

Financial Reporting Alert:

FASB Issues New Guidance on Classification and Measurement of Financial Instruments

January 6, 2016



On January 5th, the Financial Accounting Standards Board (FASB) issued its final accounting standard update (ASU) regarding the classification and measurement of financial instruments. Although this project was initially a joint project with the International Accounting Standards Board (IASB), the FASB abandoned a converged approach¹ and decided to mostly retain existing U.S. GAAP requirements. Significant changes in the new standard include requiring:

1. Investments in equity securities (with some exceptions) to be measured at fair value with changes recognized in earnings,
2. Recognition of changes in fair value of an entity's own financial liabilities measured at fair value separately within other comprehensive income rather than net income, and
3. Changes to disclosure requirements.

Effective Date

The ASU is effective for public companies for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. For private companies, the standard is effective for fiscal years beginning after December 15, 2018, and for interim periods within fiscal years beginning after December 15, 2019.

Companies will be allowed to adopt the guidance on the presentation of their own credit risk upon issuance of the ASU in financial statements of annual or interim reporting periods that have not yet been issued or, private companies, not yet been made available for issuance.

Existing GAAP Retained

Although the FASB initially proposed holistic changes to classification and measurement of all financial instruments, they finally decided to retain current U.S. GAAP related to:

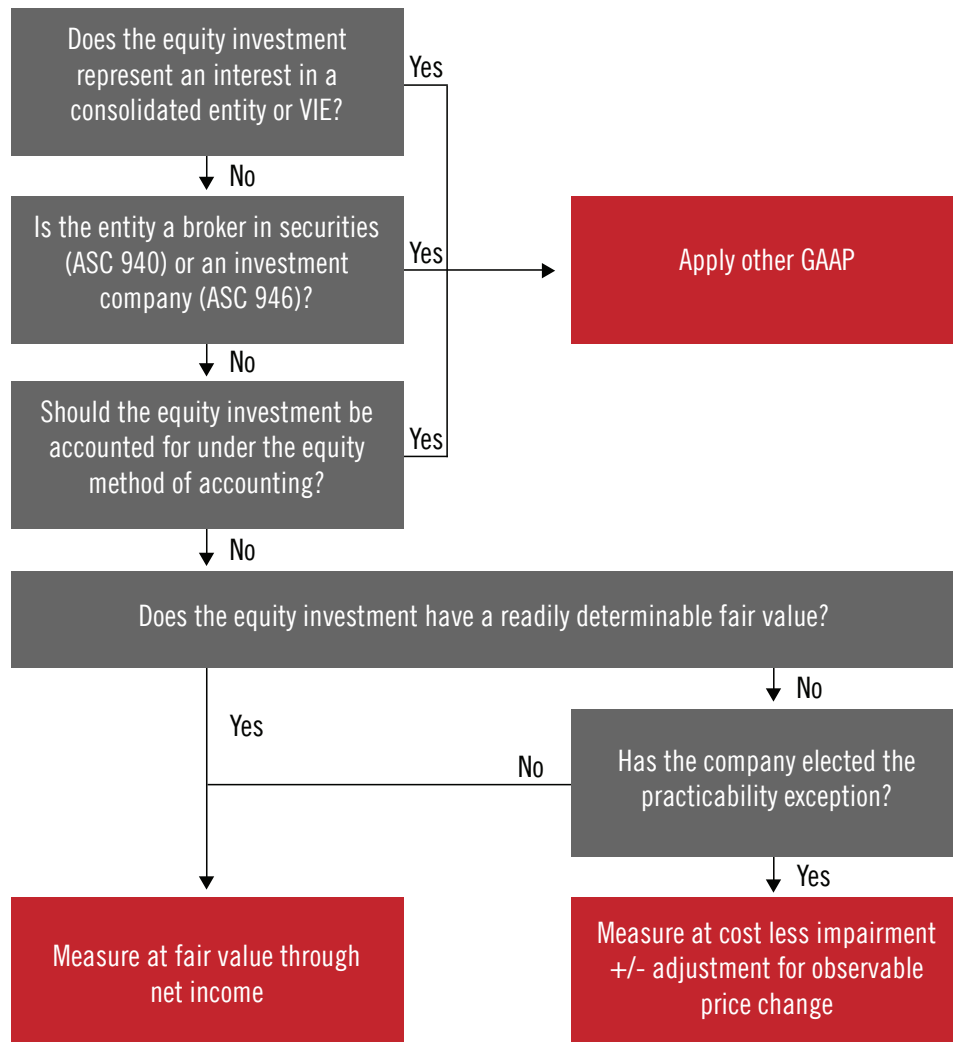
1. Classification and measurement categories for financial instruments other than equity investments,
2. The method for classifying financial instruments,
3. Bifurcation of embedded derivatives in hybrid financial assets, and
4. Accounting for equity method investments (including impairment of such investments).

Equity Instruments

All equity investments in unconsolidated entities that are not accounted for using the equity method of accounting or are variable interest entities (VIE) will generally be measured at fair value through earnings (e.g. current U.S. GAAP trading classification). There will no longer be an available-for-sale classification for equity securities with readily determinable fair values.

For equity securities that do not have a readily determinable fair value, a practicability exception is allowed for companies to record investments at cost, less impairment, and subsequently adjust for observable price changes. This practicability exception is not available to broker dealers within the scope of Accounting Standard Codification (ASC) 940 or investment companies within the scope of ASC 946.

The following flowchart further illustrates the new requirements for equity securities:



¹The IASB issued their amendments to IFRS 9 - *Financial Instruments* in July 2014.

Loans and Debt Securities

In a dramatic departure from the original exposure draft which suggested all financial instruments (loans and debt securities) should be measured at fair value through earnings, the final ASU retained current U.S. GAAP for these types of assets.

Financial Liabilities and the Fair Value Option

If the fair value option is elected for a financial liability, current U.S. GAAP requires that any periodic change in fair value be recognized in earnings. Under the ASU, changes in fair value that result from a change in the entity's own credit risk will be recognized separately in other comprehensive income. The accumulated gains and losses due to changes in the entity's own credit will be recycled from accumulated other comprehensive income to earnings when the financial liability is settled before maturity.

The FASB allows, but does not require, preparers to measure the change in the entity's own credit risk as being the portion of the periodic change in fair value that is not due to changes in a base market rate such as a risk-free interest rate. A reporting entity will be able to use an alternative method if it believes it to be a more faithful measurement of the change in credit risk for the entity.

Disclosures

The following chart illustrates the ASU's new disclosure requirements:

Item	Required Disclosures
All financial assets and liabilities	All financial assets and liabilities grouped by measurement category and form of financial assets (e.g. loans, debt securities, equity securities) – public companies must use exit price notion for measurement of fair value
Financial instruments not recognized at fair value	<ul style="list-style-type: none"> • Public business entities are required to disclose fair value either on the face of the balance sheet or in the notes • The fair value hierarchy level within which the fair value measurement is categorized (Levels 1, 2, or 3)
Practicability exception for cost-method investments	<ul style="list-style-type: none"> • The carrying amount of investments without readily determinable fair values measured using the practicability exception • The total amount of adjustments resulting from impairment • The total amount of adjustments resulting from changes in observable prices

Item	Required Disclosures
Transition requirements	<ul style="list-style-type: none">• The nature and reason for the change in accounting principle, including an explanation of the newly adopted accounting principle• The method of applying the adoption• 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• The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position

What should you do now?

Eliminating the ability to record marketable equity securities at fair value through other comprehensive income will increase earnings volatility for many companies. Accordingly, a plan to communicate the anticipated impact to further earnings should be developed and tailored specifically for investors, analysts, shareholders and other interested parties. If you have questions about how this may impact your company, please contact us at 800.900.1131.

The ASU can be downloaded from the FASB website by clicking [here](#).

This Alert is provided by RGP strictly for informational purposes only. It does not constitute or contain legal or other professional advice and is provided without representation or warranty.

RGP is instant agility. We are proven problem solvers who give you the help you need, when and how you need it. We expand your capacity and increase your capability to help you drive business forward.

Learn more about us in 30 seconds.