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It's Just an Oil Change After All

FASB Issues Final Standard for Recognition and Measurement of Financial Instruments

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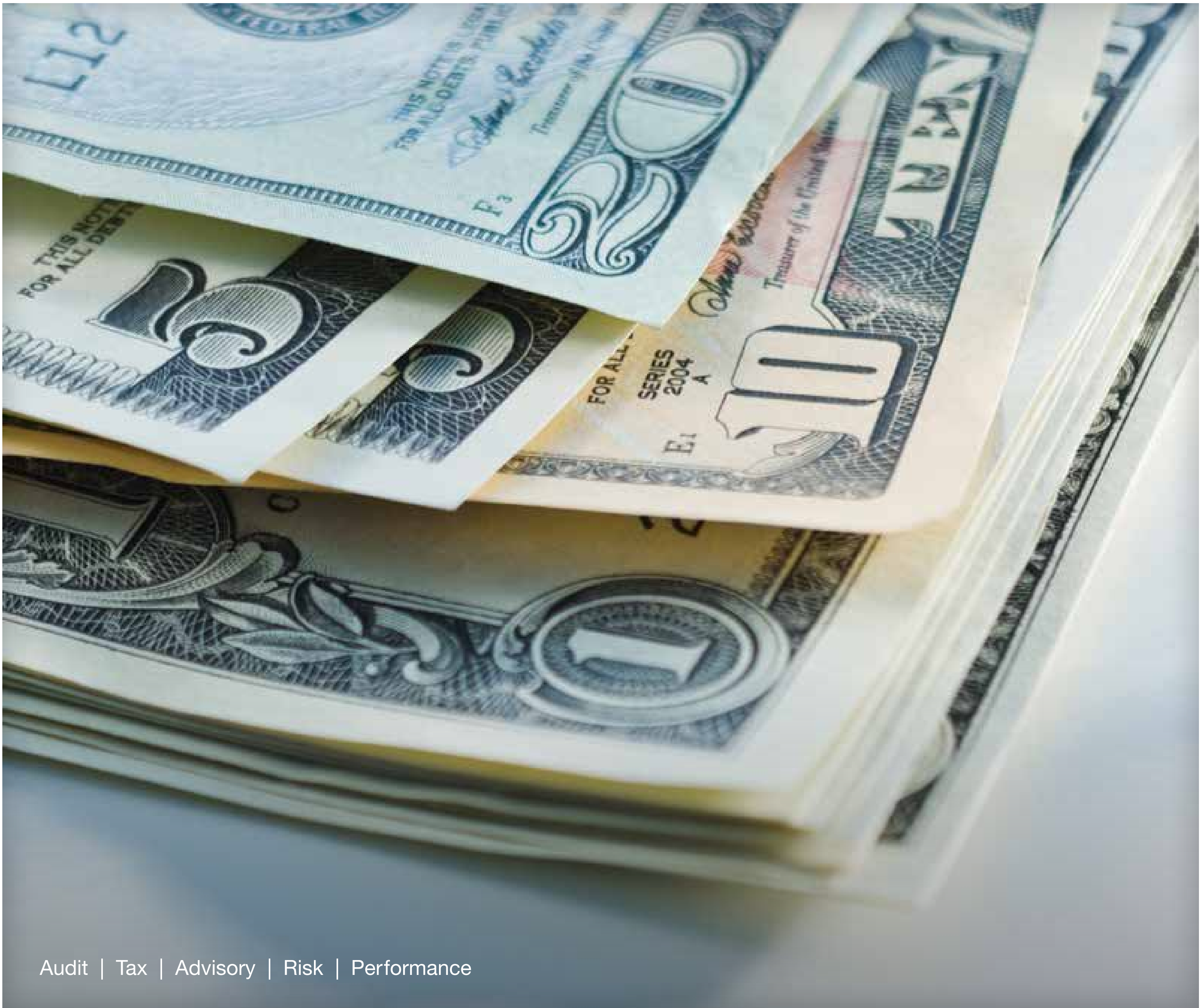

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After navigating some twists and turns, the Financial Accounting Standards Board (FASB) project on classification and measurement of financial instruments culminated in the issuance of Accounting Standards Update (ASU) No. 2016-01, “Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities,” also referred to as the “classification and measurement standard.” The most recent proposal, issued in early 2013 and recapped in the Crowe article “More Than an Oil Change,” would have required financial institutions to significantly change their process for determining the classification for securities and loans. However, the final standard, issued Jan. 5, 2016, turns out to contain few substantive changes – allowing institutions to avoid undergoing a significant overhaul, instead having only an oil change, after all.

In this article, we explain the substantive changes that survived the proposal’s evolution over more than five years – changes that primarily affect equity investments, deferred tax assets (DTAs) on available-for-sale (AFS) securities, and disclosures. Typically, changes to disclosures are the result of changes in recognition and measurement, but in this case the changes for the fair value disclosure of financial instruments are significant.

The final ASU provides two welcome developments, both of which may be adopted early. First, for liabilities elected to be carried at fair value, the change in fair value resulting from instrument-specific credit risk is presented in other comprehensive income (OCI) instead of earnings. The second provision is available only to entities that are not public business entities (PBEs), as defined by the FASB. (See sidebar, “Definition of Public Business Entity (Master Glossary)”). For that population, the disclosures of fair value for financial instruments may be removed. Readers might recall that the definition of PBE is very broad, extending far beyond those who file with the U.S. Securities and Exchange Commission (SEC).

Definition of Public Business Entity (Master Glossary)

A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.

a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).
b. It is required by the *Securities Exchange Act of 1934* (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.
c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.
d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.
e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity’s filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

Background

The most recent ASU started as a FASB convergence project with the International Accounting Standards Board (IASB) to address accounting for financial instruments. The FASB issued its initial exposure draft, "Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities – Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815)," on May 26, 2010. Although often referred to as "the fair value proposal," the exposure draft also addressed recognition and measurement, impairment, and hedging. If the initial proposal had been finalized, most financial instruments – including securities, loans, deposits, and debt (trust-preferred securities, for example) – would have been measured at fair value on the balance sheet.

Since the 2010 proposal, the FASB has split the project into three projects: (1) classification and measurement, (2) credit losses, and (3) hedging. For the first two, the FASB issued re-proposals in late 2012 and early 2013. For classification and measurement, the board took a meaningful departure from its most recent proposal and decided to make only targeted improvements to existing U.S. generally accepted accounting principles (GAAP). For credit losses, the story is much different, given that the FASB has chosen to stick with the current expected credit loss (CECL) model unveiled in its 2012 proposal. The board is re-deliberating the hedging component and plans to issue an exposure document in the second quarter of 2016.

The FASB digested the feedback received about the 2010 proposal and on Feb. 14, 2013, issued another proposal, intended to improve reporting for financial instruments by developing a consistent, comprehensive framework for classifying those instruments. The proposed ASU, "Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities," also offered the possibility of closer convergence with the IASB.

On April 12, 2013, the FASB issued another proposed ASU, "Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities – Proposed Amendments to the FASB Accounting Standards Codification." This 345-page companion proposal provided a marked version of the FASB Accounting Standard Codification (ASC) changes proposed in the recognition and measurement exposure draft.

The most significant proposed change was for financial assets and was aligned with the IASB's model. While there would have been three familiar categories – (1) fair value with changes in net income (FV/NI), (2) fair value with changes in other comprehensive income (FV/OCI), and (3) amortized cost – the classification could have differed significantly from current practice. The classification and measurement of financial assets would have been based on both the characteristics of the financial assets and the entity's business strategy for the assets. That determination would have been made using a two-step test.

First, a financial asset would be evaluated to determine whether the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest (SPPI) on the principal amount outstanding. Assets not meeting that test would have been required to be carried at FV/NI. Those that did meet the test would have been classified based on business strategy, which is step two of the test. Many of the comment letters to the FASB expressed reservations about this test, citing unnecessary complexity with the "SPPI test" as well as the expected likelihood of inadvertently scoping many assets into the FV/NI category.

The board began formal re-deliberations in late 2013 and has continued them through 2015. The deliberations have moved the project from what would have been a significant change in practice to targeted improvements in the existing security and loan accounting models.

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The final standard reflects a meaningful change from the board's February 2013 proposal by choosing to retain the existing models for securities and loans and proceed with making only targeted improvements in them.

Classification and Measurement for Securities and Loans

Although the FASB decided to leave the existing models for debt securities and loans in place, the board made changes for equity securities. As discussed later in this article, the FASB requires disclosures by measurement attribute. Following is a recap of changes made to the classification and measurement models as a result of ASU 2016-01:

Classification	Measurement
Debt Securities	
Held to Maturity	Amortized Cost
Available for Sale	Fair Value With Changes in Other Comprehensive Income
Trading	Fair Value With Changes in Net Income
Equity Securities*	Fair Value With Changes in Net Income**
Practical Expedient for Equity Securities Without a Readily Determinable Fair Value**	Amortized Cost, less impairment if any, plus or minus changes resulting from observable price changes in orderly transactions for an identical investment or a similar investment of the same issuer**
Loans	
Held for Investment	Amortized Cost
Held for Sale	Lower of Amortized Cost or Fair Value

* Excludes equity securities accounted for under the equity method of accounting.

** New, per ASU 2016-01.

Equity Securities

Under the FASB's 2013 exposure draft, all equity securities would have been measured at fair value with changes in fair value recognized in net income. To determine whether the fair value changes should be presented in net income or OCI, many stakeholders preferred to allow consideration of management's investment strategy and its plan to realize value from an equity security. The board noted that the term "strategic investments" is relatively broad and describes investments in equity securities that the reporting entity holds primarily for reasons other than to realize short-term gains.

In the end, the FASB concluded that providing an exception for strategic investments, or any other class of investment, would add complexity and not result in more useful information. Under ASU 2016-01, all equity investments will be carried at fair value with changes in earnings, and the current AFS option for equity investments will be eliminated. The two main exceptions are investments that qualify for the practicability exception and certain investments accounted for under the equity method. Following is a discussion of the exceptions.

The current AFS option for equity investments will be eliminated.

1. Practical Expedient for Equities Without a Readily Determinable Fair Value

The FASB recognized the practical challenges of measuring investments when there is no readily determinable fair value, so the board provided a practicability exception other than those exceptions using the net asset value (NAV) practical expedient. The scope encompasses more than common stock. With the recent addition of ASC Topic 321, "Investments – Equity Securities," other types of equity investments, such as limited partnerships and limited liability corporations, will be included, unless they are carried on the equity method. The definition also includes instruments that represent the right to transfer equity interests.

The new standard tweaks the master glossary definition of "equity (first definition)" as follows:

> "Any security representing an ownership interest in an entity (for example, common, preferred, or other capital stock) or the right to acquire (for example, warrants, rights, forward purchase contracts and call options) or dispose of (for example, put options and forward sale contracts) an ownership interest in an entity at fixed or determinable prices. The term equity security does not include any of the following:
>
> a. Written equity options (because they represent obligations of the writer, not investments)
>
> b. Cash-settled options on equity securities or options on equity-based indexes (because those instruments do not represent ownership interests in an entity)
>
> c. Convertible debt or preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor."

The final standard is consistent with the proposal in that these investments will be measured at cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for an identical investment or a similar investment of the same issuer. In a significant change from existing guidance, upward adjustments to fair value will be recorded. Most comment letters to the FASB supported providing relief for these investments, noting a reduction in complexity and an improvement over the cost method.

Most comment letters to the FASB supported providing relief for equity securities without a readily determinable fair value, noting a reduction in complexity and an improvement over the cost method.

This practicability exception will not be available for broker-dealers (ASC Topic 940) or investment companies (ASC Topic 946).

The FASB also took the opportunity to simplify the test for impairment. Under current GAAP, deciding whether to recognize impairment and, if so, how much impairment to recognize, is a two-step process. Cost method investments are first assessed for impairment based on whether the carrying amount is higher than the fair value of the investment. Second, when the fair value is below the carrying amount, an assessment is performed to determine whether the impairment is other than temporary or not. An impairment is not recognized unless it is deemed to be other than temporary even if the carrying amount is higher.

With the new standard, however, the FASB moves to a one-step model that uses qualitative assessment and impairment indicators to evaluate whether the investment is impaired. In the standard (ASC 321-10-35-3), the FASB provides the impairment indicators for entities to consider, including the following:

“a. A significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee

b. A significant adverse change in the regulatory, economic, or technological environment of the investee

c. A significant adverse change in the general market condition of either the geographic area or the industry in which the investee operates

d. A bona fide offer to purchase, an offer by the investee to sell, or a completed auction process for the same or similar investment for an amount less than the cost of that investment

e. Factors that raise significant concerns about the investee’s ability to continue as a going concern, such as negative cash flows from operations, working capital deficiencies, or noncompliance with statutory capital requirements or debt covenants.”

When an impairment indicator is identified, the investment must be measured at fair value.

2. Equity Method Investments

The board had proposed to make some changes for equity method investments, including requiring an evaluation of whether the investment should be classified as held for sale (HFS). Ultimately, the FASB decided to remove equity method investments from the classification and measurement project's scope so that at this point there are no equity method investment changes. Consistent with existing GAAP, an investor in equity investments should continue to use the equity method of accounting for investments that satisfy the existing criteria in ASC Topic 323, "Investments – Equity Method and Joint Ventures," which require an entity to have significant influence over the investee's operating and financing policies.

A separate project to simplify the accounting for equity method investments is on the FASB's agenda.

Valuation Allowance on Deferred-Tax Assets on Available-for-Sale Debt Securities

The FASB has observed that practice varied on evaluating DTAs on AFS securities. Some stakeholders had the view that the DTA should be evaluated separately from other DTAs, because management has control over the realizability of the asset due to management's ability to sell the securities. In the FASB's 2014 proposal, this is the position the board was proposing to take.

Later, the FASB switched course and took the position that all DTAs should be evaluated together. For the final standard, the board decided that a valuation allowance will be assessed for a DTA that is related to an AFS debt security in combination with other DTAs.

Fair Value Option

One objective of the 2014 proposal was to reduce alternative accounting methods, with the goal of improving comparability. So the FASB proposed replacing the existing unlimited FVO under current U.S. GAAP with a conditional FVO, such that the option would be permitted only in certain circumstances. Based on the feedback it received, the FASB decided to retain the unconditional FVO that is in existing GAAP under ASC Topic 825, "Financial Instruments."

Under current GAAP, the credit component of the change in value of liabilities under the FVO election is included in earnings. This results in additional earnings when an entity's credit declines, and vice versa. Many stakeholders felt recording income as an entity's creditworthiness declined was a counterintuitive result.

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The FASB agreed and concluded that, for financial liabilities that are measured at fair value under the FVO election, the portion of the fair value change attributed to a change in the instrument-specific credit risk should be presented separately in OCI rather than net income.

Disclosures

The new ASU includes the following required disclosures.

Assets and Liabilities. Entities will present all financial assets and financial liabilities, grouped by measurement category (amortized cost, FV/OCI, or FV/NI, for example) and the form of financial asset (securities and loans, for example). Entities have the option of presenting on the balance sheet or in the footnotes.

Equity Securities Using the Practicability Exception. Entities will disclose the carrying amount of investments that are measured using the practicability exception, as well as the amount of adjustments made to the carrying amount due to observable changes and impairment charges during the period. An entity will not have to disclose the information it considered to reach the carrying amount or upward or downward adjustments resulting from observable price changes.

Fair Value for Amortized Cost Financial Instruments. The final standard brings big changes for the fair value of financial assets and financial liabilities that are measured at amortized cost in accordance with ASC Topic 825, "Financial Instruments" – formerly known as FASB Statement No. 107, "Disclosures About Fair Value of Financial Instruments."

- **For Non-PBEs** – First, the good news. For non-PBEs, the FASB is removing the table completely. Recall that the definition of PBE is much broader than just those who file with the SEC. As noted in "Effective Dates," found later in this section, early adoption of this provision is permitted immediately for financial statements that have not yet been made available for issuance. For calendar year-ends, early adoption of this provision is allowed for Dec. 31, 2015, financial statements that have not yet been made available for issuance.
- **For PBEs** – The FASB is raising the bar for PBEs with an important change in how fair values will be determined for the disclosure. Currently, an exception in U.S. GAAP (ASC 825-10-55-3) permits financial instruments to be measured using an entry price. For example, the fair value of loans is commonly computed by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. This differs from the general requirement in U.S. GAAP to determine fair value using an exit price. Because the new disclosure requirement refers to "fair value" as it is defined in the glossary and is the same definition as current U.S. GAAP fair value, the exception for measuring certain assets at an entry price has been removed. As such, entities will need to measure all financial instruments in this table based on an exit price. This requirement could present challenges, particularly for loan portfolios.

The FASB is raising the bar for PBEs with an important change in how fair values will be determined. This requirement could present challenges, particularly for loan portfolios.

Consistent with existing GAAP, trade receivables and payables under one year are outside the scope of the new standard for disclosures. An entity would also disclose the level of the fair value hierarchy within which the fair value measurement of financial instruments measured at amortized cost are categorized in their entirety (Level 1, 2, or 3). Certain public companies (under the definitions used before ASU No. 2013-12) already have this requirement, which was established by ASU No. 2011-04, "Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs." In an effort to simplify, the FASB is removing the requirement for PBEs to disclose the methods and significant assumptions used to estimate the fair value for this disclosure.

Transition

Generally, making the transition will require an entity to make a cumulative-effect adjustment to the statement of financial position as of the beginning of the first reporting period in which the guidance is effective (that is, a modified-retrospective approach). For equity securities previously classified as AFS, amounts reported in accumulated OCI for equity securities that exist as of the date of adoption will be reclassified to retained earnings. For financial liabilities measured under the FVO that exists as of the date of adoption, amounts attributable to changes in instrument-specific credit risk will be reclassified from retained earnings to accumulated OCI.

For equity securities previously classified as AFS, amounts reported in accumulated OCI for equity securities that exist as of the date of adoption will be reclassified to retained earnings.

The guidance related to equity securities without readily determinable fair value (including disclosure requirements) is to be applied prospectively to all equity investments that exist as of the date of adoption.

Disclosure in the interim and annual periods of adoption should include the following information:

- The nature of and reason for the change in accounting principle, including an explanation of the newly adopted accounting principle.
- The method of applying the change.
- The effect of the adoption on any line item in the statement of financial position, if material, as of the beginning of the first period for which the guidance is effective. Presentation of financial statement subtotals is not required.
- 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 first reporting period for which the guidance is effective.

Effective Dates

For PBEs, ASU 2016-01 is effective fiscal years beginning after Dec. 15, 2017, including interim periods within those fiscal years. For calendar year-ends, adoption will be the first quarter of 2018.

For non-PBEs, the standard is effective fiscal years beginning after Dec. 15, 2018, and interim periods beginning after Dec. 15, 2019. For calendar year-ends, adoption will be Dec. 31, 2019. Non-PBEs may early adopt the standard using the PBEs' effective dates.

For two items, early adoption is permitted immediately, as of the beginning of the fiscal year, for interim or annual financial statements that have not yet been issued (for PBEs) or that have not yet been made available for issuance (for non-PBEs), for the following:

- Fair value change resulting from own credit risk for financial liabilities measured under FVO recognized through OCI
- For non-PBEs, the elimination of fair value disclosure requirements for financial instruments not recognized at fair value

What About Convergence With the IASB?

In mid-December 2011, the IASB amended IFRS 9, "Financial Instruments," to defer the mandatory effective date from Jan. 1, 2013, to Jan. 1, 2015, so that all phases of the project could have the same mandatory effective date. Subsequently, the IASB and FASB worked together in an attempt to achieve a converged solution.

The IASB issued its classification and measurement proposal, "Classification and Measurement: Limited Amendments to IFRS 9," on Nov. 28, 2012. The proposal aimed to reduce significant differences with the FASB's tentative classification and measurement model, with the goal of achieving greater international comparability in the accounting for financial instruments. The IASB followed up, on March 7, 2013, with an exposure draft, "Financial Instruments: Expected Credit Losses." The proposal retained the three-bucket approach that had been developed jointly by the IASB and FASB but was later rejected by the FASB, which cited operational concerns.

On July 24, 2014, the IASB announced the completion of final amendments to IFRS 9. The amendments complete a three-phase project to replace International Accounting Standard (IAS) No. 39, "Financial Instruments: Recognition and Measurement." Previous versions of IFRS 9 had established classification and measurement requirements (issued in 2009 and 2010) and a new hedge accounting model (issued in 2013). The most recent amendments replace those earlier versions of IFRS 9. Changes include a new expected-loss impairment model that will require more timely recognition of expected credit losses.

On July 24, 2014, the IASB announced the completion of final amendments to IFRS 9, completing a three-phase project to replace IAS 39.

IFRS 9 will be effective for annual periods beginning on or after Jan. 1, 2018, with earlier application permitted. The IASB has made available a project summary, which gives an overview of the requirements of IFRS 9. An article available on the IASB website, "IFRS 9: A Complete Package for Investors," discusses the new standard from an investor perspective. A recording of a July 29, 2014, Web presentation and Q&A session on the final standard is also available on the IASB website.

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