Classification and measurement of financial instruments – What to expect

At a glance

The FASB has substantially completed deliberations on its financial instruments—classification and measurement project. The new standard, expected to be issued later this year, makes only targeted changes to current GAAP, with the most significant change related to investments in equity instruments. Most of those investments will be required to be measured at fair value, with subsequent changes in fair value recognized in net income. No significant changes are expected to the classification and measurement guidance for investments in loans and debt securities.

The issuance date of the final standard will partly depend on whether the FASB chooses to align the effective date of the classification and measurement project with the effective date of the still to be completed impairment project.

In addition to the expected final guidance on classification and measurement, the FASB has just issued an exposure draft of proposed disclosures for hybrid financial instruments with bifurcated embedded derivatives.

Background

.1 The classification and measurement project is one component of the FASB’s financial instruments project. The project started as a joint project with the IASB, with an objective of improving the decision usefulness of financial statements by simplifying and harmonizing the accounting for financial instruments.

.2 The FASB’s most recent exposure draft, issued in February 2013, proposed significant changes to current U.S. GAAP guidance. As a result of significant negative feedback, particularly with respect to the “solely payments of principal and interest” criterion for classifying and measuring financial assets, the FASB decided to abandon that approach and instead pursue targeted amendments to current U.S. GAAP. As a result, convergence with the IASB will not be achieved.

Key provisions

.3 The decisions reached to date on the classification and measurement project are expected to impact the accounting for equity investments, financial liabilities under the fair value option, and the presentation and disclosure requirements for financial instruments. In addition, the FASB is expected to provide clarifying guidance for deferred tax assets resulting from unrealized losses on available-for-sale debt securities.
This *In depth* summarizes the FASB’s tentative decisions to date on the classification and measurement project.

**Equity investments**

All equity investments in unconsolidated entities that are not accounted for using the equity method of accounting will generally be measured at fair value through earnings. There will no longer be an available-for-sale classification for equity securities with readily determinable fair values.

**PwC observation:**

Eliminating the ability to record marketable equity securities (i.e., those with a readily determinable fair value) at fair value through other comprehensive income will increase earnings volatility for many companies. The FASB believes that fair value through earnings is the most appropriate measurement basis for equity investments not accounted for under the equity method, because their value will generally be realized through sale.

Some exceptions are expected to the fair value through earnings measurement requirement. Most notably, certain companies will be able to elect a practicability exception when measuring investments in certain equity securities that do not have a readily determinable fair value. If the practicability exception is elected, companies will record investments at cost, less impairment, and subsequently adjust for observable price changes (i.e., prices in orderly transactions for the identical investment or similar investment of the same issuer). This exception is for equity investments that do not qualify for the practical expedient in ASC 820-10-35-59, *Fair Value Measurement*, which allows the use of net asset value per share once certain conditions are met.

Once a reporting entity elects the practicability exception, it will need to perform an ongoing assessment of the investment to determine if an impairment has occurred. An impairment charge for the difference between the carrying amount and the fair value would be recognized in earnings when, based upon an assessment of various impairment indicators, the fair value of the investment is less than its carrying amount. There will be no other-than-temporary impairment model, and the recognition of an impairment will be considered a basis adjustment (i.e., not as a valuation allowance). Therefore, if there is a subsequent recovery in fair value, a previous impairment charge could not be reversed. However, the carrying amount of the investment would still need to be adjusted for any observable positive or negative price changes.

Although nonmarketable equity securities (i.e., those without a readily determinable fair value) are measured at cost, less impairment today, adjusting them to reflect any observable price changes under the practicability exception will increase the potential for earnings volatility. Nonetheless, companies will likely find the practicability exception helpful, as it will alleviate the challenges associated with gathering information necessary to determine fair value at every reporting date. The FASB’s discussions suggest that companies are not expected to perform an exhaustive search to identify observable prices under this exception. Instead, we expect that companies would only need to identify and use observable prices that they can reasonably be expected to know or that they can readily obtain (such as when there is a subsequent round of financing). The FASB is expected to clarify this point, and the concept of a “similar investment of the same issuer” in its implementation guidance.

Investment companies and broker dealers will not be permitted to elect the proposed practicability exception for investments in nonmarketable equity securities.
**Equity investments classification**

- **Does the equity investment represent an interest in a consolidated subsidiary or an interest in a consolidated VIE?**
  - Yes: Apply other GAAP
  - No

- **Is the entity a broker dealer in securities subject to Topic 940 or an investment company under Topic 946?**
  - Yes
  - No

- **Should the equity investment be accounted for under the equity method of accounting?**
  - Yes
  - No

- **Does the equity investment have a readily determinable fair value?**
  - Yes
  - No

- **Has the company elected to apply the practicability exception?**
  - Yes
  - No

* This exception is for equity investments that do not qualify for the practical expedient in ASC 820-10-35-59, *Fair Value Measurement*, which allows the use of net asset value per share once certain conditions are met.

**Loans and debt securities**

.9 No significant changes are expected to the classification and measurement guidance for investments in loans and debt securities. In addition, the guidance that requires embedded derivative features that meet certain criteria to be bifurcated and accounted for separately will be retained.

**Financial liabilities and the fair value option**

.10 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 proposed guidance, 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.

.11 The FASB will allow, but 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. The selected methodology will need to be disclosed.
PwC observation:
Although the FASB questioned the conceptual merit of assuming the change in fair value above a base market risk is attributable to a change in an entity’s own credit risk (i.e., a portion of that change may be attributable to other factors such as liquidity, etc.), it ultimately agreed to allow this approach to ease the burden on preparers.

The requirement to record the change in fair value due to an entity’s own credit risk in other comprehensive income represents a change from current U.S. GAAP and applies solely to financial liabilities that are being accounted for in accordance with the fair value option. This change does not impact other financial liabilities that are required to be measured at fair value with changes in fair value recognized in earnings, such as derivative liabilities.

.12 No significant changes are expected to the classification and measurement of liabilities that are not subject to a fair value option election.

Deferred tax
.13 Unrealized losses on available-for-sale debt securities are recognized in other comprehensive income and typically give rise to deferred tax assets. A valuation allowance is required to the extent any deferred tax asset is not realizable.

.14 The FASB is expected to require that these deferred tax assets be evaluated for realizability in combination with other deferred tax assets of an entity.

Presentation
.15 All companies will continue to follow the statement of financial position presentation requirements for financial instruments in current U.S. GAAP. However, the FASB decided that 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 will not apply to receivables and payables due within one year and demand deposit liabilities. The board concluded that the benefit to financial statement users of presenting such information did not justify the likely cost for nonpublic entities (i.e., entities other than public business entities) to obtain the necessary valuations.

.16 Public business entities will be required to provide fair value information for financial assets and liabilities based upon the exit price notion in ASC 820, Fair Value Measurement. This may represent a change in practice for some entities that had previously provided fair value information for loans using an entry price based upon their interpretation of the illustrative examples in ASC 825, Financial Instruments.
PwC observation:

The new guidance will remove the current financial statement classification categories for equity securities (i.e., trading and available for sale). This could impact a reporting entity’s process for determining the appropriate classification for cash flows arising from equity security transactions in the statement of cash flows. Currently, cash flows from purchases and sales of investments accounted for as trading securities under ASC 320, Investments – Debt and Equity Securities are classified as operating activities, whereas cash flows related to purchases and sales of investments accounted for as available-for-sale equity securities are classified as investing activities. However, because equity securities will no longer be classified as either trading or available for sale, companies may have to update their policies and procedures and related internal controls to determine how cash flows from equity securities should be classified for purposes of preparing the statement of cash flows.

Disclosures

.17 The new guidance will require new disclosures for financial instruments in addition to the disclosures required by current U.S. GAAP. These expected incremental disclosures are listed in the Appendix.

.18 Separately, on February 24, the FASB issued a proposed Accounting Standards Update (ASU) on hybrid financial instruments containing embedded derivatives for public comment. The proposed ASU would require certain additional disclosures by entities with hybrid financial instruments containing embedded derivatives that require bifurcation. The perceived need for these disclosures is a consequence of the FASB’s decision to retain the current guidance for bifurcating certain embedded derivatives from hybrid financial instruments. The intent of the proposed disclosures is to allow users to better understand the linkage between bifurcated embedded derivatives and the related host contracts. The proposed incremental disclosures are listed in the Appendix.

Transition

.19 The new guidance will require modified retrospective application to all outstanding instruments, with a cumulative effect adjustment recorded to opening retained earnings as of the beginning of the first period in which the guidance becomes effective. However, the practicability exception for equity securities without a readily determinable fair value will be available prospectively to eliminate the need for preparers to retrospectively identify any observable price changes that may have occurred in prior periods.

What’s next

.20 The FASB will discuss the effective date for its classification and measurement standard at a future meeting. The FASB has yet to decide whether to align the effective date with that of the anticipated impairment standard.

.21 Comments on the FASB’s proposed ASU on hybrid financial instruments are due by April 30, 2015. The Board hopes to issue a final standard by the end of June, 2015.
# Appendix – New disclosure requirements

## Classification and measurement project\(^1\)

<table>
<thead>
<tr>
<th>Required disclosures</th>
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<tbody>
<tr>
<td>All financial assets and liabilities</td>
<td>All financial assets and liabilities grouped by measurement category and form of financial assets (e.g., loans, securities).</td>
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</tbody>
</table>
| Financial instruments not recognized at fair value | - Public business entities are required to disclose fair value (based upon an exit price as defined in ASC 820, *Fair Value Measurement*) either on the face of the balance sheet or in the notes (except for demand deposit liabilities and receivables and payables due within one year)  
- The fair value hierarchy level within which the fair value measurement is categorized (Levels 1, 2, or 3) |
| Practicability exception for equity investments without readily determinable fair values | - 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 |
| Transition requirements | - 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 as of the beginning of the first reporting period in which the guidance is effective |

## Hybrid financial instruments containing embedded derivatives

<table>
<thead>
<tr>
<th>Proposed disclosures</th>
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</table>
| Embedded derivatives that have been bifurcated and accounted for separately from the host contract | - Carrying amount of the host contract and embedded derivative  
- Measurement attribute of the host contract (e.g., fair value, amortized cost) and embedded derivative (i.e., fair value)  
- Line item(s) within the balance sheet and income statement in which any embedded derivatives and related host contract are presented |

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\(^1\) These disclosures are incremental to those currently required under U.S. GAAP
Questions?

PwC clients who have questions about this In depth should contact their engagement partner. Engagement teams who have questions should contact the Financial Instruments team in the National Professional Services Group (1-973-236-7803).

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