



FASB Changes Accounting for Equity Investments and Financial Liabilities

The FASB issued a new accounting standard that will significantly change the income statement impact of equity investments held by an entity, and the recognition of changes in fair value of financial liabilities when the fair value option is elected.¹

Key Facts

- **Equity Investments with Readily Determinable Fair Values.** Entities must measure these equity investments at fair value and recognize changes in fair value in net income.
- **Equity Investments without Readily Determinable Fair Values.** Entities have the option to either measure these investments at fair value or at cost adjusted for changes in observable prices minus impairment. Changes in measurement under either alternative must be recognized in net income.
- **Financial Liabilities.** Entities that elect the fair value option for financial liabilities must recognize changes in fair value related to instrument-specific credit risk in other comprehensive income (OCI).
- **Deferred Taxes.** Entities must assess valuation allowances for deferred tax assets related to available-for-sale debt securities in combination with their other deferred tax assets.

Key Impacts

- **Net Income.** Because entities must recognize changes in the measurement of equity investments in net income, income statement volatility will increase.
- **Financial Liabilities.** Changes in an entity's credit risk will not affect earnings when the fair value option is elected.

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¹ FASB Accounting Standards Update 16-01, Recognition and Measurement of Financial Assets and Financial Liabilities, available at www.fasb.org.



The standard does not apply to equity method investments or investments in consolidated subsidiaries.

Equity Investments

The standard does not apply to equity method investments or investments in consolidated subsidiaries. It also does not affect certain industry standards, such as those that apply to broker-dealers or investment companies.

Equity Investments with Readily Determinable Fair Values

The standard requires equity investments that have readily determinable fair values to be measured at fair value through net income. Previously, entities would recognize changes in fair value of available-for-sale equity securities in OCI, and would recognize in net income impairment losses that were other-than-temporary.

Equity Investments without Readily Determinable Fair Values

Entities may measure equity investments without a readily determinable fair value at fair value with changes recognized in net income, or may elect a practicability exception.

Under the practicability exception, entities would report these equity investments at cost adjusted for changes in observable prices minus impairment. This could result in the carrying amount of an investment exceeding its cost. Changes in measurement must be recognized in net income.

Adjustments for Changes in Observable Prices. Regardless of whether impairment exists, the standard requires investments accounted for under the practicability exception to be adjusted for observable price changes. The observable prices must be obtained from orderly transactions for identical or similar investments issued by the same issuer.

Impairment. The standard requires a qualitative assessment of impairment indicators at each reporting period. If this assessment indicates that impairment exists, entities must adjust the carrying amount of the investments to their fair value and recognize an impairment loss in net income.

Entities that elect the practicability exception for equity investments must disclose the:

- Carrying amount of investments without readily determinable fair values;
- Annual and cumulative adjustments to the carrying value; and
- Information that they used to calculate the carrying amounts and adjustments resulting from observable price changes.

Background. Under current U.S. GAAP, equity investments without readily determinable fair values are reported at cost minus impairment. However, impairment losses are recognized only if they are considered other-than-temporary.



Entities will have to make qualitative judgments about impairment. They will need to create appropriate processes to identify and record observable price changes.

KPMG Observations

Entities will need to carefully consider the costs and benefits of electing the practicability exception. While it alleviates the need to determine the fair value at each reporting period, the practicability exception will require additional effort to:

- Identify observable transactions that are *known* or *reasonably knowable*;
- Determine whether observed transactions were orderly; and
- Determine whether observed transactions occurred for investments that are similar.

The standard indicates that entities do not need to conduct an exhaustive search for all observable price changes. However, the level of effort that will be required is a matter of judgment.

If there are orderly, observable transactions in the identical investment, the price is adjusted to the transaction price without considering other potential indications of fair value. As a result, entities may not be able to apply the same degree of judgment that they would use when determining a fair value measurement.

If there are no observable transactions in investments that are identical to an entity's investment, but an orderly transaction is observed in a similar investment, the entity must adjust the observed price for differences in rights and obligations between its investment and the similar investment.

Financial Liabilities

For entities that elect the fair value option for financial liabilities, the change in fair value that is attributable to instrument-specific credit risk must be recognized in OCI instead of net income.

Entities can define the change in fair value attributable to instrument-specific credit risk as the excess of the total change in fair value over the change in fair value attributable to changes in a base market rate, such as a risk-free rate. Entities could choose another method if it produces a faithful measurement and it is applied consistently.

Background. Under current U.S. GAAP, entities that measure financial liabilities at fair value using the fair value option recognize all changes in fair value in net income, including changes in fair value attributable to instrument-specific credit risk. Stakeholders told the FASB that higher net income that results from a deterioration in credit risk may be misleading.

Deferred Tax Assets

Entities will assess the need for a valuation allowance on a deferred tax asset related to available-for-sale debt securities in combination with their other deferred tax assets.

Background. This standard eliminates diversity in practice with respect to the valuation allowance on deferred tax assets related to available-for-sale debt securities. Some entities assess the valuation allowance on deferred tax assets related to available-for-sale debt securities separately from other deferred tax assets. Other entities perform the assessment for their deferred tax assets on a combined basis.

Disclosures

Entities that are not public business entities will not be required to disclose the fair value of financial instruments measured at amortized cost. Public business entities will still be required to do so, but no longer will have to disclose their methods and significant assumptions used to estimate those fair values.

Public business entities must use the exit-price notion when measuring the fair value of financial instruments for disclosure purposes. U.S. GAAP currently allows an entry price to be used to estimate fair values of certain instruments when a market price is not available.

For each period for which entities present the results of operations, they must disclose the portion of unrealized gains and losses that relates to equity investments held at the reporting date.

When Is the Standard Effective?

The standard is effective for public business entities for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. For all other entities, it is effective for fiscal years beginning after December 15, 2018, and interim periods in fiscal years beginning after December 15, 2019.

Early Adoption

Entities that are not public business entities may adopt the standard in fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.

Entities may early adopt the provisions related to the recognition of changes in fair value of financial liabilities. This includes financial statements of annual or interim periods that have not yet been issued or, for entities that are not public business entities, have not yet been made available for issuance. For example, if entities have not yet issued financial statements for fiscal 2015, they may apply these provisions in those financial statements. The provisions would be applied as of the beginning of the fiscal year.

In addition, entities that are not public business entities may early adopt the provisions of the standard that eliminate certain previously required disclosures. These provisions also would be applied to financial statements that have not yet been made available for issuance.

Transition

Entities must apply the standard using a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The provisions related to equity investments without a readily determinable fair value are applied prospectively to equity investments as of the adoption date.

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