ABDO EICK & MEYERS LLP

Certified Public Accountants & Consultants

Quick Reference Guide

Accounting Standard Update 2016-01

"Financial Instruments – Overall: Recognition and Measurement of Financial Assets and Financial Liabilities"

Why do I need this Quick Reference Guide?

As you may know, the Financial Accounting Standards Board routinely releases new accounting standards. Trying to determine how each of these will impact your organization can be a frustrating challenge, to say the least. The release of this particular update, Accounting Standard Update 2016-01, is significant because it amends generally accepted accounting principles—and it could dramatically alter the way you do business.

To help you better understand ASU 2016-01 and the changes it will trigger, we've assembled this Quick Reference Guide. We hope you find it helpful as you prepare for the year ahead. As always, we're here to answer any questions you may have.

Facts about ASU 2016-01

- Issued in 2016 as the completion of the first phase in a three-phase plan of providing new guidance on financial instruments:

  Phase 1: Classification and measurement (ASU 2016-01)

  Phase 2: Impairment of financial instruments (ASU 2016-13, issued in June 2016)

  Phase 3: Hedge accounting (exposure draft released in Sept. 2016)

- Goals of the three phases:

  1) Convergence with international standards. (The ASU began as a joint project with the IASB.)
  2) Reduce the complexity of reporting financial instruments.
  3) Increase the usefulness of information provided in financial reporting about an entity's exposure to financial instruments.
  4) Address issues raised to FASB in regard to accounting for hedging activities.

- Includes eight provisions, but the main changes to current U.S. GAAP primarily affect accounting for equity investments, simplification of impairment testing, and the presentation and disclosure requirements for financial instruments.

When does it take effect?

- **Publicly owned entities:** Fiscal years beginning after Dec. 15, 2017 (2018 calendar year reporting)

- **Privately owned and nonprofit entities:** Fiscal years beginning after Dec. 15, 2018 (2019 calendar year reporting)

Which industries will be affected?

- Any entity that holds or owes financial liabilities, regardless of industry.

How will it impact my day-to-day activities?

- ASU 2016-01 has been summarized into the following eight provisions:

  1) Requires equity investments to be measured at fair value with changes in fair value recognized in net income.
  2) Simplifies the impairment assessment of equity investments without readily determinable fair values with a qualitative assessment.
  3) Eliminates the requirement to disclose fair value of financial instruments measured at amortized cost for non-public entities.
  4) Eliminates the requirement for public business entities to disclose method(s) and significant assumptions used to estimate the fair value of financial instruments measured at amortized cost on the balance sheet.
  5) Requires public companies to use the exit price notion when measuring fair value of financial instruments for disclosure purposes.
  6) Requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk. This applies to when an entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments.
  7) 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.
  8) Clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets.

Provision 1

Explanation

- Requires all equity investments to be measured at fair value with changes in fair value recognized in net income, with the following exceptions:
  - Equity investments accounted for under the equity method of accounting
  - Equity investments that result in consolidation of the investee
- For equity investments that do not have readily determinable fair values: an entity may choose to measure these investments 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.
- This provision is aligned with FASB's goal of increasing the usefulness of information provided by financial reporting about an entity's exposure to financial instruments.

Changes

- There will no longer be an available-for-sale (AFS) classification for equity investments.
- Debt investments may still be classified as AFS.

Disclosure Enhancements

- Companies are required to disclose gains/losses both realized and unrealized during the period.
- Additionally, for equity securities without readily determinable fair values carried at cost minus impairment, all of the following is required to be disclosed:
    - The carrying amount of investments
    - The amount of impairments and downward adjustments, if any, both annual and cumulative
    - The amount of upward adjustments, if any both annual and cumulative.
    - As of the date of the most recent statement of financial position, additional information, in narrative form, that is sufficient for financial statement users to understand the information used by the Company to reach the carrying amounts and upward/downward adjustments and observable price changes.

Provision 2

Explanation

- Simplifies the impairment assessment of equity investments without readily determinable fair values by requiring assessment for impairment qualitatively at each reporting period. That impairment assessment is similar to the qualitative assessment for long-lived assets, goodwill, and indefinite-lived intangible assets.
- Upon determining that impairment exists, an entity should calculate the fair value of that investment and recognize as an impairment in net income any amount by which the carrying value exceeds the fair value of the investment.
- This impairment assessment reduces the complexity of the other-than-temporary impairment guidance entities were required to follow before the issuance of this ASU, thereby reducing cost for preparers of the financial statements.

Changes

- At each reporting period, an entity that holds an equity security shall make a qualitative assessment considering impairment indicators to evaluate whether the investment is impaired. Impairment indicators that an entity considers include, but are not limited to, the following:
    - 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 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 an equity security without a readily determinable fair value is impaired, an entity shall include an impairment loss in net income equal to the difference between the fair value of the investment and its carrying amount. If the investment is deemed to be impaired after conducting the

evaluation required by the above paragraph, the entity shall estimate the fair value of the investment to determine the amount of the impairment loss.

- An entity may elect to measure an equity security without a readily determinable fair value (that does not qualify for the practical expedient to estimate fair value in accordance with paragraph 820-10-35-59) at its 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.
- An election to measure an equity security in accordance with the above guidance shall be made for each investment separately. Once an entity elects to measure an equity security in accordance with this method, the entity shall continue to apply the measurement guidance until the investment does not qualify to be measured in accordance with this paragraph (for example, if the investment has a readily determinable fair value or becomes eligible for the practical expedient to estimate fair value in accordance with paragraph 820-10-35-59).
- The entity shall reassess at each reporting period whether the equity investment without a readily determinable fair value qualifies to be measured in accordance with this paragraph.

Other info

- FASB decided to retain the one-step test for recognizing impairment of equity securities without readily determinable fair values in this update. FASB continues to consider the one-step method to be simpler and more likely to result in more decision-useful information for users of financial statements than the current two-step method. FASB also notes that the one-step method permits subsequent reversals of impairment losses in certain situations.

Provision 3

Explanation

- Eliminate the requirement to disclose the fair value of financial instruments measured at amortized cost for entities that are not public business entities.
- Non-public business entities are not required to apply the fair value of financial instruments disclosure guidance in the General Subsection of Section 825-10-50 (Financial Instruments Disclosure Section); that is, the fair value hierarchy, within which the fair value measurements are categorized, no longer needs to be made in tabular format.
- Non-public entities will still be required to disclose financial assets and financial liabilities separately, grouped by measurement category (e.g., fair value, amortized cost, etc.) and form of financial asset (e.g., loans, securities, etc.).
- This provision is aligned with FASB's goal to reduce the complexity of reporting financial instruments.

Changes

- Non-public companies will no longer need to report the level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (Level 1, 2, or 3).
- Non-public entities are still required to report significant concentrations related to credit risk arising from financial instruments, including the following:
    - Information about the (shared) activity, region or economic characteristic that identifies the concentration
    - The maximum amount of loss due to credit risk that, based on the gross fair value of the financial instrument, the entity would incur if parties to the financial instruments that make up the concentration failed to completely perform according to the contract and the collateral or other security.

Provisions 4 and 5

- Applicable only for public entities

Provision 6

Explanation

- This provision requires that changes in fair value of a liability reported using the fair value option are to be recognized in other comprehensive income when the fair value change relates to changes in the instrument-specific credit risk.
    - This would not apply to instruments required to be reported at fair value—i.e., derivative instruments.
    - Gains and losses will transfer to current earnings as the instruments are settled before maturity.
- Many felt that the changes in fair value of financial liabilities did not significantly impact the true performance of the entity, and therefore should not be included in current earnings.
- Preparers may segregate change in fair value between instrument specific credit risk and changes in the market rates, but are not required to do so.
- Preparers may use other methods that faithfully represent portions of fair value changes.

Disclosures Required

- For all liabilities, this information about changes in and effects of instrument-specific credit risk is required to be disclosed when an income statement is presented:
    - The amount of change of the fair value of the liability that relates to instrument specific credit risk during the period and cumulatively.
    - How gains and losses related to instrument specific credit risk were determined.
    - When a liability is settled during the period, the amount of gain or loss that was recognized in other comprehensive income that is now recognized in net income at settlement.

Provision 7

Explanation

- Financial assets and financial liabilities are required to be presented separately by measurement category and form on the balance sheet and accompanying notes.
    - Measurement category examples would be fair value or amortized cost.
    - Form would be debt, loan, or security.

Provision 8

Explanation/Changes

- Clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets.
- Applies only to debt securities, as these are the only type of securities that can be held as available for sale.

- The explanation of these requirements was moved in the codification from topic 320 to topic 740. (76)
- This change was made as FASB received feedback during the comment period noting that some entities were performing the evaluation for AFS securities, while other entities were not. FASB's is to improve consistency in reporting. (10)

Questions? We're here to help

We've assembled a task force charged with reviewing each standard and providing guidance for our clients, so please don't hesitate to call if you have questions. We can also help you prepare for whatever transitions need to happen within your business. When it comes to changes of this magnitude, it's never too early to plan ahead.