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ACCOUNTING STANDARDS UPDATE (ASU) 2016-01

FINANCIAL INSTRUMENTS - OVERALL (SUBTOPIC 825-10) RECOGNITION AND MEASUREMENT OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

Executive Summary

- Equity investments measured at fair value are no longer classified as either available-for-sale securities or trading securities.
- Changes in the fair value for equity investments that are measured at fair value are recognized in net income rather than in other comprehensive income.
- There are no changes to the classification or measurement of investments in debt securities.
- The cost method for equity investments without readily determinable fair values for which the investor does not exert significant influence over the investee is eliminated and replaced with a new measurement alternative option.
- Under the measurement alternative, equity investments without readily determinable fair values may now be measured at cost less impairment plus or minus changes resulting from observable price changes in orderly transactions for identical or a similar securities of the same issuer.
- This ASU eliminates the disclosure requirement for non-public business entities to disclose the fair value of financial instruments measured at amortized cost; however, this ASU retains this disclosure requirement for public business entities.
- ASU 2016-01 requires separate presentation of financial assets and financial liabilities by measurement category and form on the balance sheet and in the footnotes.
- The amendments in this ASU require separate presentation in other comprehensive income for the change in fair value resulting from instrument-specific credit risk of liabilities measured using the fair value option.

Why Is It Being Issued?

The Financial Accounting Standards Board stated that the reason for the release of this ASU was to improve the reporting model for financial instruments citing a desire to further converge with the International Accounting Standards Board, specifically with International Financial Reporting Standards 9 – Financial Instruments.[1] Full convergence was not achieved, and ASU 2016-01 only represents targeted improvements to accounting for financial instruments.

Who Is Impacted?

ASU 2016-01 impacts organizations that hold financial assets or financial liabilities measured at fair value and addresses the measurement, recognition, presentation and disclosure of such instruments.

Effective Dates And Transition Type

For public business entities, the amendments went into effect for fiscal years beginning after December 15, 2017, including interim periods within those years. Non-public business entities, including not-for-profit entities and employee benefit plans, are required to adopt the provisions of ASU 2016-01 for fiscal years beginning after December 15, 2018 and interim periods within fiscal years beginning after December 15, 2019.[2]

The amendments contained within ASU 2016-01 should be adopted with a cumulative effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The amendments related to equity investments without readily determinable fair values should be adopted prospectively.[3]

Main Provisions

The amendments in ASU 2016-01 require all equity investments, except those accounted for under the equity method of accounting or those that result in consolidation, to be measured at fair value with changes in fair value recognized in net income.[4] Previously, equity investments measured at fair value were classified as either trading securities with changes in fair value recognized through net income or available-for-sale securities with changes in fair value deferred in other comprehensive income and accumulated in accumulated other comprehensive income until the security was sold. Debt securities may still be classified as available-for-sale with changes in fair value deferred in other comprehensive income and accumulated in accumulated other comprehensive income until the security is sold.

Equity investments that do not have readily determinable fair values are measured using a new measurement alternative. The measurement alternative measures qualifying investments without readily determinable fair values at cost minus impairment plus or minus changes resulting from observable price changes in orderly transactions for the same or similar securities of the same issuer.[5] Previously under legacy guidance, investments in which an entity does not have the ability to exert significant influence over the operating and financial policies of the investee and for which there is not a readily determinable fair value were accounted for under the cost method of accounting. Under the cost method, an entity's investment is initially recorded as an investment in the units of the investee at cost. Dividends distributed by the investee from net accumulated earnings of the investee are recognized net income. Dividends received in excess of the investor's share of investee earnings are recorded as reductions of the cost of the investment.

ASU 2016-01 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, an entity is required to measure the equity investment at fair value.[6] Previously, investments without a readily determinable fair value were subject to the other-than-temporary impairment model. Under ASU 2016-01, the qualitative assessment of impairment for equity investments without readily determinable fair values is performed similarly to that of long-lived assets, goodwill and indefinite-lived intangible assets.[7] If it is qualitatively determined that impairment exists, the impairment charge is the difference between the carrying value and fair value.

ASU 2016-01 removes the requirement to disclose the fair value of financial assets and liabilities measured at amortized cost for non-public entities,[8] meaning that fair value disclosures of financial liabilities such as debt are no longer required. This disclosure requirement is retained for public business entities; however, ASU 2016-01 eliminates the requirement for public business entities to disclose the methods and assumptions to estimate the fair value of financial instruments measured at amortized cost.

ASU 2016-01 requires public business entities to use the exit price notion when disclosing the fair value of financial instruments measured at amortized cost.[9] Previously, public business entities were provided an option to either use the exit price notion or the entry price notion when disclosing the fair value of financial instruments measured at amortized cost.[10]

When an entity has elected the fair value option for financial liabilities, any changes in fair value that result from a change in the instrument-specific credit risk is required to be presented in other comprehensive income.[11] The rationale for this change to financial liabilities for which the fair value option has been elected

is that any changes in fair value attributed to instrument-specific credit risk should not unduly influence net income. When the financial liability is derecognized, the amounts attributed to credit risk recorded in accumulated other comprehensive income are recognized in net income.

ASU 2016-01 requires separate presentation in the balance sheet of financial assets and liabilities by measurement category. Financial assets must be further disaggregated by form for presentation in the balance sheet or in the footnotes.[12]

Deferred tax assets created from timing differences related to available-for-sale debt securities must be subject to a valuation allowance analysis in the same manner as a valuation allowance analysis for any other deferred tax asset.[13] This means that entities may no longer support the realizability of the deferred tax assets attributed to available-for-sale debt securities based solely upon the ability and intent to hold the debt securities until maturity. Under ASC 740, Income Taxes, the realizability of a deferred tax asset depends on whether there is sufficient taxable income that will be offset by the deferred tax asset in either the carryback or carryforward period.

Endnotes

1 Financial Accounting Standards Board, Accounting Standards Update 2016-01, Financial Instruments - Overall (Subtopic 825-10) Recognition and Measurement of Financial Assets and Financial Liabilities, January 2016
2 Ibid.
3 Ibid.
4 Ibid.
5 Ibid.
6 Ibid.
7 Ibid.
8 Ibid.
9 Ibid.
10 Ibid.
11 Ibid.
12 Ibid.
13 Ibid.

Our Thoughts On

The changes required by ASU 2016-01 will impact entities holding financial assets and financial liabilities. Those entities holding equity investments measured at fair value that were previously classified as available-for-sale securities under legacy guidance will see a significant impact, because cumulative unrealized activity on these investments will be recognized in retained earnings as part of the transition adjustment, and current-year unrealized activity will be recognized in net income. Entities holding equity investments without readily determinable fair values will also see potential earnings changes as a result of the new measurement alternative.

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