

FASB In Focus

Accounting Standards Update, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*

Background

The Financial Accounting Standards Board (FASB) on January 5, 2016, issued a new Accounting Standards Update (ASU), *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*.

The new standard addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments.

Why Is the FASB Issuing This ASU?

Before the global financial crisis that began in 2008, both the FASB and the International Accounting Standards Board (IASB) began a joint project to improve and to achieve convergence of their respective standards on the accounting for financial instruments.

The global economic crisis further highlighted the need for improvement in the accounting models for financial instruments in today's complex economic environment.

As a result, the main objective in developing this new ASU is to enhance the reporting model for financial instruments to provide users of financial statements with more useful information.

What Are the Main Provisions?

The new ASU:

- Requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. However, a reporting organization may choose to measure equity investments that do not have readily determinable fair values 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.
- Simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment. When a qualitative assessment indicates that impairment exists, the reporting organization is required to measure the investment at fair value.
- Eliminates the requirement to disclose the fair value of financial instruments measured at amortized cost for reporting organizations that are not public business entities.
- Eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet.
- Requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes.
- Requires the reporting organization to present separately in other comprehensive income (OCI) the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the organization has elected to measure the liability at fair value in accordance with the fair value option for financial instruments.

- Requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements.
- Clarifies that the reporting organization should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the organization's other deferred tax assets.

Understanding Costs and Benefits

In May 2010, the FASB issued a comprehensive proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivatives and Hedging Activities: Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815)*. After

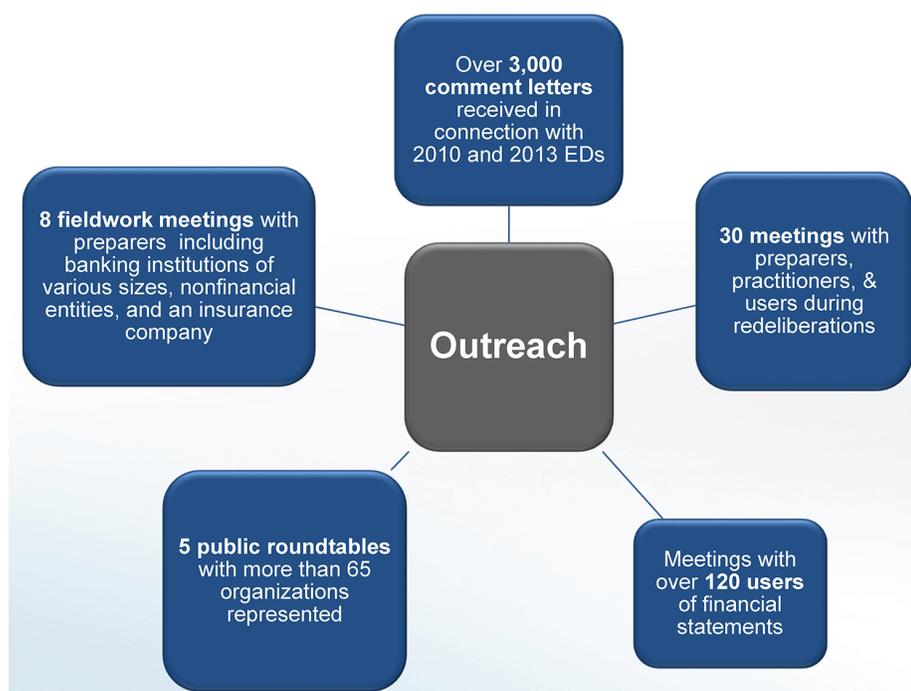
considering the input received on the May 2010 proposal, in February 2013, the FASB issued a revised proposed Accounting Standards Update, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, which was similar to IFRS 9 in most aspects. After considering feedback from stakeholders on the guidance in the 2013 proposed Update and potential revisions to that guidance that FASB and IASB jointly deliberated, the FASB concluded that the cost and complexity introduced by that model was not justified by the benefits, particularly in light of the apparent limited change to the overall accounting outcomes under the proposed classification and measurement model when compared to GAAP. In addition, the FASB anticipated that additional standard setting would be required to clarify the accounting model that was proposed by the Board in the 2013 proposed ASU. (An overview of the

outreach and feedback on these can be found in the chart below.)

Therefore, the FASB decided to retain the main provisions of GAAP for financial instruments as set forth in the Codification and decided to make targeted improvements to enhance the reporting model for financial instruments, to provide users of financial statements with more useful information, and to consider opportunities for convergence with IFRS. For example, the FASB's decision to separate changes in "own credit" from earnings for liabilities measured at fair value under the fair value option will provide more meaningful information to users of those financial statements. Users have often removed that information from GAAP earnings because the results are counterintuitive to the reporting organization's economic position.

The FASB expects that the direct costs of applying this Update are likely to be minimal and may even decrease for certain organizations. For example, this ASU does not change GAAP for most classification and measurement decisions for financial instruments, such as initial and subsequent measurement of loans, debt securities, and financial liabilities. Thus, most organizations likely will need to make few, if any, system changes in preparing to comply with the amendments at their effective date.

Summary of Outreach Conducted by the FASB



Most of the changes in this ASU require the same information, but some changes will revise the geography of that information on the financial statements. For example, all changes in the fair value of equity securities will be included in net income, rather than some (on securities classified as trading) in net income and others (on securities classified as available for sale) in OCI. That change in geography will require a change in the system for preparing the financial statements but will not change the underlying accounting system for recording an organization's transactions and other events that affect its financial instruments.

In addition, for most organizations, the FASB expects that the ongoing costs of compliance are unlikely to be higher than the costs of complying with the guidance that existed before the issuance of this ASU. As noted earlier, many of the changes to the disclosures will result in either their elimination or a reduction in requirements, which should result in a decrease of costs to preparers. Public business entities will continue to be required to disclose all fair values using an exit price, thereby eliminating the ability to use an entry price for certain fair value disclosures. The FASB understands there is diversity among reporting organizations

on whether the exit price or entry price is used. Reporting organizations that use an entry price will incur additional costs to their reporting systems, but the FASB concluded that the benefits of using an exit price consistently in the fair value disclosure requirements, which will reduce the lack of comparability among reporting organizations, justify the costs.

What Organizations Are Affected by This ASU?

This ASU affect all reporting organizations (whether public or private) that hold financial assets or owe financial liabilities.

When Will This ASU Be Effective?

For public companies, the ASU is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. For all other organizations, including not-for-profit organizations and employee benefit plans, the ASU is effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. All organizations that are *not* public companies may adopt the amendments in this ASU earlier as of the fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.

Early application of the following provisions in the ASU is permitted as of the beginning of the fiscal year of adoption:

1. The "own credit" provision, in which an organization should present separately in OCI the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk if the organization has elected to measure the liability at fair value in accordance with the fair value option for financial instruments.
2. The provision that exempts private companies and not-for-profit organizations from the requirement to apply the fair value of financial instruments disclosure guidance.

Except for the early application guidance discussed above, early adoption of the amendments in this ASU is not permitted.

An organization should apply the amendments by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The amendments related to equity securities without readily determinable fair values (including disclosure requirements) should be applied prospectively to equity investments that exist as of the date of adoption of the ASU.

For more information about the project, please visit the FASB's website at www.fasb.org.

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