New Financial Instruments Measurement & Classification Guidance Offers Relief for 2015 Financials

On January 5, 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*. Most significantly for financial institutions, FASB has retained the separate models in existing U.S. generally accepted accounting principles (GAAP) for determining classification and measurement of loans and debt securities. FASB has backed away from the sweeping overhauls proposed in its 2013 exposure draft, opting instead to make targeted improvements to current guidance, including:

- Most equity investments will be measured at fair value through net income (equity method of accounting is retained). A practical expedient is available for equity investments that don't have readily determinable fair values. Additional disclosures are required if the expedient is elected.
- Simplified impairment test for equity investments without readily determinable fair value, similar to the qualitative assessment for long-lived assets, goodwill and indefinite-lived intangible assets
- Valuation allowance on deferred tax assets (DTAs) related to available-for-sale debt securities is to be assessed in combination with other DTAs
- Eliminates disclosure of the method(s) and significant assumptions used in fair value estimates for financial instruments measured at amortized cost for public business entities
- Eliminates entry price use for certain fair value disclosures by public business entities—exit price now required
- Requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset, *i.e.*, securities or loans and receivables, on the balance sheet or in financial statement notes

The ASU affects public and private companies, not-for-profit organizations and employee benefit plans that hold financial assets or owe financial liabilities. This standard will be effective for public business entities for fiscal years beginning after December 15, 2017, including interim periods, *i.e.*, 2018 for calendar year-end companies. All other entities would have an additional year to adopt for annual financial statements and two years for interim financial statements. Nonpublic business entities can early adopt as of December 15, 2017, including interim periods.

Relief for 2015 Financial Statements

In a departure from usual transitions and early adoption guidance, the ASU contains two provisions that will be effective upon issuance for any interim or annual financial statements that haven't been issued or made available for issuance. Companies should consider the potential benefit from early adopting either of the below provisions for 2015 financial statements:

- Fair value changes resulting from own credit for financial liabilities measured under fair value option will be recognized through other comprehensive income
- Exemption for private companies and not-for-profit organizations from having to disclose fair value information about financial instruments measured at amortized cost

Financial Liabilities Own Credit

Under current GAAP, companies can elect to fair value certain debt instruments and recognize changes in fair value related to those debt instruments in earnings. If the debt decreases in price on the market, the liability associated with the debt would decrease (because a company could buy back the debt at a lower price). That decrease currently would be reported as a gain in the income statement. This guidance has been widely criticized for causing undue earnings volatility.

Under the new standard, fair value changes resulting from own credit for financial liabilities measured under the fair value option in current GAAP will be recognized through other comprehensive income instead of net income. An entity can measure the effect of own credit using any method that faithfully represents the change in an instrument's specific credit risk. The entity must disclose the method chosen and apply it consistently from period to period.

Nonpublic Entity Disclosure

All companies will continue to follow the statement of financial position presentation requirements for financial instruments in current U.S. GAAP. However, FASB decided only public business entities will be required to present fair value information for financial assets and liabilities measured at amortized cost. This information can be presented either parenthetically on the face of the balance sheet or in the notes to the financial statements and won't apply to receivables and payables due within one year and demand deposit liabilities. FASB concluded benefits to financial statement users didn't justify the costs for nonpublic entities to obtain the necessary valuations.

BKD is preparing a comprehensive white paper on the ASU. Visit BKD's Hot Topics page to learn more.

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