New Developments Summary

Accounting for financial instruments

ASU 2016-01 codifies improvements to recognition and measurement guidance

Summary

In January 2016 the FASB issued ASU 2016-01, *Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities,* to make targeted improvements to U.S. GAAP on accounting for financial instruments. This bulletin summarizes the guidance in ASU 2016-01.

The guidance in ASU 2016-01 makes targeted improvements to how entities

- Account for equity investments
- Present and disclose financial instruments
- Measure the valuation allowance on deferred tax assets related to available-for-sale debt securities

The guidance in ASU 2016-01 is effective for "public business entities," as defined, for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. For all other entities, including not-for-profit entities and employee benefit plans within the scope of ASC 960 through 965 on plan accounting, the guidance is effective for fiscal years beginning after December 15, 2018 and for interim periods within fiscal years beginning after December 15, 2019.

Early application of the guidance in ASU 2016-01 is not permitted, with certain exceptions that are discussed in Section F.

Contents

A. Overview 2
B. Accounting for equity investments........ 3
Scope........ 3
Measurement of equity investments 3
Measurement exception........ 3
Identifying similar investment of same issuer........ 5
Impairment of equity investments measured using measurement exception........ 5
Forward contracts and purchased options to buy equity investment 6
Measurement exception for forward contracts and purchased options........ 6
Disclosures about equity investments........ 7

Equity investments measured using the measurement exception 7
All equity investments........ 7
Cash flow presentation of equity investments 8
Presentation of equity investments in a classified balance sheet........ 8
Hedging........ 8
C. Presentation and disclosure of financial instruments 8
Presentation of instrument-specific credit risk of a financial liability........ 8
Instrument-specific credit risk 8
Fair value of financial instruments not measured at fair value on a recurring basis........ 9
Measuring fair value for disclosure purposes........ 9
Financial instruments exempt from fair value disclosure........ 9
Disaggregated information about financial instruments........ 10
D. Measuring valuation allowance on deferred tax assets related to available-for-sale debt securities .. 10
E. Amendments to industry-specific guidance........ 10
Insurance........ 10
Not-for-profit entities 10
F. Effective date and transition........ 11
Effective date 11
Early adoption 11
Transition........ 11
Transition disclosures 11

A. Overview

The FASB completed the recognition and measurement section of its financial instruments project with the issuance of ASU 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities*.

The guidance in ASU 2016-01 makes targeted improvements to the following areas in U.S. GAAP, which will be discussed in greater detail in this bulletin:

- How to account for equity investments
- How to present and disclose financial instruments
- How to measure the valuation allowance on deferred tax assets related to available-for-sale debt securities

The classification and measurement of financial instruments represents one of the three sections within the overall financial instruments project, along with measuring credit losses on financial assets and accounting for hedges, which are still being deliberated by the FASB.

Initially, the primary aim of the recognition and measurement section of the project was to simplify accounting for financial instruments and to converge the guidance between U.S. GAAP and IFRS. However, after issuing two exposure drafts in 2010 and in 2013, the FASB decided to focus on developing targeted improvements to current U.S. GAAP instead of devising new accounting models and converging the guidance between U.S. GAAP and IFRS. The FASB believes that such targeted improvements enhance the reporting model for financial instruments and will provide users of financial statements with more decision-useful information.

B. Accounting for equity investments

ASU 2016-01 adds a new Topic (ASC 321, *Investments – Equity Securities*) to the FASB Accounting Standards Codification®, which provides guidance on accounting for all equity investments. Prior to the issuance of ASU 2016-01, the guidance on accounting for equity investments was included in multiple topics.

Scope

The guidance in ASC 321 applies to all equity investments, including equity securities, partnership interests, and ownership interests both in unincorporated joint ventures and in limited liability companies. The guidance excludes the following types of equity investments:

- Derivative instruments
- Equity investments that are accounted for under equity method
- Equity investments that require the investor to consolidate the investee
- Ownership interests in an exchange (generally held by broker-dealers and by depository and lending institutions)
- Federal Home Loan Bank and Federal Reserve Bank stock (generally held by broker-dealers and by depository and lending institutions)

Investments in qualified housing projects

The scope of the guidance in ASC 321 does not exclude ownership interests in limited liability entities that invest in qualified housing projects; however, an entity may elect to account for such investments in accordance with the guidance in ASC 323-740, *Investments – Equity Method and Joint Ventures: Income Taxes,* using the cost, proportional amortization, or equity method.

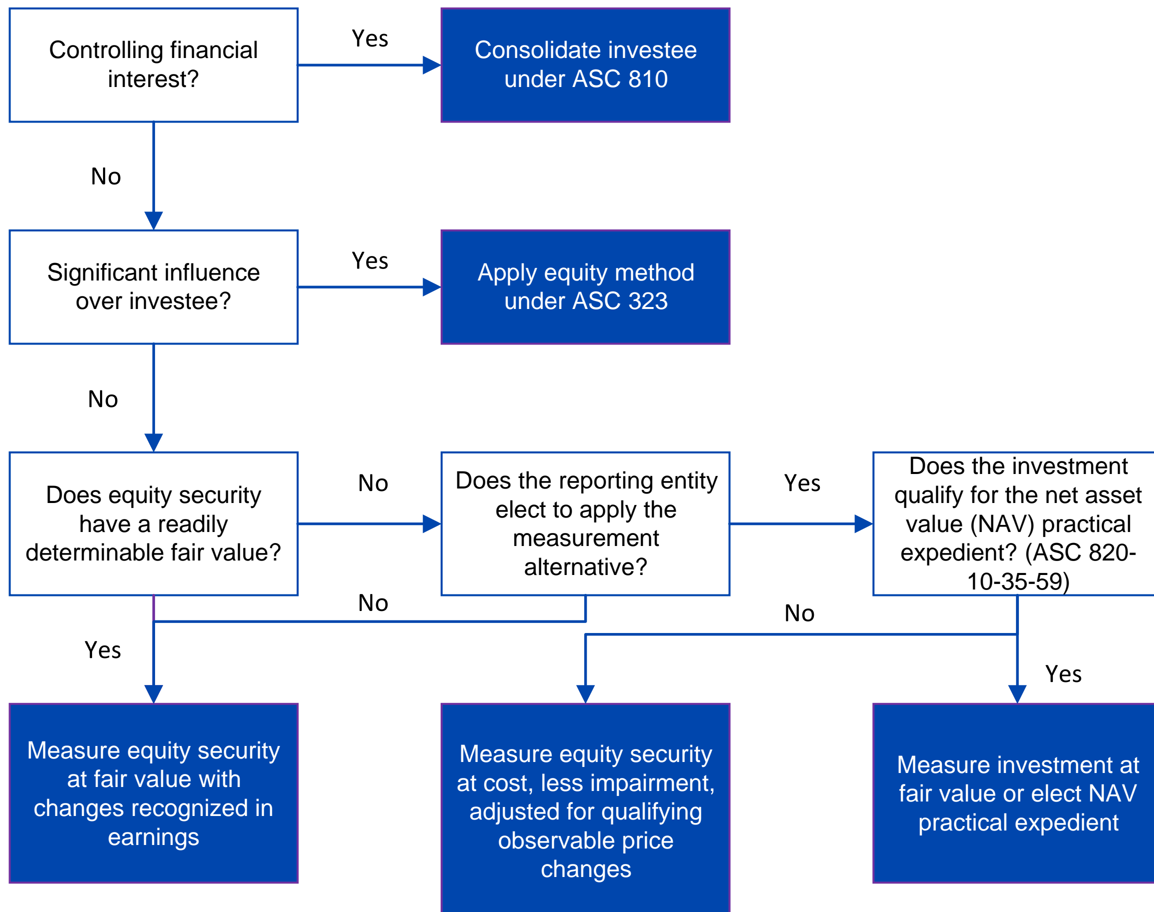
Measurement of equity investments

The guidance in ASC 321 requires all equity investments that are within its scope to be measured at fair value, with changes in fair value recognized in net income.

Measurement exception

The guidance in ASC 321 allows a measurement exception for those equity investments that do not have a "readily determinable fair value," as defined, and do not qualify to be measured using the practical expedient to estimate fair value at net asset value (NAV) of the investee in accordance with ASC 820-10-35-59, *Fair Value Measurement and Disclosure*.

The following flowchart depicts how an entity should assess whether it may apply the measurement alternative to an investment in an equity security under ASC 321-10-35-2.



The measurement exception allows those investments to be measured at their cost minus impairment, if any, plus or minus changes resulting from observable price changes in "orderly transactions," as defined, for the identical or a similar investment of the same issuer.

Orderly transactions

U.S. GAAP defines an "orderly transaction" as a transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).

Entities will need to use judgment in assessing whether or not an observable transaction in the same or a similar equity investment without a readily determinable fair value is orderly, especially when there is an insignificant observable volume or level of activity. We believe, however, that entities should presume that an observable transaction in a similar or the same equity investment is orderly, unless there are circumstances that would indicate otherwise (for example, if the seller is in or near bankruptcy or receivership or is required to sell to meet regulatory or legal requirements).

The election to measure an equity investment under the measurement exception should be made separately for each investment. Once an entity chooses to apply the measurement exception to measure an equity investment it holds, it should continue to measure the investment under the measurement exception, unless the equity investment meets any one of the following conditions:

- It obtains a "readily determinable fair value."
- It is eligible to be measured at NAV of the investee.
- It is no longer within the scope of the guidance in ASC 321 (for example, if the equity investment must be accounted for under the equity method of accounting).

Measurement exception: an accounting policy

The election to measure an equity investment using the measurement exception is an accounting policy election. Therefore, we believe that changing the measurement method of an equity investment that is measured using the measurement exception would require an entity to follow the change in accounting policy guidance in ASC 250, *Accounting Changes and Error Corrections*, unless the investment meets one of the criterion identified above.

Identifying similar investment of same issuer

As noted in the preceding section, observable price changes in orderly transactions for the same or a similar equity investment of the same issuer must be recognized in net income for equity investments without readily determinable fair values for which the measurement exception is elected. Entities will need to use judgement in identifying similar investments of the same issuer. The guidance on identifying similar investments of the same issuer in ASC 321 states that entities should consider the different rights and obligations of the securities, such as voting rights, distribution rights and preferences, and conversion features, to assess whether the equity investment held by the entity is similar to the equity investment in which an observable price change has occurred.

If the equity investment held by the entity is similar to the equity investment in which an observable price change has occurred, the entity is required to measure the equity investment at its fair value as of the date of the observable transaction. Such fair value measurement will require adjusting the observable price upward or downward for the differences in rights and obligations between the equity investment it holds and the similar security.

An observable price change in an equity investment of the same issuer that is not similar to the equity investment held by the entity should not be used to record an adjustment to the carrying amount of equity investment held by the entity; however, such an observable price change may be considered as one of the indicators while performing a qualitative assessment for impairment of equity investments measured using the measurement exception.

Impairment of equity investments measured using measurement exception

Equity investments that are measured using the measurement exception should be qualitatively evaluated for impairment at each reporting period. The impairment indicators include

- 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 a 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 an equity investment is impaired, the entity should measure the equity investment's fair value and record the difference between that fair value and the carrying value of the equity investment as an impairment loss in net income.

Forward contracts and purchased options to buy equity investment

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, *Derivatives and Hedging*.
- The contract, if a purchased option, 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 the fair value recognized in net income, unless the underlying equity investment is eligible to be measured using the measurement exception.

All equity investments purchased under a forward contract or by exercising an option must be recorded at their fair value at the settlement date.

Measurement exception for forward contracts and purchased options

Forward contracts and purchased options to acquire equity investments may be measured using the measurement exception if the underlying equity investment is eligible for the measurement exception. Therefore, such forward contracts and purchased options should be measured at cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer.

The guidance in ASU 2016-01 requires the carrying value of a forward contract or purchased option to be marked upward or downward when there is an observable price change or an impairment in the underlying equity investment or a similar equity investment of the same issuer, even though the observable price change in the equity investment underlying a forward contract or purchased option is generally only one of the inputs used to measure the contract or option.

Disclosures about equity investments

ASC 321 introduces one new disclosure requirement for equity investments measured using the measurement exception and carries forward the disclosure requirement for trading classified equity securities from ASC 320, *Investments – Debt and Equity Securities*, which will apply to all equity investments rather than applying only to those with a readily determinable fair value.

Equity investments measured using the measurement exception

The new guidance requires an entity to disclose the following information about equity investments that are measured using the measurement exception, both in interim and in annual reporting periods:

- Carrying amount
- Amount of impairment and downward adjustments recognized both during the annual period and cumulative
- Amount of upward adjustments recognized both during the annual period and cumulative
- Information (in narrative form) that management considered to determine the amount of impairment and downward or upward adjustments

All equity investments

The guidance in ASU 2016-01 requires an entity to disaggregate the net gains and losses on the equity investments recognized in the income statement during a reporting period into realized and unrealized gains and losses.

Example of disaggregated disclosure

Net gains and losses recognized during the period on equity securities	$105
Less: Net gains and losses recognized during the period on equity securities sold during the period	(80)
Unrealized gains and losses recognized during the reporting period on equity securities still held at the reporting date	$ 25

Cash flow presentation of equity investments

The guidance in ASU 2016-01 requires an entity to classify cash flows from purchases and sales of equity investments on the basis of the nature and purpose for which it acquired the securities. This guidance is the same as the guidance for debt securities classified as trading in ASC 320.

Presentation of equity investments in a classified balance sheet

The guidance in ASU 2016-01 states that marketable equity investments representing the investment of cash available for current operations must be included in current assets.

Hedging

The guidance in ASU 2016-01 prohibits entities from designating equity investments as a hedged item or transaction.

C. Presentation and disclosure of financial instruments

Presentation of instrument-specific credit risk of a financial liability

The existing guidance in ASC 825 gives entities an option to carry certain financial liabilities at fair value and requires them to recognize these change in fair value in net income. The guidance in ASU 2016-01 amends this guidance by requiring entities to present the portion of the fair value change that results from instrument-specific credit risk in other comprehensive income. The amount that is recognized in other comprehensive income will be recycled through net income upon derecognition of the related financial liability (a financial liability is derecognized only if the debtor has extinguished the liability by either paying the creditor or being legally released, either judicially or by the creditor, from being the primary obligor under the liability).

This presentation guidance is limited to liabilities that are measured at fair value in accordance with the fair value option guidance in ASC 825. Therefore, other liabilities that are measured at fair value, for example, derivative liabilities, are not within the scope of this provision, and the total fair value change for such liabilities should be presented in net income.

Instrument-specific credit risk

The guidance in ASU 2016-01 does not define instrument-specific credit risk, but provides guidance to measure such risk. The entity may use either of the following methods to measure instrument-specific credit risk:

- The portion of the total change in fair value that excludes the amount resulting from a change in a base market risk, such as a risk-free rate or a benchmark interest rate
- Any other method that faithfully represents the portion of the total change in fair value resulting from a change in instrument-specific credit risk

The method that the entity chooses to measure instrument-specific credit risk should be used consistently for each financial liability from period to period. An entity may, however, choose different methods to measure the instrument-specific credit risk of different liabilities for which the fair value option in ASC 825 is elected.

Instrument-specific credit risk of nonrecourse liabilities

The guidance in ASU 2016-01 allows entities to continue to present the instrument-specific credit risk of nonrecourse financial liabilities of consolidated collateralized financing entities in net income, instead of separately presenting them in other comprehensive income. Even though the guidance in ASU 2016-01 does not specifically address the presentation of instrument-specific credit risk of nonrecourse liabilities that are held by a reporting entity, paragraph BC112 in the Basis for Conclusions clarifies that the new guidance does not intend to change how entities identify and measure the changes in instrument-specific credit risk that was disclosed under the requirements of previous U.S. GAAP; rather, the new guidance only intends to change the presentation of the disclosed amount in the statement of comprehensive income. The Board also acknowledged that entities did not disclose changes in instrument-specific credit risk for nonrecourse liabilities under the guidance in previous U.S. GAAP.

We believe that when applying the presentation and measurement guidance in ASU 2016-01 for instrument-specific credit risk, entities may also look at the guidance in paragraph B5.7.13 of IFRS 9, *Financial Instruments*, which states that "The credit risk on the collateralised liability will be less than the credit risk of the non-collateralised liability. The credit risk for a collateralised liability may be close to zero."

Fair value of financial instruments not measured at fair value on a recurring basis

The new guidance exempts all entities, except public business entities, from disclosing the fair value of financial instruments that are not measured at fair value on a recurring basis.

Public business entities must continue to disclose the fair value of financial instruments not measured at fair value on a recurring basis, but are no longer required to disclose the following information:

- The methods and significant assumptions used to estimate the fair value
- Description of the changes in the method(s) and significant assumptions used to estimate the fair value of financial instruments, if any, during the period

Measuring fair value for disclosure purposes

The new guidance requires entities to use the exit price notion in ASC 820 in calculating the fair values of financial instruments not measured at fair value on a recurring basis. It also eliminates the guidance that allowed entities to calculate the fair value of certain financial instruments, such as loans receivables and long-term debt, using an entry price notion.

Financial instruments exempt from fair value disclosure

The new guidance adds the following three financial instruments to the list of financial instruments not measured at fair value on a recurring basis that are exempt from the fair value disclosure requirements:

- Investments in equity securities measured using the measurement exception
- Trade receivables and payables due in one year or less
- Deposit liabilities with no defined maturities or contractual maturities

Disaggregated information about financial instruments

The guidance in ASU 2016-01 requires that entities provide disaggregated information about the financial assets and financial liabilities by measurement categories (that is, fair value through net income, fair value through other comprehensive income, and amortized cost). An entity should further disaggregate the financial assets it holds by their form (that is, securities, and loans and receivables).

D. Measuring valuation allowance on deferred tax assets related to available-for-sale debt securities

The guidance in ASC 740 requires entities to reduce the carrying amount of deferred tax assets, if necessary, by the amount of any tax benefit that is not expected to be realized. The guidance in ASU 2016-01 further clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale debt securities in combination with the entity's other deferred tax assets.

This clarification eliminates the diversity in practice where some entities were evaluating the need for a valuation allowance on deferred tax assets related to available-for-sale debt securities separately from other deferred tax assets. For example, an entity's intent and ability to hold the available-for-sale debt security with unrealized losses until recovery, which may not be until maturity, will no longer be considered a tax-planning strategy, even if the specific deferred tax assets are expected to reverse as time passes.

E. Amendments to industry-specific guidance

Insurance

ASU 2016-01 removes the specific guidance that requires insurance entities to measure equity investments without readily determinable fair value similarly to available-for-sale equity securities. Upon adoption of the guidance in ASU 2016-01, insurance companies should account for all equity investments under the guidance in ASC 321. See Section B above, which summarizes the guidance in ASC 321.

Not-for-profit entities

ASU 2016-01 adds a new Subtopic to the Codification, ASC 958-321, *Not-for-Profit Entities: Investments – Equity Securities*, which includes guidance for accounting for equity investments held by a not-for-profit entity. In addition, ASU 2016-01 rewrites the guidance in ASC 958-320, *Investments – Debt Securities*, to enhance reading comprehensibility. It also moves guidance on income statement presentation for investments by not-profit-entities to ASC 958-225, *Income Statement*. The guidance in ASU 2016-01 also removes the guidance in ASC 958-325, *Investments – Others*, on measuring certain equity investments, such as venture capital funds, partnership interests, and equity securities without readily determinable fair values at cost, and requires not-for-profit entities to account for such investments in accordance with ASC 321 and ASC 958-321 upon adoption of the ASU.

F. Effective date and transition

Effective date

The guidance in ASU 2016-01 is effective as follows:

- *For public business entities*: Fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017
- *For all other entities:* Fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019.

Early adoption

Early adoption of the guidance in ASU 2016-01 is not permitted, with the following exceptions:

- Entities that are not public business entities may early adopt the new guidance as of the effective date for public business entities—that is, for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017.
- The following provisions can be adopted in the financial statements of fiscal years or interim periods that have not yet been issued or have not yet been made available for issuance as of January 5, 2016:
  - Presentation of instrument-specific credit risk in other comprehensive income for all entities
  - Discontinuation of the fair value disclosures for financial instruments not measured at fair value by entities that are not public business entities

Transition

The guidance in ASU 2016-01 should be applied by adjusting the opening balance sheet of the fiscal year of adoption, with a corresponding adjustment to the opening balance of the retained earnings. The guidance related to the measurement and disclosure of equity investments without readily determinable fair value is applicable prospectively to those investments that exist as of the date of adoption. Similarly, the guidance that requires using the exit price notion in ASC 820 to measure fair value of financial instruments for disclosure purposes is applicable prospectively.

Transition disclosures

The following transition disclosures are required in the annual financial statements of the period of adoption for all entities. If an entity issues interim financial statements, then these disclosures should be provided in each interim financial statement of the fiscal year of adoption:

- The nature 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 fiscal year; however, presentation of the effect on 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 fiscal year.

- If the prior-year amounts disclosed for comparative purposes are no longer comparable because of measuring the fair value of financial instruments under ASC 820, the new guidance requires an entity to disclose this fact in conformity with the guidance in ASC 205-10.

© 2016 Grant Thornton LLP, U.S. member firm of Grant Thornton International Ltd. All rights reserved.

This Grant Thornton LLP bulletin provides information and comments on current accounting and tax issues and developments. It is not a comprehensive analysis of the subject matter covered and is not intended to provide accounting, tax, or other advice or guidance with respect to the matters addressed in the document. All relevant facts and circumstances, including the pertinent authoritative literature, need to be considered to arrive at conclusions that comply with matters addressed in this document.

Moreover, nothing herein shall be construed as imposing a limitation on any person from disclosing the tax treatment or tax structure of any matter addressed herein. To the extent this document may be considered to contain written tax advice, any written advice contained in, forwarded with, or attached to this document is not intended by Grant Thornton to be used, and cannot be used, by any person for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code.

For additional information on topics covered in this document, contact your Grant Thornton LLP professional.

Distribution – All audit, tax, and advisory services professionals