Grant Thornton

New Developments Summary

Recognition and measurement of financial instruments

ASU 2018-03 clarifies certain aspects of the guidance in ASU 2016-01

Summary

In ASU 2018-03, *Technical Corrections and Improvements to Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, the FASB issued the following technical corrections and improvements intended to clarify certain aspects of the guidance on recognizing and measuring financial assets and liabilities in ASU 2016-01:

- Clarification regarding the ability to discontinue application of the measurement alternative for equity securities without a readily determinable fair value
- Clarification of the measurement date for fair value adjustments to the carrying amount of equity securities without a readily determinable fair value for which the measurement alternative is elected
- Clarification of the unit of account for fair value adjustments to forward contracts and purchased options on equity securities without a readily determinable fair value for which the measurement alternative is expected to be elected
- Presentation requirements for certain hybrid financial liabilities for which the fair value option is elected
- Measurement of financial liabilities denominated in a foreign currency for which the fair value option is elected
- Transition guidance for equity securities without a readily determinable fair value

The amendments in ASU 2018-03 are effective for public business entities for fiscal years beginning after December 15, 2017 and for interim periods within those fiscal years beginning after June 15, 2018. Public business entities with fiscal years beginning between December 15, 2017 and June 15, 2018 are not required to adopt the amendments until interim periods beginning after June 15, 2018.

For all other entities, the effective date is the same as the effective date for ASU 2016-01.

All entities may early adopt the amendments, including adoption in an interim period, provided they have already adopted ASU 2016-01.

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A. Overview

In ASU 2018-03, *Technical Corrections and Improvements to Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, the FASB issued certain technical corrections and improvements intended to clarify certain aspects of the guidance in ASU 2016-01. The clarifications in ASU 2018-03 relate to three classes of financial instruments:

- Equity securities without a readily determinable fair value
- Financial liabilities for which the fair value option is elected
- Forward contracts and purchase options on equity securities without a readily determinable fair value for which the measurement alternative is expected to be applied

B. Equity securities without readily determinable fair values

Under ASC 321, *Investments – Equity Securities*, equity securities are measured at fair value as of each reporting date, with all changes in fair value recognized through net income. However, an entity may elect to measure equity securities without a readily determinable fair value that do not qualify for the practical expedient to estimate the fair value at the net asset value (NAV) of the investee in accordance with ASC 810-10-35-59, *Fair Value Measurement and Disclosures*, pursuant to a measurement alternative. The measurement alternative under ASC 321-10-35-2 allows those investments to be measured at their cost minus impairment, if any, plus or minus any changes resulting from observable price changes in “orderly transactions,” as defined, for the identical or a similar investment of the same issuer.

Discontinuation of the measurement alternative

An entity that elects to apply the measurement alternative in ASC 321-10-35-2 must continue to apply it until the investment either (a) has a readily determinable fair value, or (b) becomes eligible for the NAV practical expedient. The amendments in the ASU allow an entity that elects to measure an equity security without a readily determinable fair value using the measurement alternative to subsequently elect to measure the security at fair value. This election is irrevocable and must be applied to all identical or similar investments of the same issuer, including future purchases of identical or similar investments of the same issuer. Any resulting gains or losses on the securities for which this election is made must be recorded in earnings at the time of the election.

Application of ASC 250 to election to discontinue applying the measurement alternative

ASU 2018-03 amends the guidance in ASC 321-10-35-2 by allowing an entity to elect to stop applying the measurement alternative and, from the election date forward, to instead measure the equity securities (and any identical and similar securities of the same issuer) at fair value without applying the provisions of ASC 250, *Accounting Changes*. This means that the entity does not need to establish preferability or apply the change retrospectively.

However, after an entity has made the irrevocable election to discontinue applying the measurement alternative in ASC 321-10-35-2 and to measure the equity securities (and any identical and similar securities of the same issuer) at fair value, any subsequent changes to this accounting policy would be subject to the guidance in ASC 250.

Additionally, the election created by this amendment is separate from, and does not impact, the fair value option in ASC 825, including the dates when the fair value option may be elected.

Measurement date for fair value adjustments

An entity that elects the measurement alternative in ASC 321-10-35-2 for an equity security without a readily determinable fair value must record an upward or downward adjustment in the carrying value of the security for observable transactions in the same or similar securities of the same issuer. ASU 2018-03 amends the guidance in ASC 321-10-55-9 to clarify that an entity should adjust the carrying value of the equity security as of the date of the observable transaction instead of as of the balance-sheet date.

Transition guidance

The transition guidance in ASU 2016-01 requires a modified retrospective transition approach, except for equity securities without a readily determinable fair value, for which a prospective approach is prescribed. The FASB originally required a prospective approach for equity securities without a readily determinable fair value because it considered the difficulties that entities might encounter to determine the last observable transaction price that would be required to apply a modified retrospective transition approach. The amendments in the ASU 2018-03 clarify that the prospective transition approach is available only to equity securities without a readily determinable fair value for which the measurement alternative in ASC 321-10-35-2 is elected. For all other equity securities (including equity securities without readily determinable fair values for which the measurement alternative is not elected that are measured at fair value), the modified retrospective transition approach should be applied.

Transition by insurance entities to measurement alternative

The guidance in ASC 944-325, *Financial Services – Insurance: Investments – Other*, requires insurance entities to recognize equity securities without a readily determinable fair value at fair value, with changes in fair value recognized in other comprehensive income. However, the guidance in ASC 944-325 is superseded by ASU 2016-01. Therefore, upon adoption of ASU 2016-01, insurance entities subject to ASC 944 must account for their equity investments in accordance with the guidance in ASC 321. The guidance in ASU 2018-03 clarifies that insurance entities should apply a prospective transition method to the equity securities without a readily determinable fair value that are measured using the measurement alternative in

> ASC 321. The guidance further clarifies that if there are amounts in other comprehensive income related to such equity investments, those amounts should also be recognized prospectively. The FASB did not prescribe a method of prospectively recognizing the amounts in other comprehensive income upon transition, but the method chosen by an insurance entity should be applied consistently.

C. Financial liabilities for which the fair value option is elected

Entities can elect to account for financial liabilities at fair value pursuant either to the fair value option in ASC 825 for stand-alone financial liabilities or to the fair value election for hybrid financial instruments in ASC 815, *Derivatives and Hedging*.

Presentation for certain hybrid financial liabilities

ASU 2016-01 amends the guidance in ASC 825 regarding how changes in the fair value of a financial liability related to a change in the instrument-specific credit risk are presented, requiring entities to present these changes as a component of other comprehensive income. The amendments in ASU 2018-03 clarify that this requirement applies to both hybrid financial instruments that are liabilities measured at fair value pursuant to ASC 815 in addition to stand-alone financial liabilities for which the fair value option in ASC 825 is elected.

Measurement of financial liabilities denominated in a foreign currency

For financial liabilities denominated in a foreign currency for which the fair value option is elected, the amendments in ASU 2018-03 clarify that the change in the fair value of the liability should be determined in the following order:

- First, determine the amount of the change in fair value that relates to instrument-specific credit risk measured in the currency of denomination when changes in instrument-specific credit risk are presented separately from the total change in the fair value of the financial liability.
- Second, remeasure both components of the change in fair value of the financial liability into the functional currency of the reporting entity using end-of-period spot rates. The remeasurement of the component of the total change in fair value related to instrument-specific credit risk should be presented as a component of other comprehensive income.

D. Forward contracts and purchased options

Under ASU 2018-03, forward contracts and purchased options to acquire equity investments that meet all of the following characteristics should be accounted for as if the entity holds the underlying equity investment:

- The contract is entered into to purchase investments that qualify for accounting under ASC 321.
- The contract's terms require physical settlement of the contract by delivery of the securities.
- The contract is not a derivative instrument subject to the guidance in ASC 815.
- If a purchased option, the contract has no intrinsic value at acquisition.

Therefore, such forward contracts and purchased options must be measured at fair value at each reporting period, with changes in fair value recognized in net income, unless the underlying equity investment may be measured using the measurement exception.

Unit of account

ASC 815-10-35-6 states that entities should recognize changes in the fair value of forward contracts and purchased options on equity securities without a readily determinable fair value for which the measurement alternative in ASC 321-10-35-2 is applied when these changes occur. The amendments in ASU 2018-03 clarify that a change in the observable price or impairment of the underlying securities of such a forward contract or purchased option should result in a remeasurement of the entire fair value of the forward contract or purchased option as of the date when the observable transaction took place.

E. Effective date

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