



Financial instruments

**Recognition and measurement of
financial assets and financial liabilities**

US GAAP

October 2018



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Narrow amendments have driven meaningful change

What began as an ambitious project to overhaul the classification and measurement requirements for financial instruments evolved into a narrower scope project. While the accounting changes were ultimately limited to specific areas, that doesn't overshadow the significant changes within those areas.

Perhaps the biggest change is the measurement alternative for equity securities without a readily determinable fair value, which introduced a new concept into US GAAP – cost adjusted to fair value when there are observable transactions – with greater volatility in earnings. To date, the measurement alternative has been the biggest source of interpretive questions, which is reflected in the number of Q&As that we have dedicated to it. It has also been the area where changes to processes and controls have been the most significant relative to other changes in the standard.

Our purpose in this updated publication is to explain the changes from legacy US GAAP and help you gain an in-depth understanding of these requirements by answering the questions that we are encountering in practice.

Kimber Bascom and Mark Northan
Department of Professional Practice, KPMG LLP

About this publication

The purpose of this publication is to assist you in understanding the requirements of FASB Accounting Standards Update No. 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities.

The standard includes changes to the accounting for equity investments, the accounting for financial liabilities measured at fair value under the fair value option, the measurement of a valuation allowance for deferred tax assets related to available-for-sale debt securities, and the presentation of cash flows for equity securities.

Accounting literature

Unless otherwise stated, the discussion reflects both of the following Accounting Standards Updates:

- No. 2016-01, Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities
- No. 2018-03, Technical Corrections and Improvements to Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities

Organization of the text

Each chapter of this publication includes excerpts from the FASB's Accounting Standards Codification® and overviews of the relevant requirements. Our in-depth guidance is explained through Q&As that reflect the questions we are encountering in practice. We include examples to explain key concepts, and we explain the changes from legacy US GAAP.

Our commentary is referenced to the Codification and to other literature, where applicable. The following are examples.

- 321-10-55-9 is paragraph 55-9 of ASC Subtopic 321-10.
- ASU 2016-01.BC87 is paragraph 87 of the basis for conclusions to ASU 2016-01.

Pending content

In some cases, the Codification is subject to content that becomes effective after ASU 2016-01. When an excerpt from the Codification is affected by pending content:

- the specific sentences that have been superseded are struck out and the added text is underlined; and
- the amended sentences are included at the end of the excerpt, marked as pending content.

In addition, when a Codification reference relates to an amendment in ASU 2018-03, it is identified as pending content.

October 2018 update

This edition of our publication includes new and updated interpretations on a variety of topics.

New Questions and Examples added since our March 2018 edition are identified with ** and items that have been significantly updated or revised are identified with #.

Abbreviations

We use the following abbreviations in this publication.

AFS	Available-for-sale
AOCI	Accumulated other comprehensive income
OCI	Other comprehensive income

1. Executive summary

This publication discusses how the following standards affect the recognition and measurement of certain financial instruments for all entities:

- ASU 2016-01, [Technical Corrections and Improvements to Financial Instruments—Overall \(Subtopic 825-10\): Recognition and Measurement of Financial Assets and Financial Liabilities](#); and
- ASU 2018-03, [Technical Corrections and Improvements to Financial Instruments—Overall \(Subtopic 825-10\): Recognition and Measurement of Financial Assets and Financial Liabilities](#).

What changed?	What stayed the same?
<p>The key changes from legacy US GAAP relate to:</p> <ul style="list-style-type: none"> — the accounting for equity investments; — the accounting for financial liabilities measured at fair value under the fair value option; — the presentation and disclosure requirements for financial instruments; and — the measurement of deferred tax assets related to AFS debt securities. 	<p>These standards did not change the legacy classification and initial measurement guidance for loans and debt securities.</p> <p>The subsequent measurement basis for loans and debt securities continue to be amortized cost or fair value based on their classification.</p>

Equity investments with readily determinable fair values		
Legacy US GAAP	ASU 2016-01/2018-03	Impact
<p>Either:</p> <ul style="list-style-type: none"> — measured at fair value with changes in fair value recognized in OCI if classified as AFS; or — measured at fair value with changes in fair value recognized in net income if classified as trading (or if the fair value option was elected). 	<p>Measure at fair value with changes in fair value recognized in net income.</p>	<p>Greater volatility in earnings.</p>

Equity investments without readily determinable fair values		
Legacy US GAAP	ASU 2016-01/2018-03	Impact
Measured at cost less impairment (assuming that the fair value option has not been elected)	Either: <ul style="list-style-type: none"> — measure at fair value with changes in fair value recognized in net income; or — use the measurement alternative (cost +/- fair value changes when there are observable prices less impairment) 	<ul style="list-style-type: none"> — Greater volatility in earnings. — Greater judgment, development of new processes, procedures and controls. — Additional disclosures if the measurement alternative is elected.

Financial liabilities measured at fair value under the fair value option		
Legacy US GAAP	ASU 2016-01/2018-03	Impact
Recognized all changes in fair value in net income.	<ul style="list-style-type: none"> — Recognize changes in fair value due to instrument-specific credit risk in OCI. — Recognize all other changes in fair value in net income. 	<ul style="list-style-type: none"> — Addresses potentially counterintuitive results in which an entity reports a gain from an increase in its own credit risk, and a loss from a decrease in its own credit risk. — Judgment required when determining changes in fair value due to instrument-specific credit risk.

Deferred tax assets related to AFS debt securities		
Legacy US GAAP	ASU 2016-01/2018-03	Impact
Determined the need for a valuation allowance either: <ul style="list-style-type: none"> — in combination with other deferred tax assets; or — separately from other deferred tax assets. 	Determine the need for a valuation allowance in combination with other deferred tax assets.	Potential for recognizing an additional valuation allowance.

Disclosures about the fair value of financial assets and liabilities measured at amortized cost		
Legacy US GAAP	ASU 2016-01/2018-03	Impact
<ul style="list-style-type: none"> — All entities required to disclose the fair value of financial instruments measured at amortized cost. — Option to estimate the fair values of certain financial instruments for disclosure purposes using either the entry price or the exit price notion. — Public business entities required to disclose the methods and significant assumptions used to estimate the fair value of financial instruments measured at amortized cost. 	<ul style="list-style-type: none"> — No disclosures about the fair value of financial instruments measured at amortized cost required for non-public business entities. — The exit price notion should be used to estimate fair value for disclosures of all financial instruments. — No disclosure required of the methods and significant assumptions used in estimating the fair value of financial instruments measured at amortized cost. 	<ul style="list-style-type: none"> — Fewer disclosures. — All fair values measured on a consistent basis, providing users with comparable information. — Increased cost and effort to estimate fair value using exit price notion for financial instruments (e.g. loans) previously measured using an entry price notion.

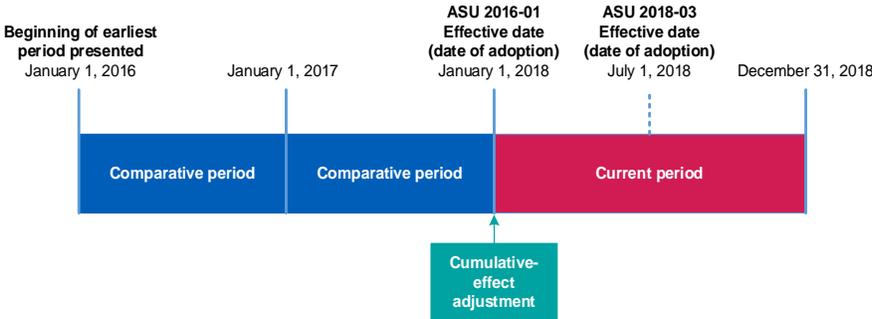
The standard and technical corrections are effective ...		
For ...	ASU 2016-01	ASU 2018-03 (technical corrections)
Public business entities:	<ul style="list-style-type: none"> — Annual and interim periods in fiscal years beginning after December 15, 2017. 	<ul style="list-style-type: none"> — Fiscal years beginning after December 15, 2017 and interim periods within those fiscal years beginning after June 15, 2018. — Entities with fiscal years beginning in the period between December 15, 2017 and June 15, 2018 are not required to adopt ASU 2018-03 until the interim period beginning after June 15, 2018.
All other entities:	<ul style="list-style-type: none"> — Annual periods in fiscal years beginning after December 15, 2018, and interim periods in fiscal years beginning one year later. 	<ul style="list-style-type: none"> — Annual periods in fiscal years beginning after December 15, 2018, and interim periods in fiscal years beginning one year later.

Early adoption is permitted in prescribed circumstances		
What may be early adopted?	By ...	In ...
ASU 2016-01 – Guidance on the recognition of changes in the fair value of financial liabilities measured at fair value under the fair value option.	All entities.	Any period for which financial statements have not yet been issued or made available for issuance.
ASU 2016-01 – Elimination of certain previously required disclosures of fair value in Section 825-10-50.	Entities other than public business entities.	Any period for which financial statements have not yet been made available for issuance.
The entire ASU 2016-01.	Entities other than public business entities.	Annual and interim periods in fiscal years beginning after December 15, 2017.
ASU 2018-03 (technical corrections)	Public business entities.	Immediately, including in an interim period.
	Entities other than public business entities that have not adopted ASU 2016-01.	Not permitted.
	Entities other than public business entities that have adopted ASU 2016-01.	Immediately, including in an interim period.

Retrospective transition approach with some relief
<p>ASU 2016-01</p> <ul style="list-style-type: none"> — In general, the standard should be applied using a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. — Prospective application for equity investments without a readily determinable fair value for which the measurement alternative was elected (see Question 5.3.10). <p>ASU 2018-03 (technical corrections)</p> <ul style="list-style-type: none"> — ASU 2018-03 should be applied using a cumulative-effect adjustment to the balance sheet. The adjustment should be determined as of the beginning of the fiscal year of adoption, even if ASU 2018-03 is adopted in an interim period. — See Appendix for further discussion of transition considerations for an entity that adopts ASU 2016-01 and the amendments in ASU 2018-03 on different dates.

Example adoption dates

If a calendar year-end public business entity adopts the standard and technical corrections in accordance with the mandatory effective dates, the following are the relevant dates.



2. Equity securities

Detailed contents

New item added to this chapter: **
Item significantly updated in this chapter: #

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- 2.2.15 Are investments in qualified affordable housing projects previously accounted for under the cost method in the scope of Topic 321? **
- 2.2.20 Is an equity instrument that does not meet the definition of a security in the scope of Topic 321?
- 2.2.30 Are investments in contracts to acquire or sell equity instruments, such as options and forward contracts, in the scope of Topic 321?
- 2.2.40 Is preferred stock in the scope of Topic 321?
- 2.2.50 How should a bank account for its investment in Federal Home Loan Bank and Federal Reserve Bank stock?

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- 2.3.180 How does Topic 321 change the legacy guidance on impairment of equity securities without a readily determinable fair value?
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- 2.3.07 Observable transaction price obtained before financial statements are issued **
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- 2.3.20 Treatment of previously capitalized transaction costs when an observed transaction occurs

2.1 How the standard works

Equity investments with readily determinable fair values	
Legacy US GAAP	ASU 2016-01/2018-03
<p>Either:</p> <ul style="list-style-type: none"> — measured at fair value with changes in fair value recognized in OCI if classified as AFS; or — measured at fair value with changes in fair value recognized in net income if: <ul style="list-style-type: none"> — classified as trading; or — the fair value option was elected. 	<p>Measure at fair value with changes in fair value recognized in net income.</p>

Equity investments without readily determinable fair values	
Legacy US GAAP	ASU 2016-01/2018-03
<p>Measured at cost less impairment (assuming that the fair value option has not been elected).</p>	<p>Either:</p> <ul style="list-style-type: none"> — measure at fair value with changes in fair value recognized in net income; or — use the measurement alternative (cost +/- fair value changes when there are observable prices less impairment)

2.2 Scope



Excerpt from ASC 321-10

> Instruments

15-4 The guidance in the Investments—Equity Securities Topic establishes standards of financial accounting and reporting for investments in **equity securities** and other ownership interests in an entity, including investments in partnerships, unincorporated joint ventures, and limited liability companies as if those other ownership interests are equity securities.

15-5 The guidance in this Topic does not apply to any of the following:

- a. Derivative instruments that are subject to the requirements of Topic 815, including those that have been separated from a host contract as required by Section 815-15-25. If an investment otherwise would be in the scope of this Topic and it has within it an embedded derivative that is required by that Section to be separated, the host instrument (as described in that Section) remains within the scope of this Topic.

- b. Investments accounted for under the equity method (Topic 323).
- c. Investments in consolidated subsidiaries.
- d. An exchange membership that has the characteristics specified in paragraph 940-340-25-1(b) for an ownership interest in the exchange.
- e. Federal Home Loan Bank and Federal Reserve Bank Stock (Subtopic 942-325).

15-6 Paragraph 815-10-15-141 explains that the guidance in the Certain Contracts on Debt and Equity Securities Subsections applies to those forward contracts and purchased options that are not derivative instruments subject to Topic 815 but that involve the acquisition of securities that will be accounted for under Topic 321.

20 Glossary

Equity security – Any security representing an ownership interest in an entity (for example, common, preferred, or other capital stock) or the right to acquire (for example, warrants, rights, forward purchase contracts, and call options) or dispose of (for example, put options and forward sale contracts) an ownership interest in an entity at fixed or determinable prices. The term equity security does not include any of the following:

- a. Written equity options (because they represent obligations of the writer, not investments)
- b. Cash-settled options on equity securities or options on equity-based indexes (because those instruments do not represent ownership interests in an entity)
- c. Convertible debt or preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor.



Question 2.2.10#

Are all equity instruments in the scope of Topic 321?

Interpretive response: No. The following equity instruments are outside of the scope of Topic 321: [321-10-15-5, 323-740-25-2 – 25-2A]

- investments in consolidated subsidiaries;
- investments that are accounted for under the equity method;
- derivative instruments that are accounted for under Topic 815;
- exchange memberships that have the characteristics specified in paragraph 940-340-25-1(b) for an ownership interest in the exchange;
- stock issued by the Federal Home Loan Bank and Federal Reserve Bank;
- and
- investments in qualified affordable housing projects. See Question 2.2.15 for further discussion on investments in qualified affordable housing projects accounted for under the cost method before ASU 2016-01.

Certain types of preferred stock are also outside the scope of Topic 321. See further discussion in [Question 2.2.40](#).



Question 2.2.15**

Are investments in qualified affordable housing projects previously accounted for under the cost method in the scope of Topic 321?

Interpretive response: No. If a limited partnership investment in a qualified affordable housing project does not qualify for the proportional amortization method (or the proportional amortization method is not elected), it is accounted for under Subtopic 970-323 (real estate – equity method and joint ventures). Before ASU 2016-01, an investor with virtually no influence accounted for its investment under a modified cost method, as illustrated in Subtopic 323-740. [323-740-25-2, 323-30-S99-1, 970-323-25-5 – 25-6]

There is conflicting guidance about whether an investment in a qualified affordable housing project previously accounted for under the cost method is in the scope of Topic 321.

- Subtopic 970-323 indicates that a real estate investor with virtually no influence over a partnership investee should account for its investment under Topic 321. This would prohibit applying the cost method.
- However, specific guidance permitting the cost method was added to 323-740 by ASU 2016-01, and an illustration of the modified application of the cost method was retained in 323-740.

As a result, we believe that the FASB's intent was to continue to allow the modified cost method for qualified affordable housing investors with virtually no influence that do not apply the proportional amortization or equity methods. [323-740-25-2A, 323-740-55-7]



Question 2.2.20

Is an equity instrument that does not meet the definition of a security in the scope of Topic 321?

Interpretive response: Yes. The standard does not distinguish between equity securities and other types of equity ownership interests. However, this publication generally refers to 'equity security' for ease of reference. [321-10-15-4]



Question 2.2.30

Are investments in contracts to acquire or sell equity instruments, such as options and forward contracts, in the scope of Topic 321?

Interpretive response: It depends. Topic 321 does not apply to derivative contracts that are subject to the requirements of Topic 815 (derivatives and hedging). However, investments in contracts not subject to Topic 815 that provide an entity with the right to acquire or dispose of an ownership interest in another entity at fixed or determinable prices are in the scope of Topic 321. [321-10-15-6, 321-20 Glossary]

This means that share-settled contracts such as warrants, purchased call options, forward purchase contracts, purchased put options and forward sale contracts are in the scope of Topic 321 if they are outside the scope of Topic 815. However, written options are not in the scope of Topic 321 because they are considered to be obligations of the writer, not investments.

In addition, contracts to buy equity instruments that, once acquired, will be outside of the scope of Topic 321 (e.g. investments that will be accounted for under the equity method) are outside of the scope of Topic 321. [\[321-10-15-6, 321-20 Glossary\]](#)

 **Question 2.2.40**
Is preferred stock in the scope of Topic 321?

Interpretive response: It depends on whether the preferred stock meets the definition of a debt security or an equity security. The legal form of an instrument does not always determine whether a security should be accounted for as an equity security (in the scope of Topic 321) or a debt security (outside the scope of Topic 321).

The master glossary definition of equity security specifically excludes preferred stock that, by its terms, either must be redeemed by the issuing entity or is redeemable at the option of the investor. Such preferred stock meets the definition of a debt security and is in the scope of Subtopic 320-10. On adoption of ASU 2016-13, these securities will be in the scope of Subtopic 326-20 (if classified as held-to-maturity) or Subtopic 326-30 (if classified as AFS). [\[320-10 Glossary, 321-10 Glossary\]](#)

We believe that for a preferred share that is redeemable at the option of the investor to be classified as a debt security (outside the scope of Topic 321), the investor must have the unilateral ability to redeem its investment. Additionally, the investor’s determination of whether an investment in preferred stock meets the definition of a debt or equity security will not necessarily align with the issuer’s balance sheet classification. For example, there may be instances where the investor will conclude that its investment in a preferred share meets the definition of a debt security, while the issuer classifies the preferred share as equity (e.g. temporary equity) in its financial statements.

The following illustrates different preferred stock redemption options, the investor’s associated classification, and whether we believe the security is in the scope of Topic 321.

Redemption option	Classification
Redemption option is currently exercisable by the investor.	Debt security (outside the scope of Topic 321)
Redemption option is time-based – i.e. it will become exercisable by the investor following the passage of time.	Debt security (outside the scope of Topic 321)

Redemption option	Classification
Redemption option will become exercisable by the investor upon the occurrence of a contingent event that is outside the investor's control.	Equity security (in the scope of Topic 321)



Example 2.2.10 Preferred stock

ABC Corp. owns 10% of the outstanding preferred stock of Company XYZ. If there is a change in control of XYZ, all of the preferred shareholders may elect to redeem the preferred stock for cash. There are no other mandatory or optional redemption features. A change in control has not yet occurred.

ABC accounts for its preferred stock as an equity security in the scope of Topic 321 because XYZ is not required to redeem the stock and ABC cannot unilaterally cause redemption of the stock.



Question 2.2.50 How should a bank account for its investment in Federal Home Loan Bank and Federal Reserve Bank stock?

Interpretive response: Although Federal Home Loan Bank and Federal Reserve Bank stock is an equity interest, it is explicitly outside the scope of Topic 321. An investment in Federal Home Loan Bank and Federal Reserve Bank stock is measured at cost and evaluated for impairment based on the bank's expectation of the ultimate recoverability of the stock's cost basis.
[\[321-10-15-5, 942-325-35\]](#)

2.3 Applying the measurement alternative



Excerpt from ASC 321-10

>> Equity Securities Without Readily Determinable Fair Values

35-2 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 this paragraph shall be made for each investment separately. Once an entity elects to measure an equity security in accordance with this paragraph, the entity

shall continue to apply the measurement guidance in this paragraph 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. If an entity measures an equity security in accordance with this paragraph (and the security continues to qualify for measurement in accordance with this paragraph), the entity may subsequently elect to measure the equity security at fair value. If an entity subsequently elects to measure an equity security at fair value, the entity shall measure all identical or similar investments of the same issuer, including future purchases of identical or similar investments of the same issuer, at fair value. The election to measure those securities at fair value shall be irrevocable. Any resulting gains or losses on the securities for which that election is made shall be recorded in earnings at the time of the election.

20 Glossary

Orderly Transaction – A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).

Pending Content

Transition Date: (P) December 16, 2017; (N) December 16, 2018 | Transition Guidance: 825-10-65-3

35-2 ... If an entity measures an equity security in accordance with this paragraph (and the security continues to qualify for measurement in accordance with this paragraph), the entity may subsequently elect to measure the equity security at fair value. If an entity subsequently elects to measure an equity security at fair value, the entity shall measure all identical or similar investments of the same issuer, including future purchases of identical or similar investments of the same issuer, at fair value. The election to measure those securities at fair value shall be irrevocable. Any resulting gains or losses on the securities for which that election is made shall be recorded in earnings at the time of the election.

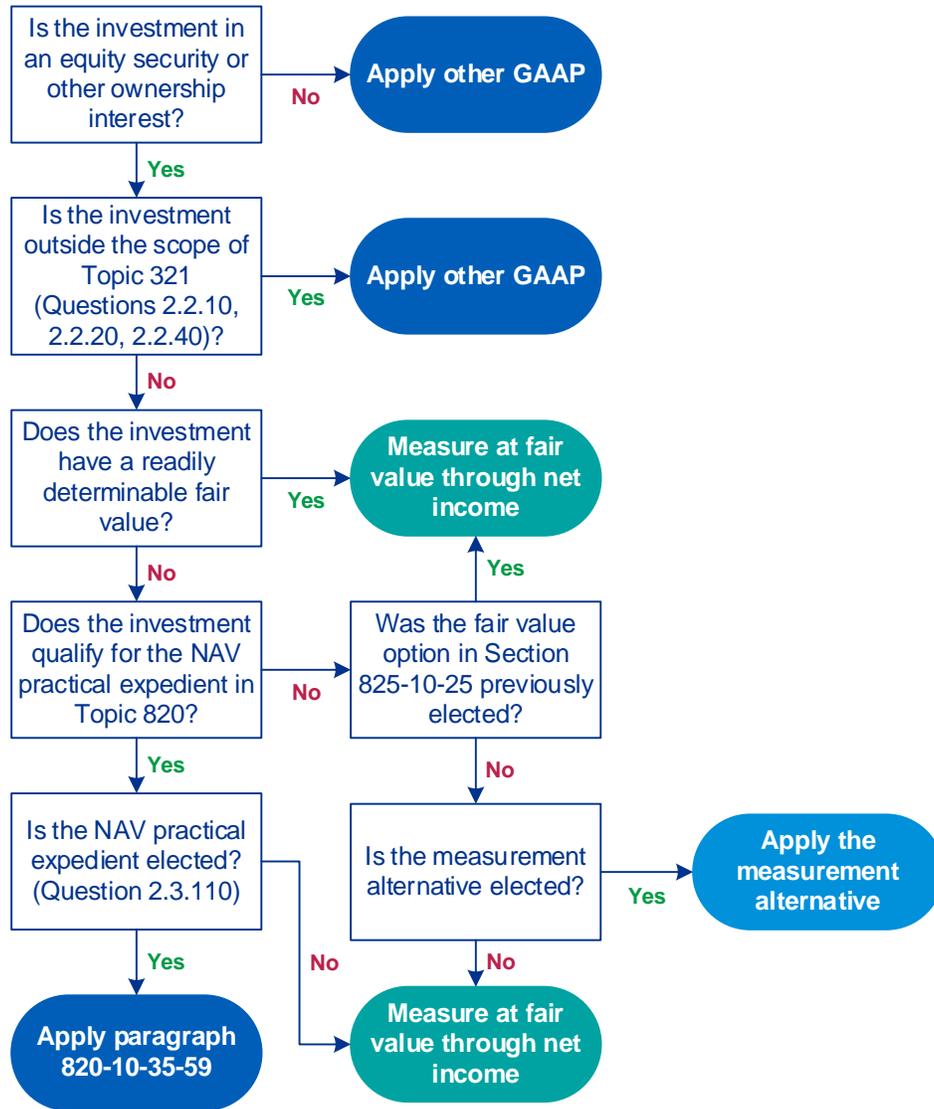
2.3.10 Overview



Question 2.3.10

Which investments are eligible for the measurement alternative?

Interpretive response: The following flowchart highlights the steps involved in analyzing whether an equity investment is eligible for the measurement alternative.



Based on discussions with the FASB staff, we understand that an entity cannot elect the measurement alternative for equity investments without a readily determinable fair value on adoption of the standard if, before adoption, it had elected the fair value option under section 825-10-25.

Paragraph 825-10-25-2 states that the decision about whether to elect the fair value option is irrevocable unless a new election date occurs (as discussed in paragraph 825-10-25-4). A new election date under this paragraph is not created by the adoption of a new accounting standard. Therefore, if an entity previously elected the fair value option under section 825-10-25, the election survives the adoption of the new standard and the entity continues to record the equity investment at fair value through earnings. [825-10-25-2, 25-4]



Question 2.3.20

Is there a difference between 'readily determinable' fair value and the definition of the same term used to determine whether an equity investment is in the scope of Topic 320?

Interpretive response: No. The definition of readily determinable fair value was not changed by ASU 2016-01. As a result, we believe equity securities classified as AFS or trading under Topic 320 are not eligible to apply the measurement alternative under paragraph 321-10-35-2.



Question 2.3.25**

Does a restriction on the sale or transfer of an investment impact whether the equity security has a readily determinable fair value?

Interpretive response: It depends. If the equity security would otherwise have a readily determinable fair value, we believe that whether the restriction would cause the security to not have a readily determinable fair value depends on the nature and duration of the restriction.

Nature of restriction

The nature of the restriction(s) affects whether the restriction is considered in measuring fair value.

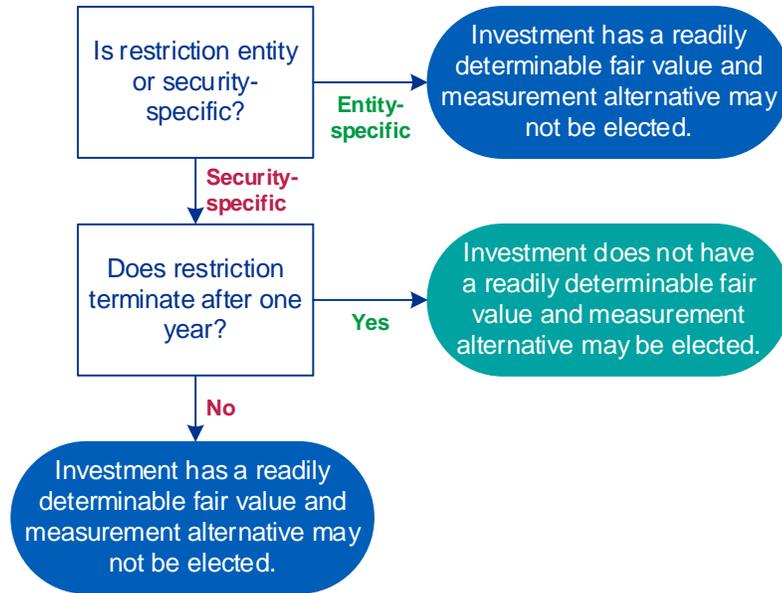
- If the restriction is security-specific, the fair value of the restricted security would generally include an adjustment to the quoted price of similar but unrestricted securities.
- However, for entity-specific restrictions, the price of the restricted security should not be adjusted because the restriction is not considered to be an attribute of the asset being valued.

If a restriction is not considered in measuring fair value, we believe it should not affect the determination of whether the equity security has a readily determinable fair value.

Duration of restriction

If a security-specific restriction terminates within one year, the equity security has a readily determinable fair value. [820-10-15-5]

If a security without the restriction would otherwise have met the definition of having a readily determinable fair value, the following flowchart indicates the sequence of questions to determine whether the measurement alternative may be elected.



For more information on determining if a restriction is security- or entity-specific, see Question C40 in KPMG’s [Q&A: Fair value measurement](#).

Question 2.3.30 What documentation is required to support an entity’s election to use the measurement alternative?

Interpretive response: The standard does not prescribe how an entity should document its election.

We expect an entity to document its election to use the measurement alternative concurrently with its decision to elect this option. Paragraph 321-10-35-2 requires an entity that elects the measurement alternative to do so separately for each investment. We believe an entity may choose to separately document its election for each eligible investment, or may document the election as part of a policy that applies to specific investments and that includes sufficient criteria to determine which investments are subject to the election.

Question 2.3.40 May an entity elect the measurement alternative after initial recognition of an equity security?

Interpretive response: Only in limited circumstances. We believe the election to apply the measurement alternative is available only:

- at initial recognition of an equity security without a readily determinable fair value;
- when the fair value of an equity security ceases to be readily determinable;
- or

- when an existing investment without a readily determinable fair value initially becomes subject to Topic 321 – e.g. if an investment no longer qualifies to be accounted for under the equity method.
-



Question 2.3.55

When applying the measurement alternative, does Topic 820 apply when observable price changes are identified?

Interpretive response: Yes. Under the measurement alternative, the equity security is measured at cost plus or minus changes resulting from observable prices in orderly transactions for the identical or a similar investment of the same issuer, less impairment (if any). [321-10-35-2]

We understand that when the measurement alternative is applied and a transaction price is observed for the identical or similar security, the FASB staff believes that the equity security should be measured at fair value under the guidance in Topic 820 – as opposed to recording an adjustment based solely on the observed transaction price. Therefore, an entity is required to adjust the carrying amount of the security to reflect its fair value at the date that the observable transaction for the identical or similar security took place – i.e. the measurement date.

Judgment is required to determine what (if any) adjustments should be made to the observed transaction price.

For further discussion of potential adjustments an entity would make to the observed transaction price when measuring fair value under guidance in Topic 820, see [Question 2.3.150](#).

An entity should provide the disclosures required by Topic 820 for assets and liabilities that are measured at fair value on a nonrecurring basis, including equity securities accounted for under the measurement alternative. These disclosures include the valuation techniques and inputs used to develop those measurements. This requires consideration of unobservable inputs used in the fair value measurement and the corresponding levels in the fair value hierarchy. The fair value disclosures are required only when a transaction price is observed for the identical or similar security, or when an impairment is recognized.

We expect that the FASB staff's view may require some entities to revise their existing policies with respect to the implementation of ASU 2016-01 to include consideration of the guidance in Topic 820.

See KPMG's [Q&A: Fair value measurement](#) for additional guidance on fair value measurement.



Question 2.3.60

When applying the measurement alternative, what adjustments are made when no observable prices are available during a reporting period?

Interpretive response: If an entity applies the measurement alternative and there are no observable prices available during a reporting period, no adjustment is made to the carrying amount of the equity security (assuming there is no impairment). Even if there are no observable prices, an entity still needs to assess the security for impairment.



Question 2.3.70#

When applying the measurement alternative, in what period should an entity adjust the carrying amount of an equity security?

Interpretive response: It depends. If an observable transaction takes place before the end of the reporting period, but the entity only becomes aware of the transaction price after the end of the reporting period, the period in which the carrying amount is adjusted depends on whether:

- the entity's financial statements have been issued; and
- the entity is able to demonstrate it made a reasonable effort to identify observable transactions in the period in which the observable transaction took place.

Financial statements have not been issued for the previous reporting period

If the entity identifies an observable transaction before issuance of the financial statements for the previous reporting period, and the observable transaction took place in the previous reporting period, we believe the carrying amount of the equity security should be adjusted in those financial statements.

Under Subtopic 855-10 (subsequent events), the entity's receipt of information about an observable transaction price represents a recognized subsequent event. As a result, the financial statements for the previous reporting period (i.e. the period in which the transaction occurred) should include the effect of the observed transaction price.

Financial statements have been issued for the previous reporting period

If the entity is able to demonstrate it used reasonable efforts in the previous reporting period, but didn't identify the transaction in question, we believe the carrying amount of the equity security should be adjusted in the current period – i.e. the period in which the entity became aware of the transaction in the equity security.

Alternatively, if the entity is not able to demonstrate it made a reasonable effort to identify observable transaction prices before the issuance of the financial statements for the previous reporting period, we believe the adjustment should be considered to be a correction of a prior period error under Topic 250 (accounting changes and error corrections).



Example 2.3.07* *

Observable transaction price obtained before financial statements are issued

In January 1, Year 1, ABC Corp. invests in common shares issued by Company XYZ. The common shares do not have a readily determinable fair value and ABC elects to measure its investment using the measurement alternative.

In January, Year 2 (before issuance of Year 1 financial statements), ABC obtains transaction price information for a third-party sale of identical shares of XYZ. The observable transaction took place in November, Year 1. ABC determines that the fair value of XYZ shares as of November Year 1 was different from ABC's cost basis. ABC is unaware of any subsequent observable transactions in these shares.

Because ABC identified the observable price before issuing the Year 1 financial statements, it adjusts the carrying amount of its investment in XYZ in its Year 1 financial statements. The carrying amount is adjusted to equal the fair value as of November Year 1 (i.e. the measurement date). ABC also makes a qualitative assessment considering impairment indicators to evaluate whether the investment is impaired.



Example 2.3.10

Observable transaction price obtained after financial statements were issued

ABC Corp. is a calendar year-end company that invests in common shares issued by Company XYZ in January Year 1. The common shares do not have a readily determinable fair value and ABC elects to measure its investment using the measurement alternative.

When preparing its Year 1 financial statements, ABC demonstrated that it used reasonable efforts to identify whether there were any transactions in the identical or similar security of XYZ. ABC did not become aware of any transactions before it issued its Year 1 financial statements.

In December Year 2, ABC becomes aware of a sale in November Year 1 of the identical shares of XYZ. The fair value of XYZ shares as of November Year 1 was different from ABC's cost basis. ABC is unaware of any other observable transactions in these shares.

Because ABC used reasonable efforts to identify observable prices before the Year 1 financial statements were issued, it should adjust the carrying amount of its investment in XYZ's common shares in the period in which it identifies the observable transaction.

As a result, ABC takes the following actions. [\[321-10-35-3\]](#)

- It adjusts the carrying amount of the security to equal the fair value as of November Year 1 (i.e. the measurement date) in its Year 2 financial statements.
- It makes a qualitative assessment considering impairment indicators to evaluate whether the investment is impaired.



Question 2.3.80

What are the characteristics of a transaction that is forced or not orderly?

Interpretive response: Generally, a forced transaction occurs under duress or when the seller is otherwise forced to accept a price that a willing market participant would not accept. Whether a transaction is forced is based on the facts and circumstances of the specific transaction and the parties participating in that transaction.

Circumstances that *may* indicate that a specific transaction is not orderly include the following.

- There was not adequate exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities under current market conditions.
- There was a usual and customary marketing period, but the seller marketed the asset or liability to a single market participant.
- The seller is in, or near, bankruptcy or receivership – i.e. is distressed.
- The seller was required to sell to meet regulatory or legal requirements – i.e. was forced to sell.
- The transaction price is an outlier when compared with other recent transactions for the same or a similar asset or liability.

A decrease in the volume or level of activity for an asset or liability on its own may not indicate that a transaction or a quoted price in that market is not orderly. It is not appropriate to presume that no transactions are orderly in a market in which there has been a decrease in the volume or level of activity.

An orderly transaction assumes sufficient time to market the asset or liability in the usual and customary manner. For certain types of assets, including liquid financial instruments (e.g. actively traded stock), the usual and customary market exposure may be short. In other situations (e.g. illiquid equity investments), a longer market exposure might be required to generate interest, contact potential buyers, conduct negotiations, and complete legal agreements. Therefore, the amount of time that is considered customary depends on the type of asset or liability.



Question 2.3.90

How extensive should an entity's analysis be to support a conclusion that the observable price was obtained from an orderly transaction?

Interpretive response: We believe an entity can generally assume that all transactions are orderly transactions unless there is evidence to suggest otherwise. An entity is not required to undertake exhaustive efforts to determine whether a transaction is orderly, but it cannot ignore contrary evidence that is reasonably available.

It is not appropriate to assume that all transactions in a relatively illiquid market are forced and therefore not orderly. For example, transactions between market participants executed in a manner that is usual and customary under current market conditions generally should be considered orderly, even in a relatively illiquid market. The fact that the current market conditions broadly are described as illiquid should not dictate that a specific transaction is not orderly.



Question 2.3.100

What does an entity do if it has evidence that an observed transaction is not orderly?

Interpretive response: An entity with evidence that an observed transaction price is from a transaction that is not orderly should ignore that transaction. The entity should not adjust the carrying amount of the equity investment based on that observed transaction when using the measurement alternative.



Question 2.3.110

Can an entity apply the measurement alternative to an investment that is eligible for, but for which the entity has not elected, the net asset value practical expedient?

Interpretive response: No. Topic 321 allows an entity to measure an equity investment without a readily determinable fair value using the measurement alternative only if the investment is not eligible for Topic 820's practical expedient to measure fair value using the investment's net asset value. If the investment is eligible for the net asset value practical expedient but the entity chooses not to apply that practical expedient, the investment is measured at fair value through net income.

The net asset value practical expedient applies to investments in either: [820-10-35-59]

- investment companies in the scope of Topic 946 (investment companies);
or
- real estate funds that measure investments at fair value and issue financial statements consistent with the measurement principles in Topic 946.



Question 2.3.120

If an entity applies the measurement alternative, can it subsequently elect to measure the equity security at fair value?

Interpretive response: Under ASU 2016-01, this had not been permitted. However, ASU 2018-03 allows an entity that applies the measurement alternative to subsequently elect to measure the equity security at fair value

under Topic 820. The election applies to the equity security and all identical or similar investments of the same issuer.

Once the election is made it is irrevocable and also applies to all future purchases of identical or similar investments of the same issuer. Any resulting gains and losses on the securities for which that election is made should be recorded in earnings at the time of election. [Pending content: 321-10-35-2]

Once the election is made, an entity will need processes and controls to identify future purchases of identical or similar investments of the same issuer and ensure that they are also measured at fair value under Topic 820.

See [Appendix](#) for considerations for an entity that adopts ASU 2016-01 and the amendments in ASU 2018-03 on different dates.



Question 2.3.125

How are previously capitalized transaction costs considered in measuring the fair value of a security when an observable transaction occurs?

Interpretive response: A fair value measurement excludes transaction costs. [820-10-35-9B]

Therefore, transaction costs should not be considered in the fair value measurement of an equity security when a transaction is observed for a similar or identical security.

If an entity had previously included transaction costs in the carrying amount of the security, this means that they will in effect be written off at the first remeasurement date.



Example 2.3.20

Treatment of previously capitalized transaction costs when an observed transaction occurs

In January Year 1, ABC Corp. purchases 100 common shares of Company XYZ for \$1,000 and incurs \$50 of transaction costs. The common shares do not have a readily determinable fair value and ABC elects to measure its investment using the measurement alternative.

ABC's practice is to capitalize transaction costs. Therefore, it records the initial cost basis of its investment in XYZ common shares as \$1,050.

In August Year 1, ABC identifies an observable transaction for identical common shares of XYZ at a price of \$12 per share, and determines that the transaction is orderly. When determining fair value, ABC concludes that no adjustment to the observed transaction price is necessary. Additionally, ABC makes a qualitative assessment considering impairment indicators and determines that the investment is not impaired.

ABC adjusts the carrying amount of its investment in XYZ to \$1,200 with an unrealized gain of \$150 (\$1,200 - \$1,050) recognized in net income. The transaction cost of \$50 is not considered in the fair value measurement.

2.3.20 Adjustments for observable transactions



Excerpt from ASC 321-10

>>> Identifying Observable Price Changes

55-8 To identify observable price changes, an entity should consider relevant transactions that occurred on or before the balance sheet date that are known or can be reasonably known. To identify price changes that can be reasonably known, the entity should make a reasonable effort (that is without expending undue cost and effort) to identify any observable transactions of which it may not be readily aware of. The entity need not conduct an exhaustive search for all observable price changes.



Question 2.3.130#

What types of transactions are potential sources for observable prices?

Interpretive response: In general, we expect that observable prices will be obtained from orderly transactions between market participants involving the purchase and sale of equity securities. Examples of such transactions could include purchases and sales in secondary market transactions or, in certain circumstances, new issuances of equity securities.

A bona fide offer to purchase or sell an equity security at less than its carrying amount may be an impairment indicator. However, such offers are not observable transaction prices and would not trigger an adjustment to the carrying amount of equity investments without readily determinable fair values when applying the measurement alternative. Similarly, a broker quote is not an observable price unless it represents an actual transaction. [321-10-35-2 – 35-3, 321-20 Glossary]

The standard requires an entity to make a reasonable effort without expending undue cost and effort to identify price changes that are known or that can be reasonably known. Judgment should be exercised when determining the level of 'reasonable effort' required to identify an observable price change.

When there is a reasonable expectation that there could be third-party transactions involving identical or similar securities, we generally expect an entity to conduct a search for observable prices for these transactions. We do not believe an entity should limit its search to identifying whether the entity itself had purchased or sold these securities in the reporting period.

Third-party sources may provide management with data points for measuring equity investments. However, management is responsible for understanding

the source of information obtained from third parties and for determining whether a price is obtained from an observable transaction.

In applying the standard, an entity may have to design new procedures and controls to:

- determine the sources of information for observable transactions;
- identify similar securities to monitor for observable transactions;
- determine fair value as of the date that the observable transaction took place; and
- determine how to monitor that each equity security under the measurement alternative continues to meet the qualifying criteria.



Question 2.3.140

If an entity issues equity securities to employees as share based compensation, are such transactions a potential source for observable transaction prices?

Interpretive response: No. Transactions with employees as share-based compensation are not considered to be observable prices from orderly transactions. This is because they do not involve market participants purchasing or selling shares. Additionally, there is no exposure to the market to allow for marketing activities that are usual and customary.



Question 2.3.150

Should an entity adjust the observed transaction price of the identical or similar instrument when measuring fair value?

Interpretive response: In many cases, the observed transaction price for an identical or similar security is a reliable indication of fair value. However, we believe there may be circumstances in which a fair value measurement under Topic 820 differs from the observed transaction price, even if the identical security was exchanged.

Judgment is required to determine what (if any) adjustments should be made to the observed transaction price. The guiding principle from Topic 820 is that any adjustments that would be applied by a market participant should be considered in the fair value measurement.

The following table includes examples of potential adjustments an entity should consider (not exhaustive).

Factor	Considerations when measuring fair value under Topic 820
Block discounts, control premiums and other differences in	Topic 820 specifically prohibits the consideration of block discounts (or blockage factors) in a fair value measurement. This is because they are specific to the size of a company's holding and its decision to transact in a block (i.e. they are entity-specific considerations).

Factor	Considerations when measuring fair value under Topic 820
marketability (or liquidity)	<p>If the price paid in the observed transaction included a block discount that was incurred by the seller, the entity should adjust the transaction price to remove the impact of the block discount.</p> <p>Alternatively, if an investor paid a premium to acquire a controlling interest in the investee, the entity should make an adjustment to remove any control premium.</p> <p>In addition, if there are other differences between the marketability (or liquidity) of the equity security sold in the observed transaction and the equity security held by the entity, an adjustment is necessary to reflect those differences.</p> <p>For more information on these adjustments, see Questions G30 and G40 in KPMG’s Q&A: Fair value measurement.</p>
Principal (or most advantageous) markets	<p>Equity securities may be transacted at different prices in different markets. An adjustment to the transaction price may be necessary if the market in which the observed transaction takes place is different from the reporting entity’s principal (or most advantageous) market.</p>
Other indications of value	<p>If the evidence indicates that the transaction is orderly, an entity considers that transaction price when measuring fair value. The weighting placed on the transaction price (when compared to other indicators of fair value) depends on the facts and circumstances of the transaction and the nature and quality of other available inputs.</p>
Rights and obligations	<p>If an entity identifies an observable transaction for a similar (but not identical) security, the observable price should be adjusted to reflect differences in the rights and obligations of the securities (see Question 2.3.170).</p>

See KPMG’s [Q&A: Fair value measurement](#) for additional guidance and examples for determining fair value.



Question 2.3.155**

Does an observable transaction that results in an investment moving to/from the equity method from/to the measurement alternative result in remeasuring the equity investment?



Excerpt from ASC 323-10

>> Increase in Level of Ownership or Degree of Influence

35-33 Paragraph 323-10-15-12 explains that an investment in common stock of an investee that was previously accounted for on other than the equity method may become qualified for use of the equity method by an increase in the level of ownership described in paragraph 323-10-15-3 (that is, acquisition of additional voting stock by the investor, acquisition or retirement of voting stock by the investee, or other transactions). If an investment qualifies for use of the equity method (that is, falls within the scope of this Subtopic), the investor

shall add the cost of acquiring the additional interest in the investee (if any) to the current basis of the investor's previously held interest and adopt the equity method of accounting as of the date the investment becomes qualified for equity method accounting.

35-34 The carrying amount of an investment in common stock of an investee that qualifies for the equity method of accounting as described in paragraph 323-10-15-12 may differ from the underlying equity in net assets of the investee. The difference shall affect the determination of the amount of the investor's share of earnings or losses of an investee as if the investee were a consolidated subsidiary. However, if the investor is unable to relate the difference to specific accounts of the investee, the difference shall be recognized as goodwill and not be amortized in accordance with Topic 350.

>> Decrease in Level of Ownership or Degree of Influence

35-35 Sales of stock of an investee by an investor shall be accounted for as gains or losses equal to the difference at the time of sale between selling price and carrying amount of the stock sold.

35-36 An investment in voting stock of an investee may fall below the level of ownership described in paragraph 323-10-15-3 from sale of a portion of an investment by the investor, sale of additional stock by an investee, or other transactions and the investor may thereby lose the ability to influence policy, as described in that paragraph. An investor shall discontinue accruing its share of the earnings or losses of the investee for an investment that no longer qualifies for the equity method. The earnings or losses that relate to the stock retained by the investor and that were previously accrued shall remain as a part of the carrying amount of the investment. The investment account shall not be adjusted retroactively under the conditions described in this paragraph. Topic 321 addresses the accounting for investments in equity securities that are not consolidated or accounted for under the equity method.



Excerpt from ASC 321-10

>> Equity Method Is No Longer Appropriate

30-1 If an equity security no longer qualifies to be accounted for under the equity method (for example, due to a decrease in the level of ownership), the security's initial basis shall be the previous carrying amount of the investment. Paragraph 323-10-35-36 states that the earnings or losses that relate to the stock retained by the investor and that were previously accrued shall remain as a part of the carrying amount of the investment and that the investment account shall not be adjusted retroactively. Subsequently, the security shall be accounted for pursuant to paragraph 321-10-35-1.

Background: Equity investments accounted for under the equity method are not in the scope of Topic 321. [321-10-35-2, 323-10-15-12, 35-36]

- A decrease in the level of ownership (or degree of influence) may result in an investment no longer qualifying for use of the equity method but rather falling in the scope of Topic 321.

- Similarly, an increase in the level of ownership (or degree of influence) may result in an investment in the scope of Topic 321 subsequently qualifying for use of the equity method. If an equity investment does not have a readily determinable fair value, an entity may elect the measurement alternative.

Interpretive response: *This question continues to be discussed in practice, and it is possible that additional guidance may be provided by the FASB, EITF and/or SEC staff. Consequently, there may be further developments around this issue, in which case we will update this interpretive response in a future edition.*

It depends. We believe that whether an investor that will apply, or has applied, the measurement alternative should remeasure its previously held equity interest depends on whether it is moving out of, or into, the equity method of accounting.

Change	ASC 321 remeasurement?	Rationale
Move from equity method to measurement alternative following sale of a portion of the equity securities	No	<p>When an investment no longer qualifies for the equity method, the investor establishes its initial basis for applying Topic 321 based on the carrying amount of its retained interest when it stopped applying the equity method. [321-10-30-1]</p> <p>The investment is not adjusted retroactively. The carrying amount of the retained interest established at the end of equity method accounting is not adjusted before applying the measurement alternative. [321-10-30-1, 323-10-35-36]</p>
Move from measurement alternative to equity method following purchase of additional equity securities	Yes	<p>When an investment initially qualifies for the equity method, an entity adds the amount paid for the additional interest to the current basis of its previously held interest. [323-10-35-33]</p> <p>While the guidance does not define ‘current basis’, we believe that because the transaction was observed while the previously held investment was accounted for under the measurement alternative, the current basis should be interpreted to include a final remeasurement to fair value that is triggered by the observed transaction price.</p>

An investor's basis in equity securities that moved from the measurement alternative to the equity method comprises the following.



2.3.30 Observable transactions involving a similar investment of the same issuer



Excerpt from ASC 321-10

>>> Identifying Similar Investment in Same Issuer

55-9 To identify whether a security issued by the same issuer is similar to the equity security held by the entity, the entity should consider the different rights and obligations of the securities. Differences in rights and obligations could include characteristics such as voting rights, distributions rights and preferences, and conversion features. The entity should adjust the observable price of a similar security for the different rights and obligations to determine the amount that should be recorded as an upward or downward adjustment in the carrying value of the security measured in accordance with paragraph 321-10-35-2 to reflect the ~~current~~ fair value of the security as of the date that the observable transaction for the similar security took place.

Pending Content

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55-9 ... The entity should adjust the observable price of a similar security for the different rights and obligations to determine the amount that should be recorded as an upward or downward adjustment in the carrying value of the security measured in accordance with paragraph 321-10-35-2 to reflect the fair value of the security as of the date that the observable transaction for the similar security took place.



Question 2.3.160

How does an entity determine whether two instruments are similar?

Background: ABC Corp. owns Series A preferred instruments of an investee and recently observed a transaction in Series B preferred instruments of the same investee.

The two series have different liquidation preferences, different dividend rates, and neither has voting rights. All other rights and obligations are the same.

Interpretive response: Determining whether an investment issued by the same issuer is similar to the equity security held by the entity is a matter of judgment.

We expect an entity to consider the extent of differences in rights and obligations between the investments, including the extent to which those differences would affect the fair values of those investments. In the background example, the rights and obligations considered by ABC include the differences in liquidation preferences and dividend rates.

In general, if the differences between those rights and obligations are not expected to have a significant effect on the fair value of the investment being valued, then the two instruments are considered similar. In contrast, if the effect on the fair value is expected to be significant, then the two instruments are not considered similar.

We expect that there are instances in which an entity cannot determine qualitatively whether the differences in rights and obligations have a significant effect on the fair value of an investment. In those circumstances, an entity could choose to either (1) assess the significance of the difference quantitatively (by estimating the fair value) or (2) consider other factors.

Based on our discussions with the FASB staff, these 'other' factors could include the complexity of the calculation (i.e. the degree of difficulty) required to adjust the observable price for the differences in rights and obligations. If an entity chooses this approach and concludes that the degree of difficulty is high, it will generally conclude that the security is not similar. Alternatively, if the entity determines that the degree of difficulty is low, we generally expect it to calculate the adjustment and assess the significance quantitatively.



Question 2.3.170

When measuring fair value, what adjustments should be made to the observed transaction price of a similar instrument to reflect differences between the two instruments?

Interpretive response: When an entity observes a transaction for a similar (but not identical) security, it should consider the guidance in [Question 2.3.150](#).

One aspect of that guidance is that an entity should consider adjustments that are necessary to reflect difference in the rights and obligations between the equity security that was transacted and the equity security held by the entity.
 [Pending content: 321-10-55-9]

These differences may include characteristics such as voting rights, distribution rights and preferences, liquidation preferences, conversion ratios, dividends and anti-dilution provisions.

Continuing with the scenario in [Question 2.3.160](#), if the investments are determined to be similar, ABC should adjust the recent observable price of the Series B instruments to reflect the differences in liquidation preferences and dividend rates between the two series. Outside of this scenario, other instruments may have additional differences that should be considered when determining the appropriate adjustment.

See KPMG's [Q&A: Fair value measurement](#) for additional guidance and examples for determining fair value.

2.3.40 Impairment



Excerpt from ASC 321-10

>> Impairment of Equity Securities Without Readily Determinable Fair Values

35-3 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 and is measured in accordance with paragraph 321-10-35-2 shall be written down to its fair value if a qualitative assessment indicates that the investment is impaired and the fair value of the investment is less than its carrying value, as determined using the guidance in paragraph 321-10-35-2. 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. A significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee
- b. A significant adverse change in the regulatory, economic, or technological environment of the investee
- c. A significant adverse change in the general market condition of either the geographical area or the industry in which the investee operates
- d. 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
- e. 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.

35-4 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. That is, if the investment is deemed to be impaired after conducting the evaluation required by paragraph 321-10-35-3, the entity shall estimate the fair value of the investment to determine the amount of the impairment loss.



Question 2.3.180

How does Topic 321 change the legacy guidance on impairment of equity securities without a readily determinable fair value?

Interpretive response: Before Topic 321, US GAAP required a two-step analysis for assessing and recording impairment on a cost-method equity security. An entity was required to assess cost-method equity investments for impairment based on whether the fair value of the equity investment was lower than the carrying amount. However, the entity did not recognize impairment in net income unless the impairment was determined to be other-than-temporary.

The new standard provides a one-step analysis for determining whether an equity security without a readily determinable fair value is impaired, which operates as follows. [\[321-10-35-4\]](#)

- The entity performs a qualitative assessment each reporting period to identify impairment.
- When the qualitative assessment indicates that impairment exists, the entity estimates the fair value of the investment.
- If the fair value of the investment is determined to be less than its carrying amount, the entity writes down the investment to its fair value and recognizes the write-down in net income.

The FASB intended that the one-step impairment test would reduce subjectivity, improve comparability, and lessen the burden on preparers by eliminating the need to forecast whether the equity securities will recover their value. The Board also considered the one-step method to be simpler and likely to result in more decision-useful information for financial statement users than the current two-step method. [\[ASU 2016-01.BC89\]](#)

The FASB provided the measurement alternative to relieve an entity from having to estimate at each reporting date the fair value of equity investments without a readily determinable fair value. The qualitative impairment analysis is consistent with this objective, because an entity estimates fair value only if the qualitative impairment analysis indicates an investment is impaired.

The standard includes a representative, but not all inclusive, list of possible impairment indicators that focus on significant factors or events. As a result, while an entity no longer has to apply judgment in determining whether an investment is other-than-temporarily impaired, it continues to be required to make similar types of judgments to determine when a factor or event is significant.



Question 2.3.190

Can impairment losses be subsequently reversed under Topic 321?

Interpretive response: Yes, but only if there is an observable transaction price for the identical or similar investment of the same issuer at a higher amount than the carrying amount established when the impairment was recognized. [\[321-10-35-2, ASU 2016-01.BC89\]](#)



Question 2.3.200

Does the guidance in Topic 321 change how an entity analyzes an equity method investment for potential impairment?

Interpretive response: No. The Board stated that it decided not to adopt changes to the equity method of accounting, including the impairment test applied to an equity method investment. Therefore, Topic 323 (equity method investments and joint ventures), continues to apply to equity method investments. [321-10-15-5, ASU 2016-01.BC87]

Topic 323 requires a two-step impairment test. [323-10-35-32]

- The first step determines whether the equity method investment is impaired based on whether fair value is less than its carrying amount.
- The second step determines whether that impairment is other-than-temporary.

2.3.50 Forward contracts and purchased options



Excerpt from ASC 815-10

Certain Contracts on Debt and Equity Securities

35-6 Changes in the fair value of forward contracts and purchased options on equity securities within the scope of this Subsection shall be recognized in earnings as they occur. Changes in observable price or impairment of forward contracts and purchased options on equity securities without readily determinable fair value within the scope of this Subsection measured in accordance with paragraph 321-10-35-2 shall be recognized in earnings as they occur. A change in observable price or impairment of the underlying securities of forward contracts and purchased options on equity securities shall result in a remeasurement of the entire fair value of the forward contracts and purchased options as of the date that the observable transaction took place. Equity securities within the scope of this Subsection purchased under a forward contract or by exercising an option shall be recorded at their fair values at the settlement date.

Pending Content

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35-6 ... A change in observable price or impairment of the underlying securities of forward contracts and purchased options on equity securities shall result in a remeasurement of the entire fair value of the forward contracts and purchased options as of the date that the observable transaction took place...



Question 2.3.210

May an entity elect the measurement alternative for forward contracts and purchased options that are not subject to Topic 815?

Interpretive response: Yes. As addressed in [Question 2.2.30](#), Topic 321 provides guidance on forward contracts and purchased options that are not derivatives subject to the requirements of Topic 815, but involve the acquisition of securities that will be accounted for under Topic 321. [\[321-10-15-6\]](#)

Under Topic 321, an entity may elect the measurement alternative for forward contracts and purchased options on equity securities without readily determinable fair values. If the measurement alternative is elected, changes in observable prices or impairment are recognized in earnings as they occur. [\[ASU 2016-01.BC11, 815-10-35-6\]](#)

ASU 2018-03 amended Topic 321 to require an entity to perform a fair value remeasurement of the forward contract or purchased option if the entity observes a transaction in the underlying security. An entity is not permitted to adjust the cost basis for only the change in fair value associated with the price observed for the underlying security. Instead, it updates all of the other assumptions used in the fair value measurement. [\[Pending content: 815-10-35-6\]](#)

See [Appendix](#) for considerations for an entity that adopts ASU 2016-01 and the amendments in ASU 2018-03 on different dates.

3. Financial liabilities for which the fair value option is elected

Detailed contents

3.1 How the standard works

3.2 Scope

Question

- 3.2.10 Does paragraph 825-10-45-5 apply to hybrid financial liabilities for which the fair value option was elected under paragraph 815-15-25-4 in addition to fair value option elections under Subtopic 825-10?

3.3 Determining instrument-specific credit risk

Questions

- 3.3.10 What is the base method for identifying instrument-specific credit risk?
- 3.3.20 In what circumstances can an entity apply the base method?
- 3.3.30 How should an entity report changes in fair value due to changes in foreign exchange rates?

3.1 How the standard works

Legacy US GAAP	ASU 2016-01/2018-03
Recognized all changes in fair value in net income.	<ul style="list-style-type: none"> — Recognize changes in fair value due to instrument-specific credit risk in OCI. — Recognize all other changes in fair value in net income.

3.2 Scope

Excerpt from ASC 825-10

>> Financial Liabilities for Which Fair Value Option Is Elected

45-5 If an entity has designated a financial liability under the fair value option in accordance with this Subtopic or Subtopic 815-15 on embedded derivatives, the entity shall measure the financial liability at fair value with qualifying changes in fair value recognized in net income. The entity shall present separately in other comprehensive income the portion of the total change in the fair value of the liability that results from a change in the instrument-specific credit risk. The entity may consider the portion of the total change in fair value that excludes the amount resulting from a change in a base market risk, such as a risk-free rate or a benchmark interest rate, to be the result of a change in instrument-specific credit risk. Alternatively, an entity may use another method that it considers to faithfully represent the portion of the total change in fair value resulting from a change in instrument-specific credit risk. The entity shall apply the method consistently to each financial liability from period to period.

Pending Content

Transition Date: (P) December 16, 2017; (N) December 16, 2018 | Transition Guidance: 825-10-65-3

45-5 If an entity has designated a financial liability under the fair value option in accordance with this Subtopic or Subtopic 815-15 on embedded derivatives, the entity shall measure the financial liability at fair value with qualifying changes in fair value recognized in net income...



Question 3.2.10

Does paragraph 825-10-45-5 apply to hybrid financial liabilities for which the fair value option was elected under paragraph 815-15-25-4 in addition to fair value option elections under Subtopic 825-10?

Interpretive response: Yes. There are instances in which an entity may elect the fair value option under either Subtopic 825-10 (financial instruments overall) or Subtopic 815-15 (embedded derivatives) for hybrid financial liabilities with embedded derivatives that would otherwise require bifurcation.

ASU 2018-03 clarifies that the guidance in paragraph 825-10-45-5 applies to all liabilities for which an entity elected the fair value option, regardless of which Subtopic was the basis for the election. [Pending content: 825-10-45-5]

See [Appendix](#) for considerations for an entity that adopts ASU 2016-01 and the amendments in ASU 2018-03 on different dates.

3.3 Determining instrument-specific credit risk



Excerpt from ASC 825-10

>> Financial Liabilities for Which Fair Value Option Is Elected

45-5 If an entity has designated a financial liability under the fair value option in accordance with this Subtopic or Subtopic 815-15 on embedded derivatives, the entity shall measure the financial liability at fair value with qualifying changes in fair value recognized in net income. The entity shall present separately in other comprehensive income the portion of the total change in the fair value of the liability that results from a change in the instrument-specific credit risk. The entity may consider the portion of the total change in fair value that excludes the amount resulting from a change in a base market risk, such as a risk-free rate or a benchmark interest rate, to be the result of a change in instrument-specific credit risk. Alternatively, an entity may use another method that it considers to faithfully represent the portion of the total change in fair value resulting from a change in instrument-specific credit risk. The entity shall apply the method consistently to each financial liability from period to period.

45-5A When changes in instrument-specific credit risk are presented separately from other changes in fair value of a liability denominated in a currency other than an entity's functional currency, the component of the change in fair value of the liability resulting from changes in instrument-specific credit risk shall first be measured in the liability's currency of denomination, and then the cumulative amount shall be adjusted to reflect the current exchange rate in accordance with paragraph 830-20-35-2. The remeasurement of the component of the change in fair value of the liability resulting from the

cumulative changes in instrument-specific credit risk shall be presented in accumulated other comprehensive income.

Pending Content

Transition Date: (P) December 16, 2017; (N) December 16, 2018 | Transition Guidance: 825-10-65-3

45-5 If an entity has designated a financial liability under the fair value option in accordance with this Subtopic or Subtopic 815-15 on embedded derivatives, the entity shall measure the financial liability at fair value with qualifying changes in fair value recognized in net income...

45-5A When changes in instrument-specific credit risk are presented separately from other changes in fair value of a liability denominated in a currency other than an entity's functional currency, the component of the change in fair value of the liability resulting from changes in instrument-specific credit risk shall first be measured in the liability's currency of denomination, and then the cumulative amount shall be adjusted to reflect the current exchange rate in accordance with paragraph 830-20-35-2. The remeasurement of the component of the change in fair value of the liability resulting from the cumulative changes in instrument-specific credit risk shall be presented in accumulated other comprehensive income.



Question 3.3.10

What is the base method for identifying instrument-specific credit risk?

We use the term 'base method' to describe the only specific method for determining instrument-specific credit risk identified in the standard. For financial liabilities for which an entity elects the fair value option, the base method calculates instrument-specific credit risk as the:

- total change in fair value of a financial liability; less
- changes in fair value of the financial liability arising from a change in a base market risk, such as a risk-free rate or a benchmark interest rate.



Question 3.3.20

In what circumstances can an entity apply the base method?

Interpretive response: We believe an entity is generally **permitted** to apply the base method described in the standard when the debt is plain-vanilla and provides full recourse to the borrower in the event of nonperformance. However, an entity is not required to use the base method. An entity may elect to apply another method, if that method provides a more faithful representation of the change in fair value resulting from a change in instrument-specific credit risk.

The FASB developed the base method because it did not want to require an entity to separate an instrument's credit risk into components such as its own nonperformance risk and changes in the market pricing of credit risk. However, the FASB did not intend to permit an entity to exclude from earnings other types of changes in fair value. [ASU 2016-01.BC107]

Based on discussions with the FASB staff, we believe it is not appropriate to apply the base method to instruments such as nonrecourse debt liabilities or hybrid instruments containing embedded derivatives that would have required bifurcation if the fair value option had not been elected.

Nonrecourse debt is debt in which the creditor does not have general recourse to the debtor, but instead has recourse only to the assets used as collateral in the transaction. The Board observed in the basis for conclusions that, under legacy US GAAP, an entity does not disclose changes in instrument-specific credit risk for nonrecourse debt, and that it did not intend to change how an entity identifies and measures changes in instrument-specific credit risk. Therefore, we believe all changes in the fair value of nonrecourse debt liabilities should be recognized in net income. [ASU 2016-01.BC112]

When an entity elects the fair value option for a hybrid financial instrument that includes an embedded derivative that would have otherwise required bifurcation, the entity should use an alternative method that faithfully reflects the portion of the total change in fair value that results from a change in instrument-specific credit risk. An entity should design the method to ensure that the portion of the total change in the fair value of the hybrid instrument that is associated with changes in the fair value of the embedded derivative (unrelated to the issuer's credit risk) is included in net income.



Question 3.3.30

How should an entity report changes in fair value due to changes in foreign exchange rates?

Interpretive response: The change in fair value, expressed in functional currency terms, of a financial liability denominated in a currency other than the entity's functional currency includes the change in fair value attributable to changes in currency exchange rates and changes in fair value attributable to other factors.

ASU 2018-03 further clarifies how the changes in fair value attributable to changes in currency exchange rates should be split between: [Pending content: 825-10-45-5A]

- the instrument-specific credit risk component (recognized in OCI); and
- the remaining changes in fair value (recognized in net income).

See [Appendix](#) for considerations for an entity that adopts ASU 2016-01 and ASU 2018-03 on different dates.

We believe the approach can be considered in five steps.

Step 1:	Determine the fair value of the instrument and the cumulative change in fair value due to instrument-specific credit risk since issuance in the financial liability's currency of denomination.
Step 2:	Remeasure the financial liability using the period-end exchange rate, which will be the carrying amount in functional currency at the measurement date.
Step 3:	Remeasure the cumulative instrument-specific credit risk component of the change in fair value since issuance (which will be recognized in AOCI using the period-end exchange rate).
Step 4:	Recognize in OCI for the current period the difference between the amount determined in Step 3 at the end of the current period, and the amount determined in Step 3 at the end of the previous period.
Step 5:	Recognize in earnings for the current period the difference between the total change in fair value of the financial liability for the current period (in functional currency) and the amount determined in Step 4.

4. Establishing a valuation allowance for deferred tax assets

Detailed contents

Item significantly updated in this chapter:

4.1 How the standard works

4.2 AFS debt securities

Question

4.2.10 How do the amendments change practice on assessing the need for a valuation allowance on deferred tax assets related to AFS debt securities?

Example

4.2.10 Evaluating the need for a valuation allowance on deferred tax assets #

4.1 How the standard works

Deferred tax assets related to AFS debt securities	
Legacy US GAAP	ASU 2016-01/2018-03
<p>Determined the need for a valuation allowance either:</p> <ul style="list-style-type: none"> — in combination with other deferred tax assets; or — separately from other deferred tax assets. 	<p>Determine the need for a valuation allowance in combination with other deferred tax assets.</p>

4.2 AFS debt securities



Excerpt from ASC 740-10

> Establishment of a Valuation Allowance for Deferred Tax Assets

30-16 As established in paragraph 740-10-30-2(b), there is a basic requirement to reduce the measurement of deferred tax assets not expected to be realized. An entity shall evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale debt securities in combination with the entity's other deferred tax assets.



Question 4.2.10

How do the amendments change practice on assessing the need for a valuation allowance on deferred tax assets related to AFS debt securities?

Interpretive response: Topic 740 (income taxes) requires an entity to recognize a valuation allowance when, based on available evidence, it is more likely than not that all or some portion of the deferred tax assets will not be realized because of the inability to generate sufficient taxable income in the period or of the character necessary to use the benefit of the deferred tax assets. [740-10-30-5, 30-18]

There are often circumstances when the fair value of a debt security declines because of changes in market factors even though the entity holding the debt security expects to collect all of the contractual cash flows if the entity holds the debt security to maturity. In these cases, an intent and ability to hold a debt security to maturity may be a qualifying tax-planning strategy for the fair value loss on an AFS security that is recognized in OCI, because the recovery of the unrealized loss in the future will result in taxable income.

Under legacy US GAAP, there was diversity in practice about how to take into account a tax-planning strategy to hold AFS debt securities to maturity to collect

the contractual cash flows when an entity evaluates the need for a valuation allowance. An entity followed one of two approaches.

- **Approach A.** Evaluate the need for a valuation allowance for deferred tax assets related to AFS debt securities in combination with all other deferred tax assets.
- **Approach B.** Evaluate the need for a valuation allowance for deferred tax assets related to AFS debt securities on a stand-alone basis. This separate evaluation could result in the conclusion that a valuation allowance is not necessary because the future taxable income from the recovery of the book basis (i.e. collection of all contractual cash flows) will offset the deductions (i.e. current unrealized fair value loss) giving rise to the deferred tax assets. Previously, this view was supportable even if a valuation allowance was required on an entity's other deferred tax assets.

Under the new standard, an entity assesses the need for a valuation allowance for deferred tax assets related to AFS debt securities in combination with its other deferred tax assets – i.e. it should follow Approach A. [740-10-30-16]

In applying Approach A, an entity assesses the realizability of its deferred tax assets (including deferred tax assets related to AFS debt securities) in combination using the following four sources of taxable income: [740-10-30-18]

- future reversals of existing taxable temporary differences;
- future taxable income excluding reversing temporary differences and carryforwards;
- taxable income in carryback years if carryback is permitted by the tax law; and
- tax-planning strategies.

An entity must recognize a valuation allowance if it cannot support a position that there will be sufficient future taxable income from these four sources and concludes that it is more likely than not that some or all of its deferred tax assets will not be realized. An entity that expects future losses, or that is unable to reliably forecast future taxable income, may only use the future taxable income generated by holding the AFS debt securities to maturity to offset future losses, and not to realize existing deferred tax assets. Therefore, an entity that followed Approach B should carefully consider whether it needs an additional valuation allowance on adoption of ASU 2016-01.



Example 4.2.10#

Evaluating the need for a valuation allowance on deferred tax assets

ABC Corp. recognized the following deferred tax assets at December 31, 2017:

- unrealized losses on AFS debt securities (recognized in OCI) – \$2,000.
- net operating loss carryforwards – \$3,500.

Debt securities

The AFS debt securities mature in three years, and the unrealized losses are because of an increase in general interest rates (not the issuers' credit concerns). ABC followed Approach B and does not have a valuation allowance

against this deferred tax asset. Approach B requires a qualifying tax-planning strategy that the entity has the intent and the ability to hold these debt securities to maturity and collect all the contractual cash flows.

Net operating loss carryforwards

ABC does not have taxable temporary differences. Further, it is in a cumulative loss position (it has been losing money for the last few years) and expects losses to continue for the next two or three years. Therefore, ABC has a valuation allowance against its deferred tax asset related to net operating loss carryforwards.

Adoption of ASU 2016-01

ABC adopts ASU 2016-01 on January 1, 2018. On adoption, it evaluates the need for a valuation allowance for deferred tax assets related to AFS debt securities together with all of its other deferred tax assets (Approach A).

The cumulative loss in recent years provides significant negative evidence regarding the existence of sufficient future taxable income to support a conclusion that it is more likely than not that all or some portion of the deferred tax assets of ABC will be realized. This negative evidence is difficult to overcome even if ABC were to support its expectations of future taxable income with forecasts, including the expected reversal of unrealized losses on its AFS debt securities that it has both the intent and the ability to hold to maturity. [740-10-30-21, 30-23]

ABC is unable to overcome the significant negative evidence with sufficient positive evidence, and therefore records an additional valuation allowance against the deferred tax asset related to unrealized loss through a cumulative-effect adjustment on transition to ASU 2016-01. [740-10-30-17, 825-10-65-2]

5. Effective dates and transition

Detailed contents

5.1 How the standard works

5.2 Effective dates

5.3 Transition

Questions

5.3.10 On adoption of the standard, what transition approach is required for equity securities without readily determinable fair values?

5.3.20 On adoption of the standard, what transition approach is required for equity securities previously classified as AFS?

5.3.30 What is the effect of the transition guidance on equity securities without a readily determinable fair value that are held by an insurance entity?

Example

5.3.10 Transition considerations when electing the measurement alternative

5.1 How the standard works

	Public business entities	All other entities
Effective date of ASU 2016-01: [825-10-65-2(a) – 65-2(b)]	Annual and interim periods in fiscal years beginning after December 15, 2017	<ul style="list-style-type: none"> — Annual periods in fiscal years beginning after December 15, 2018 — Interim periods in fiscal years beginning after December 15, 2019
Effective date of ASU 2018-03: [825-10-65-3]	<ul style="list-style-type: none"> — Fiscal years beginning after December 15, 2017 and interim periods within those fiscal years beginning after June 15, 2018. — Entities with fiscal years beginning in the period between December 15, 2017 and June 15, 2018 are not required to adopt ASU 2018-03 until the interim period beginning after June 15, 2018. 	<ul style="list-style-type: none"> — Same effective dates as ASU 2016-01
Early adoption of ASU 2016-01: [825-10-65-2(b) – 65-2(d)]	<ul style="list-style-type: none"> — All entities may early adopt the guidance on the recognition of changes in the fair value of financial liabilities measured at fair value under the fair value option in any period for which financial statements have not been issued or made available for issuance. — Entities other than public business entities may elect not to disclose the information about fair value of financial instruments required by the General Subsection of Section 825-10-50 in financial statements that have not yet been made available for issuance. — For entities other than public business entities, early adoption is permitted for annual and interim periods in fiscal years beginning after December 15, 2017. 	

	Public business entities	All other entities
Early adoption of ASU 2018-03: [825-10-65-3]	<ul style="list-style-type: none"> Public business entities with fiscal years beginning after December 15, 2017, and all other entities that have already adopted ASU 2016-01, may early adopt ASU 2018-03 immediately, including in an interim period. For entities other than public business entities, early adoption of ASU 2018-03 is not permitted. 	
Transition requirements: [825-10-65-2 – 65-3]	<ul style="list-style-type: none"> Cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption. Prospective application for equity investments without a readily determinable fair value for which the measurement alternative was elected. ASU 2018-03 should be applied using a cumulative-effect adjustment to the balance sheet. The adjustment should be determined as of the beginning of the fiscal year of adoption, even if the ASU is adopted in an interim period. See Appendix for further discussion of transition considerations for an entity that adopts ASU 2016-01 and the amendments in ASU 2018-03 on different dates. 	

Some entities may have significant unrealized gains associated with equity securities without readily determinable fair values. ASU 2018-03 requires an entity that chooses fair value measurement to treat those unrealized losses as a cumulative-effect adjustment to the opening balance of retaining earnings. In contrast, an entity that chooses the measurement alternative will ultimately recognize those gains (together with changes in fair value subsequent to adoption) in earnings. See [Question 5.3.10](#) for additional information about ASU 2018-03.

5.2 Effective dates



Excerpt from ASC 825-10

> Transition Related to Accounting Standards Update No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities.*

65-2 The following represents the transition and effective date information related to Accounting Standards Update No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*:

- A **public business entity** shall apply the pending content that links to this paragraph for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Except as indicated in (c), early

application of the pending content that links to this paragraph by a public business entity is not permitted.

- b. All other entities shall apply the pending content that links to this paragraph for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early application of the pending content that links to this paragraph is permitted for all other entities as of the fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Except as indicated in (b) through (d), earlier application of the pending content that links to this paragraph by all other entities is not permitted.
- c. All entities may adopt the presentation guidance in paragraphs 825-10-45-5 through 45-7 for financial statements of fiscal years or interim periods that have not yet been issued or that have not yet been made available for issuance.
- d. Entities that are not public business entities may elect not to disclose the information about fair value of financial instruments required by the General Subsection of Section 825-10-50 in financial statements of fiscal years or interim periods that have not yet been made available for issuance.

> Transition Related to Accounting Standards Update No. 2018-03, *Technical Corrections and Improvements to Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities.*

65-3 The following represents the transition and effective date information related to Accounting Standards Update No. 2018-03, *Technical Corrections and Improvements to Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*:

- a. A **public business entity** shall apply the pending content that links to this paragraph for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years beginning after June 15, 2018. Public business entities with fiscal years beginning in the period between December 15, 2017, and June 15, 2018, are not required to adopt the pending content that links to this paragraph until the interim period beginning after June 15, 2018. Early adoption, including adoption in an interim period, of the pending content that links to this paragraph by a public business entity is permitted.
- b. All other entities shall apply the pending content that links to this paragraph for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019, in accordance with paragraph 825-10-65-2(b). Early application is not permitted unless the entity has early adopted Update 2016-01 in accordance with paragraph 825-10-65-2(b).

5.3 Transition



Excerpt from ASC 825-10

> Transition Related to Accounting Standards Update No. 2016-01, Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities.

65-2 The following represents the transition and effective date information related to Accounting Standards Update No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*:

- e. An entity shall apply the pending content that links to this paragraph by means of a cumulative-effect adjustment to the statement of financial position as of the beginning of the fiscal year in which the pending content that links to this paragraph is applied. The pending content that links to this paragraph related to equity securities without **readily determinable fair values** (including disclosure requirements) shall be applied prospectively to all equity investments for which an entity elects the measurement alternative in accordance with paragraph 321-10-35-2 that exist as of the date of adoption of the pending content that links to this paragraph. An insurance entity subject to the guidance in Topic 944 on financial services—insurance shall apply a prospective transition method when applying the pending content that links to this paragraph related to equity securities without readily determinable fair values. The insurance entity shall apply the selected prospective transition method consistently to the entire population of equity securities for which the measurement alternative is elected.
- f. An entity shall apply prospectively the pending content that links to this paragraph that requires the exit price notion in Topic 820 on fair value measurement to be used to measure fair value of financial instruments for disclosure purposes. If because of measuring fair value of financial instruments in accordance with the guidance in Topic 820 the prior-year figures shown for comparative purposes will no longer be comparable, an entity shall make a disclosure to explain that fact. That disclosure is in conformity with the guidance in Subtopic 205-10 on presentation of financial statements that requires that any change in the manner of or basis for presenting corresponding items for two or more periods that affects comparability of financial statements shall be disclosed.

Pending Content

Transition Date: (P) December 16,, 2017; (N) December 16, 2018 | Transition Guidance: 825-10-65-3

- c. **65-2(e)** ...The pending content that links to this paragraph related to equity securities without **readily determinable fair values** (including disclosure requirements) shall be applied prospectively to all equity investments for which an entity elects the measurement alternative in accordance with paragraph 321-10-35-2 that exist as of the date of adoption of the pending content that links to this paragraph. An insurance entity subject to the guidance in Topic 944 on financial services—insurance shall apply a

prospective transition method when applying the pending content that links to this paragraph related to equity securities without readily determinable fair values. The insurance entity shall apply the selected prospective transition method consistently to the entity's entire population of equity securities for which the measurement alternative is elected.

> Transition Related to Accounting Standards Update No. 2018-03, Technical Corrections and Improvements to Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities

65-3 The following represents the transition and effective date information related to Accounting Standards Update No. 2018-03, *Technical Corrections and Improvements to Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*:

- d. Public business entities with fiscal years beginning in the period between December 15, 2017, and June 15, 2018, or other entities that have early adopted the amendments in Update 2016-01 in accordance with paragraph 825-10-65-2(b) and that choose to adopt the pending content that links to this paragraph at the required adoption date or in an interim period before the required adoption date, shall apply the pending content that links to this paragraph by means of a cumulative-effect adjustment to the statement of financial position from the beginning of the fiscal year in which the pending content that links to this paragraph is applied to the adoption date of the pending content that links to this paragraph.
- e. All other entities that have not adopted the amendments in Update 2016-01 shall follow the transition guidance in paragraph 825-10-65-2(e) as amended.



Question 5.3.10

On adoption of the standard, what transition approach is required for equity securities without readily determinable fair values?

Interpretive response: ASU 2016-01 requires an entity to adopt the new standard prospectively for all equity securities without readily determinable fair values.

However, ASU 2018-03 amended the guidance in ASU 2016-01 to clarify that the prospective transition approach applies only when the measurement alternative is elected. [Pending content: 825-10-65-2]

Under ASU 2018-03, for equity securities for which the measurement alternative is not elected, an entity applies the new standard by making a cumulative-effect adjustment to the opening balance of retained earnings. [825-10-65-2]

See [Appendix](#) for considerations for an entity that adopts ASU 2016-01 and the amendments in ASU 2018-03 on different dates.



Example 5.3.10

Transition considerations when electing the measurement alternative

ABC Corp. is a calendar year-end public business entity that invests in common shares issued by Company XYZ. The common shares do not have a readily determinable fair value. On adoption of ASU 2016-01 (on January 1, 2018), ABC elects to measure its investment using the measurement alternative.

ABC identified observable transactions for similar shares issued by XYZ on the following dates:

- December 21, 2017
- January 15, 2018.

Because ABC elected the measurement alternative for the common shares, it applies the new standard prospectively. Therefore, ABC does not consider the December 21, 2017 transaction or record a cumulative-effect adjustment on adoption of the new standard.

ABC adjusts the carrying amount of its investment in XYZ common stock through earnings to reflect its fair value on January 15, 2018. At the end of the reporting period, ABC makes a qualitative assessment considering the impairment indicators to evaluate if the investment is impaired.



Question 5.3.20

On adoption of the standard, what transition approach is required for equity securities previously classified as AFS?

Interpretive response: An entity is required to adopt the new standard through a cumulative-effect adjustment to the balance sheet as of the beginning of the year of adoption. Therefore, unrealized gains and losses previously reported in AOCI related to equity securities classified as AFS are reclassified to beginning retained earnings in the year of adoption. [ASU 2016-01.BC150]



Question 5.3.30

What is the effect of the transition guidance on equity securities without a readily determinable fair value that are held by an insurance entity?

Interpretive response: Legacy US GAAP required an insurance entity to report unrealized gains and losses on equity securities without readily determinable fair values, net of tax, in OCI. The new standard supersedes this industry-specific guidance. [944-325-35-1]

An entity is required to adopt the new standard prospectively for equity securities without readily determinable fair values. However, the new standard does not prescribe how to account for amounts in AOCI at the adoption date. In

a January 2018 meeting, the Board clarified that there is not one prescribed methodology to recognize these amounts prospectively. However, the Board indicated a chosen method should be applied consistently to all equity securities for which the measurement alternative was applied. [2018-03.BC22, Pending content: 825-10-65-2(e)]

Therefore, on adoption of the ASU an insurance entity should establish an accounting policy on how to release those amounts from AOCI and apply it consistently to all applicable securities.

We believe various approaches at transition are acceptable. While other approaches may also be available, acceptable approaches include the following.

1. AOCI amounts existing at the adoption date are maintained, without adjustment, until the security is sold. Once the security is sold, the AOCI amounts will be released to earnings. Under this approach, impairment and any adjustments due to observable prices subsequent to the adoption date are recognized through earnings;
2. AOCI amounts at adoption are maintained until the first observable transaction or impairment is identified for the security. At that time, the full amount in AOCI related to that security is released to earnings; or
3. AOCI amounts at adoption are released incrementally to the extent that subsequent impairment or observable transactions offset the amount in AOCI for that security. On sale, any remaining amount in AOCI related to that security is recognized through earnings.

The following illustrates how to apply the third approach.

AOCI at transition	Impairment or observable transaction indicates FV decline	Observable transaction indicates FV increase
Security in an unrealized gain position	AOCI released to earnings as an offset. Any amount of impairment or observable decline in excess of AOCI recognized in earnings.	Adjustment recognized in earnings. AOCI remains unchanged.
Security in an unrealized loss position	The adjustment recognized in earnings. AOCI remains unchanged.	AOCI released to earnings as an offset. Any amount of observable increase in excess of AOCI recognized in earnings.

We do not believe it is acceptable to release the amounts in AOCI through retained earnings at the adoption date. Such an approach would not be consistent with the requirement to adopt the ASU prospectively.

6. Cash flow presentation

Detailed contents

Item significantly updated in this chapter: #

6.1 How the standard works

6.2 Overview

Question

6.1.10 How does the new standard affect cash flow presentation? #

6.1 How the standard works

Legacy US GAAP	ASU 2016-01/03
<ul style="list-style-type: none"> — Cash flows from purchases and sales of AFS securities were classified as cash flows from investing activities. — Cash flows from purchases and sales of trading securities were classified as operating or investing activities based on the nature and purposes for which the securities were acquired. 	<p>Cash flows from purchases and sales of equity securities are classified based on the nature and purpose for which the securities were acquired.</p>

6.2 Overview



Excerpt from ASC 321-10

> Cash Flow Presentation

45-1 An entity shall classify cash flows from purchases and sales of **equity securities** on the basis of the nature and purpose for which it acquired the **securities**.



Question 6.1.10#

How does the new standard affect cash flow presentation?

Interpretive response: The new standard eliminates the AFS classification for equity securities and the associated guidance that requires cash flows for such securities to be classified as an investing activity. Instead, an entity classifies cash flows from purchases and sales of all equity securities based on the nature and purpose for which they were acquired. [321-10-45-1]

Therefore, even though a security is measured at fair value through net income (if the measurement alternative is not elected), the cash flows are not necessarily an operating activity. An entity determines the classification based on the nature and purpose for which a security was acquired. Therefore, if an entity actively buys and sells securities with the intended purpose of generating trading profits in the short term, cash flows from those transactions are operating activities. [321-10-45-1, 230-10-45]

In contrast, if the entity's investment objective and strategy is not to engage in such trading activities, cash flows from purchases and sales of equity securities are investing activities.

In addition, when determining cash flows from operating activities, an entity that uses the indirect method of preparing the statement of cash flows should adjust net income for changes in the fair value of the equity securities recognized in net income.

Entities that adopt ASU 2016-01 and ASU 2018-03 on different dates

For a calendar year-end public business entity, ASU 2016-01 was effective on January 1, 2018. However, public business entities are not required to adopt amendments in ASU 2018-03 until the interim period beginning after June 15, 2018 (e.g. July 1, 2018).

There are some specific transition considerations that apply only when an entity adopts ASU 2018-03 in a period subsequent to the date of adoption of ASU 2016-01.

Based on discussions with the FASB staff, it is our understanding that if ASU 2018-03 is adopted in a later period, the cumulative-effect adjustment to retained earnings should be determined as of the beginning of the fiscal year of adoption. However, balance sheet amounts (other than retained earnings) should be adjusted to amounts that would have been recorded as if ASU 2018-03 had always been applied. This transition approach will, in some cases, result in an earnings effect that should be recognized in the period of adoption of ASU 2018-03. The guidance in ASU 2018-03 should be applied prospectively and not applied retroactively to previous interim periods.

The following table summarizes the guidance if an entity adopts ASU 2016-01 before the technical corrections, the amendments in ASU 2018-03, and the transition impact when ASU 2018-03 is adopted after ASU 2016-01.

ASU 2018-03	Applying ASU 2016-01 (before adopting ASU 2018-03)	Applying ASU 2018-03 (technical corrections)	Transition impact if ASU 2018-03 is adopted after ASU 2016-01
Issue 1: Equity securities without a readily determinable fair value – discontinuation (Q&A 2.3.120)	If an entity applies the measurement alternative, it may not subsequently elect to measure the equity security at fair value under Topic 820.	If an entity applies the measurement alternative, it may subsequently elect to measure the equity security (and all identical or similar investments of the same issuer) at fair value under Topic 820.	None. This amendment is applied prospectively on adoption of ASU 2018-03.
Issue 2: Equity securities without a readily determinable fair value – adjustments	If an entity applies the measurement alternative, an adjustment is made to reflect the fair value of the security whenever a transaction of the identical or a similar security is observed.	If an observable transaction of the identical or a similar security occurs, an adjustment is made to reflect the fair value at the date the observable transaction took place.	It depends. If, in interim periods before adopting ASU 2018-03, an entity made adjustments to reflect the fair value at the reporting date (as

ASU 2018-03	Applying ASU 2016-01 (before adopting ASU 2018-03)	Applying ASU 2018-03 (technical corrections)	Transition impact if ASU 2018-03 is adopted after ASU 2016-01
	<p>ASU 2016-01 was not clear whether the adjustment should be made to reflect fair value of the equity security at the date the observable transaction took place or at the reporting date.</p>		<p>opposed to the date that the observable transaction took place), the entity adjusts the carrying amount to the fair value as of the date of the most recent observable transaction (that occurred before adopting ASU 2018-03).</p> <p>The offsetting entry is to earnings in the interim period of adoption.</p>
<p>Issue 3: Forward contracts and purchased options on equity securities that do not have a readily determinable fair value – applying the measurement alternative (Q&A 2.3.210)</p>	<p>If an entity applies the measurement alternative to forward contracts and purchased options, and a transaction of the identical or a similar investment is observed, an adjustment is made to reflect the fair value of the security.</p> <p>ASU 2016-01 did not require an entity to remeasure forward contracts or purchased options if an entity observed a transaction in the underlying security (unless it was determined to be similar to the forward contract or purchased option).</p>	<p>If an entity observes a transaction in the underlying security, an adjustment is made to reflect the fair value of forward contracts and purchased options as of the date the observable transaction took place.</p>	<p>If an entity observed a transaction in the underlying security that took place subsequent to adopting ASU 2016-01, but before adopting ASU 2018-03, an entity adjusts the forward contract or purchased option value to the fair value as of the date that the observed transaction took place.</p> <p>The offsetting entry is to earnings in the interim period of adoption.</p>
<p>Issue 4: Presentation requirements for certain fair value option liabilities (Q&A 3.2.10)</p>	<p>An entity presents separately the portion of the total change in the fair value of a liability attributable to a change in instrument-specific credit risk within OCI.</p>	<p>The presentation requirement for instrument-specific credit risk applies regardless of whether the fair value option was elected under</p>	<p>If an entity had not applied the guidance in ASU 2016-01 to financial liabilities for which the fair value option was elected under Subtopic 815-15,</p>

ASU 2018-03	Applying ASU 2016-01 (before adopting ASU 2018-03)	Applying ASU 2018-03 (technical corrections)	Transition impact if ASU 2018-03 is adopted after ASU 2016-01
	<p>However, ASU 2016-01 was not clear whether the updated presentation requirements should also be applied to certain hybrid financial liabilities for which the fair value option was elected under Subtopic 815-15.</p>	<p>Subtopic 815-15 or Subtopic 825-10.</p>	<p>the entity recognizes amounts attributable to changes in instrument specific credit risk in AOCI as if ASU 2018-03 had been applied in all previous periods.</p> <p>The offsetting entries are to the cumulative-effect adjustment to retained earnings (determined as of the beginning of the fiscal year), with the remainder recognized as an earnings effect in the interim period of adoption.</p>
<p>Issue 5: Fair value option liabilities denominated in a foreign currency (Q&A 3.3.30)</p>	<p>ASU 2016-01 updated the presentation requirements for instrument-specific credit risk when the fair value option is elected for a financial liability under Subtopic 825-10.</p> <p>However, it did not prescribe how an entity should determine the fair value changes attributable to instrument-specific credit risk for a foreign-currency denominated liability for which the fair value option is elected.</p> <p>It is our understanding that the approach outlined in Question 3.3.30 is commonly applied in practice; however, there may be</p>	<p>ASU 2018-03 provides specific guidance for determining instrument-specific credit risk for these liabilities.</p>	<p>It depends.</p> <p>If an entity had applied an acceptable method other than the one described in ASU 2018-03, the entity recognizes amounts attributable to changes in instrument specific credit risk in AOCI as if ASU 2018-03 had been applied in all previous periods.</p> <p>The offsetting entries are to the cumulative-effect adjustment to retained earnings (determined as of the beginning of the fiscal year), with the remainder recognized as an earnings effect in</p>

ASU 2018-03	Applying ASU 2016-01 (before adopting ASU 2018-03)	Applying ASU 2018-03 (technical corrections)	Transition impact if ASU 2018-03 is adopted after ASU 2016-01
	circumstances where other approaches may have been acceptable.		the interim period of adoption.
<p>Issue 6: Transition guidance for equity securities without readily determinable fair values (Q&A 5.3.10)</p>	<p>ASU 2016-01 requires an entity to adopt the standard prospectively for all equity securities without a readily determinable fair value.</p>	<p>An entity adopts the standard prospectively only for equity securities without a readily determinable fair value in which the measurement alternative is applied.</p> <p>If an entity elects to measure equity securities without a readily determinable fair value at fair value under ASC 820, a cumulative-effect adjustment to the opening balance of retained earnings is required.</p>	<p>If an entity had elected to measure equity securities at fair value under Topic 820, and applied the guidance prospectively, it would have recognized in earnings any unrealized gains or losses on those equity securities that existed at the date of adopting ASU 2016-01.</p> <p>On adoption of ASU 2018-03 in a subsequent interim period, an entity records a cumulative-effect adjustment (determined as of the beginning of the fiscal year).</p> <p>The offsetting entry is to earnings in the interim period of adoption. This has the practical effect of reversing the earnings effect of unrealized gains or losses that existed at the date of adopting ASU 2016-01.</p>

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Lindsey Freeman

Eric Goldberg

Michael Hall

Danielle Imperiale

Mahesh Narayanasami

Mark Northan

Jennifer Stemple

kpmg.com/socialmedia



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