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Financial Instruments Enhanced Reporting Model

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Johnson Lambert LLP is dedicated to keeping you current on the impact the Financial Accounting Standards Board's (FASB) Accounting Standards Update (ASU) 2016-01, *Financial Instruments Recognition and Measurement*, ASU 2018-03, *Improvements to Financial Instruments*, and ASU 2018-13, *Changes to the Disclosure Requirements for Fair Value Measurement* will have on financial statements prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). This white paper presents the most impactful changes to the reporting model for equity securities and certain modifications to disclosures for financial instruments.

Background

In 2008, the FASB and International Accounting Standards Board (IASB) embarked on a joint project to explore improvements to financial instruments accounting standards. Although the FASB and the IASB worked together for several years, the FASB ultimately elected to only make targeted improvements to existing GAAP.

Overview and Effective Dates

The guidance introduces a new reporting model for equity securities whereby ***changes in fair value are recognized in net income*** and an alternative measurement model for equity securities without readily determinable fair values. The FASB also made several amendments to improve the effectiveness of certain disclosures.

The FASB issued ASU 2016-01 in January 2016 and ASU 2018-03 in February 2018, which are effective for non-public, calendar year-end filers December 31, 2019, with early adoption permitted no sooner than first quarter 2018. The FASB issued ASU 2018-13 in August 2018, which is effective for non-public, calendar year-end filers December 31, 2020, with early adoption permitted.

Equity Securities

Impacted Equity Securities

The term equity securities encompass a variety of financial instruments, ranging from common stocks, preferred stocks and mutual funds to ownership interests in partnerships, unincorporated joint ventures and limited liability companies. ASU 2016-01 specifically excludes those securities accounted for under the equity method and consolidated subsidiaries.

New Reporting Model

The new reporting model requires entities to measure most equity securities at fair value and recognize changes in fair value in net income. This change should be applied prospectively via a cumulative-effect adjustment on the first day of the fiscal year of adoption. (see illustration in Appendix A).

As the change in the fair value of equity securities now flows through the income statement, an entity with a substantial equity security portfolio may experience significant volatility in earnings.

Alternative Model

Historically, insurance companies were required to report all equity securities at fair value, even those where fair value was not readily determinable. Now an entity may elect a measurement alternative for equity securities that do not have readily determinable fair values and do not qualify for the practical expedient to estimate fair value using the net asset value (NAV) per share (or its equivalent). This alternative may be advantageous for some entities, as it allows entities to measure securities at cost, less any impairment, plus or minus changes resulting from observable price changes in orderly transactions for the identical or similar investment of the same issuer. A separate election to use the alternative model is required for each eligible security and must be applied consistently until the security's fair value is readily determinable. An assessment of whether the security is eligible to use the measurement alternative must be performed at each reporting period. Adjustments made resulting from observable price changes should reflect the fair value of the security as of the date the observable transaction occurred, not the current reporting date. The guidance also allows securities that do not have readily determinable fair values to be remeasured at fair value either upon (1) the occurrence of an observable price change or (2) identification of an impairment. Upon concluding an impairment exists, the difference between the carrying value and fair value is recognized as an impairment in net income. Impairment indicators may include significant deterioration or adverse changes in the credit rating, earnings performance, economic, regulatory or technological environment of the investee, or in the general market in which the investee operates.

Recognize changes in fair value for equity securities through the income statement.

At adoption, insurance companies should apply a prospective method consistently to the entire population of securities for which the measurement alternative is elected. An entity may subsequently elect to measure the securities at fair value. This election is irrevocable and should be applied to all identical or similar securities. Any resulting gains or losses are recorded in net income at the time of the election.

An entity electing the alternative model must disclose:

- The carrying amount of securities without readily determinable fair values
- The amount of annual and cumulative impairments and downward adjustments, if any
- The amount of annual and cumulative upward adjustments, if any
- Narrative information to help financial statement readers understand the quantitative disclosures, including the information considered in determining the carrying amounts and adjustments resulting from observable price changes (as of the current reporting date)

Summary of Key Revisions

Pre ASU 2016-01	Post ASU 2016-01
Equity securities are measured at fair value with adjustments flowing through other comprehensive income (available-for-sale) or net income (trading).	**The available-for-sale and trading designations are eliminated. Equity securities are held at fair value with adjustments flowing through net income.**
Equity securities without readily determinable fair values may be accounted for at cost. The impairment process consists of two steps: **1. Determining whether an impairment exists** **2. If yes, determining whether the impairment is other-than-temporary.**	**Equity investments without readily determinable fair values may be recorded at cost minus impairment (if any), plus or minus adjustments for observable price changes in orderly transactions for identical or similar investments by the same issuer. Impairment is determined by assessing the fair value to determine whether an impairment exists.**

At adoption, an entity is required to disclose the following:

- The nature of and reason for the change in accounting principle, with an explanation of the newly adopted principle
- The method of applying the change
- The effect of the adoption on any line in the statement of financial position, if material, as of the beginning of the fiscal year of adoption
- The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the fiscal year of adoption

Debt Securities

The FASB also made the following amendments related to debt securities:

- Eliminated the requirement to disclose the fair value of debt securities held at amortized cost
- Requires an entity to evaluate the need for a valuation allowance on deferred tax assets (DTAs) related to available-for-sale debt securities in conjunction with the entity's other DTAs, rather than separately evaluating its ability to realize such DTAs by considering its intent and ability to hold the debt securities until recovery or maturity

Improved Disclosures

New Disclosures

Financial assets and financial liabilities must be presented separately by measurement category and form on the balance sheet or in the notes to the financial statements, as illustrated below.

	As of 12.31.18
Debt Securities – Available-for-Sale	$1,200,000
Debt Securities – Held to Maturity	100,000
Debt Securities – Trading	500,000
Debt Securities – Fair Value Option	250,000
Equity Securities	200,000
Premium Receivables	350,000
Loan Receivables	10,000

Eliminated Disclosures

The following disclosures are no longer required:

- The amount and reasons for transfers between Level 1 and Level 2 of the fair value hierarchy
- The policy for timing of transfers between levels
- The valuation processes for Level 3 fair value measurements
- The changes in unrealized gains and losses for the period included in earnings for recurring Level 3 fair value measurements held at the end of the reporting period

Modified Disclosures

Rather than provide a roll forward for Level 3 securities, entities will disclose transfers into and out of Level 3 and purchases and issues of Level 3 assets and liabilities. An entity that invests in certain entities that calculate NAV, is required to disclose the timing of liquidation of an investee's assets and the date when restrictions from redemption might lapse *only* if the investee has communicated the timing to the entity or announced the timing publicly.

Appendix A

Illustrations

The following illustrations show the impact of ASU 2016-01 on the statement of income and statement of shareholders' equity. For illustrative purposes, the entity early adopted the ASU in 2018 and the investment portfolio consists solely of equity securities.

Statement of Income

Year Ended December 31, 2018

	Pre ASU 2016-01	Impact of ASU 2016-01	Post ASU 2016-01
Revenues			
Premiums earned	$400,000		$400,000
Other income	10,000		10,000
Net investment income earned	30,000		30,000
Unrealized gains on equity securities[1]		44,430	44,430
Net realized capital gains	40,000		40,000
Total revenues	480,000		524,430
Loss and expenses			
Losses and loss adjustment expenses incurred, net	300,000		300,000
Commissions expense	50,000		50,000
Selling, general and administrative expenses	50,000		50,000
Depreciation expense	20,000		20,000
Total expenses	420,000		420,000
Income before tax expense	60,000		104,430
Income taxes			
Current expense	14,000		14,000
Deferred expense[2]	5,000	9,330	14,330
Total income tax expense	19,000		28,330
Net income	41,000		$76,100
Other comprehensive income:			
Unrealized holding gain, net of deferred income tax expense of $17,330	66,700		
Reclassification adjustment, net of income tax expense of $8,400	(31,600)		
Other comprehensive Income	35,100		
Total comprehensive income	$76,100		

[1]Unrealized gains and losses are reported gross of tax.
[2]The tax effect of unrealized gains and losses are reported as a deferred expense.

Statement of Shareholders' Equity

Pre ASU 2016-01

	Common Stock	Accumulated Other Comprehensive Income, Net of Tax	Retained Earnings	Total
January 1, 2018	$10,000	$100,000	$2,000,000	$2,110,000
Other Comprehensive Income		35,100		35,100
Net income			41,000	41,000
December 31, 2018	$10,000	$135,100	$2,041,000	$2,186,100

Post ASU 2016-01

	Common Stock	Accumulated Other Comprehensive Income, Net of Tax	Retained Earnings	Total
January 1, 2018	$10,000	$100,000	$2,000,000	$2,110,000
Impact of adoption of ASU 2016-01		(100,000)	100,000	-
Net income			76,100	76,100
December 31, 2018	$10,000	$ -	$2,176,100	$2,186,100

References:

ASU 2016-01, *Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, January 2016

ASU 2018-03, *Technical Corrections and Improvements to Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, February 2018

ASU 2018-13, *Fair Value Measurement (Topic 820): Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement*, August 2018