



Financial Accounting Standards Board

ORIGINAL PRONOUNCEMENTS

AS AMENDED

Statement of Financial Accounting Standards No. 115

Accounting for Certain Investments in Debt and
Equity Securities

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Statement of Financial Accounting Standards No. 115 Accounting for Certain Investments in Debt and Equity Securities

STATUS

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Effective Date: For fiscal years beginning after December 15, 1993

Affects: Amends ARB 43, Chapter 3A, paragraph 4(f)

Amends APB 18, paragraph 19(l)

Supersedes FAS 12

Replaces FAS 60, paragraphs 45 and 46

Amends FAS 60, paragraphs 50 and 51

Deletes FAS 60, footnote 7

Amends FAS 65, paragraphs 4 through 8, 9(a), 9(c), 12, 17, 28, and 29

Amends FAS 80, paragraph 5

Amends FAS 91, paragraphs 3 and 27(a)

Amends FAS 97, paragraph 28

Amends FAS 102, paragraph 8 and footnote 4

Amends FAS 109, paragraph 36(b)

Supersedes FIN 11

Supersedes FIN 12

Supersedes FIN 13

Supersedes FIN 16

Amends FIN 40, paragraphs 4 and 5

Amends FTB 79-19, paragraph 1

Replaces FTB 79-19, paragraph 6

Amends FTB 85-1, paragraph 3

Affected by: Paragraph 3(a) amended by FAS 157, paragraph E15(a)

Paragraph 4 amended by FAS 124, paragraph 110; FAS 133, paragraph 534(a); and FAS 159, paragraph C5(a)

Paragraph 7 amended by FAS 125, paragraph 233; FAS 135, paragraph 4(t); and FAS 140, paragraph 362

Paragraph 8(c) amended by FAS 144, paragraph C13

Paragraph 12(a) amended by FAS 134, paragraph 5

Paragraph 13 amended by FAS 130, paragraph 33(a), and FAS 133, paragraph 534(b)

Paragraph 15(b) amended by FAS 133, paragraph 534(c)

Paragraphs 15(c) and 15(d) amended by FAS 130, paragraphs 33(b) and 33(c), respectively

Paragraph 16 amended by FAS 130, paragraph 33(d); FAS 133, paragraph 534(d); and FSP FAS 115-2/FAS 124-2, paragraph A2(a)

Paragraph 17 replaced by FAS 135, paragraph 4(t), and amended by FAS 159, paragraph C5(b)

Paragraph 18 amended by FAS 159, paragraph C5(c)

Paragraph 18A added by FSP FAS 115-2/FAS 124-2, paragraph A2(b)

Paragraph 19 amended by FAS 133, paragraph 534(e), and FSP FAS 115-2/FAS 124-2, paragraph A2(c)

Paragraphs 20 through 22 amended by FAS 133, paragraphs 534(f) through 534(h), respectively

Paragraph 115 amended by FAS 133, paragraph 534(i)

Paragraph 128(a) amended by FAS 134, paragraph 4

Paragraph 137 amended by FAS 133, paragraph 534(j), and FAS 157, paragraph E15(b)

Footnote 2 replaced by FAS 157, paragraph E15(a)

Footnote 4 amended by FAS 135, paragraph 5(c); FAS 145, paragraph 9(h); and
FSP FAS 115-1/FAS 124-1, paragraph B2

Footnote 4 deleted by FSP FAS 115-2/FAS 124-2, paragraph A2(a)

Other Interpretive Pronouncement: FTB 94-1

Other Interpretive Releases: FASB Special Report, *A Guide to Implementation of Statement 115 on
Accounting for Certain Investments in Debt and Equity Securities: Questions
and Answers* (in *Current Text* Section I80)

FASB Staff Positions FAS 115-1/FAS 124-1 and FAS 115-2/FAS 124-2

AICPA Accounting Standards Executive Committee (AcSEC)

Related Pronouncements: SOP 78-9

SOP 90-3

SOP 93-1

SOP 01-6

PB 4

PB 5

PB 6

Issues Discussed by FASB Emerging Issues Task Force (EITF)

Affects: EITF Issues No. 85-25, 86-40, 89-18, and 91-5

Interpreted by: Paragraph 3 interpreted by EITF Topic No. D-39

Paragraph 7 interpreted by EITF Issue No. 96-10 and Topic No. D-39

Paragraph 9 interpreted by EITF Topic No. D-51

Paragraph 12 interpreted by EITF Issue No. 98-13

Paragraph 13 interpreted by EITF Topic No. D-41

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98-15, 99-4, 99-20, 00-8, 00-18, 00-27, 01-1, 02-2, and 08-4 and Topics No. D-11, D-40,
and D-74

SUMMARY

This Statement addresses the accounting and reporting for investments in equity securities that have readily determinable fair values and for all investments in debt securities. Those investments are to be classified in three categories and accounted for as follows:

- Debt securities that the enterprise has the positive intent and ability to hold to maturity are classified as *held-to-maturity securities* and reported at amortized cost.
- Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as *trading securities* and reported at fair value, with unrealized gains and losses included in earnings.
- Debt and equity securities not classified as either held-to-maturity securities or trading securities are classified as *available-for-sale securities* and reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of shareholders' equity.

This Statement does not apply to unsecuritized loans. However, after mortgage loans are converted to mortgage-backed securities, they are subject to its provisions. This Statement supersedes FASB Statement No. 12, *Accounting for Certain Marketable Securities*, and related Interpretations and amends FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, to eliminate mortgage-backed securities from its scope.

This Statement is effective for fiscal years beginning after December 15, 1993. It is to be initially applied as of the beginning of an enterprise's fiscal year and cannot be applied retroactively to prior years' financial statements. However, an enterprise may elect to initially apply this Statement as of the end of an earlier fiscal year for which annual financial statements have not previously been issued.

Statement of Financial Accounting Standards No. 115

Accounting for Certain Investments in Debt and Equity Securities

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INTRODUCTION

1. This Statement addresses the accounting and reporting for certain investments in **debt securities**¹ and **equity securities**. It expands the use of fair value accounting for those securities but retains the use of the amortized cost method for investments in debt securities that the reporting enterprise has the positive intent and ability to hold to maturity.

2. This Statement was undertaken mainly in response to concerns expressed by regulators and others about the recognition and measurement of investments in debt securities, particularly those held by financial institutions. They questioned the appropriateness of using the amortized cost method for certain investments in debt securities in light of certain trading and sales practices. Their concerns also were prompted by the existence of inconsistent guidance on the reporting of debt securities held as assets in various AICPA Audit and Accounting Guides. The AICPA’s Accounting Standards Executive Committee (AcSEC) and the major CPA firms, among others,

urged the Board to reexamine the accounting for certain investments in **securities**.

**STANDARDS OF FINANCIAL ACCOUNTING
AND REPORTING**

Scope

3. Except as indicated in paragraph 4, this Statement establishes standards of financial accounting and reporting for investments in equity securities that have readily determinable fair values and for all investments in debt securities.

- a. The fair value of an equity security is readily determinable if sales prices or bid-and-asked quotations are currently available on a securities exchange registered with the Securities and Exchange Commission (SEC) or in the over-the-counter market, provided that those prices or quotations for the over-the-counter market are publicly reported by the National Association of

¹Words that appear in the glossary in Appendix C are set in **boldface type** the first time they appear.

Securities Dealers Automated Quotations systems or by Pink Sheets LLC. Restricted stock² meets that definition if the restriction terminates within one year.

- b. The fair value of an equity security traded only in a foreign market is readily determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to above.
- c. The fair value of an investment in a mutual fund is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions.

4. This Statement does not apply to investments in equity securities that, absent the election of the fair value option under FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, would be required to be accounted for under the equity method nor to investments in consolidated subsidiaries. This Statement does not apply to enterprises whose specialized accounting practices include accounting for substantially all investments in debt and equity securities at market value or fair value, with changes in value recognized in earnings (income) or in the change in net assets. Examples of those enterprises are brokers and dealers in securities, defined benefit pension plans, and investment companies. This Statement applies to cooperatives and mutual enterprises, including credit unions and mutual insurance companies, but does not apply to not-for-profit organizations. FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, establishes standards for not-for-profit organizations. This Statement does not apply to investments in derivative instruments that are subject to the requirements of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. If an investment would otherwise be in the scope of this Statement and it has within it an embedded derivative that is subject to Statement 133, the host instrument (as described in Statement 133) remains within the scope of this Statement. A transaction gain or loss on a held-to-maturity foreign-currency-denominated debt security shall be accounted for pursuant to FASB Statement No. 52, *Foreign Currency Translation*.

5. This Statement supersedes FASB Statement No. 12, *Accounting for Certain Marketable Securities*, and supersedes or amends other accounting pronouncements listed in Appendix B.

Accounting for Certain Investments in Debt and Equity Securities

6. At acquisition, an enterprise shall classify debt and equity securities into one of three categories: held-to-maturity, available-for-sale, or trading. At each reporting date, the appropriateness of the classification shall be reassessed.

Held-to-Maturity Securities

7. Investments in debt securities shall be classified as *held-to-maturity* and measured at amortized cost in the statement of financial position only if the reporting enterprise has the positive intent and ability to hold those securities to maturity. A security may not be classified as held-to-maturity if that security can contractually be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment. A debt security with those characteristics should be evaluated in accordance with paragraphs 12–16 of Statement 133 to determine whether it contains an embedded derivative that must be accounted for separately.

8. The following changes in circumstances, however, may cause the enterprise to change its intent to hold a certain security to maturity without calling into question its intent to hold other debt securities to maturity in the future. Thus, the sale or transfer of a held-to-maturity security due to one of the following changes in circumstances shall not be considered to be inconsistent with its original classification:

- a. Evidence of a significant deterioration in the issuer's creditworthiness
- b. A change in tax law that eliminates or reduces the tax-exempt status of interest on the debt security (but not a change in tax law that revises the marginal tax rates applicable to interest income)
- c. A major business combination or major disposition (such as sale of a component of an entity) that necessitates the sale or transfer of held-to-maturity securities to maintain the enterprise's existing interest rate risk position or credit risk policy
- d. A change in statutory or regulatory requirements significantly modifying either what constitutes a permissible investment or the maximum level of investments in certain kinds of securities, thereby

²The fair value of restricted stock shall be measured based on the quoted price of an otherwise identical unrestricted security of the same issuer, adjusted for the effect of the restriction, in accordance with the provisions of FASB Statement No. 157, *Fair Value Measurements*.

causing an enterprise to dispose of a held-to-maturity security

- e. A significant increase by the regulator in the industry's capital requirements that causes the enterprise to downsize by selling held-to-maturity securities
- f. A significant increase in the risk weights of debt securities used for regulatory risk-based capital purposes.

In addition to the foregoing changes in circumstances, other events that are isolated, nonrecurring, and unusual for the reporting enterprise that could not have been reasonably anticipated may cause the enterprise to sell or transfer a held-to-maturity security without necessarily calling into question its intent to hold other debt securities to maturity. All sales and transfers of held-to-maturity securities shall be disclosed pursuant to paragraph 22.

9. An enterprise shall not classify a debt security as held-to-maturity if the enterprise has the intent to hold the security for only an indefinite period. Consequently, a debt security should not, for example, be classified as held-to-maturity if the enterprise anticipates that the security would be available to be sold in response to:

- a. Changes in market interest rates and related changes in the security's prepayment risk
- b. Needs for liquidity (for example, due to the withdrawal of deposits, increased demand for loans, surrender of insurance policies, or payment of insurance claims)
- c. Changes in the availability of and the yield on alternative investments
- d. Changes in funding sources and terms
- e. Changes in foreign currency risk.

10. Although its asset-liability management may encompass consideration of the maturity and repricing characteristics of all investments in debt securities, an enterprise may decide that it can accomplish the necessary adjustments under its asset-liability management without having all of its debt securities available for disposition. In that case, the enterprise may choose to designate certain debt securities as unavailable to be sold to accomplish those ongoing adjustments deemed necessary under its asset-liability management, thereby enabling those debt securities to be accounted for at amortized cost on the basis of a positive intent and ability to hold them to maturity.

11. Sales of debt securities that meet either of the following two conditions may be considered as ma-

turities for purposes of the classification of securities under paragraphs 7 and 12 and the disclosure requirements under paragraph 22:

- a. The sale of a security occurs near enough to its maturity date (or call date if exercise of the call is probable) that interest rate risk is substantially eliminated as a pricing factor. That is, the date of sale is so near the maturity or call date (for example, within three months) that changes in market interest rates would not have a significant effect on the security's fair value.
- b. The sale of a security occurs after the enterprise has already collected a substantial portion (at least 85 percent) of the principal outstanding at acquisition due either to prepayments on the debt security or to scheduled payments on a debt security payable in equal installments (both principal and interest) over its term. For variable-rate securities, the scheduled payments need not be equal.

Trading Securities and Available-for-Sale Securities

12. Investments in debt securities that are not classified as held-to-maturity and equity securities that have readily determinable fair values shall be classified in one of the following categories and measured at fair value in the statement of financial position:

- a. *Trading securities.* Securities that are bought and held principally for the purpose of selling them in the near term (thus held for only a short period of time) shall be classified as *trading securities*. Trading generally reflects active and frequent buying and selling, and trading securities are generally used with the objective of generating profits on short-term differences in price.
- b. *Available-for-sale securities.* Investments not classified as trading securities (nor as held-to-maturity securities) shall be classified as *available-for-sale securities*.

Reporting Changes in Fair Value

13. Unrealized **holding gains and losses** for trading securities shall be included in earnings. Unrealized holding gains and losses for available-for-sale securities (including those classified as current assets) shall be excluded from earnings and reported in other comprehensive income until realized except as indicated in the following sentence. All or a portion of the unrealized holding gain and loss of an available-for-sale security that is designated as being hedged in a

fair value hedge shall be recognized in earnings during the period of the hedge, pursuant to paragraph 22 of Statement 133. Paragraph 36 of FASB Statement No. 109, *Accounting for Income Taxes*, provides guidance on reporting the tax effects of unrealized holding gains and losses reported in other comprehensive income.

14. Dividend and interest income, including amortization of the premium and discount arising at acquisition, for all three categories of investments in securities shall continue to be included in earnings. This Statement does not affect the methods used for recognizing and measuring the amount of dividend and interest income. Realized gains and losses for securities classified as either available-for-sale or held-to-maturity also shall continue to be reported in earnings.

Transfers between Categories of Investments

15. The transfer of a security between categories of investments shall be accounted for at fair value.³ At the date of the transfer, the security's unrealized holding gain or loss shall be accounted for as follows:

- a. For a security transferred from the trading category, the unrealized holding gain or loss at the date of the transfer will have already been recognized in earnings and shall not be reversed.
- b. For a security transferred into the trading category, the portion of the unrealized holding gain or loss at the date of the transfer that has not been previously recognized in earnings shall be recognized in earnings immediately.
- c. For a debt security transferred into the available-for-sale category from the held-to-maturity category, the unrealized holding gain or loss at the date of the transfer shall be reported in other comprehensive income.
- d. For a debt security transferred into the held-to-maturity category from the available-for-sale category, the unrealized holding gain or loss at the date of the transfer shall continue to be reported in a separate component of shareholders' equity, such as accumulated other comprehensive income, but shall be amortized over the remaining life of the security as an adjustment of yield in a manner consistent with the amortization of any premium or discount. The amortization of an un-

realized holding gain or loss reported in equity will offset or mitigate the effect on interest income of the amortization of the premium or discount (discussed in footnote 3) for that held-to-maturity security.

Consistent with paragraphs 7–9, transfers from the held-to-maturity category should be rare, except for transfers due to the changes in circumstances identified in subparagraphs 8(a)–8(f). Given the nature of a trading security, transfers into or from the trading category also should be rare.

Impairment of Securities

16. For individual securities classified as either available-for-sale or held-to-maturity, an enterprise shall determine whether a decline in fair value below the amortized cost basis is other than temporary. (If a security has been the hedged item in a fair value hedge, the security's "amortized cost basis" shall reflect the effect of the adjustments of its carrying amount made pursuant to paragraph 22(b) of Statement 133.) The enterprise shall apply the guidance in FSP FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, to determine whether the decline in fair value is other than temporary and how an other-than-temporary impairment should be recognized. The amortized cost basis shall be written down by the amount of an other-than-temporary impairment recognized in earnings. The new amortized cost basis shall not be changed for subsequent recoveries in fair value. Subsequent increases in the fair value of available-for-sale securities shall be included in other comprehensive income pursuant to paragraph 13; subsequent decreases in fair value, if not an other-than-temporary impairment, also shall be included in other comprehensive income.

Financial Statement Presentation

17. An enterprise shall report its investments in available-for-sale securities and trading securities separately from similar assets that are subsequently measured using another measurement attribute on the face of the statement of financial position. To accomplish that, an entity shall either (a) present the aggregate of those fair value and non-fair-value amounts in

³For a debt security transferred into the held-to-maturity category, the use of fair value may create a premium or discount that, under amortized cost accounting, shall be amortized thereafter as an adjustment of yield pursuant to FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.

⁴[This footnote has been deleted. See Status page.]

the same line item and parenthetically disclose the amount of fair value included in the aggregate amount or (b) present two separate line items to display the fair value and non-fair-value carrying amounts. An enterprise that presents a classified statement of financial position shall report individual held-to-maturity securities, individual available-for-sale securities, and individual trading securities as either current or noncurrent, as appropriate, under the provisions of ARB No. 43, Chapter 3A, "Working Capital—Current Assets and Current Liabilities."⁵

18. Cash flows from purchases, sales, and maturities of available-for-sale securities and held-to-maturity securities shall be classified as cash flows from investing activities and reported gross for each security classification in the statement of cash flows. Cash flows from purchases, sales, and maturities of trading securities shall be classified based on the nature and purpose for which the securities were acquired.

Disclosures

18A. The disclosures in this Statement are required for interim and annual periods.

19. For securities classified as available-for-sale, all reporting enterprises shall disclose the amortized cost basis, the aggregate fair value, the total other-than-temporary impairment recognized in accumulated other comprehensive income, the total gains for securities with net gains in accumulated other comprehensive income, and the total losses for securities with net losses in accumulated other comprehensive income, by major security type as of each date for which a statement of financial position is presented. For securities classified as held-to-maturity, all reporting enterprises shall disclose the amortized cost basis, the aggregate fair value, gross unrecognized holding gains, gross unrecognized holding losses, the net carrying amount, the total other-than-temporary impairment recognized in accumulated other comprehensive income, and the gross gains and losses in accumulated other comprehensive income for any derivatives that hedged the forecasted acquisition of the held-to-maturity securities, by major security

type as of each date for which a statement of financial position is presented. Major security types shall be based on the nature and risks of the security. An enterprise should consider the (shared) activity or business sector, vintage, geographic concentration, credit quality, or economic characteristic in determining whether disclosure for a particular security type is necessary and whether it is necessary to further separate a particular security type into greater detail. In complying with this requirement, financial institutions⁶ shall include in their disclosure the following major security types, though additional types also may be necessary:

- a. Equity securities (segregated by industry type, company size, or investment objective)
- b. Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies
- c. Debt securities issued by states of the United States and political subdivisions of the states
- d. Debt securities issued by foreign governments
- e. Corporate debt securities
- f. Residential mortgage-backed securities
- g. Commercial mortgage-backed securities
- h. Collateralized debt obligations
- i. Other debt obligations.

20. For investments in debt securities classified as available-for-sale and separately for securities classified as held-to-maturity, all reporting enterprises shall disclose information about the contractual maturities of those securities as of the date of the most recent statement of financial position presented. Maturity information may be combined in appropriate groupings. In complying with this requirement, financial institutions shall disclose the fair value and the net carrying amount (if different from fair value) of debt securities based on at least 4 maturity groupings: (a) within 1 year, (b) after 1 year through 5 years, (c) after 5 years through 10 years, and (d) after 10 years. Securities not due at a single maturity date, such as mortgage-backed securities, may be disclosed separately rather than allocated over several maturity groupings; if allocated, the basis for allocation also shall be disclosed.

⁵Chapter 3A of ARB 43 indicates in paragraph 4 that "the term *current assets* is used to designate cash and other assets or resources commonly identified as those which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business." That paragraph further indicates that the term also comprehends "marketable securities representing the investment of cash available for current operations." Paragraph 5 indicates that "a one-year time period is to be used as a basis for the segregation of current assets in cases where there are several operating cycles occurring within a year."

⁶For purposes of the disclosure requirements of paragraphs 19 and 20, the term *financial institutions* includes banks, savings and loan associations, savings banks, credit unions, finance companies, and insurance companies, consistent with the usage of that term in AICPA Statement of Position 90-11, *Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets*.

21. For each period for which the results of operations are presented, an enterprise shall disclose:

- a. The proceeds from sales of available-for-sale securities and the gross realized gains and gross realized losses that have been included in earnings as a result of those sales
- b. The basis on which the cost of a security sold or the amount reclassified out of accumulated other comprehensive income into earnings was determined (that is, specific identification, average cost, or other method used)
- c. The gross gains and gross losses included in earnings from transfers of securities from the available-for-sale category into the trading category
- d. The amount of the net unrealized holding gain or loss on available-for-sale securities for the period that has been included in accumulated other comprehensive income and the amount of gains and losses reclassified out of accumulated other comprehensive income into earnings for the period
- e. The portion of trading gains and losses for the period that relates to trading securities still held at the reporting date.

22. For any sales of or transfers from securities classified as held-to-maturity, the net carrying amount of the sold or transferred security, the net gain or loss in accumulated other comprehensive income for any derivative that hedged the forecasted acquisition of the held-to-maturity security, the related realized or unrealized gain or loss, and the circumstances leading to the decision to sell or transfer the security shall be disclosed in the notes to the financial statements for each period for which the results of operations are presented. Such sales or transfers should be rare, except for sales and transfers due to the changes in circumstances identified in subparagraphs 8(a)–8(f).

**The provisions of this Statement need
not be applied to immaterial items.**

This Statement was adopted by the affirmative votes of five members of the Financial Accounting Standards Board. Messrs. Sampson and Swieringa dissented.

Messrs. Sampson and Swieringa disagree with the accounting treatment prescribed in paragraphs 6–18 of this Statement because it does not resolve two of the most important problems that caused the Board to

Effective Date and Transition

23. This Statement shall be effective for fiscal years beginning after December 15, 1993. Except as indicated in the following paragraph, initial application of this Statement shall be as of the beginning of an enterprise's fiscal year; at that date, investments in debt and equity securities owned shall be classified based on the enterprise's current intent. Earlier application as of the beginning of a fiscal year is permitted only in financial statements for fiscal years beginning after issuance of this Statement. This Statement may not be applied retroactively to prior years' financial statements.

24. For fiscal years beginning prior to December 16, 1993, enterprises are permitted to initially apply this Statement as of the end of a fiscal year for which annual financial statements have not previously been issued. This Statement may not be applied retroactively to the interim financial statements for that year.

25. The effect on retained earnings of initially applying this Statement shall be reported as the effect of a change in accounting principle in a manner similar to the cumulative effect of a change in accounting principle as described in paragraph 20 of APB Opinion No. 20, *Accounting Changes*. That effect on retained earnings includes the reversal of amounts previously included in earnings that would be excluded from earnings under this Statement (refer to paragraph 13). The unrealized holding gain or loss, net of tax effect, for securities classified as available-for-sale as of the date that this Statement is first applied shall be an adjustment of the balance of the separate component of equity. The pro forma effects of retroactive application (discussed in paragraph 21 of Opinion 20) shall not be disclosed.

address the accounting for certain investments in debt and equity securities—namely, accounting based on intent, and gains trading. They believe that those problems can only be resolved by reporting all securities that are within the scope of this Statement at fair value and by including unrealized changes in fair value in earnings.

This Statement requires that debt securities be classified as held-to-maturity, available-for-sale, or

trading and that securities in each classification be accounted for differently. As a result, three otherwise identical debt securities could receive three different accounting treatments within the same enterprise. Moreover, classification of debt securities as held-to-maturity is based on management's positive intent and ability to hold to maturity. The notion of intent to hold to maturity (a) is subjective at best, (b) is not likely to be consistently applied, (c) given the provisions in paragraphs 8–11, is not likely to be descriptive of actual transactions and events, and (d) disregards the best available information about the present value of expected future cash flows from a readily marketable debt security—namely, its observable market price. Effective management of financial activities increasingly requires a flexible approach to asset and liability management that is inconsistent with a hold-to-maturity notion.

This Statement also requires that certain debt securities classified as held-to-maturity be reported at amortized cost and that certain debt and equity securities classified as available-for-sale be reported at fair value with unrealized changes in fair value excluded from earnings. Those requirements provide the opportunity for the managers of an enterprise to manage its earnings by selectively selling securities and thereby selectively including realized gains in earnings and selectively excluding unrealized losses from earnings. An impressive amount of empirical evidence indicates that many financial institutions have engaged in that behavior. That behavior undermines the relevance and reliability of accounting information.

The Board concluded that unrealized changes in fair value for trading securities should be reported in earnings because that reporting reflects the economic consequences of the events of the enterprise (such as changes in fair values) as well as the transactions

(such as sales of securities) when those events and transactions occur and results in more relevant reporting (paragraph 92). However, the Board concluded that similar reporting of unrealized changes in fair value for available-for-sale securities has the potential for significant earnings volatility that is unrepresentative of both the way enterprises manage their businesses and the impact of economic events on the overall enterprise and, therefore, decided that those changes should be excluded from earnings (paragraphs 93 and 94). Those conclusions do not alleviate the potential for volatility in reported earnings; rather, they provide the opportunity for selective volatility in reported earnings—that is, the volatility in reported earnings that results from the recognition of unrealized changes in fair value in earnings through selective sales of securities.

Reporting all securities that are within the scope of this Statement at fair value and including unrealized changes in fair value in earnings would result in reflecting the consequences of economic events (price changes) in the periods in which they occur rather than when managers wish to selectively recognize those consequences in earnings. Messrs. Sampson and Swieringa believe that this reporting is the only way to resolve the problems of accounting based on intent and gains trading that have raised concerns about the relevance and credibility of accounting for certain investments in debt and equity securities.

In addition, Mr. Sampson is concerned that the conclusions adopted in this Statement may, in some cases, portray unrepresentative volatility in capital because enterprises are not permitted to recognize the unrealized changes in fair value of the liabilities that are related to investments accounted for as available-for-sale securities.

Members of the Financial Accounting Standards Board:

Dennis R. Beresford,
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Appendix A

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

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Appendix A

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction and Overview

26. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this Statement. It includes reasons for accepting certain views and rejecting others. Individual Board members gave greater weight to some factors than to others.

27. The Board tried to resolve several problems with the current accounting and reporting practices for debt and equity securities. Those problems, which are discussed in greater detail in this appendix, are summarized as follows:

- a. *Inconsistent literature.* The authoritative literature on investments in debt securities is inconsistent among different industries and has resulted in diversity in reporting.
- b. *LOCOM not evenhanded.* The current requirement to use the lower-of-cost-or-market (LOCOM) method for debt securities held for sale and for noncurrent marketable equity securities is not evenhanded because it recognizes the net diminution in value but not the net appreciation in the value of those securities.
- c. *Greater relevance of fair value information.* Some believe that fair value information about debt securities is more relevant than amortized cost information in helping users and others assess the effect of current economic events on the enterprise.
- d. *Gains trading.* The current requirement to use the amortized cost method permits the recognition of

holding gains through the selective sale of appreciated securities but does not require the concurrent recognition of holding losses.

- e. *Accounting based on intent.* Current accounting for a debt security is based not on the characteristics of the asset but on management's plans for holding or disposing of the investment. Intent-based accounting impairs comparability.

28. After concluding that the project would not prescribe the comprehensive use of fair value accounting for all securities and related liabilities, the Board supported an approach that resolves the first two problems listed in paragraph 27. It partially addresses the third issue and leaves the last two problems unresolved, although required disclosures will at least highlight situations where gains trading exists. Nevertheless, because the disparities among industries and the differences in recognizing unrealized gains and unrealized losses are eliminated, the Board considers this standard to be an improvement in financial reporting.

Background Information

29. In May 1986, the Board added to its agenda a project to reexamine the accounting for financial instruments, including issues involving off-balance-sheet financing. The Board focused initially on disclosures, resulting in the issuance of FASB Statements No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, in March 1990 and No. 107, *Disclosures about Fair Value of Financial Instruments*, in December 1991.

30. Regulators and others have expressed concerns about the recognition and measurement of investments in debt securities, particularly those held by financial institutions. In 1988, the Office of the Comptroller of the Currency issued a banking circular that identified certain investment practices deemed to be unsuitable and specified that securities acquired in connection with those practices generally should not be classified in the investment portfolio. That same year the Federal Home Loan Bank Board released a proposed statement of policy that addressed the classification of securities as held for investment, held for sale, and held for trading.

31. Those regulators questioned the appropriateness of using the amortized cost method rather than the LOCOM method when trading and sales practices

were inconsistent with the amortized cost method. They expressed specific concerns about "gains trading" by financial institutions, an activity implying that decisions to sell certain securities are based on being able to report gains in the financial statements. In gains trading, appreciated securities are sold to recognize gains, but securities with unrealized losses are held and, because the amortized cost method is used, unrealized losses are not recognized. Those practices suggest that, rather than being held for investment, the securities in the portfolio are being held for sale, in which case the LOCOM method is usually considered to be more appropriate. Some regulators also expressed concern about an institution's ability to "defer" the recognition of losses by using the amortized cost method even though they did not engage in gains-trading activities.

32. Those concerns, along with inconsistent guidance on the reporting of debt securities held as assets in the AICPA Audit and Accounting Guides, prompted AcSEC to undertake a project on the measurement and reporting of debt securities held as assets by financial institutions. That project led to the exposure for comment of a proposed Statement of Position (SOP), *Reporting by Financial Institutions of Debt Securities Held as Assets*, in May 1990.

33. In September 1990, the chairman of the SEC emphasized some of the shortcomings of reporting investments at amortized cost and indicated that, for banks and thrift institutions, "serious consideration must be given to reporting all investment securities at market value." In October 1990, AcSEC concluded that the project on debt securities held as assets by financial institutions could be most effectively dealt with by the FASB and urged the FASB to undertake a limited-scope project on the recognition and measurement of investment securities. AcSEC indicated that "an objective standard, such as one based on market value measurements, may be more appropriate. . . ." AcSEC noted that current economic developments suggested that, in addition to depository institutions, it might be desirable to include insurance companies, mortgage bankers, finance companies, and other commercial enterprises in the scope of any FASB Statement. In November 1990, the major CPA firms advised the FASB that they endorsed AcSEC's recommendations.

34. As an interim measure, AcSEC issued Statement of Position 90-11, *Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets*, in November 1990. That SOP requires disclosure of, among other things, the estimated market

values, gross unrealized gains, and gross unrealized losses, by pertinent category, for debt securities held as assets by financial institutions. That SOP was initially effective for 1990 calendar-year reporting.

35. Although AcSEC's focus was on the accounting for investments in debt securities, AcSEC also suggested that the FASB could conform the accounting for debt securities and equity securities by amending Statement 12 to include debt securities.

36. Early in the development of the project, the Board and staff members held meetings with representatives of banks, thrifts, insurance enterprises, industrial enterprises, and regulators to better understand why investments in debt and equity securities are held and how they are used in managing interest rate risk. During the course of the project, the Board and staff members consulted frequently with the Financial Accounting Standards Advisory Council (FASAC), the Financial Instruments Task Force, professional groups, regulators, users of financial statements, and other interested parties.

37. In September 1992, the Board issued an Exposure Draft, *Accounting for Certain Investments in Debt and Equity Securities*, for a 90-day comment period. Approximately 600 organizations and individuals responded to the Exposure Draft, many with multiple letters. In November and December 1992, members of the Board and staff also conducted eight field visits to constituents to discuss the Exposure Draft. The results of those visits were useful to the Board during its deliberations of the issues addressed by this Statement.

38. In December 1992 and January 1993, the Board held a public hearing on the proposals in the Exposure Draft. Twenty-eight individuals and firms presented their views at the 3-day public hearing. In March 1993, the Board's Financial Instruments Task Force met and discussed, among other things, the Exposure Draft and a staff draft of possible revisions to reflect the Board's redeliberations to that date.

Relevance of Fair Values of Investments in Securities

39. Some Board members believe that measuring all investments in debt and equity securities at fair value in the financial statements is relevant and useful to present and potential investors, creditors, and others in making rational investment, credit, and similar decisions—the first objective of financial reporting,

as discussed in FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*. Other Board members are uncertain about the relevance of measuring those investments at fair value and believe that the relevance of that information should be evaluated after the results of applying Statement 107 are analyzed.

40. Some Board members believe the fair value of debt and equity securities is useful because it assists investors, creditors, and other users in evaluating the performance of an enterprise's investment strategies. Investors are interested in assessing the amounts, timing, and uncertainty of prospective net cash inflows to an enterprise, since those are also the main source of cash flows from the enterprise to them. Fair value portrays the market's estimate of the present value of the net future cash flows of those securities, discounted to reflect both the current interest rate and the market's estimate of the risk that the cash flows will not occur. Other Board members believe that fair value information is less relevant for debt securities that will be held to maturity.

41. Several articles and reports in recent years have indicated the potential usefulness of information about the market value of investment securities, particularly as an indicator of the solvency of financial institutions. Those articles indicate that some depository institutions have failed, or experienced impairment of earnings or capital, because of speculative securities activities and that other institutions have experienced an erosion of the liquidity of their securities portfolios as a result of decreases in the market value of those securities. In a liquidity shortage, the fair value of investments, rather than their amortized cost, is the amount available to cover an enterprise's obligations.

42. Some persons question the relevance of fair value measures for investments in securities, arguing in favor of reporting based on amortized cost. They believe that amortized cost provides relevant information because it focuses on the decision to acquire the asset, the earning effects of that decision that will be realized over time, and the ultimate recoverable value of the asset. They argue that fair value ignores those concepts and focuses instead on the effects of transactions and events that do not involve the enterprise, reflecting opportunity gains and losses whose recognition in the financial statements is, in their view, not appropriate until they are realized.

43. Opponents of fair value reporting also challenge the subjectivity that may be necessary in estimating

fair values and question the usefulness of reporting fair values for securities if they are not readily marketable. They argue that the questionable reliability impairs the relevance of the fair value information. The Board understands that reliability is an important factor in financial reporting and, therefore, decided that for equity securities the scope be limited to those that have readily determinable fair values. The scope of this Statement includes only those debt instruments that are securities. The Board believes that sufficiently reliable estimates of fair value can be made for those instruments. The Board also believes that the increased use of fair values in financial reporting, partially reflecting the requirements in Statement 107 and SOP 90-11, will result in increased availability and reliability of fair value information.

Scope and Project Approach

44. The Board decided to limit the scope of the project because of its desire to expedite resolution of the problems with the current accounting and reporting practices for investment securities. Accordingly, the Board decided to address the accounting for only certain financial assets and not to change the accounting for financial liabilities nor include other assets.

Financial Assets

45. In deciding which assets to include in the scope of the Statement, the Board excluded receivables that are not securities because of concerns about the effort and cost required in some cases to make a reasonable estimate of fair value. Examples of receivables that are not securities include commercial accounts receivable, consumer installment loans, commercial real estate loans, residential mortgage loans, and checking account overdraft advances.

46. The Board decided to model the definition of *security* (paragraph 137) after the definition provided in the Uniform Commercial Code. The Board decided not to use the definition provided in the Securities Exchange Act of 1934 because that definition is too broad; it encompasses instruments that the Board concluded should not be included in the scope of this Statement, such as notes for routine personal bank loans.

47. The Board decided to include certain equity securities in the scope of this Statement because the relevance of fair value is at least as great for those equity securities as for debt securities, since equity securities can be converted to cash only through sale

at fair value. The Board decided the scope should include only equity securities with readily determinable fair values because a broader scope would include equity instruments that would present significant valuation problems, such as investments in closely held companies and partnerships. By including only equity securities with readily determinable fair values, this Statement addresses the same investments in marketable equity securities as addressed in Statement 12.

48. Some respondents noted that the definition of *equity security* in Statement 12 included stock warrants and other options to acquire or dispose of equity securities, whereas the definition in the Exposure Draft did not. Those respondents suggested that the definition be consistent with Statement 12. The Board agreed and has revised the definition of *equity security* to include those options.

Financial Liabilities

49. Some enterprises, particularly financial institutions, manage their interest rate risk by coordinating their holdings of financial assets and financial liabilities. This practice would suggest that, in order for the financial statements to present a more accurate view of an enterprise's exposure to risk, some liabilities should be reported at fair value if some investments are required to be reported at fair value. The Board considered in significant detail whether enterprises should be permitted the option of reporting at fair value the liabilities that are related to the investments in debt securities that are reported at fair value.

50. The valuation of liabilities was considered as an option rather than as a requirement because the Board understood that many enterprises that typically invest their resources primarily in physical assets or intangible assets rather than in financial assets do not manage interest rate risk by relating their financial assets and liabilities.

51. The Board believes it would be preferable to permit certain related liabilities to be reported at fair value especially if all investments in debt securities were required to be reported at fair value. However, the Board was unable to identify, and respondents did not propose, any approach for valuing liabilities that the Board considered workable and not unacceptably complex or permissive. Because many enterprises manage interest rate risk on an overall basis for all financial assets and liabilities rather than for specific financial assets and liabilities, difficulties arose

in trying to identify which liabilities should be considered as related to the debt securities being reported at fair value.

52. The Board also was unable to agree on how deposit liabilities of banks and thrifts should be valued. Some Board members believe that the fair value of a deposit liability should be based on the terms of the obligation, that is, if the deposit is payable on demand, the fair value cannot be less than the amount that could be withdrawn. That amount represents the settlement amount with the counterparties and is consistent with the Board's decision in Statement 107 that the unit of measure for financial instruments generally should be the individual instrument rather than the portfolio. Other Board members would anticipate the depositor's probable forbearance in exercising its right to withdraw the funds on deposit; thus, in their view, the fair value of the deposit liability should be based on the probable timing of the expected future cash outflows—which essentially incorporates the institution's core deposit intangible into the valuation of deposit liabilities. The value associated with the probable timing of those expected cash flows is currently recognized in purchase business combinations, but as an intangible asset.

53. Similar difficulties exist for the valuation of certain liabilities of life insurance companies. Differing views exist about how the fair value of liabilities would be determined. For example, some respondents believe the fair value of an insurer's liabilities depends on what assets it holds, whereas others believe the fair value of the insurer's obligations to make future cash outflows should be determined independent of the composition of its assets. In addition, some believe that a life insurer's liabilities for policy reserves should not be less than the amount payable on demand at the policyholder's option for the cash surrender value, particularly since most life insurance policies result in the payment of the cash value at surrender rather than in the payment of death benefits. Others believe the cash surrender value should not be a minimum level for the fair value of the liabilities.

54. Because the Board was unable to develop a workable approach for identifying specific related liabilities and determining their fair value once identified, it decided not to require that all investments in debt securities be reported at fair value and, in replacing the LOCOM method with fair value for certain securities, decided not to include the unrealized changes in fair value in earnings. Instead, the Board

agreed to an approach that would introduce more fair value into the financial reporting for investments in debt and equity securities but not change the valuation of related liabilities. The Board believes that the approach in this standard is appropriate because it is built on existing practice, which does not involve the valuation of liabilities.

55. Many respondents, principally bankers and insurers, commented that the approach in the Exposure Draft was unfair because it was one-sided, applying fair value to only some financial assets and no liabilities. Those respondents indicated that if the Board requires that securities be reported at fair value, it should also require (or at least permit) enterprises to report the related liabilities at fair value to avoid unrepresentative volatility in their financial statements. The Board believes that unrepresentative volatility (as well as unrepresentative smoothing) may also result from the use of historical cost accounting when securities are selectively sold and gains or losses are recognized. That volatility may be more acceptable to some because management can control it by deciding which securities to sell and when.

56. As indicated previously, the Board believes it would be preferable to permit certain related liabilities to be reported at fair value if all investments in debt securities were required to be reported at fair value. But this Statement does not broadly expand the use of fair value in reporting securities, and current practice recognizes the net diminution in fair value of securities held for sale (through the LOCOM method) without considering changes in the value of any liabilities. Consequently, the Board believes it is not essential to address the valuation of liabilities in this Statement and that the changes required by this Statement will provide more relevant, reliable, and useful information.

The Approach in This Statement

57. In developing this Statement, the Board considered two frequently heard criticisms of fair value accounting for debt and equity securities: (a) fair values are not as relevant for debt securities that are held to maturity and (b) the valuation of only some assets, without related liabilities, could result in inappropriate volatility of reported earnings. Those two criticisms prompted the Board to consider both retaining the use of amortized cost accounting for debt securities that are held to maturity and reporting the unrealized holding gains and losses on securities available for sale outside earnings.

Investments being held to maturity

58. Some persons believe that amortized cost is a more relevant measure of debt securities because, if a debt security is held to maturity, that cost will be realized, absent default, and any interim unrealized gains and losses will reverse. The Board concluded that amortized cost is most likely to be relevant for those debt securities that will be held to maturity and decided to prescribe different accounting for those debt securities. This criterion is consistent with the provisions of the AICPA Audit and Accounting Guide, *Audits of Savings Institutions*, which requires “the intent and ability to hold to maturity” as a prerequisite for use of the amortized cost method. The use of the amortized cost method in FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, also is based on the ability and intent to hold debt securities to maturity, whereas the guidance for banks is based on the ability and intent to hold securities on a long-term basis.

59. The Board deliberately chose to make the *held-to-maturity* category restrictive because it believes that the use of amortized cost must be justified for each investment in a debt security. At acquisition, an enterprise should determine if it has the positive intent and ability to hold a security to *maturity*, which is distinct from the mere absence of an intent to sell. The Board believes that, if management’s intention to hold a debt security to maturity is uncertain, it is not appropriate to carry that investment at amortized cost; amortized cost is relevant only if a security is actually held to maturity. In establishing intent, an enterprise should consider pertinent historical experience, such as sales and transfers of debt securities classified as held-to-maturity. A pattern of sales or transfers of those securities is inconsistent with an expressed current intent to hold similar debt securities to maturity.

60. The Board decided that a debt security that is available to be sold in response to changes in market interest rates, changes in the security’s prepayment risk, the enterprise’s need for liquidity, changes in foreign exchange risk, or other similar factors should not be included in the held-to-maturity category because the possibility of a sale is indicative that the enterprise does not have a positive intent and ability to hold the security to maturity. A debt security that is considered available to be sold as part of an enterprise’s asset-liability management activities should not be classified as held-to-maturity. Similarly, an enterprise that maintains a dynamic hedging program in

which changes in external factors require that certain securities be sold to maintain an effective hedge would not have the intent and ability to hold those securities to maturity.

61. In articulating the views expressed in the preceding paragraph, the Exposure Draft used the phrase *might be sold*. Many respondents misunderstood the Board’s intended meaning of that phrase, extracting it from its context and emphasizing the uncertainty of future events—that anything “might” happen. The Board expects that extremely remote “disaster scenarios” (such as a run on a bank or an insurance company) would not be anticipated by an enterprise in deciding whether it had the positive intent and ability to hold a debt security to maturity. This Statement does not use the phrase *might be sold* to avoid the potential for misunderstanding.

62. The Board believes that an enterprise’s decision to classify a security as held-to-maturity implies that during the term of the security the enterprise’s decisions about continuing to hold that security will not be affected by changes in market interest rates or the security’s prepayment risk. That decision is consistent with the view that a change in fair value, which would reflect a change in market interest rates or prepayment risk, is not relevant for a security that will be held to maturity. The Board believes that the classification of a debt security as held-to-maturity is theoretically incompatible with the subsequent designation of a futures contract or other financial instrument as a hedge of that debt security’s interest rate risk. That designation is the basis for hedge accounting (that is, deferring and amortizing the change in value due to changes in market interest rates), which effectively reflects an alteration in the characteristics of the debt security (as though a new synthetic instrument has been created).

63. Because of that theoretical incompatibility, the Board proposed in the Exposure Draft that, subsequent to a debt security’s classification as held-to-maturity, hedge accounting could not be achieved by designating a futures contract as a hedge of that security. Respondents generally opposed the proposed restriction on the use of hedge accounting as unnecessary and contrary to the Board’s current efforts to address hedging issues on a comprehensive basis. The Board decided that, even though a theoretical incompatibility may exist for subsequent hedges of held-to-maturity securities, the proposed restriction on using hedge accounting should not be included in the final standard because the accounting for all

hedging transactions is currently being addressed by the Board in a separate project. The Board also noted that hedge accounting does not provide the same accounting results as the sale of the security because it does not result in immediate recognition of the security's unrealized holding gain or loss.

64. The Exposure Draft indicated that "the sale of a debt security near enough to its maturity (for example, within 30 days) that interest rate risk is substantially eliminated as a pricing factor shall be considered in substance held to maturity." A number of respondents requested that the example of 30 days be changed to 90 days, many noting that the guidance regarding cash equivalents in FASB Statement No. 95, *Statement of Cash Flows*, applies a 3-month cutoff in determining whether securities are "so near their maturity that they present insignificant risk of changes in value because of changes in interest rates." The Board agreed with the suggestion and changed the example of "30 days" to "three months."

65. Some respondents commented that interest rate risk is also substantially eliminated as a pricing factor near to a call date when the issuer is expected to exercise the call option. Those respondents suggested that the standard also address the sale of a callable debt security near to the call date if exercise of the call is probable. The Board agreed with that suggestion.

66. A few respondents reported that many banks routinely sell their investments in mortgage-backed securities after a substantial portion of the principal has been recovered through prepayments. They explained that the "tail" portion of a mortgage-backed security is sold because it no longer represents an efficient investment to the enterprise mainly due to the economic costs of accounting for remnants of the original issue. They requested that the Board consider permitting enterprises to sell securities classified as held-to-maturity prior to their maturity when prepayments have reduced the remaining principal to low levels. The Board decided for practical reasons that selling a debt security after a substantial portion of the principal has been collected should be considered equivalent to holding the security to maturity. The Board decided that the collection of 85 percent of the principal outstanding at acquisition (not the principal outstanding at issuance for securities purchased in the secondary market) constituted a reasonable threshold of what represents a "substantial portion of the principal." However, the Board limited application of this practical exception to collections of principal due either to prepayments on the debt se-

curity or to scheduled payments on a security payable in equal installments (both principal and interest) over its term (except that the scheduled payments need not be equal for variable-rate debt).

67. Some respondents indicated that, although they have the intent to hold the vast majority of their investments to maturity, they do not know at acquisition which specific securities will or will not be sold. Having to classify securities upon acquisition does not, in their opinion, provide the desired degree of flexibility to manage their portfolio. The Board considered two approaches that would potentially address those concerns.

68. The Board considered an approach that would eliminate the need to classify specific debt securities as available-for-sale or held-to-maturity. Instead, enterprises would designate the percentage of the securities acquired each year that would not be held to maturity and, at each reporting date, recognize a pro rata portion of the unrealized holding gain or loss on all securities. The Board rejected that approach because it would obscure the reporting of discrete investments. Under that approach, no specific debt security would be reported at fair value; instead, the carrying amount of the available-for-sale securities would be a blended amount—an allocation of portfolio totals—that, in the Board's view, would not be useful to users of financial statements. The Board also noted that the approach would continue to limit management's discretion in selling securities.

69. The Board also considered whether the standard should permit enterprises to sell without justification some specified amount of held-to-maturity securities without calling into question the enterprise's intent to hold other debt securities to maturity. The Board rejected that approach as being inconsistent with the premise underlying the use of amortized cost—that management intends to hold all such securities to maturity. However, the Board decided that the sale of a held-to-maturity security due to events that are isolated, nonrecurring, and unusual for the reporting enterprise that could not have been reasonably anticipated should not necessarily call into question the enterprise's intent to hold other debt securities to maturity. But if the sale of a held-to-maturity security occurs without justification, the materiality of that contradiction of the enterprise's previously asserted intent must be evaluated.

70. The Board recognizes that the intent to hold a security to maturity is not absolute and that in some circumstances management's intent could change for

certain securities. The Exposure Draft acknowledged that, for example, management might decide to sell a security because of either an increase in the security's credit risk or a change in the tax law that eliminates the tax-exempt status of interest on that security. Respondents identified a variety of other circumstances that they believed should justify the sale of a security classified as held-to-maturity.

71. Some respondents believed that enterprises should be permitted to sell held-to-maturity securities to generate taxable gains to offset existing taxable losses, or vice versa. Some respondents also desired to be able to sell those securities in response to changes in the enterprise's anticipated future profitability. It was suggested, for example, that if taxable losses were expected for the next several years, the enterprise should be permitted to sell tax-exempt securities classified as held-to-maturity. The Board rejected those suggested reasons for selling held-to-maturity securities. Securities that may need to be sold to implement tax-planning strategies should be classified as available-for-sale, not held-to-maturity.

72. Some respondents suggested that the standard permit the sale of a held-to-maturity security in advance of any deterioration in the creditworthiness of the issuer, perhaps based solely on industry statistics. The Board believes that the sale must be in response to an actual deterioration, not mere speculation. That deterioration should be supported by evidence about the issuer's creditworthiness; however, the enterprise need not await an actual downgrading in the issuer's published credit rating or inclusion on a "credit watch" list.

73. Some respondents suggested that major business combinations and major dispositions should be identified as circumstances that would justify being able to sell a held-to-maturity security. The Board agreed that, following a pooling of interests, the continuing management may need to sell or transfer some held-to-maturity securities to maintain the enterprise's existing credit risk policy, foreign exchange risk exposure, or interest rate risk position under its asset-liability management policy. Similarly, following a major purchase acquisition, some of the acquiring enterprise's held-to-maturity securities may need to be transferred or sold because of the nature of the liabilities assumed—even though all of the acquired securities are classified anew following such a business combination.

74. The Board acknowledged that, after a major disposition, some held-to-maturity securities may need

to be transferred or sold to maintain the interest rate risk exposure that predated the disposition. In considering those issues, the Board rejected a suggestion to automatically permit investment portfolio restructurings after a business combination or disposition. The Board believes that held-to-maturity securities should be transferred or sold only when the transfer or sale is necessary to maintain a particular risk exposure consistent with the enterprise's risk posture prior to the business combination or disposition. Furthermore, the Board believes those necessary transfers or sales should occur concurrent with or shortly after the business combination or disposition.

75. Some respondents suggested that the transfer or sale of a held-to-maturity security should be permitted in response to changes in the regulatory environment. The Board believes that if an enterprise is forced to dispose of a held-to-maturity security because a change in statutory or regulatory requirements significantly modifies what constitutes a permissible investment, that disposition should not call into question management's intent to hold the remaining securities in that category to maturity. Similarly, if a change in statutory or regulatory requirements significantly reduces the maximum level of investment that the enterprise can make in certain kinds of securities or in securities with a specified low credit quality, the sale of held-to-maturity securities to comply with that newly imposed maximum also should not call into question the classification of other held-to-maturity securities. The Board also agreed that if regulators significantly increase the risk weights of certain debt securities used for risk-based capital purposes, the sale of held-to-maturity securities with those recently increased risk weights should not call into question the classification of other held-to-maturity securities.

76. Some respondents suggested that the sale of held-to-maturity securities should always be permitted to meet regulatory capital requirements. The Board rejected blanket approval for those sales. It noted that an enterprise's ability and intent to hold securities to maturity would be called into question by the sale of held-to-maturity securities to realize gains to replenish regulatory capital that had been reduced by a provision for loan losses. The Board believes that gains trading with held-to-maturity securities to meet an enterprise's capital requirements is inconsistent with the held-to-maturity notion. In contrast, if an enterprise chooses to downsize to comply with a

significant increase in the industry's capital requirements, the sale of one or more held-to-maturity securities in connection with that downsizing would not call into question the classification of other held-to-maturity securities.

77. In some circumstances it may not be possible to hold a security to its original stated maturity, such as when the security is called by the issuer prior to maturity. The issuer's exercise of the call option effectively accelerates the security's maturity and should not be viewed as inconsistent with classification in the held-to-maturity category.

Investments not being held to maturity

78. For investments in debt securities that management does not have the positive intent and ability to hold to maturity, and for investments in equity securities with readily determinable fair values, the Board concluded that fair value information is more relevant than amortized cost information, in part because it reflects the effects of management's decision to buy a financial asset at a specific time and then continue to hold it for an unspecified period of time. For example, if an enterprise invests in a fixed-rate security and interest rates fall, the enterprise is in a better position than if it had invested in a variable-rate security. Movements in fair values, and thus market returns, during the period that a debt or equity security is held also provide a benchmark from which to assess the results of management's decisions and its success in maximizing the profitable use of the enterprise's economic resources. That success, or failure, is relevant and should be reflected in the financial statements in the period that the event (that is, the change in interest rates) occurs.

79. The Board decided that those investments in debt and equity securities should be reported at fair value. However, because of concerns about the potential volatility that would result from reporting the fair value changes of only some assets, and no liabilities, in earnings, the Board determined that the unrealized holding gains and losses for available-for-sale securities should be excluded from earnings. The basis for that conclusion is discussed in paragraphs 90–95.

80. The Board concluded that investments that are bought and held principally for the purpose of selling them in the near term should be classified as *trading* securities. Trading generally reflects active and frequent buying and selling, and trading securities gen-

erally are used with the objective of generating profits on short-term differences in price. The designation of trading securities under this Statement is the same as present practice by depository institutions.

81. Some respondents suggested that the criteria for classifying assets as current or noncurrent be used to distinguish between trading securities and available-for-sale securities. The Board disagreed because that suggestion is inconsistent with the character of trading securities, which are acquired generally with the objective of generating profits on short-term differences in price. Other respondents suggested that all securities classified as current should be classified as trading securities. The Board believes that available-for-sale securities should not be automatically transferred to the trading category because the passage of time has caused the maturity date to be within one year or because management intends to sell the security within one year.

82. All investments in debt and equity securities that are valued at fair value and are not classified as trading securities would be classified as *available-for-sale securities*. This category would include marketable equity securities previously covered by Statement 12, except to the extent that the investor classifies some of them as trading securities. Additionally, the available-for-sale category will include debt securities that are being held for an unspecified period of time, such as those that the enterprise would consider selling to meet liquidity needs or as part of an enterprise's risk management program.

83. At acquisition, an investor should determine and document the classification of debt and equity securities into one of the three categories—held-to-maturity, available-for-sale, or trading. At each reporting date, the appropriateness of the classification must be reassessed. For example, if an enterprise no longer has the ability to hold securities to maturity, their continued classification as held-to-maturity would not be appropriate.

Transfers between categories of investments

84. Many respondents noted that the Exposure Draft's proposed requirement to account for transfers at fair value and recognize in earnings any unrealized holding gains and losses existing at the date of a transfer would facilitate gains trading; a change in management's intent would cause an appreciated security to be transferred, resulting in immediate recognition of the gain in earnings. Respondents urged the

Board not to provide that opportunity, especially in a standard that they expected would help resolve the gains trading issue, not aggravate it. Some respondents suggested that all unrealized holding gains or losses on transferred securities be deferred in a separate component of equity. Others supported an approach that reported unrealized holding gains and losses in a manner consistent with the category into which the security has been transferred.

85. The Board acknowledged that the proposed accounting for transfers would have permitted discretionary adjustments to earnings that could weaken the credibility of reported earnings. To avoid that potential consequence, the Board decided that unrealized holding gains and losses would be recognized in earnings only if the security were transferred into the trading category. Otherwise, the unrealized holding gains and losses that had not yet been recognized in earnings would be reported in a separate component of equity. In certain respects, this approach is similar to the notion of recognizing unrealized gains and losses in a manner consistent with the category into which the security has been transferred. Because the Board expects transfers from the held-to-maturity category to be rare, special disclosures about the circumstances that resulted in the transfers are required.

Comments on the approach in this Statement

86. As stated previously, some Board members would have preferred to require the use of fair value for all investments in debt and equity securities, even if the Board was unable to resolve at this time how to deal with the option to account for related liabilities at their fair values. Other Board members would have preferred to require the use of fair value for all securities, but only if it were practicable to permit the valuation of liabilities at their fair values. Other Board members, as well as many respondents, believe that consideration of the use of fair value for all investments in debt and equity securities should be delayed until the results of applying Statement 107 can be analyzed.

87. Despite those various views, Board members believe that the existing diversity in guidance must be addressed and that an interim solution is appropriate at this point, given the present status of the overall project on the recognition and measurement of financial instruments. The Board expects that the use of fair value measurements for financial instruments will be reassessed at an appropriate future point in the financial instruments project. This reassessment

would likely include an evaluation of the relevance, reliability, and use of fair values based on experience from applying Statement 107 and this Statement. The Board has no preconceived views about the outcome of that consideration.

88. The Board also recognizes that the classification of investments in debt securities into three categories and the use of management intent as a criterion to distinguish among the categories present some difficulties. The classification of debt securities into three categories, each of which has different accounting, could result in comparability problems among enterprises. Enterprises with virtually identical securities may account for those securities differently. Additionally, basing the distinction in accounting treatment on management intent could result in an inconsistent application of the standard and contribute to comparability difficulties. Some constituents as well as some Board members question the relevance of accounting that results from using the intent of management as a criterion.

89. While the Board recognizes that there are some difficulties associated with the use of management intent as a criterion, and with the classification of identical instruments into several categories, it believes that this standard will improve financial reporting overall because it will standardize for all enterprises the criterion for when a debt security should be reported at amortized cost and specify a more even-handed approach for recognizing unrealized gains and unrealized losses.

Reporting Changes in Fair Value

90. This Statement provides requirements for reporting changes in the fair value of investments in securities. The total change in fair value consists of both the unpaid interest income earned on a debt security (or the unpaid accrued dividends on an equity security) and the remaining change in fair value that results from holding a security, known as the *unrealized holding gain or loss*. The reporting requirements for unrealized holding gains and losses depend on the classification of securities as trading or available-for-sale, as outlined in paragraph 13. This Statement does not change the current practice of including interest income in earnings, regardless of a security's classification.

91. For trading securities, the Board decided that unrealized holding gains and losses should be included in the determination of earnings, consistent with

present accounting. The Board also decided that unrealized holding gains and losses on available-for-sale securities should be excluded from the determination of earnings. The unrealized holding gains and losses should be reported as a net amount in a separate component of shareholders' equity until the holding gains and losses are realized or a provision for impairment is recognized.

92. For securities that are actively managed, the Board believes that financial reporting is improved when earnings reflect the economic consequences of the events of the reporting enterprise (such as changes in fair value) as well as the transactions (such as purchases and sales of securities) that occur. Including changes in fair value in the determination of earnings results in more relevant financial information to current shareholders, whose composition typically changes to some degree from one reporting period to the next. Including unrealized changes in fair value in earnings provides a more equitable reporting of results and changes in shareholders' equity among the different shareholder groups over the period that a security is held by recognizing in each reporting period the effects of economic events occurring in those periods. Thus, the Board concluded that unrealized changes in value on trading securities should be reported in earnings.

93. However, some enterprises, particularly financial institutions, that consider both their investments in securities and their liabilities in managing interest rate risk contend that reporting unrealized holding gains and losses on only the investments, and not related liabilities, in earnings has the potential for significant volatility that is unrepresentative of both the way they manage their business and the impact of economic events on the overall enterprise.

94. Based principally on those concerns, the Board decided that unrealized holding gains and losses on debt and equity securities that are available for sale but that are not actively managed in a trading account should be reported outside earnings—a method of reporting currently used for some securities under Statement 12. That reporting would alleviate the potential for volatility in reported earnings resulting from a requirement to value some assets at fair value without at least permitting fair-value-based accounting for related liabilities. It also would mitigate concerns about reporting the fluctuation in fair value of long-term investments in earnings. However, the Board recognizes that volatility in earnings can still result from the sale of securities. Furthermore, the approach does not resolve concerns about gains trading.

95. Many respondents, particularly bankers and insurers, emphasized that reporting the unrealized holding gains and losses for available-for-sale securities in a separate component of equity would create volatility in reported capital. The Board acknowledges that reporting those securities at fair value will cause greater volatility in total shareholders' equity than use of the amortized cost method would, but believes that the greater relevance of fair value for those securities significantly outweighs the disadvantages of that potential volatility in equity. Furthermore, the Board believes those disadvantages are mitigated by the supplemental disclosures of fair value for other financial assets and liabilities pursuant to Statement 107.

Benefits and Costs

96. In accomplishing its mission, the Board follows certain precepts, including the precept to promulgate standards only when the expected benefits of the information exceed the perceived costs. The Board endeavors to determine that a proposed standard will fill a significant need and that the costs imposed to meet that standard, as compared to other alternatives, are justified in relation to the overall benefits of the resulting information.

97. The benefits of reporting debt and equity securities at fair value are discussed in paragraphs 39–43 of this Statement. Furthermore, in eliminating the inconsistencies in the existing authoritative literature, this Statement is beneficial in avoiding the diversity and confusion resulting from the current accounting guidance. It also eliminates the unevenhandedness of LOCOM, which recognizes the net diminution in value of securities but not the net appreciation in value.

98. The incremental costs of the accounting and disclosure requirements of this Statement have been minimized in several ways. The Board has been informed that many enterprises already have systems in place to manage the market risk of their portfolios and that those systems provide much of the information that is necessary to comply with this Statement. Additionally, the required disclosures in Statement 107 provide much of the information required in this Statement. For financial institutions, the incremental burden is further minimized by the existing disclosure requirements of SOP 90-11 and regulatory reporting requirements. Furthermore, because the LOCOM method is not used, enterprises will not be required to combine portfolios of investments of various subsidiaries.

99. The Board is sensitive to the economic consequences that may result from the new information. For example, many respondents commented that enterprises may no longer invest in long-term instruments, such as long-term U.S. Treasury securities and corporate bonds, to reduce the potential for volatility in reported capital. They further suggested that such discontinued investment could jeopardize the market for those long-term securities. Some respondents also predicted that this Statement would exacerbate the credit crunch by causing financial institutions to make fewer loans, particularly long-term loans.

100. However, the nature and extent of those consequences are highly uncertain and are difficult to isolate from the effects of other events that will occur independent of that new information. For example, regulatory agencies are continuing to make changes in regulations that may affect the future costs of doing business for certain enterprises. Even if the Board could isolate the likely consequences of the information provided pursuant to this Statement from other events that produce change, it is outside the Board's role to deal with those possible consequences. The Board's objective in this pronouncement is to improve the consistency in how information about investments in securities is determined so that users of financial statements may make better-informed decisions.

Enterprises Included in Scope

101. Although the issues that gave rise to the Board's consideration of this Statement were raised in the context of financial institutions, particularly depository institutions, the Board believes that this Statement should not be limited to the accounting by those institutions. The Board's approach to standard setting generally has been to consider the accounting for a specific transaction or financial instrument and not to try to develop specialized accounting methods for different industries, particularly for transactions that are not unique to a specific industry.

102. The Board considered whether certain enterprises should be excluded from the scope of this Statement based on industry, size, or nonpublic status and concluded that any enterprise that chooses to invest in marketable securities should be able to make or gain access to a reasonable estimate of fair value. Deregulation and market forces have blurred the distinction between industries and have heightened desires for greater comparability between financial

statements of enterprises nominally in different industries. Those factors reinforced the Board's belief that all enterprises with identical financial instruments should account for those instruments in the same manner.

103. Some respondents suggested that nondepository financial institutions (particularly life insurance companies) be exempted from this Statement. The Board believes that distinguishing between nondepository financial institutions and other financial institutions is not warranted because both types of institutions invest their resources primarily in financial assets and the fair value of investments in debt and equity securities of all financial institutions is similarly affected by changes in market interest rates. Furthermore, Statement 60 already requires that the use of amortized cost in accounting for debt securities held by insurance companies be based on the ability and intent to hold the securities to maturity.

104. Other respondents suggested that nonfinancial institutions be exempted from this Statement. The Board believes that a distinction between financial and nonfinancial institutions is not warranted even though commercial and industrial companies invest their resources primarily in physical assets rather than financial assets. To the extent that those enterprises invest in debt and equity securities, those financial assets have the same future economic benefits as when held by a financial institution.

105. Respondents, principally bankers, also suggested that smaller and nonpublic enterprises be exempted because they lack the capabilities or resources necessary to provide estimates of fair values. The Board believes that prudent investment management normally warrants knowledge of market estimates, and smaller enterprises should have access to those estimates. Additionally, the fair value of investments in debt and equity securities owned by smaller or nonpublic enterprises is affected by changes in market interest rates in the same manner as those owned by large or public enterprises. The Board notes that even small, nonpublic banks have been required for many years to disclose the market value of their investments in securities.

106. The Board also considered exempting not-for-profit organizations, such as health and welfare organizations, hospitals, colleges and universities, religious institutions, trade associations, and private foundations, from the scope of this Statement. The Board believes that for those organizations not currently reporting their investments at fair value, the

measurement standards in this Statement would probably be an improvement to the current accounting for investments in debt and equity securities, such as those held in endowment funds. At issue is whether those requirements should be articulated in this Statement or in a later Statement after the Board resolves its agenda project on financial statement display by not-for-profit organizations. The Board decided it was more efficient to solicit and consider comments only on the accounting by enterprises other than not-for-profit organizations. Accordingly, not-for-profit organizations are not required to apply the provisions in this Statement. The Board intends to address the issue of accounting for investments by not-for-profit organizations within its separate overall project on not-for-profit organizations.

107. Some respondents questioned whether a credit union was included in the scope as a financial institution or excluded as a not-for-profit organization. FASB Concepts Statement No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, states in paragraph 7, “Examples of organizations that clearly fall outside the focus of this Statement include all investor-owned enterprises and other types of organizations, such as mutual insurance companies and other mutual cooperative entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants.” Accordingly, because credit unions, like mutual insurance companies, provide economic benefits to their members, they are not considered nonbusiness or not-for-profit organizations and, thus, are *not* excluded from the scope of this Statement.

108. The Board understands that enterprises in certain industries apply specialized accounting practices that include accounting for substantially all investments in debt and equity securities at market value or fair value, with the changes in those values recognized in earnings or in changes in net assets. The Board decided not to change the accounting by those enterprises because it believes that, for those enterprises, that accounting provides more relevant information for users of their financial statements. Consequently, those enterprises, such as brokers and dealers in securities, defined benefit pension plans, and investment companies, are excluded from the scope of this Statement.

Other Issues

Terminology

109. The Board decided to use the term *fair value* in this Statement to avoid confusion between the terms *fair value* and *market value*; some constituents associate the term *market value* only with items that are traded on active secondary markets (such as exchange and dealer markets). However, the Board does not make that distinction, intending the term to be applicable whether the market for an item is active or inactive, primary or secondary. The Board decided to use the term *fair value* also to maintain consistency with the terminology in Statement 107 and the financial instrument proposals made recently by the International Accounting Standards Committee and the Canadian Institute of Chartered Accountants. Those proposals would require disclosures of fair value for financial assets and financial liabilities.

Determining Fair Values

110. The Board concluded that quoted market prices, if available, provide the most reliable measure of fair value. Quoted market prices are easy to obtain and are reliable and verifiable. They are used and relied upon regularly and are well understood by investors, creditors, and other users of financial information.

111. Although quoted market prices are not available for all debt securities, the Board believes that a reasonable estimate of fair value can be made or obtained for the remaining debt securities required to be valued at fair value by this Statement. Some respondents mentioned the difficulty of reliably estimating the fair value of local municipal bonds; however, because municipal bonds are often intended to be held to maturity, to that extent, they are not reported at fair value. For debt securities that do not trade regularly or that trade only in principal-to-principal markets, a reasonable estimate of fair value can be made using a variety of pricing techniques, including, but not limited to, discounted cash flow analysis, matrix pricing, option-adjusted spread models, and fundamental analysis. The Board realizes that estimating fair value may require judgment but noted that a considerable degree of judgment is also needed when complying with other long-standing accounting and reporting requirements.

Impairment of Securities

112. The Board concluded that it is important to recognize in earnings all declines in fair value below the amortized cost basis that are considered to be other-than-temporary; a loss inherent in an investment security should be recognized in earnings even if it has not been sold. This is consistent with the other-than-temporary-impairment notion that was included in Statement 12.

113. The Board recognizes that the impairment provisions of this Statement differ from those in FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, which indicates that a loan is impaired when it is probable that the creditor (investor) will be unable to collect all amounts due according to the contractual terms of the loan agreement. This Statement requires that the measure of impairment be based on the fair value of the security, whereas Statement 114 permits measurement of an unsecuritized loan's impairment based on either fair value (of the loan or the collateral) or the present value of the expected cash flows discounted at the loan's effective interest rate. The Board recognizes that a principal difference between securities and unsecuritized loans is the relatively greater and easier availability of reliable market prices for securities, which makes it more practical and less costly to require use of a fair value approach. In addition, some Board members believe that securities are distinct from receivables that are not securities and that securities warrant a different measure of impairment—one that reflects both current estimates of the expected cash flows from the security and current economic events and conditions.

114. During the course of this project, some have urged the Board to develop guidance that would resolve recent practice problems about the application of other-than-temporary impairment. Although the Board believes that other-than-temporary impairment exists if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of the security, the Board believes that providing comprehensive guidance on other-than-temporary impairment involves issues beyond the scope of this Statement.

Financial Instruments Used to Hedge Investments at Fair Value

115. This Statement does not address the accounting for other financial instruments used to hedge investments in securities.

Amendment of Statement 91

116. Some respondents noted that the change from LOCOM to fair value for reporting available-for-sale securities would cause FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, to no longer apply to those securities. Paragraph 3 of Statement 91 indicates that it does not apply to loans and securities reported at fair value. The Board noted that the intent of that provision was to exclude only the loans and securities whose changes in value were included in earnings, not those loans and securities whose changes in value are reported in a separate component of shareholders' equity. Consequently, the Board agreed to amend Statement 91 to clarify that only loans and securities reported at fair value with changes in value reported in earnings are excluded from that Statement's scope. Thus, Statement 91 would continue to apply to available-for-sale securities that previously were reported at amortized cost or LOCOM.

Financial Statement Presentation and Disclosure

117. The Board decided not to require the presentation of individual amounts for the three categories of investments on the face of the statement of financial position, provided the information is presented in the notes. Thus, enterprises that report certain investments in debt securities as *cash equivalents* in accordance with the provisions of Statement 95 can continue that practice, provided that the notes reconcile the reporting classifications used in the statement of financial position.

118. Some respondents asked how the cash flows from purchases, sales, and maturities of trading and available-for-sale securities should be classified in the statement of cash flows. Because trading securities are bought and held principally for the purpose of selling them in the near term, the cash flows from purchases and sales of trading securities should be classified as cash flows from operating activities. However, available-for-sale securities are not acquired for that purpose. The Board believes that cash flows from purchases, sales, and maturities of available-for-sale securities should be classified as cash flows from investing activities and reported gross in the statement of cash flows.

119. The Board believes that the financial statement disclosures required by this Statement provide infor-

mation that is useful in analyzing an enterprise's investment strategies and exposures to risk. Gross unrealized gains and losses may indicate the results of hedging activities. Information about the sale or transfer of securities, including information on realized gains and losses, would reveal reallocations of the enterprise's resources and would help identify gains-trading activity. In considering the disclosures to be required, the Board consulted with representative organizations of users of financial statements. Respondents were generally supportive of the disclosures proposed in the Exposure Draft.

Effective Date and Transition

120. The Board proposed that this Statement should be effective for fiscal years beginning after December 15, 1993 for all enterprises. The Board considered whether to permit a delayed effective date for smaller enterprises (as provided in Statement 107) but decided that extra time was not required to develop the fair value information required by this Statement. In contrast, Statement 107 required disclosure of the fair value of all financial instruments, some of which are more difficult to value. The Board noted that smaller financial institutions are already required by SOP 90-11 to disclose the market value of their investments in debt securities. Respondents generally concurred with the proposed effective date, indicating that no deferral of the effective date was needed.

121. Some respondents requested that application of the new standard in 1993 financial statements be permitted, in part to enable them to include the cumulative effect of the accounting change in the income statement for 1993 rather than 1994. The Board decided to permit enterprises, for fiscal years beginning prior to December 16, 1993, to initially apply this Statement as of the end of a fiscal year for which annual financial statements have not previously been issued.

122. Because the classification of securities among the three categories is based on the enterprise's current intent, the Board decided that retroactive application of the provisions of this Statement is inappropriate. Except as permitted in the preceding paragraph, this Statement should be applied prospectively as of the beginning of the fiscal year.

123. As indicated in paragraph 23, at the date of initial application of this Statement, the enterprise's investments in debt and equity securities shall be clas-

sified based on the enterprise's current intent. The classification at initial application should not be considered a transfer between categories; thus, the accounting for transfers in paragraph 15 is not relevant to the initial application of this Statement. At the date of initial application, the unrealized holding gain or loss, net of tax effect, for securities classified as available-for-sale should be reported in the separate component of shareholders' equity. The unrealized holding gains and losses, net of tax effect, previously included in earnings that would be excluded from earnings under this Statement would be reversed in the income statement as the cumulative effect of a change in accounting principle.

Appendix B

AMENDMENTS TO EXISTING PRONOUNCEMENTS

124. This Statement supersedes Statement 12 and related FASB Interpretations No. 11, *Changes in Market Value after the Balance Sheet Date*, No. 12, *Accounting for Previously Established Allowance Accounts*, No. 13, *Consolidation of a Parent and Its Subsidiaries Having Different Balance Sheet Dates*, and No. 16, *Clarification of Definitions and Accounting for Marketable Equity Securities That Become Nonmarketable*.

125. The following is added to paragraph 4 of Chapter 3A of ARB 43 following *operations* in subitem (f):

, including investments in debt and equity securities classified as trading securities under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*

126. The following sentence is added to the end of paragraph 19(l) of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*:

FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, addresses the accounting for investments in equity securities with readily determinable fair values that are not consolidated or accounted for under the equity method.

127. FASB Statement 60 is amended as follows:

a. Paragraph 45 is replaced by the following:

All investments in debt securities and investments in equity securities that have readily determinable fair values, as defined by FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, shall be accounted for in accordance with the provisions of that Statement.

b. Paragraph 46 is replaced by the following:

Investments in equity securities that are not addressed by Statement 115 because they do not meet the criteria in paragraph 3 of that Statement shall be reported at fair value, and changes in fair value shall be recognized as unrealized gains and losses and reported, net of applicable income taxes, in a separate component of equity.

c. The last two sentences of paragraph 50 and footnote 7 to that paragraph are deleted.

d. The first sentence of paragraph 51 is replaced by the following:

If a decline in the fair value of an equity security that is not addressed by Statement 115 because it does not meet the criteria in paragraph 3 of that Statement is considered to be other than temporary, the investment shall be reduced to its net realizable value, which becomes its new cost basis.

128. Statement 65 is amended as follows:

a. In paragraph 4, *and mortgage-backed securities* is deleted.

b. In paragraph 5, *and mortgage-backed securities* is deleted.

c. In the first sentence of paragraph 6, *or mortgage-backed security* is deleted. In the last sentence of paragraph 6, *or mortgage-backed security* and *or security* are deleted. The following is added to paragraph 6 immediately after the first sentence:

The securitization of a mortgage loan held for sale shall be accounted for as the sale of the mortgage loan and the purchase of a mortgage-backed security classified as a trading security at fair value.

d. In paragraph 7, all references to *or mortgage-backed security* and *or security* are deleted.

e. In the last sentence of paragraph 8, *as being held for sale* is replaced by *as being either mortgage loans held for sale or mortgage-backed securities classified as trading securities under Statement 115*.

f. In the first sentence of paragraph 9(a), *and mortgage-backed securities* is deleted. The following is added to the end of paragraph 9(a):

If the fair value of a mortgage-backed security subject to an investor purchase commitment exceeds the commitment price, the implicit loss on the commitment shall be recognized.

g. In each sentence of paragraph 9(c), the first usage of *market value* is replaced by *fair value*.

h. In paragraph 12, all references to *or mortgage-backed securities* and *or securities* are deleted.

i. The following is added to the penultimate sentence in paragraph 17 after *investor*:

(or fair value of the mortgage loan at the time it is securitized)

j. In paragraphs 28 and 29, *and mortgage-backed securities* is deleted.

129. In the last sentence of paragraph 5 of FASB Statement No. 80, *Accounting for Futures Contracts*, the phrase *until it is amortized* or is added after *equity*.

130. Statement 91 is amended as follows:

a. In paragraph 3, *if the changes in market value are included in earnings* is added at the end of the last sentence.

b. In paragraph 27(a), which amends paragraph 6 of Statement 65, *or security* is deleted.

131. In paragraph 28 of FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, the phrase *investments that are classified as trading securities* and is added after *except* in the parenthetical expression of the amendment of Statement 60 in the fourth sentence of that paragraph.

132. FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*, is amended as follows:

- a. The following sentence is added to the end of paragraph 8:

Cash flows from purchases, sales, and maturities of available-for-sale securities shall be classified as cash flows from investing activities and reported gross in the statement of cash flows.

- b. In footnote 4 to paragraph 9, *and mortgage-backed securities* is deleted.

133. In paragraph 36(b) of Statement 109, *changes in the carrying amount of marketable securities under FASB Statement No. 12, Accounting for Certain Marketable Securities* is replaced by *changes in the unrealized holding gains and losses of securities classified as available-for-sale under FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities*.

134. In paragraphs 4 and 5 of FASB Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises*, the references to Statement 12 are deleted.

135. FASB Technical Bulletin No. 79-19, *Investor's Accounting for Unrealized Losses on Marketable Securities Owned by an Equity Method Investee*, is amended as follows:

- a. In paragraph 1, *accumulated changes in the valuation allowance for marketable equity securities* is replaced by *unrealized holding gains or losses on investments in debt and equity securities*.

- b. Paragraph 6 is replaced by the following:

If a subsidiary or other investee that is accounted for by the equity method is required to include unrealized holding gains and losses on investments in debt and equity securities in the stockholders' equity section of the balance sheet pursuant to the provisions of Statement 115, the parent or investor shall adjust its investment in that investee by its proportionate share of the unrealized gains and losses and a like amount shall be included in the stockholders' equity section of its balance sheet.

136. In paragraph 3 of FASB Technical Bulletin No. 85-1, *Accounting for the Receipt of Federal Home Loan Mortgage Corporation Participating Preferred Stock*, the phrase *a marketable equity security that subsequently should be reported in accordance with Statement 12 (at the lower of cost or market)* is replaced by *an equity security that subsequently should be reported at fair value in accordance with FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities*.

Appendix C

GLOSSARY

137. This appendix contains definitions of terms or phrases as used in this Statement.

Debt security

Any security representing a creditor relationship with an enterprise. It also includes (a) preferred stock that by its terms either must be redeemed by the issuing enterprise or is redeemable at the option of the investor and (b) a collateralized mortgage obligation (CMO) (or other instrument) that is issued in equity form but is required to be accounted for as a nonequity instrument regardless of how that instrument is classified (that is, whether equity or debt) in the issuer's statement of financial position. However, it excludes option contracts, financial futures contracts, forward contracts, and lease contracts.

- Thus, the term *debt security* includes, among other items, U.S. Treasury securities, U.S. government agency securities, municipal securities, corporate bonds, convertible debt, commercial paper, all securitized debt instruments, such as CMOs and real estate mortgage investment conduits (REMICs), and interest-only and principal-only strips.
- Trade accounts receivable arising from sales on credit by industrial or commercial enterprises and loans receivable arising from consumer, commercial, and real estate lending activities of financial institutions are examples of receivables that do not meet the definition of *security*; thus, those receivables are not debt securities (unless they have been securitized, in which case they would meet the definition).

Equity security

Any security representing an ownership interest in an enterprise (for example, common, preferred, or other capital stock) or the right to acquire (for example, warrants, rights, and call options) or dispose of (for example, put options) an ownership interest in an enterprise at fixed or determinable prices. However, the term does not include convertible debt or preferred stock that by its terms either must be redeemed by the issuing enterprise or is redeemable at the option of the investor.

Holding gain or loss

The net change in fair value of a security exclusive of dividend or interest income recognized but not yet received and exclusive of any write-downs for other-than-temporary impairment.

Security

A share, participation, or other interest in property or in an enterprise of the issuer or an obligation of the issuer that (a) either is represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer, (b) is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment, and (c) either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

