about certain financial assets and financial liabilities.

Under the new guidance, entities have to measure equity investments (except those accounted for under the equity method, those that result in consolidation of the investee and certain other investments) at fair value and recognize any changes in fair value in net income (FV-NI). However, for equity investments that don't have readily determinable fair values and don't qualify for the existing practical expedient in Accounting Standards Codification (ASC) 820<sup>2</sup> to estimate fair value using the net asset value (NAV) per share (or its equivalent) of the investment, the guidance provides a new measurement alternative. Entities may choose to measure those investments at cost, less any impairment, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer.

For financial liabilities measured using the FVO in ASC 825,<sup>3</sup> entities need to present any change in fair value caused by a change in instrument-specific credit risk (i.e., the entity's own credit risk) separately in other comprehensive income (OCI). All entities can early adopt this provision.

Under the new guidance, entities that aren't public business entities (PBEs) are no longer required to disclose the fair value of financial instruments measured at amortized cost, and they can early adopt this provision for any financial statements they haven't yet issued or made available for issuance. PBEs no longer have to disclose the method(s) and significant assumptions they use to estimate the fair value for financial instruments measured at amortized cost on the balance sheet.

The new guidance also changes other aspects of US GAAP. However, it does not broadly change the classification and measurement guidance for all financial instruments. For example, the guidance for classifying and measuring investments in debt securities and loans is unchanged, as is the guidance for financial liabilities, except for financial liabilities measured using the FVO.

We note that, while the FASB made only targeted changes to the guidance, entities may find it challenging to implement the standard, particularly the new measurement alternative guidance for equity investments without readily determinable fair values.

This publication has been updated to address amendments<sup>4</sup> the FASB recently issued to clarify the new guidance on transition, the application of the measurement alternative and presentation of financial liabilities measured using the fair value option. We also added interpretive guidance on the accounting and disclosure requirements for equity investments measured under the measurement alternative and updated the questions and answers in Appendix A. Appendix B compares the US GAAP guidance, as amended, to the guidance in IFRS 9.<sup>5</sup>

ASU 2016-01 is effective for PBEs for fiscal years beginning after 15 December 2017, including interim periods within those fiscal years. For non-PBEs, it is effective for fiscal years beginning after 15 December 2018, and for interim periods within fiscal years beginning after 15 December 2019.

The amendments are effective for PBEs for fiscal years beginning after 15 December 2017, and interim periods within those fiscal years beginning after 15 June 2018. That is, calendar-year PBEs will adopt the amendments in the third quarter of 2018. For all other entities, the amendments have the same effective date and transition requirements as ASU 2016-01.

The interpretations we provide in this publication are preliminary and are subject to change as more information becomes available. We may identify additional issues during implementation, and our views may evolve during that process.

## Equity investments

The new guidance requires entities to measure more equity investments at fair value than they do today. This guidance is codified in a new topic, ASC 321, *Investments – Equity Securities*.

## **Scope**

### ***Entities***

The new guidance applies to all entities, including cooperatives and mutual entities (such as credit unions and mutual insurance entities) and trusts that do not report substantially all of their securities at fair value. The guidance does not apply to entities in certain industries with specialized accounting practices that include accounting for substantially all investments at fair value, with changes in fair value recognized in income or in the change in net assets.

Examples of entities excluded from the scope of the guidance include:

- ▶ Brokers and dealers in securities (ASC 940)
- ▶ Defined benefit pension and other postretirement plans (ASC 960, 962 and 965)
- ▶ Investment companies (ASC 946)

### ***Instruments***

The guidance applies to investments in equity securities and other ownership interests in an entity, including investments in partnerships, unincorporated joint ventures and limited liability companies. The guidance defines an equity security as “any security representing an ownership interest in an entity (e.g., common, preferred, or other capital stock) or the right to acquire (e.g., warrants, rights, forward purchase contracts, and call options) or dispose of (e.g., put options and forward sale contracts) an ownership interest in an entity at fixed or determinable prices.”

The guidance says the term equity security does not include any of the following items:

- ▶ Written equity options (because they represent obligations of the writer, not investments)
- ▶ Cash-settled options on equity securities or options on equity-based indexes (because they do not represent ownership interests in an entity)
- ▶ Convertible debt or preferred stock that must be redeemed by the issuer or is redeemable at the option of the investor

The guidance on equity securities does not apply to any of the following instruments:

- ▶ Derivative instruments that are subject to the requirements of ASC 815,<sup>6</sup> including those that have been separated from a host contract as required by ASC 815-15-25, even if the host contract is an equity investment within the scope of the new ASC 321 guidance
- ▶ Investments accounted for under the equity method (ASC 323)
- ▶ Investments in consolidated subsidiaries
- ▶ An exchange membership that has the characteristics of an ownership interest as specified in ASC 940-340-25-1(b)
- ▶ Federal Home Loan Bank and Federal Reserve Bank stock

In this publication, we refer to equity securities and other ownership interests that are in the scope of the new ASC 321 guidance as equity investments.

### ***Investments in limited partnerships***

The Securities and Exchange Commission (SEC) staff guidance on the application of the equity method to investments in limited partnerships, which appears in ASC 323-30-S99, is not affected by ASU 2016-01. That guidance requires investments of greater than 3% to 5% in limited partnerships to be accounted for under the equity method. Before an entity adopts

Entities no longer recognize unrealized holding gains and losses in OCI on equity securities they had classified as available for sale.

ASU 2016-01, it generally accounts for investments in limited partnerships and similar entities that are not accounted for under the equity method at cost, less any impairment. Under the new guidance, these investments generally need to be recorded at FV-NI unless the measurement alternative is elected.

### How we see it

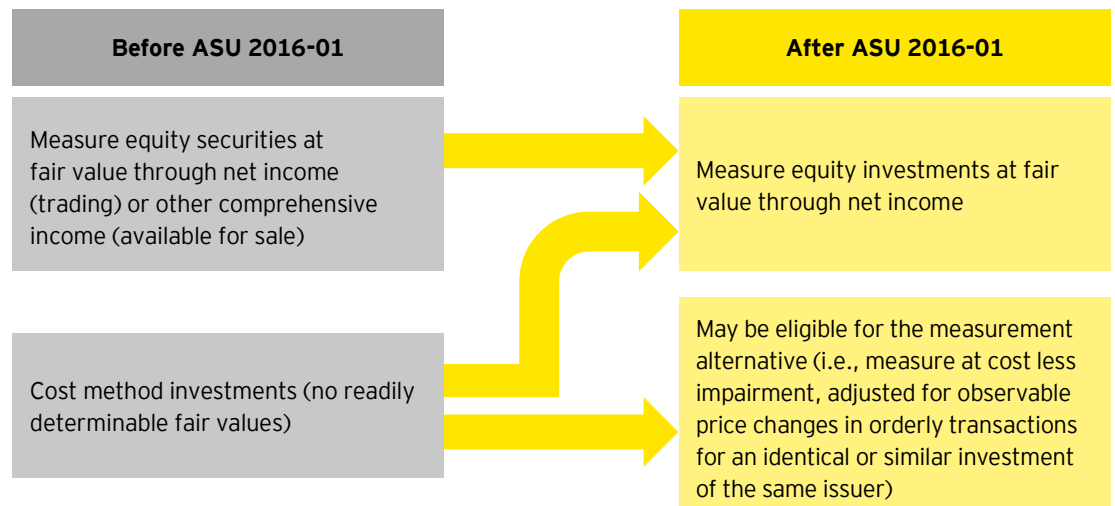
Before an entity adopts ASU 2016-01, it generally accounts for an investment in a qualified affordable housing project that is not accounted for using the proportional amortization method, in accordance with ASC 970-323<sup>7</sup> (i.e., using the cost or equity method). ASU 2016-01 adds ASC 323-740-25-2A, which says it may be appropriate to use the cost method to account for investments in qualified affordable housing projects, but removes the references to the cost method from ASC 970-323. As a result, questions arose about whether it would be appropriate to continue to account for investments in qualified affordable housing projects under the cost method upon adoption of the ASU.

We understand that the Board did not intend to prohibit an investor from using the cost method of accounting to account for an investment in a qualified affordable housing project following the adoption of the ASU. An investor must first evaluate such an investment to determine whether the equity method of accounting is required. If the investor is not required to apply the equity method, and the investment does not qualify for the proportional amortization method or the investor elects not to apply it, we believe that it can elect, as an accounting policy choice, to account for the investment under the cost method (as illustrated in ASC 323-740-55) or in accordance with ASC 321.

### Accounting

Under the new guidance, entities generally measure equity investments in the scope of the guidance at FV-NI at the end of each reporting period. They no longer are able to classify equity investments as trading or available for sale (AFS), and they no longer recognize unrealized holding gains and losses on equity securities that were classified as AFS in OCI before they adopted the new guidance. They also no longer use the cost method of accounting as it was applied before they adopted ASU 2016-01 for equity securities that do not have readily determinable fair values. As such, the new guidance could significantly increase earnings volatility for some entities, especially those that hold significant investments in equity securities they classified as AFS before adopting ASU 2016-01.

The following chart shows how entities recognize and measure equity investments in the scope of the guidance before and after adopting ASU 2016-01.



### ***Equity investments without readily determinable fair values***

Entities can elect a measurement alternative for equity investments that do not have readily determinable fair values and do not qualify for the practical expedient in ASC 820 to estimate fair value using the NAV per share (or its equivalent). Under the alternative, they measure these investments 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. An entity has to make a separate election to use the alternative for each eligible investment and has to apply the alternative consistently from period to period until the investment's fair value becomes readily determinable. Entities also have to reassess at each reporting period whether an investment qualifies for this alternative.



#### **FASB amendment**

The FASB issued an amendment to clarify that an entity measuring an equity investment using the measurement alternative may change its measurement approach to an ASC 820 fair value method. However, it will have to apply that change to all identical or similar equity investments of the same issuer. This election is irrevocable and will apply to all future purchases of identical or similar equity investments of the same issuer. Refer to Question 3 in Appendix A for further discussion.

The ASU provides limited implementation guidance on identifying observable price changes. To identify observable price changes, the ASU states that 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 are expected to make a reasonable effort (without expending undue cost and effort) to identify any observable transactions. However, they are not required to perform exhaustive searches.

We understand that price changes to be used generally result from observable and orderly transactions between independent parties where the fair value of the consideration is readily determinable. For example, an entity would consider a price observable (and would adjust the carrying amount of its investment) if the issuer of the equity securities it holds issued identical or similar securities in exchange for cash or another security with a readily determinable fair value. However, if the issuer issued the identical or similar securities to its employees in exchange for services, the transaction would not create an observable price that the investor would be required to use to adjust the carrying amount of its investment.

The FASB has not provided much guidance on how to identify a similar investment of the same issuer. The implementation guidance states that 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, such as voting rights, distribution rights and preferences, and conversion features.



#### **FASB amendment**

The FASB issued an amendment to clarify that the adjustments made under the measurement alternative reflect the fair value of the security as of the date that the observable transaction for a similar security took place rather than the current reporting date.

ASU 2016-01 also says that if the instruments are considered to be similar, the entity should adjust the observable price of the similar security for the different rights and obligations to determine the amount that should be recorded as an upward or downward adjustment in the carrying value of the security being measured. The amendment clarifies that any adjustment should reflect the fair value of the security as of the date that an observable transaction took place, rather than the current reporting date. Therefore, the FASB concluded that it would be inappropriate to adjust the fair value to reflect events or other circumstances that occurred after the transaction date because market conditions would not be the same.

We believe that when an entity holds an equity investment that is measured using the measurement alternative and observes an orderly transaction for the same or a similar investment of the same issuer, or when the investment is impaired, it must adjust the carrying amount of its investment to fair value determined in accordance with the principles of ASC 820. However, the entity is not required to subsequently adjust the carrying amount of that investment (e.g., at the next reporting date) to fair value until the next observable transaction or impairment event.

The following illustration shows how an entity may determine whether equity investments are similar under the measurement alternative.

#### **Illustration 1 - Determining if equity investments are similar**

##### **Example 1: Series A and Series B preferred shares**

Entity ABC owns Series A preferred shares that are measured using the measurement alternative. It observes an orderly transaction in Series B preferred shares of the same issuer. The Series A and Series B preferred shares have different dividend rates, but all of their other features are the same.

In this case, Entity ABC may conclude that the Series A and Series B preferred shares are similar. Therefore, it would adjust the carrying amount of its Series A preferred shares to their fair value as of the observable transaction date.

##### **Example 2: Common shares and Series A preferred shares**

Entity ABC owns common shares that are measured using the measurement alternative. It observes an orderly transaction in Series A preferred shares of the same issuer. Investors in the common shares have voting rights and rights to any dividends that are declared. Investors in the Series A preferred shares have rights to a cumulative dividend, liquidation rights and a non-voting board seat.

In this case, Entity ABC may conclude that the common shares and Series A preferred shares are not similar. Therefore, it would not adjust the carrying amount of its common shares for this observed transaction.

However, if the observable price in the Series A preferred share transaction is below the carrying price of the entity's common shares, this could be an indicator of impairment that would require measurement of the common shares at fair value.

An observable price for an instrument of the same issuer that's not similar but that's below the carrying price of the entity's investment could be an indicator of impairment that could result in a fair value measurement. For example, a Series A preferred stock that has an observable price may have sufficiently different liquidation and other rights from the Series B preferred stock of the same issuer that an entity holds, and the entity may therefore determine that the Series A stock is not similar to its Series B stock. However, an observable price for the Series A stock that is lower than the entity's carrying value of the Series B stock could be an indicator of impairment for the Series B stock. Other indicators of impairment and the measurement requirements when an investment is considered impaired are discussed below.

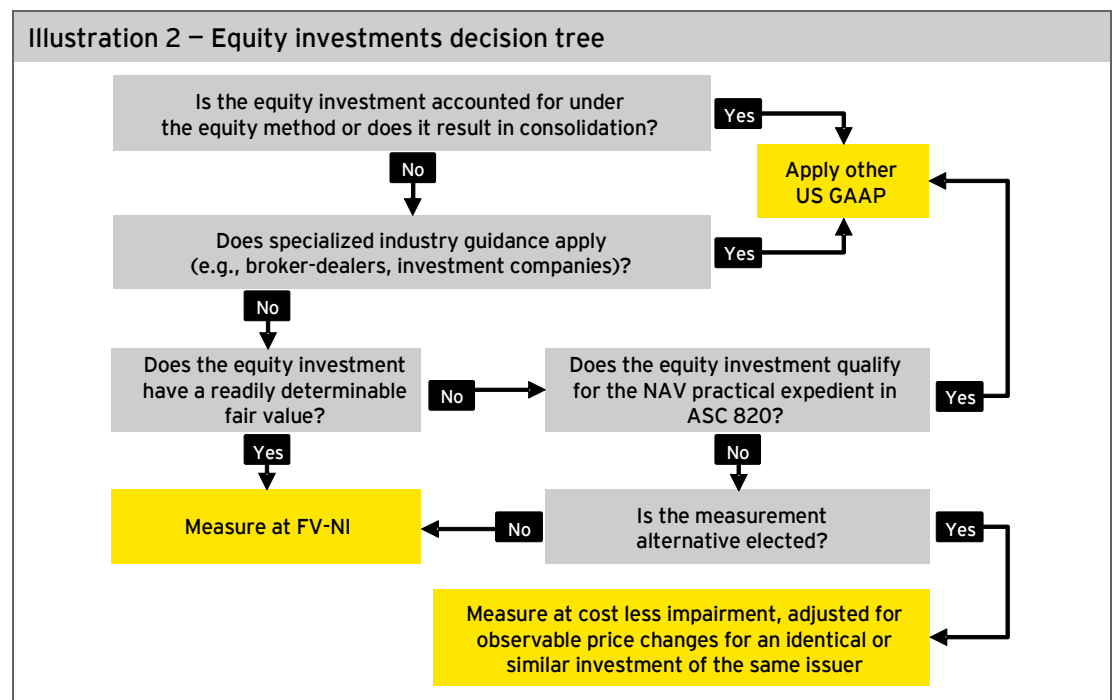
## How we see it

Applying the new measurement alternative for equity investments without readily determinable fair values may be challenging. Identifying observable price changes for these instruments requires entities to develop new policies, processes and controls to make sure they comply with the new standard. Identifying transactions that can reasonably be known and evaluating whether undue cost and effort will need to be expended requires judgment. Specific facts and circumstances need to be considered as part of this assessment.

Determining whether another ownership interest is similar to the equity investment held also requires significant judgment. Entities need to establish a framework with key considerations for determining whether an equity security for which the measurement alternative is elected is similar to another security issued by the same issuer. The framework needs to be reasonable and consistently applied. We expect interpretations of what is a similar interest to vary.

The following illustration shows how an entity evaluates the recognition and measurement of equity investments under the new standard.

Applying the new measurement alternative for equity investments without readily determinable fair values may be challenging.



At each reporting date, an entity that uses the measurement alternative to measure an equity investment without a readily determinable fair value is required to make a qualitative assessment of whether the investment is impaired.

The impairment indicators an entity needs to consider are consistent with those in ASC 320-10-35-27<sup>8</sup> and include, but are not limited to, the following:

- ▶ A significant deterioration in the earnings performance, credit rating, asset quality or business prospects of the investee
- ▶ A significant adverse change in the regulatory, economic or technological environment of the investee
- ▶ A significant adverse change in the general market condition of either the geographical area or the industry in which the investee operates



- ▶ 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
- ▶ 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 a qualitative assessment indicates that the investment is impaired, the entity has to estimate the investment's fair value in accordance with the principles of ASC 820 and, if the fair value is less than the investment's carrying value, recognize an impairment loss in net income equal to the difference between carrying value and fair value. The entity is no longer able to consider whether the decline is other than temporary, as required under the previous guidance. This single-step model for assessing impairment is expected to accelerate the recognition of losses in investments without readily determinable fair values.

#### ***Forward contracts and purchased options on equity securities***

Before adopting ASU 2016-01, an entity accounted for forward contracts and purchased options (that were not derivatives and that met certain other requirements under ASC 815-10-15-141) that were entered into to purchase equity securities in the scope of ASC 320 (because they had readily determinable fair values), designated them as AFS or trading and measured them in a manner consistent with the accounting for the underlying securities under ASC 320. Forward contracts and purchased options that were not derivatives and did not meet all of the other criteria in ASC 815-10-15-141 that were entered into to purchase equity securities without readily determinable fair values were generally carried at cost, less any impairment, unless the fair value option was elected.

Because the new guidance eliminates the classification categories for equity securities, forward contracts and purchased options (that are not derivatives and that meet the other requirements of ASC 815-10-15-141, as amended) on equity securities are accounted for in a manner consistent with the accounting for other equity investments after an entity adopts ASU 2016-01. That is, they are measured at fair value with changes in fair value recognized in earnings as they occur. As a result, the changes in the fair value of these forward contracts and purchased options on equity securities will no longer be eligible for recognition in OCI.

If the forward contracts and purchased options (that are not derivatives and that meet the other criteria in ASC 815-10-15-141), as amended, do not have readily determinable fair values, an entity may elect to use the measurement alternative discussed above. Changes in observable prices or impairment of these forward contracts and purchased options are also recognized in earnings as they occur. Use of the cost method is no longer permitted. Equity securities purchased under a forward contract or by exercising an option are recorded at their fair values at the settlement date.



#### **FASB amendment**

The FASB issued an amendment to clarify that when an entity elects to use the measurement alternative to remeasure eligible forward contracts and purchased options on equity securities, it must remeasure the entire fair value of the forward or option when observable transactions involving the underlying equity securities or impairment of those securities occur. Refer to Question 2 in Appendix A for further discussion.



## Financial liabilities measured using the FVO

For financial liabilities measured using the FVO in ASC 825, the change in fair value caused by a change in the entity's own credit risk is presented separately in OCI. For simple (e.g., non-hybrid) financial liabilities, an entity may consider this amount to be the difference between the total change in the fair value of the instrument and the amount resulting from a change in a base market rate (e.g., a risk-free interest rate such as the US Treasury rate, a benchmark interest rate such as LIBOR). An entity may use another method that it believes results in a faithful measurement of the fair value change attributable to its own credit risk. However, it has to apply the method consistently to each financial liability from period to period.

The new guidance is a significant change. Before adopting ASU 2016-01, an entity was required to recognize the instrument's entire change in fair value through earnings. The counterintuitive result of treating changes in fair value in this way is that net income rises if an entity's own credit risk increases and falls if an entity's own credit risk decreases. In making this change, the FASB responded to stakeholders' concerns that recognizing a gain due to an increase in an entity's own credit risk could be misleading, especially when the entity lacks the intent or ability to realize those gains by transacting at fair value.

Upon derecognition of the financial liability, the accumulated gains and losses due to changes in an entity's own credit risk will be reclassified from OCI to net income.

The Board did not intend to change how entities identify and measure changes in their own credit risk that they disclosed before adopting ASU 2016-01. The Board's intent was to simply replace the guidance that required disclosing changes in an entity's own credit risk with a requirement to present those same amounts in OCI. Also, the new guidance does not change the accounting for financial liabilities of a consolidated collateralized financing entity (CFE) accounted for using the measurement alternative under ASC 810-10-30-10 through 30-15<sup>9</sup> and ASC 810-10-35-6 through 35-8.

### How we see it

The new guidance does not scope out nonrecourse financial liabilities that are accounted for under the FVO but do not arise from the consolidation of a CFE. In response to a technical inquiry, the FASB staff said the new guidance regarding the presentation of changes in an entity's own credit was not intended to apply to nonrecourse financial liabilities with contractual terms that require the liability to be settled only with cash flows from related financial assets (e.g., certain transfers of financial assets that don't meet the derecognition requirements of ASC 860<sup>10</sup>) because such financial liabilities do not have instrument-specific credit risk. The SEC staff has also said it would expect all fair value changes relating to these nonrecourse liabilities to be recorded in earnings.<sup>11</sup> Refer to Question 16 in Appendix A for further discussion.

Although the guidance says entities have to consistently apply the method they use to measure changes in fair value attributable to their own credit risk, we believe they can identify different benchmark rates (e.g., LIBOR, the US Treasury rate) for different financial liabilities measured using the FVO.

When the FASB introduced the FVO, one of the stated objectives was to improve financial reporting by allowing entities to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply the complex hedge accounting guidance. In practice, however, entities generally have not used the FVO option as an alternative to applying fair value hedge accounting for recognized financial liabilities because recognizing changes in fair value resulting from their own credit risk in net income makes earnings more volatile.

The following example illustrates the application of the new guidance to a financial liability measured under the FVO that is economically hedged.

**Illustration 3 – Economic hedge of a financial liability measured under the FVO under the new guidance**

On 1 January 20X1, Company XYZ issues a noncallable note with a par value of \$500,000, a fixed payment rate of 6% and a maturity date of 31 December 20X8.

Concurrently, Company XYZ enters into a “pay-floating/receive-fixed” interest rate swap with Bank ABC to economically hedge its exposure to changes in the fair value of its fixed-rate debt. The terms and notional amount of the swap match those of the fixed-rate debt, including periodic payment dates and the maturity date.

Company XYZ elects to use the FVO on its fixed-rate note as an alternative to designating the swap as a fair value hedge of its fixed-rate debt. Because it elects the FVO, the company is required to present the portion of the total changes in fair value of its fixed-rate debt that results from a change in its own credit risk in OCI.

The table below shows the unrealized gains and losses related to the instruments at 31 December 20X1 (amounts are hypothetical and are assumed for illustrative purposes):

Financial instrument	Total unrealized gain/(loss)	Changes in own credit risk recognized in OCI	Unrealized gain/(loss) recognized in earnings
Interest-rate swap	\$ 15	\$ -	\$ 15
Fixed-rate debt	(25)	(9)	(16)
<b>Net</b>	<b>\$ (10)</b>	<b>\$ (9)</b>	<b>\$ (1)</b>

The fair values of the interest-rate swap and fixed-rate debt are determined in accordance with the measurement requirements of ASC 820.

The total change in the fair value of the interest rate swap, including changes due to the credit risk associated with both parties to the swap (assuming the swap is uncollateralized), is recognized in earnings. In contrast, the amount of the change in fair value of the fixed-rate debt that's reported in earnings does not include changes in fair value that result from a change in the entity's own credit risk. The amount attributed to changes in its own credit risk is recognized in OCI.

It should be noted that the change in the fair value of the swap attributed to changes in credit risk will generally be significantly less than the change in the fair value of the entity's fixed-rate debt attributable to its own credit risk. That's because the credit risk on the derivative is bilateral in nature and based on net exposure (i.e., the net cash payments expected to be made based on the difference between the fixed and variable legs of the swap), whereas the credit risk of the debt instrument considers the risk of loss of both principal and interest payments. As a result, the amounts recorded in earnings under the new guidance are more closely aligned with the results that could be achieved if fair value hedge accounting had been applied.



## FASB amendments

The FASB issued an amendment to clarify that an entity that elects to use the FVO to measure certain financial liabilities would present the fair value change attributable to its own credit risk in OCI, regardless of whether it elected the FVO in accordance with ASC 815-15 or ASC 825-10. It also issued an amendment to clarify how to present financial liabilities denominated in a foreign currency and measured using the FVO. Refer to Questions 14 and 17, respectively, in Appendix A for further discussion.

## 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. An unrealized loss can give rise to a deferred tax asset (DTA), which must be assessed for realizability.

Under the new guidance, entities have to assess the realizability of a DTA related to an AFS debt security in combination with their other DTAs. The FASB believes that there is no conceptual basis for segregating deferred tax assets relating to fair value changes of AFS debt securities without also segregating other individual deferred tax assets. Future realization of DTAs depends on the existence of sufficient taxable income of the appropriate character in either the carryback or carryforward period under the tax law. The four sources of taxable income to be considered when determining whether a valuation allowance is required are:

- ▶ Taxable income in prior carryback years, if carryback is permitted under the tax law
- ▶ Future reversals of existing taxable temporary differences
- ▶ Tax-planning strategies
- ▶ Future taxable income exclusive of reversing temporary differences and carryforwards

The new guidance eliminates one method that previously was acceptable for assessing the realizability of DTAs related to AFS debt securities. An entity is no longer able to separately evaluate the DTAs related to AFS debt securities and support realizability solely by considering 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 the new guidance, an entity must assess the realizability of DTAs related to AFS debt securities using the same four sources of taxable income that are used for other DTAs. When an entity develops its projections of future taxable income to assess the realizability of all DTAs, including those related to AFS debt securities, it includes the expected reversal of unrealized losses on AFS debt securities that it has both the intent and ability to hold until recovery as a component of its overall projection of future taxable income. However, it is not appropriate to forecast future appreciation in fair values of AFS debt securities related to other factors, such as anticipating the effect of future interest rate reductions or favorable changes to a debtor's creditworthiness.

An entity may not be able to rely on projections of future taxable income for purposes of evaluating realizability of DTAs if significant negative evidence exists (e.g., cumulative losses in recent years).

Entities are no longer able to separately evaluate DTAs related to AFS debt securities and support realizability solely by considering their intent and ability to hold the securities until recovery.

**Illustration 4 – Assessing the realizability of deferred tax assets**

Company A has DTAs related to the following at 31 December 20X2 (there are no deferred tax liabilities):

Net operating loss carryforwards	\$ 400
Unrealized losses on AFS debt securities	<u>15</u>
Total	<u>\$ 415</u>

To evaluate the realizability of its DTAs, Company A considers the four sources of taxable income described in ASC 740. Assume that Company A concludes that it will have no taxable income from prior carryback years, future reversals of existing taxable temporary differences or tax-planning strategies at the end of 20X2. In that case, Company A must look to the fourth source, which is a projection of taxable income exclusive of reversing temporary differences and carryforwards. Company A would develop its projection of future taxable income considering all sources of income. Since Company A has the intent and ability to hold the debt security until recovery, the projections of future taxable income will include the expected reversal of the previously recognized unrealized loss over the remaining holding period until recovery. The overall projection of future taxable income is a source of income for all DTAs.

By their very nature, projections of taxable income require judgments and estimates about future events that are less certain than past events that can be objectively measured. Both positive and negative evidence should be considered in determining whether a valuation allowance is needed. Because estimates of future taxable income require significant judgment, the more negative evidence that exists (e.g., cumulative losses in recent years), the less reliance can be placed on projections of future taxable income.

That is, expectations about future taxable income would rarely be sufficient to overcome the negative evidence of recent cumulative losses, even if an entity supports its expectations with detailed forecasts and projections. In this fact pattern, if Company A were to conclude that significant negative evidence exists (e.g., cumulative losses in recent years), it is unlikely that the positive evidence from its projections of future taxable income would overcome this significant negative evidence, and a valuation allowance of \$415 likely would be required on its DTAs at 31 December 20X2. In that case, even though Company A has the intent and ability to hold to the debt security to the recovery of the unrealized loss, ASC 740-10-30-16 requires that the related DTA be evaluated in combination with the company's other deferred tax assets.

**How we see it**

Depending on an entity's previous accounting policy, the ASU may require an entity to increase its valuation allowance on its deferred tax assets, particularly if the entity has a recent history of losses or other significant negative evidence affecting its ability to rely on future projections of taxable income. The new guidance does not address how to account for the corresponding offset to any increase in the valuation allowance that is a direct effect of adopting the ASU. We believe the corresponding offset should be recognized as a decrease in retained earnings upon transition.

## Presentation and disclosure

The ASU revises the disclosure requirements for interim and annual reporting periods.

### Disclosures

#### ***Financial assets and financial liabilities***

The new guidance requires entities to present financial assets and financial liabilities separately, grouped by measurement category (e.g., FV-NI) and form (securities or loans and receivables) of financial asset in the statement of financial position or in the accompanying notes to the financial statements.

#### ***Financial instruments that are not measured at fair value***

For entities other than PBEs, the guidance eliminates the requirement in ASC 825 to disclose the fair values of financial instruments measured at amortized cost on the balance sheet. For PBEs, it eliminates the requirement to disclose the method(s) and significant assumptions they use to estimate the fair value of financial instruments that are measured at amortized cost on the balance sheet. However, PBEs must continue to disclose how they have categorized their fair value measurements in the fair value hierarchy (i.e., Level 1, 2 or 3).

The guidance also requires PBEs to base their fair value disclosures for financial instruments that are not measured at fair value in the financial statements on the exit price notion in ASC 820. That requires a change in practice for entities that have been using an entry price, consistent with the illustration in ASC 825-10-55-3. The Board acknowledged that some entities have been using entry prices to measure the fair value of loans that do not have market prices because ASC 825-10 permits it for entities that have not yet adopted ASU 2016-01. However, the Board said that requiring these disclosures to be made on the basis of exit prices will give users better information, which justifies the additional cost to providers.

Another change for PBEs is that they are no longer able to assert that it is not practicable to estimate the fair value of financial instruments and to just provide additional disclosures, as ASC 825 permits entities that have not yet adopted ASU 2016-01 to do.

The guidance excludes investments in equity investments without readily determinable fair values, trade receivables and payables due in one year or less, and demand deposit liabilities from these disclosure requirements.

The guidance doesn't change the disclosure requirements of ASC 820 for financial instruments that are recognized at fair value.

#### ***Financial liabilities that are measured using the FVO***

The guidance requires expanded disclosures about the effects of an entity's own credit risk and changes in it for all liabilities measured under the FVO. Previously, similar disclosures were required only for financial liabilities that were "significantly affected" by such changes. For each period (interim and annual) for which an income statement is presented, entities are required to disclose all of the following information:

- ▶ The amount of change, during the period and cumulatively, in the fair value of the liability that is attributable to changes in its own credit risk
- ▶ How the unrealized gains and losses attributable to changes in its own 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

***Equity investments without readily determinable fair values***

For each interim and annual reporting period, entities that apply the measurement alternative for measuring equity investments without readily determinable fair values are required to disclose:

- ▶ The carrying amount of these investments
- ▶ The amount of impairments and downward adjustments, if any, both annual and cumulative
- ▶ The amount of upward adjustments, if any, both annual and cumulative
- ▶ Qualitative information as of the date of the most recent statement of financial position that enables financial statement users to understand the quantitative disclosures and the information the entity considered in determining the carrying amounts and upward or downward adjustments resulting from observable price changes

We believe that entities have to disclose the annual and cumulative amounts of any upward and downward adjustments (on a gross basis) made under the measurement alternative only for equity investments that they hold at each reporting date. That is, these disclosures are not required for equity investments that are sold during the reporting period. We also believe entities are not required to present a rollforward for the carrying amount of equity securities without readily determinable values that are measured using the measurement alternative (i.e., they do not need to reconcile the beginning and ending carrying amounts of such investments each reporting period).

An entity must also provide the nonrecurring fair value measurement disclosures required under ASC 820 in its interim and annual financial statements whenever it adjusts the carrying amount of an investment measured under the measurement alternative. That is, an entity must provide these disclosures whenever there is an observable transaction for the same or a similar investment of the same issuer or when its investment is impaired. The disclosures required under ASC 820 do not replace those required under ASC 321. Refer to our Financial reporting developments (FRD) publication, *Fair value measurement*, for further discussion.

***Equity investments held at the reporting date***

For all equity investments, entities need to disclose the portion of unrealized gains and losses recognized during the period that relates to equity investments held at the reporting date for each period for which results of operations are presented. That amount is calculated as the difference between net gains and losses recognized during the period on equity investments and net gains and losses recognized during the period on equity investments sold during the period.

**How we see it**

While the ASU eliminates some fair value disclosure requirements, it requires a number of new disclosures for equity investments without readily determinable fair values that are measured using the new measurement alternative, financial liabilities that are measured using the FVO and equity investments held at the reporting date. Entities will also need to provide the nonrecurring fair value measurement disclosures required by ASC 820 whenever they adjust the carrying amount of an equity investment measured under the measurement alternative. Entities may need to develop additional processes and controls to aggregate and present this information.

Many financial institutions had been using the entry price notion to measure the fair value for disclosure purposes of loans that are not measured at fair value. Financial institutions that are PBEs need to apply judgment to comply with the requirement to use an exit price notion because loans typically do not have observable market prices.

## **Statement of cash flows considerations**

The new guidance in ASC 321 and the consequential amendments to ASC 230<sup>12</sup> require entities to classify cash flows from purchases and sales of equity investments on the basis of the nature and purpose for which they acquired the ownership interests.

Prior to adoption of the ASU, the cash flow classification generally follows the accounting for the investment. For example, purchases and sales of trading securities were classified in the statement of cash flows as operating or investing based on the nature and purpose for which the securities were acquired, while purchases and sales of AFS securities were classified as investing activities. The elimination of equity security classification categories (i.e., trading and AFS) may affect a reporting entity's determination of the appropriate cash flow classification for these investments.

Because the ASU generally requires changes in the fair value of equity investments to be reflected in net income, entities that use the indirect method of preparing the statement of cash flows need to remember to adjust net income for these amounts to determine cash flows from operating activities.

## **Effective date**

ASU 2016-01 is effective for PBEs for annual periods beginning after 15 December 2017, and interim periods therein. For all other entities, it is effective for fiscal years beginning after 15 December 2018, and interim periods within fiscal years beginning after 15 December 2019. Non-PBEs can early adopt the standard as of the effective date for PBEs.

All entities can early adopt the provision requiring them to recognize the fair value change from instrument-specific credit risk in OCI for financial liabilities measured using the FVO in ASC 825, and non-PBEs can early adopt the provision that eliminates the fair value disclosures for financial instruments not recognized at fair value.

The amendments in ASU 2018-03 are effective for PBEs for fiscal years beginning after 15 December 2017, and interim periods within those fiscal years beginning after 15 June 2018. That is, calendar-year PBEs will adopt the amendments in the third quarter of 2018. For all other entities, the amendments have the same effective date as ASU 2016-01. Early adoption by all entities, including adoption in an interim period, is permitted if ASU 2016-01 has been adopted.

## **Transition**

An entity generally records a cumulative-effect adjustment to the statement of financial position as of the beginning of the fiscal year in which the guidance is adopted. However, the ASU requires that the amendments related to equity investments without readily determinable fair values (including disclosure requirements) be applied prospectively to all investments that exist as of the date of adoption.



### **FASB amendment**

The FASB issued an amendment to ASC 825-10-65-2(e) to clarify that entities use a prospective transition approach only for investments they elect to measure using the measurement alternative. An entity that does not elect to use the measurement alternative for an equity investment without a readily determinable fair value but instead subsequently measures that investment at fair value, will recognize any adjustment to the carrying value necessary at transition in the cumulative-effect adjustment. Refer to Question 9 in Appendix A for further discussion.



PBEs with fiscal years beginning in the period between 15 December 2017 and 15 June 2018, and other entities that have early adopted ASU 2016-01 and adopt or early adopt the amendments in ASU 2018-03 will record a cumulative-effect adjustment to the statement of financial position from the beginning of the fiscal year in which the amendments are adopted to the adoption date. That is, a calendar-year PBE that adopts these amendments in the third quarter of 2018 will record a cumulative-effect adjustment from 1 January 2018 to 1 July 2018 in its third-quarter Form 10-Q. All other entities that have not adopted ASU 2016-01 will record a cumulative-effect adjustment to the statement of financial position at the beginning of the fiscal year in which ASU 2016-01 is adopted.

The requirement to use the exit price notion to measure the fair value of financial instruments for disclosure purposes is also applied prospectively. Entities also need to make a disclosure explaining any lack of comparability with prior-period figures resulting from measuring the fair value of these financial instruments using an exit price notion.

Unrealized gains and losses reported in accumulated OCI for AFS equity securities are reclassified to beginning retained earnings in the year of adoption. In addition, amounts in retained earnings attributable to changes in own credit risk for financial liabilities measured under the FVO that exist as of the date of adoption will also be reclassified to accumulated OCI.

The following disclosures, which are consistent with ASC 205-10,<sup>13</sup> are required under ASC 825-10-65-2 in the period of adoption:

- ▶ The nature of and reason for the change in accounting principle, with an explanation of the newly adopted principle
- ▶ The method of applying the change
- ▶ The effect of the adoption on any line in the statement of financial position, if material, as of the beginning of the fiscal year of adoption
- ▶ The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the fiscal year of adoption

When interim financial statements are issued, the above should be provided in all interim financial statements for the fiscal year of adoption and in the annual financial statements for the fiscal year of adoption.

### How we see it

Entities with unrealized gains or losses on AFS equity securities are required to reclassify those amounts to beginning retained earnings in the year of adoption. As a result, an entity that doesn't sell the securities prior to adoption will never realize those amounts in net income.

Entities with amounts in retained earnings attributable to changes in their own credit risk for financial liabilities measured under the FVO are required to reclassify those amounts from beginning retained earnings to accumulated OCI in the year of adoption. As a result, those amounts may affect net income again if the financial liability is settled at fair value before its scheduled maturity.

Public entities also need to provide the disclosures discussed in SEC Staff Accounting Bulletin Topic 11.M<sup>14</sup> about the effects of recently issued accounting standards, if they are known.

An amendment clarifies that the prospective transition approach can only be used for equity investments measured under the measurement alternative.

## Transition for insurers

Insurance companies in the scope of ASC 944<sup>15</sup> that elect the measurement alternative for equity securities without readily determinable fair values may have amounts accumulated in OCI related to these investments. Because the transition guidance in ASU 2016-01 requires a prospective transition approach for these equity securities, questions were raised about how to apply the approach to amounts accumulated in OCI. The FASB did not provide guidance in the amendments on how insurance companies should recognize these amounts prospectively. As a result, insurers need to select a method they consider appropriate. However, the amendments state that insurers need to consistently apply the method they have selected to their entire population of equity securities measured using the measurement alternative.

### How we see it

Insurers that elect to apply the measurement alternative to their equity investments without readily determinable fair values have to establish an accounting policy for applying a prospective transition approach for amounts they have already accumulated in OCI related to these investments. These insurers should not reclassify the amounts to beginning retained earnings or to the cost basis of the respective investments because these would be retrospective approaches.

### Endnotes:

- <sup>1</sup> ASU 2016-01, *Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, January 2016.
- <sup>2</sup> ASC 820, *Fair Value Measurement*.
- <sup>3</sup> ASC 825, *Financial Instruments*.
- <sup>4</sup> ASU 2018-03, *Technical Corrections and Improvements to Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*.
- <sup>5</sup> International Financial Reporting Standard 9, *Financial Instruments*.
- <sup>6</sup> ASC 815, *Derivatives and Hedging*.
- <sup>7</sup> ASC 970, *Real Estate – General*.
- <sup>8</sup> ASC 320, *Investments – Debt and Equity Securities*.
- <sup>9</sup> ASC 810, *Consolidation*.
- <sup>10</sup> ASC 860, *Transfers and Servicing*.
- <sup>11</sup> Remarks by Brian Staniszewski, Professional Accounting Fellow, Office of the Chief Accountant, at the 2016 AICPA National Conference on Current SEC and PCAOB Developments, 5 December 2016, <https://www.sec.gov/news/speech/staniszewski-2016-aicpa.html>.
- <sup>12</sup> ASC 230, *Statement of Cash Flows*.
- <sup>13</sup> ASC 205, *Presentation of Financial Statements*.
- <sup>14</sup> SEC Staff Accounting Bulletin Topic 11.M, *Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period*.
- <sup>15</sup> ASC 944, *Financial Services – Insurance*.

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## Appendix A: Implementation questions and answers

This section provides answers to questions that entities may have when applying or considering the effects of the new guidance on recognizing and measuring financial instruments.

### Equity investments

**Question 1** Are investments in money market funds that are classified as cash equivalents within the scope of ASU 2016-01?

Yes. The ASU does not provide a scope exception for financial instruments solely because they are classified as cash equivalents on an entity's balance sheet. Therefore, entities that are in the scope of the ASU and hold money market funds that are classified as cash equivalents on their balance sheet will need to account for those investments in accordance with the provisions of ASC 321 and provide the applicable disclosures.

**Question 2** Should an entity adjust the carrying value of a purchased option or forward contract in the scope of ASC 321 as described in ASC 815-10-25-18 if it observes a transaction involving the underlying equity security?

Yes. ASU 2018-03 clarifies that when an entity elects to use the measurement alternative to remeasure eligible forward contracts and purchased options on equity securities, it must remeasure the entire fair value of the forward or option when observable transactions involving the underlying equity securities or impairment of those securities occurs. That is, an entity must update all inputs to the valuation of the forward or option, not just the input relating to the change in the value of the underlying equity security.

**Question 3** If an entity elects the measurement alternative, can it voluntarily change that election?

Yes. ASU 2016-01 requires entities to reassess at each reporting period whether an investment they elect to measure using the measurement alternative continues to qualify for the alternative. ASU 2018-03 clarifies that if an entity measures an equity investment using the measurement alternative (and the investment continues to qualify for the measurement alternative), it may change its measurement approach to a fair value method in accordance with the principles of ASC 820.

An entity that elects to change its measurement approach for an equity security will have to do so for that security and all identical or similar investments of the same issuer. The guidance does not address what should be considered a "similar" equity investment when applying the measurement alternative or when electing to discontinue its use. As a result, an entity will have to develop a reasonable framework to interpret the term "similar" and consistently apply it.

Further, the election to discontinue the measurement alternative is irrevocable and will apply to all future purchases of identical or similar investments of the same issuer. The Board explained in the Background Information and Basis for Conclusions of ASU 2018-03 that it believes an entity should not measure the same equity security in different ways simply because of differences in the timing of the purchases.

**Question 4** Can an entity "unelect" the fair value option under ASC 825 and elect the measurement alternative upon adoption of ASU 2016-01?

No. Under ASC 825-10-25-2, the election to measure an eligible financial instrument using the FVO is irrevocable unless a new election date occurs as discussed in ASC 825-10-25-4. Adoption of a new accounting standard is not considered a new election date. Accordingly, it would not be appropriate for an entity to "unelect" the FVO and elect the measurement alternative for an equity investment without a readily determinable fair value upon adoption of the ASU. The FVO election is irrevocable and the ASU did not supersede that provision.

**Question 5** When an entity adjusts the carrying amount of an equity investment using the measurement alternative for an observable transaction, must it apply the fair value measurement guidance in ASC 820 to estimate the fair value?

Under ASU 2016-01, an entity must adjust the carrying amount of an equity investment measured under the measurement alternative when it observes an orderly transaction for the same or a similar investment of the same issuer. The amended guidance clarifies that these adjustments are made to reflect the fair value of the

security as of the date of the observable transaction. We believe that when there is an observable transaction, the carrying amount must be adjusted to reflect its fair value determined in accordance with the principles of ASC 820.

**Question 6** If an entity identifies an observable transaction before the end of its reporting period and obtains price information for that transaction after the reporting date but before issuing its financial statements, should the entity adjust the carrying value of its investment measured under the measurement alternative in the reporting period in which the transaction occurred (i.e., in its not-yet-released financial statements) or should it wait until the next reporting period to make that adjustment?

We believe an entity that elects the measurement alternative should use an approach consistent with ASC 820 when determining whether to adjust financial statements that are not yet issued to reflect observable prices in transactions that occurred during that reporting period. Accordingly, the entity should adjust the carrying value of its investment in those (not-yet-released) financial statements to reflect the fair value as of the date of the observable transaction.

For example, assume that an entity owns a series of preferred stock that is measured using the measurement alternative. On 15 March, the entity is informed that the issuer of those securities issued a new series of preferred stock to third-party investors. The entity (investor) made reasonable efforts, but could not obtain information about the rights and obligations of the newly issued securities or the price at which they were purchased and sold by 31 March (i.e., the end of its first quarter reporting period). On 15 April (prior to the issuance of its first quarter financial statements), the entity obtains additional information about the recently issued preferred shares (i.e., those issued on 15 March) and concludes that the securities are similar to those it held as of 31 March. It also discovers that the transaction price is higher than the price at which its investment is currently recorded.

In this example, the entity would adjust its first quarter financial statements for the observable price information that it obtained on 15 April because it observed an orderly transaction for the same or similar security of the same issuer that occurred during the first quarter.

**Question 7** How should an entity account for transaction costs of acquiring equity investments?

ASC 321 does not provide guidance on how to account for transaction costs related to investments in equity securities. However, for equity investments measured at FV-NI, transaction costs are recognized in net income in the reporting period of acquisition as a result of the period-end adjustment of the investment's carrying amount to fair value. This is consistent with the treatment of those costs for equity securities that were classified as trading before the adoption of ASU 2016-01.

We believe that for equity investments that are measured using the measurement alternative, if the investor accounts for transaction costs at acquisition as part of the investment's carrying amount, that carrying amount (including the transaction costs) will be adjusted to fair value at the time of the next observable price change or impairment event, as applicable. The transaction cost will be recognized in net income at that time.

**Question 8** If the measurement alternative is elected to measure a foreign currency-denominated equity security that lacks a readily determinable fair value, should the entity use the historical exchange rate or the current exchange rate to remeasure that security into its functional currency?

The FASB has proposed an amendment<sup>1</sup> to ASC 830<sup>2</sup> to clarify that foreign currency-denominated equity investments that are measured using the measurement alternative are nonmonetary items that should be remeasured using their historical exchange rates. As a result, entities should use the exchange rate on the later of the date the investment was acquired or the date on which its carrying value was adjusted, if applicable, to remeasure these investments.

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<sup>1</sup> Proposed ASU, *Codification Improvements*.

<sup>2</sup> ASC 830, *Foreign Currency Matters*.

For an equity investment that is measured using the measurement alternative, a carrying value adjustment is required either as a result of an (1) observable price in an orderly transaction for the same or similar security of the same issuer or (2) impairment to reflect the investment's then current fair value. Therefore, if an equity investment that is measured using the measurement alternative is subsequently adjusted to reflect its then current fair value, the current exchange rate on the date of that adjustment must be used, and the entire change in the carrying amount is recognized in earnings. This is consistent with the accounting for equity investments that are measured at FV-NI, whereby the entire fair value change (including the amount attributable to changes in foreign exchange rates using current exchange rates) is recognized in earnings.

**Question 9 Does the transition provision that requires the guidance for equity securities without readily determinable fair values to be applied prospectively apply to all equity securities without readily determinable fair values or just to those for which the measurement alternative has been elected?**

The amended guidance clarifies that entities have to use a prospective transition approach only for equity investments they elect to measure using the measurement alternative. That is, if an entity measures equity securities without readily determinable fair values at fair value, it must record a cumulative-effect adjustment to the statement of financial position as of the beginning of the fiscal year in which the guidance is adopted.

The Board said in the Basis for Conclusions in ASU 2018-03 that it intended the prospective transition approach to be used only in connection with the measurement alternative because it may be difficult for entities that use the measurement alternative to identify observable transactions that occurred before adoption.

**Question 10 If an entity holds an equity investment that qualifies to be measured using the NAV practical expedient under ASC 820 but has been carried at cost (i.e., the entity had not elected that practical expedient), can it use the measurement alternative upon adoption of ASU 2016-01?**

No. The measurement alternative may only be used when the fair value of an equity investment is not readily determinable and the investment does not qualify for the NAV practical expedient.

Under ASC 820, an entity may only elect the NAV practical expedient at initial recognition of the instrument. However, upon adoption of the ASU, an entity may elect to use the NAV practical expedient to measure its qualifying investments. Entities that currently use the cost method need to consider the facts and circumstances of their investments to determine whether the investments qualify to be measured using the NAV practical expedient. The scope of the NAV practical expedient is limited to investments without readily determinable fair values in entities that calculate NAV per share (or its equivalent, such as member units or an ownership interest in partners' capital) consistently with the measurement principles of ASC 946, *Financial Services – Investment Companies*. That is, the investment must be in an entity that measures its investment assets at fair value (in accordance with the principles of ASC 820) on a recurring basis. For example, investments in hedge funds, private equity funds and venture capital funds may be eligible for the NAV practical expedient.

An equity investment that has a readily determinable fair value as defined in the ASC Master Glossary is not eligible for the NAV practical expedient, with one exception. Although the Master Glossary notes that a restricted stock would be deemed to have a readily determinable fair value only if the restriction terminated within one year, the guidance in ASC 820 states that the length of an equity security's restriction period is not considered when determining whether the investment qualifies for the NAV practical expedient. That is, a restricted stock could be determined to have a readily determinable fair value if it meets the criteria outlined in that definition, ignoring the restriction period threshold, in which case it would not be eligible for the NAV practical expedient.

**Question 11 What are some key considerations for an entity that holds equity investments carried at cost, but qualify to be measured under the NAV practical expedient upon adoption of the ASU?**

As a practical matter, an entity may determine that it would be operationally less difficult to elect the NAV practical expedient rather than to estimate a fair value measurement in accordance with ASC 820. However, if management decides to use the NAV practical expedient for qualifying equity investment(s), that does not alleviate its responsibility to understand, assess and conclude on the appropriateness of the NAV provided by the investee fund. This may potentially create practical challenges for first-time application of the expedient. Entities need to have processes and controls in place to determine the continued eligibility of investments

they measure using the NAV practical expedient and whether any adjustments should be made to the NAV when using that value to measure their equity investments. For example, an adjustment to the NAV may be required if it is not calculated as of the entity's measurement date.

Entities also need to consider the timing of when NAV values are available because that may present practical challenges. That is, an investor needs to determine whether investee NAV information will be available in sufficient time for its financial reporting purposes. In addition, an investor needs to make sure that the investee has performed appropriate procedures in determining the NAV that the investor will use in its financial reporting. Refer to Section 18 of our FRD on fair value measurement for further discussion.

**Question 12** When an entity adopts ASU 2016-01, what will the transition accounting look like for an AFS investment in a series of preferred stock issued by a public company (with an unrealized gain recorded in OCI) and an investment in another series of preferred stock issued by the same company that is restricted for sale for more than one year and accounted for under the cost method?

The transition accounting for the two investments may differ. Because the preferred stock with no sale restriction has a readily determinable fair value, the entity will record the effect of adoption on this investment as a cumulative-effect adjustment to the statement of financial position (i.e., retained earnings) as of the beginning of the fiscal year in which the guidance is adopted.

Because the preferred stock with the sale restriction greater than one year is deemed not to have a readily determinable fair value, the entity may elect to use the measurement alternative or an ASC 820 fair value to measure this security. Under the amended guidance, an entity that elects the measurement alternative would account for the effect of adoption on this investment prospectively. Therefore, the cost basis of this investment is only adjusted through net income when there is an observable price change in an orderly transaction for an identical or similar investment of the same issuer or an impairment after adoption of the standard.

In other words, assuming that the restricted investment is similar to the investment that is not restricted, the entity will adjust the carrying value of the restricted stock through earnings when there is an observable transaction involving the unrestricted stock (perhaps as soon as in the quarter of adoption). On the other hand, if the entity instead elects to measure the restricted shares using fair value, it will record a cumulative-effect adjustment to beginning retained earnings on transition (consistent with the transition accounting for equity securities with readily determinable fair values).

**Question 13** Does an entity that measures an equity investment using the measurement alternative need to provide the fair value disclosures required by ASC 820 and ASC 825 for that investment in its interim and annual financial statements?

As discussed in Question 5 above, when there is an observable transaction or an impairment, the amount to which an equity investment measured under the measurement alternative is adjusted must reflect its fair value determined in accordance with the principles of ASC 820. As a result, when such an adjustment is made, an entity must provide the nonrecurring fair value measurement disclosures required under ASC 820 in its interim and annual financial statements in addition to the disclosures required by ASC 321.

However, ASU 2016-01 amends ASC 825 to exclude equity investments measured using the measurement alternative from its disclosure requirements. Therefore, entities are not required to provide fair value disclosures under ASC 825 (e.g., fair value disclosures for financial instruments not measured at fair value) for these investments.

### **Financial liabilities measured using the fair value option**

**Question 14** Does the new presentation guidance described in ASC 825-10-45-5 apply to hybrid financial liabilities for which the FVO has been elected in accordance with ASC 815-15-25-4 through 25-6?

Yes. An amendment clarifies that an entity that elects to use the FVO to measure certain financial liabilities must follow the new presentation guidance in ASC 825-10-45-5 relating to its own credit risk, regardless of whether it elected the FVO in accordance with ASC 815-15 or ASC 825-10. As a result, the guidance applies to changes in fair value caused by a change in an entity's own credit risk related to a hybrid financial liability for which the FVO is elected under ASC 815-15.



**Question 15 Does the method described in ASC 825-10-45-5 for measuring the amount of the change in fair value caused by a change in an entity's own credit risk apply to hybrid financial liabilities for which the FVO has been elected?**

No. For hybrid financial liabilities for which the FVO has been elected, it is not appropriate for an entity to measure the amount of the change in fair value caused by a change in an entity's own credit risk using the method described in ASC 825-10-45-5. That's because the difference between the total change in the fair value of the hybrid financial liability and the amount resulting from a change in a base market rate, such as a risk-free rate or a benchmark interest rate, does not result in a faithful measurement of the fair value change caused by a change in the issuing entity's own credit risk. Applying such an approach inappropriately results in changes in fair value attributable to the embedded derivative to also be captured in OCI, rather than in net income as required by ASC 815. As a result, an entity needs to use another method for determining the change in fair value attributable to a change in its own credit risk and apply that method consistently.

**Question 16 Does the new presentation guidance apply to nonrecourse financial liabilities for which the FVO has been elected?**

No. In response to a technical inquiry, the FASB staff said it was not the Board's intent to change how instrument-specific credit risk is measured for nonrecourse financial liabilities using the FVO. That's because a nonrecourse financial liability does not have instrument-specific credit risk (ISCR). For example, if the repayment of a nonrecourse financial liability depends solely on the value or cash flows of underlying collateral rather than the ability of the debtor to pay, the risk associated with non-payment relates to asset-specific performance risk rather than instrument-specific credit risk.

However, if a collateralized financial liability provides the creditor with recourse to anything other than the pledged collateral, the new presentation guidance would apply, and the entity would have to measure and present separately in OCI the change in fair value of the financial liability caused by a change in its own credit risk. For these instruments, determining the change in fair value attributable to a change in its own credit risk will require judgment. It may not be appropriate for an entity to consider the portion of the total change in fair value that excludes the amount resulting from a change in a base market risk to be solely attributable to a change in the entity's own credit risk. As a result, an entity may need to consider using another method for determining the change in fair value attributable to a change in its own credit risk.

**Question 17 If an entity elects the FVO for a foreign currency-denominated financial liability, how should changes in fair value attributable to ISCR be recognized and presented?**

For financial liabilities measured using the FVO, ASC 825-10-45-5 generally requires the change in fair value caused by a change in the entity's own credit risk to be presented separately in OCI. The amended guidance clarifies that when the amount of change in fair value that relates to an entity's own credit risk is presented separately from the liability's other changes in fair value, that change should first be measured in the currency in which it is denominated. The reporting entity will then remeasure the cumulative change in fair value related to its own credit risk into its functional currency using the end-of-period spot rate.

As a result, when the change in fair value attributable to the entity's own credit risk is presented separately in OCI, the effect of remeasurement of this amount into the entity's functional currency will also be recorded in OCI. The change in fair value of the financial liability, including the portion attributed to changes in foreign exchange rates, but excluding the functional currency amount attributed to the entity's own credit risk, will be recorded in net income.

The Board believes this measurement is consistent with practice prior to adoption of the new guidance, based on its outreach with stakeholders that have foreign currency-denominated FVO financial liabilities and that measured their own credit risk for disclosure purposes.



## Appendix B: Comparison of US GAAP with IFRS

The following table highlights key differences between the guidance in US GAAP and IFRS 9.

Topic	US GAAP	IFRS 9
<b>Debt securities, loans and receivables</b>	<p>Classification and measurement depend largely on the legal form of the instrument (i.e., whether the financial asset represents a security or a loan) and management's intent for the instrument.</p> <p>At acquisition, debt instruments that meet the definition of a security are classified in one of three categories and subsequently measured as follows:</p> <ul style="list-style-type: none"> <li>▶ Held to maturity:* amortized cost</li> <li>▶ Trading: FV-NI</li> <li>▶ Available for sale:* fair value, with changes in fair value recognized through OCI (FV-OCI)</li> </ul> <p>Loans and receivables that do not meet the definition of a security are generally measured at amortized cost. Loans held for sale are measured at the lower of cost or fair value.</p>	<p>Regardless of an instrument's legal form, classification and measurement depend on the instrument's contractual cash flow characteristics and the business model under which they are managed.</p> <ul style="list-style-type: none"> <li>▶ A financial asset passes the cash flow characteristics test if its contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest.</li> <li>▶ Financial assets that pass the cash flow characteristics test are subsequently measured at amortized cost,* FV-OCI* or FV-NI, based on the entity's business model for managing them. Financial assets that fail the cash flow characteristics test are subsequently measured at FV-NI.</li> </ul>
<b>Equity investments (except those accounted for under the equity method, those that result in consolidation of the investee and certain other investments)</b>	<p>These instruments are measured at FV-NI at the end of each reporting period.</p> <ul style="list-style-type: none"> <li>▶ A measurement alternative is available for equity investments that do not have readily determinable fair values and do not qualify for the net asset value practical expedient under ASC 820. 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.</li> <li>▶ An entity may elect to change its measurement approach from the measurement alternative to fair value (i.e., apply ASC 820). However, if it chooses to do so, it must apply that change to all identical or similar equity investments of the same issuer. This election is irrevocable and applies to all future purchases of identical or similar equity investments of the same issuer.</li> </ul>	<p>These instruments are measured at FV-NI at the end of each reporting period.</p> <ul style="list-style-type: none"> <li>▶ An irrevocable FV-OCI election is available for nonderivative equity investments that are not held for trading. If the FV-OCI election is made, gains or losses recognized in OCI are not recycled upon derecognition of investments.</li> </ul>
<b>Financial liabilities (except derivatives)</b>	<p>These instruments are generally measured at amortized cost. Amounts related to short sales are generally measured at FV-NI.</p>	<p>These instruments are generally measured at amortized cost.</p> <p>FV-NI is required if held for trading. Financial liabilities held for trading include but are not limited to the following:</p> <ul style="list-style-type: none"> <li>▶ Business strategy at acquisition, issuance or inception is to subsequently transact at fair value</li> <li>▶ Short sales</li> <li>▶ Part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking</li> </ul>

\* Credit losses are recognized in earnings under both US GAAP and IFRS. However, the models for measuring credit impairment under US GAAP and IFRS differ.

Topic	US GAAP	IFRS 9
Fair value option	<p>An entity may elect, generally at inception, to measure certain financial assets and financial liabilities (and certain nonfinancial instruments that are similar to financial instruments) at FV-NI.</p> <p>An entity may also elect FVO for a hybrid financial instrument that would otherwise require bifurcation. Under this option, the entire instrument is measured at FV-NI.</p>	<p>Financial assets: An entity may irrevocably elect to measure these instruments at FV-NI at inception if doing so eliminates or significantly reduces an accounting mismatch.</p> <p>Financial liabilities: An entity may irrevocably elect to measure these instruments at FV-NI at inception if:</p> <ul style="list-style-type: none"> <li>▶ Doing so eliminates or significantly reduces accounting mismatches.</li> <li>▶ The 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.</li> <li>▶ They are hybrid contracts that contain one or more embedded derivatives meeting certain conditions.</li> </ul>
Hybrid instruments	<p>Embedded derivatives should be separated from their host nonderivative contracts and accounted for as derivatives if certain requirements are met.</p>	<p>Hybrid financial assets are not eligible for bifurcation. Derivatives embedded in nonfinancial assets and in liabilities (both financial and nonfinancial) are separated if they meet certain criteria.</p>
Changes in instrument-specific credit risk (or own credit risk) related to financial liabilities measured under the FVO	<p>Changes in an entity's own credit risk are recognized in OCI.</p> <ul style="list-style-type: none"> <li>▶ Amounts accumulated in OCI are reclassified to net income upon settlement of the financial liability.</li> <li>▶ There is an exception for financial liabilities of certain consolidated collateralized financing entities.</li> </ul>	<p>Changes in an entity's own credit risk are recognized in OCI unless doing so creates or increases an accounting mismatch.</p> <ul style="list-style-type: none"> <li>▶ An entity is prohibited from reclassifying changes in fair value attributable to its own credit risk presented in OCI to net income upon the settlement of the financial liability.</li> </ul>
Unrealized foreign currency gains or losses on debt instruments denominated in a foreign currency measured at FV-OCI	<p>Changes in unrealized foreign currency gains or losses are recognized in OCI.</p>	<p>Changes in unrealized foreign currency gains or losses are recognized in net income.</p>