Q&A 115—A Guide to Implementation of Statement 115 on Accounting for Certain Investments in Debt and Equity Securities: Questions and Answers

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INTRODUCTION

In May 1993, the Financial Accounting Standards Board (FASB) issued Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities.

The Board cannot anticipate all of the implementation questions that may arise for a particular Statement and provide answers to those questions when the Statement is issued. Questions of implementation are often raised with the FASB staff by preparers, auditors, and others. Because of the high number of inquiries received, the FASB staff determined that this Special Report should be issued as an aid in understanding and implementing Statement 115.

The questions and answers in this Special Report are organized by the general topics in Statement 115 to which the questions relate. Illustrations are included as necessary to supplement the answers. Other interpretations of Statement 115 are listed in Appendix A. SEC Staff Accounting Bulletin No. 59, Accounting for Noncurrent Marketable Equity Securities, and AICPA Auditing Interpretation, Evidential Matter for the Carrying Amount of Marketable Securities, are reprinted with permission in Appendix B.

Transition guidance is provided in ♦ Question 61 of this Special Report.

Questions and Answers

Scope

1. **Q**—Does FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, apply to a loan that has been insured, such as a loan insured by the Federal Housing Administration, or to a conforming mortgage loan?

   **A**—No. Statement 115 applies to debt securities, as defined in ♦ paragraph 137, including debt instruments that have been securitized.1(2) Securitization is the process by which financial assets are transformed into securities that can be sold to investors. Even if a loan could readily be converted into a security, the loan is not within the scope of Statement 115 until it has been securitized.

2. **Q**—For a loan that was restructured in a troubled debt restructuring involving a modification of terms, does Statement 115 apply to the accounting by the creditor (that is, investor) if the restructured loan meets the definition of a security in Statement 115?

   **A**—Yes, Statement 115 applies to all debt securities. Refer to FASB Technical Bulletin No. 94-1, Application of Statement 115 to Debt Securities Restructured in a Troubled Debt Restructuring...
3. Q—Are options on securities within the scope of Statement 115?

A—It depends. An investment in an option on securities should be accounted for under the requirements of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, if the option meets the definition of a derivative instrument, including the criteria for net settlement in paragraph 9 of Statement 133. If an option to buy an equity security does not meet the definition of a derivative instrument and has a readily determinable fair value, it would be within the scope of Statement 115 (paragraph 3 of Statement 115 provides further guidance with respect to whether the fair value of a security is readily determinable). [Revised 9/01.]

The definition of equity security in paragraph 137 includes any security representing "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." As indicated above, such instruments would be within the scope of Statement 115 if they do not meet the definition of a derivative instrument in Statement 133. The definition of equity security in paragraph 137 does not include written equity options because they represent obligations of the writer, not investments. It also does not include cash-settled options on equity securities or options on equity-based indexes, because those instruments do not represent ownership interests in an enterprise. Options on debt securities are not within the scope of Statement 115, but are within the scope of Statement 133 if they meet the definition of a derivative instrument, including the criteria for net settlement in paragraph 9 of that Statement. For additional accounting guidance when purchased options have terms that require physical settlement of securities, refer to EITF Issue No. 96-11, "Accounting for Forward Contracts and Purchased Options to Acquire Securities Covered by FASB Statement No. 115." [Revised 12/98; 9/01.]

4. Q—What accounting literature addresses the accounting for equity securities that do not have readily determinable fair values?

A—APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, describes the cost method and the equity method of accounting for investments in common stock and specifies the criteria for determining when to use the equity method. Equity securities that do not have readily determinable fair values that are not required to be accounted for by the equity method are typically carried at cost, as described in paragraph 6 of Opinion 18, adjusted for other-than-temporary impairment. [Revised 12/98.]

Other types of rights to acquire or dispose of ownership interests in an enterprise (for example, options and warrants) that do not have readily determinable fair values will generally meet the definition of a derivative instrument and be accounted for under the requirements of Statement 133 (see Question 3 for additional discussion). If those interests fail to meet the definition of a derivative instrument, there is no existing authoritative literature that addresses the accounting. [Revised 12/98; 9/01.]

Q—An entity invests in a limited partnership interest (or a venture capital company) that meets the definition of an equity security but does not have a readily determinable fair value. That is, it does not have a fair value per unit that is "currently available on a securities exchange" under paragraph 3(a) or a "fair value per share (unit) [that] is determined and published and is the basis for current transactions" under paragraph 3(c). However, substantially all of the partnership's assets consist of investments in debt securities or equity securities that have readily determinable fair values. Is it appropriate to "look through" the form of an investment to determine whether Statement 115 applies?
A—No, an entity should not "look through" the form of its investment to the nature of the securities held by an investee. In the specific situation described above, the investment would be considered an equity security that does not have a readily determinable fair value, as defined in paragraph 3. Thus, Statement 115 would not apply to that type of investment. ♦ EITF Topic No. D-46, "Accounting for Limited Partnership Investments," provides guidance on the accounting for limited partnership investments.

6. Q—Does Statement 115 apply to certificates of deposit (CDs) or guaranteed investment contracts (GICs)?

A—It depends on the characteristics of the particular CD or GIC. The definition of security in ♦ paragraph 137 was modeled after the definition provided in the Uniform Commercial Code. Most CDs would not meet this definition, but certain negotiable "jumbo" CDs might. Likewise, certain GICs might be considered securities, while others would not.

7. Q—Are short sales of securities (sales of securities that the seller does not own at the time of sale) covered by Statement 115?

A—No. Short sales represent obligations to deliver securities, not investments. Short sale obligations generally are marked to market, with changes in value recorded in earnings as they occur, in accordance with the audit and accounting Guides published by the AICPA for certain industries. Refer to paragraph 59(d) of Statement 133 for additional information. [Revised 9/01.]

8. Q—If, subsequent to the purchase of equity securities, an investor enters into an arrangement that limits its ability to sell the securities, would the shares be considered "restricted" under ♦ footnote 2 to paragraph 3?

A—No. The definition of restricted stock refers to governmental or contractual requirements that presumably would exist at acquisition. Footnote 2 indicates that if stock is pledged as collateral, it is not considered restricted. The same logic applies to other arrangements entered into by the investor that may restrict its ability to sell the securities. Refer to FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, ♦ paragraph 15, for guidance on pledges of assets. [Revised 12/98; 9/01.]

9. Q—Does Statement 115 apply to preferred stock that is convertible into marketable common stock?

A—If the convertible preferred stock is "redeemable" (that is, it has mandatory redemption provisions or is redeemable at the option of the investor), it would be considered a debt security under ♦ paragraph 137 and Statement 115 would apply, regardless of whether it has a readily determinable fair value. If the convertible preferred stock is not "redeemable," it would be considered an equity security under paragraph 137 and, therefore, Statement 115 would apply only if the preferred stock has a readily determinable fair value.

10. Q—Does Statement 115 apply to financial statements issued by a trust?

A—It depends. ♦ Paragraph 4 states, "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." Thus, Statement 115 would apply to financial statements issued by a trust that does not report substantially all of its securities at fair value.

Held-to-Maturity Securities—♦ Paragraphs 6–11
11. Q—Paragraph 6 states, "At each reporting date, the appropriateness of the [security's] classification shall be reassessed." If paragraph 6 requires an enterprise to reassess its classifications of securities, why do transfers or sales of held-to-maturity securities for reasons other than those specified in paragraphs 8 and 11 call into question ("taint") an enterprise's intent to hold other debt securities to maturity in the future?

A—Paragraph 6 requires two things. First, an enterprise must decide at acquisition how to classify a security and must document that decision—it may not wait until a later date. If, after initially classifying a debt security as available-for-sale, an enterprise is able to demonstrate that it has the ability to hold the security to maturity and decides that it has the intent to do so, it would transfer the security to the held-to-maturity category and account for the transfer in accordance with paragraph 15. Second, because an enterprise is expected not to change its intent about a held-to-maturity security, the requirement to reassess the appropriateness of a security's classification focuses on the enterprise's ability to hold a security to maturity. Paragraph 6 acknowledges that facts and circumstances can change; for example, an enterprise can lose the ability to hold a debt security to maturity. However, that acknowledgment in no way diminishes the restrictive nature of the held-to-maturity category. [Revised 12/98.]

12. Q—What are the consequences of a sale or transfer of held-to-maturity securities for a reason other than those specified in paragraphs 8 and 11? In other words, what does it mean to "call into question its intent to hold other debt securities to maturity in the future"?

A—A sale or transfer of a held-to-maturity security for a reason other than those specified in paragraphs 8 and 11 calls into question whether any remaining held-to-maturity securities should continue to be classified in that category. Any remaining held-to-maturity securities should be reclassified to available-for-sale when the sale or transfer represents a material contradiction with the entity's stated intent to hold those securities to maturity or when a pattern of such sales has occurred. The reclassification would be recorded in the reporting period in which the sale or transfer occurred and accounted for as a transfer under paragraph 15. All sales or transfers of held-to-maturity securities are subject to the disclosure requirements of paragraph 22, regardless of the treatment of remaining held-to-maturity securities.

13. Q—If a sale or transfer of a security classified as held-to-maturity occurs for a reason other than those specified in paragraphs 8 and 11, does the sale or transfer call into question ("taint") the enterprise's intent about only the same type of securities (for example, municipal bonds) that were sold or transferred, or all securities that remain in the held-to-maturity category?

A—All securities that remain in the held-to-maturity category would be "tainted." The enterprise makes the same assertion about all debt securities in the held-to-maturity category—namely, that it has the positive intent and ability to hold each security to maturity. Paragraph 8 indicates that a sale or transfer in response to certain changes in conditions will not call into question an enterprise's intent to hold other debt securities to maturity in the future; paragraph 11 provides two additional exceptions. If the enterprise sells or transfers any held-to-maturity securities for reasons other than those specified in paragraphs 8 and 11, its continuing assertions about all other debt securities classified in the held-to-maturity category are called into question.

14. Q—If held-to-maturity securities are reclassified to available-for-sale because sales occurred for reasons other than those specified in paragraphs 8 and 11, what amount of time must pass before the enterprise can again classify securities as held-to-maturity?

A—Paragraph 59 states, "In establishing intent, an enterprise should consider pertinent historical experience, such as sales and transfers of debt securities classified as held-to-maturity." After securities are reclassified to available-for-sale in response to a "taint", judgment is required
in determining when circumstances have changed such that management can assert with a greater
degree of credibility that it now has the intent and ability to hold debt securities to maturity.

15. **Q**—Is it consistent with Statement 115 to have a documented policy to initially classify all debt
securities as held-to-maturity but then automatically transfer every security to available-for-sale
when it reaches a predetermined point before maturity (for example, every held-to-maturity
security will be transferred to available-for-sale 24 months prior to its stated maturity) so that an
entity has the flexibility to sell securities?

**A**—No. Securities should be classified as held-to-maturity only if the enterprise has the positive
intent and ability to hold them to maturity. Under the policy described above, the enterprise does
not intend to hold any security to maturity.

16. **Q**—May securities classified as held-to-maturity be pledged as collateral? [Revised 12/98.]

**A**—Yes. The use of a security as collateral for an obligation is not inconsistent with the
held-to-maturity category provided that the transaction is not accounted for as a sale under
Statement 140 4a(5) and the enterprise intends and expects to be able to satisfy the obligation and
recover access to its collateral. If the transaction is accounted for as a sale under Statement 140,
the securities pledged as collateral may not be classified as held-to-maturity. [Revised 12/98; 9/01.]

17. **Q**—May held-to-maturity securities be subject to a repurchase agreement (or a securities lending
agreement)?

**A**—Yes, if the transaction is accounted for as a secured borrowing under Statement 125 and the
enterprise intends and expects to be able to repay the borrowing and recover access to its
collateral. [Revised 12/98; 9/01.]

18. **Q**—May convertible debt securities be classified as held-to-maturity?

**A**—Securities should be classified as held-to-maturity only if the enterprise has the positive intent
and ability to hold them to maturity. Classifying a security as held-to-maturity means that the
enterprise is indifferent to future opportunities to profit from changes in the security's fair value
and intends to accept the debt security's stipulated contractual cash flows, including the repayment
of principal at maturity. Convertible debt securities generally bear a lower interest rate because the
investor hopes to benefit from appreciation in value of the option embedded in the debt security.
Given the unique opportunities for profit embedded in a convertible security, it generally would be
contradictory to assert the positive intent and ability to hold a convertible debt security to maturity
and forego the opportunity to exercise the conversion feature. The exercise of a conversion feature
on a security classified as held-to-maturity will call into question an investor's stated intent to hold
other debt securities to maturity in the future.

Refer to paragraphs 12–13, 61(k) and 534(a) of Statement 133 for additional guidance. If
convertible debt is bifurcated into an equity option and a host debt instrument under the
requirements of Statement 133, it generally still would be contradictory to assert the positive
intent and ability to hold the debt host contract to maturity and forego the opportunity to exercise
the conversion feature. [Revised 12/98; 9/01.]

19. **Q**—May a callable debt security be classified as held-to-maturity?

**A**—Generally yes. Paragraph 77 of Statement 115 states, "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." However a callable debt security purchased at a
significant premium might be precluded from held-to-maturity classification under paragraph
14 of Statement 140 if it can be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its investment. [Revised 12/98; 9/01.]

20. Q—May a puttable debt security be classified as held-to-maturity?

A—A puttable debt security should be classified as held-to-maturity only if the enterprise has the positive intent and ability to hold it to maturity. The exercise of a put option on a security classified as held-to-maturity will call into question an investor's stated intent to hold other debt securities to maturity in the future. Furthermore, a puttable debt security might be precluded from held-to-maturity classification pursuant to paragraph 14 of Statement 140. [Revised 12/98; 9/01.]

21. Q—The Federal Financial Institutions Examination Council (FFIEC) Policy Statement, "Supervisory Policy Statement on Securities Activities," issued in December 1991 and adopted by the respective regulators, identifies criteria for determining when a mortgage derivative product should be considered a "high-risk mortgage security." In certain situations, regulators can direct institutions to sell "high-risk mortgage securities." Can a mortgage derivative product (held by a regulated institution) that is not a "high-risk mortgage security" at purchase but that could later become a "high-risk mortgage security" before maturity due to a change in market interest rates and the related change in the security's prepayment risk be classified at acquisition as a held-to-maturity security under Statement 115?

A—A regulated enterprise should consider the divestiture policy of its particular regulator in assessing its ability to hold to maturity a debt security that might become a "high-risk mortgage security." If an enterprise concludes that it has the positive intent and ability to hold the security to maturity, it may be classified as held-to-maturity. Refer to EITF Topic No. D-39, "Questions Related to the Implementation of FASB Statement No. 115," for additional information. [Revised 12/98.]

Depending on the attributes of the mortgage derivative product, other accounting literature may apply. Paragraph 233 of Statement 125 amended Statement 115 to preclude held-to-maturity classification for a security that 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. Paragraph 362 of Statement 140 carried forward that amendment without reconsideration. [Revised 12/98; 9/01.]

Under Statement 133 the accounting for certain mortgage derivative products has changed. That is, if a mortgage derivative product would otherwise be in the scope of Statement 115 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 Statement 115. The embedded derivative instrument should be separated from the host contract and accounted for as a derivative instrument pursuant to Statement 133 (see paragraph 12 of Statement 133). [Revised 12/98; 9/01.]

22. Q—May a mortgage-backed interest-only certificate be classified as held-to-maturity?

A—No. Paragraph 233 of Statement 125 amended Statement 115 to effectively prohibit interest-only strips from being classified as held-to-maturity. Paragraph 362 of Statement 140 carried forward that amendment without reconsideration. [Revised 12/98; 9/01.]

23. Q—If an enterprise holds a debt security classified as held-to-maturity, and that security is downgraded by a rating agency, would a sale or transfer of that security call into question the entity's intent to hold other debt securities to maturity in the future?

A—No. A downgrading of an issuer's published credit rating is an example of "evidence of a
significant deterioration in the issuer's creditworthiness," a specific exception provided for in ♦ paragraph 8(a).

24. **Q**—What constitutes a "major" business combination or a "major" disposition under ♦ paragraph 8(c)?

**A**—Statement 115 does not specify a quantitative threshold for a major business combination or disposition. The Statement refers to a sale of a component of an entity 10(8) as an example of a major disposition; ♦ paragraphs 73 and 74 describe circumstances surrounding business combinations accounted for as poolings of interests and purchases. 11(9) A purchase or sale of a large pool of financial assets (for example, conforming mortgages) or liabilities (for example, deposit liabilities) would not be considered a major business combination or disposition that would justify the sale of held-to-maturity securities. It is important to emphasize that paragraph 8(c) permits sales of held-to-maturity securities only when the combination or disposition "necessitates the sale or transfer of held-to-maturity securities to maintain the enterprise's existing interest rate risk position or credit risk policy" (emphasis added). Sales of held-to-maturity securities to fund an acquisition (or a disposition, for example, if deposit liabilities are being assumed by the other party) are inconsistent with paragraph 8. [Revised 5/03]

25. **Q**—Is it consistent with Statement 115 to reassess the classification of held-to-maturity securities concurrent with or shortly after a major business combination accounted for as a purchase?

**A**—Yes, provided that the conditions of ♦ paragraph 8(c) are met. ♦ Paragraph 73 states, ". . . 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."

26. **Q**—May securities classified as held-to-maturity be sold under the exception provided in ♦ paragraph 8(c) in anticipation of or otherwise prior to a major business combination or disposition without calling into question the enterprise's intent to hold other debt securities to maturity in the future?

**A**—No. ♦ Paragraph 74 states that ". . . necessary transfers or sales should occur concurrent with or shortly after the business combination or disposition."

27. **Q**—Paragraph 74 states that ". . . necessary transfers or sales should occur concurrent with or shortly after the business combination or disposition." How long is "shortly"?

**A**—The Statement does not define "shortly." As time passes, however, it is increasingly difficult to demonstrate that the business combination, and not other events or circumstances, necessitated the transfer or sale of held-to-maturity securities.

28. **Q**—If a regulator directs a particular institution (rather than all institutions supervised by that regulator) to sell or transfer held-to-maturity securities (for example, to increase liquid assets), are those sales or transfers consistent with ♦ paragraph 8(d)?

**A**—No. Paragraph 8(d) describes a change in regulations applicable to all entities affected by the legislation or regulator enacting the change. (The same is true of paragraphs 8(e) and 8(f).) However, it is possible that the circumstances causing a regulator to direct an institution to sell securities could be considered an event that is "isolated, nonrecurring, and unusual . . . that could not have been reasonably anticipated" as described in paragraph 8. Refer to ♦ Question 32.

29. **Q**—Is a sale of held-to-maturity securities in response to an unsolicited tender offer from the issuer consistent with ♦ paragraph 8?
A—No. An unsolicited tender offer from the issuer is not, in itself, one of the conditions specified in paragraphs 8(a)–8(f), nor is it an event that is "isolated, nonrecurring, and unusual . . . that could not have been reasonably anticipated" as described in paragraph 8. Thus, the sale of a held-to-maturity security in response to a tender offer will call into question an investor's stated intent to hold other debt securities to maturity in the future.

30. Q—Is it consistent with Statement 115 for an insurance company or other regulated enterprise to classify securities as held-to-maturity and also indicate to regulators that those securities could be sold to meet liquidity needs in a defined interest rate scenario whose likelihood of occurrence is reasonably possible but not probable?

A—No. It is inconsistent for an insurance company or other regulated enterprise to assert that it has the ability and intent to hold a security to maturity and concurrently tell regulators that the security is available to be sold if a particular interest rate scenario occurs.

31. Q—Is it ever appropriate to apply the exceptions in ♦ paragraphs 8(a)–8(f) to situations that are similar, but not the same?

A—No. It is not appropriate to analogize to the exceptions specified in paragraphs 8(a)–8(f). (♦ Question 32 explains what constitutes an event that is "isolated, nonrecurring, and unusual . . . that could not have been reasonably anticipated.")

32. Q—What constitutes an event that is "isolated, nonrecurring, and unusual . . . that could not have been reasonably anticipated" as described in ♦ paragraph 8?

A—The penultimate sentence of paragraph 8 states that an event that is "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" (emphasis added). Other than the "extremely remote 'disaster scenarios' (such as a run on a bank or an insurance company)" referred to in ♦ paragraph 61, very few events would meet all four of those conditions.

33. Q—♦ Paragraph 11(b) allows a sale of a held-to-maturity security to be considered a maturity when the enterprise has collected a substantial portion (at least 85 percent) of the principal outstanding at acquisition due to scheduled payments on a debt security payable in equal installments (that comprise both principal and interest) over its term. What types of securities would typically qualify or not qualify for this exception?

A—This limited practical exception applies to debt securities that are payable in equal installments that comprise both principal and interest, for example, certain level-payment mortgage-backed securities. The exception also applies to variable-rate debt securities when the scheduled payments would be payable in equal installments absent a change in interest rates. It is not appropriate to apply this limited practical exception by analogy to a debt security that has a contractual payment schedule of level principal payments plus interest that accrues based on the declining outstanding principal balance; the payments on that type of security do not represent equal installments that are made up of both principal and interest.

Trading Securities and Available-for-Sale Securities—♦ Paragraph 12

34. Q—How often must sales occur to consider an activity "trading"?

A—The phrases selling them in the near term and held for only a shortperiod of time in the description of trading securities contemplate a holding period generally measured in hours and
days rather than months or years. Thus, if a security is acquired with the intent of selling it within hours or days, the security must be classified as trading. However, at acquisition an enterprise is not precluded from classifying as trading a security it plans to hold for a longer period. Refer to ♦ Question 35. Also, see ♦ paragraph 3 of FASB Statement No. 134, Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise, for clarification of the term trading for a mortgage banking enterprise. [Revised 12/98.]

35. Q—If an enterprise acquires a security without the intent to sell it in the near term, may it classify the security in the trading category?

A—Yes. Classification of a security as trading is not precluded simply because the enterprise does not intend to sell it in the near term. The Board deliberately used the terms generally and principally in describing the trading category in ♦ paragraph 12(a). However, the decision to classify a security as trading should occur at acquisition; transfers into or from the trading category should be rare (refer to ♦ paragraph 15).

36. Q—If an enterprise decides to sell a security that has been classified as available-for-sale, should it be transferred to trading?

A—No. ♦ Paragraph 81 states, "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." Sales of available-for-sale securities should be disclosed in accordance with ♦ paragraph 21. Similarly, if an enterprise plans to sell a security from the held-to-maturity category in response to one of the conditions in ♦ paragraph 8, the security should not be automatically reclassified to available-for-sale or trading prior to the sale. The disclosures required by ♦ paragraph 22 should be provided in the period of the sale. (Refer to ♦ Question 47 for guidance on recognizing other-than-temporary impairment on a security that the enterprise has decided to sell.)

37. Q—What should be the initial carrying amount under Statement 115 of a previously nonmarketable equity security that becomes marketable (that is, due to a change in circumstances, it now has a fair value that is readily determinable)?

A—The cost basis of the nonmarketable security (reduced by any other-than-temporary impairment that has been recognized) should become the basis of the security to be accounted for under Statement 115. To the extent that a change in marketability provides evidence that an other-than-temporary impairment has occurred, a write-down should be recorded prior to applying Statement 115, and the loss should be classified in a manner consistent with other write-downs of similar investments. (This response presumes that the nonmarketable security had not been accounted for under the equity method. Refer to ♦ Question 38.)

38. Q—What should be the initial carrying amount under Statement 115 of a marketable equity security that should no longer be accounted for under the equity method (for example, due to a decrease in the level of ownership)?

A—Paragraph 19(l) of APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock, states that the earnings or losses that relate to the stock retained should remain as a part of the carrying amount of the investment and that the investment account should not be adjusted retroactively. The security's initial basis under Statement 115 would be the previous carrying amount of the investment. Subsequently, the security would be accounted for pursuant to ♦ paragraph 13 of Statement 115. Refer to ♦ paragraphs 6 and 19 of Opinion 18 for additional information.
39. **Q**—How is a sale of an available-for-sale security recorded?

**A**—Enterprises have different bookkeeping methods for available-for-sale securities. Generally, a debit to cash (or trade date receivable) is recorded for the sales proceeds, and a credit is recorded to remove the security at its fair value (or sales price). The amount recorded in other comprehensive income, representing the unrealized gain or loss at the date of sale, is reversed into earnings, and the deferred tax accounts are adjusted. Some adjustment to this procedure will be necessary for enterprises that have not yet recorded the security's change in value up to the point of sale (perhaps because fair value changes are recorded at the end of each interim period) or when write-downs for other-than-temporary impairment have been recognized. [Revised 12/98.]

40. **Q**—How is a sale of a trading security recorded?

**A**—All changes in a trading security's fair value are reported in earnings as they occur. Thus, the sale of a trading security does not necessarily give rise to a gain or loss. Generally, a debit to cash (or trade date receivable) is recorded for the sales proceeds, and a credit is recorded to remove the security at its fair value (or sales price). If the enterprise is not taxed on a mark-to-market basis, the deferred tax accounts would be adjusted. Some adjustment to this procedure will be necessary for enterprises that have not yet recorded the security's change in value up to the point of sale (perhaps because fair value changes are recorded at the end of each day).

41. **Q**—If a derivative instrument is used to hedge a security classified as available-for-sale, may changes in the fair value of the derivative instrument also be recorded in other comprehensive income? [Revised 12/98.]

**A**—Under Statement 133, changes in the fair value of a derivative instrument must be recorded currently in earnings unless designated as a qualifying cash flow hedge. Refer to paragraphs 23 and 38 of Statement 133 for additional information. Statement 133 also addresses the accounting for the available-for-sale security. Refer to EITF Issues ♦ No 96-15, "Accounting for the Effects of Changes in Foreign Currency Exchange Rates on Foreign-Currency-Denominated Available-for-Sale Debt Securities," and ♦ No. 97-7, "Accounting for Hedges of the Foreign Currency Risk Inherent in an Available-for-Sale Marketable Equity Security," for additional information. [Revised 12/98; 9/01.]

42. **Q**—If an interest rate swap is used to change the interest rate characteristics of an available-for-sale security from a fixed rate to a floating rate or vice versa, does Statement 115 provide guidance on accounting for hedging activities, including those involving interest rate swaps. [Revised 9/01/]

**A**—No. Statement 133 provides guidance on accounting for hedging activities, including those involving interest rate swaps. [Revised 9/99; 9/01.]

**Transfers between Categories of Investments—♦ Paragraph 15**

43. **Q**—When securities are transferred from available-for-sale to held-to-maturity or vice versa, is the subsequent amortization of a premium or discount based on the amortized cost of the security or its fair value at the date of transfer?

**A**—When a security is transferred from available-for-sale to held-to-maturity, the difference between the par value of the security and its fair value at the date of transfer is amortized as a yield adjustment in accordance with FASB Statement No. 91, *Accounting for Nonrefundable Fees*
that fair value amount, adjusted for subsequent amortization, becomes the security's amortized cost basis for the disclosures required by paragraphs 19, 20, and 22.

When a security is transferred from held-to-maturity to available-for-sale, the security's amortized cost basis carries over to the available-for-sale category for the following purposes: the subsequent amortization of the historical premium or discount, the comparisons of fair value and amortized cost for the purpose of determining unrealized holding gains and losses under paragraph 13, and the required disclosures of amortized cost. As paragraphs 15 and 22 indicate, transfers from the held-to-maturity category should be rare, except for transfers due to the changes in circumstances identified in paragraphs 8(a)-8(f).

44. **Q—** Paragraph 15 indicates that for transfers involving the trading category, the unrealized holding gain or loss should be recognized in earnings. How should the gain or loss be classified on the income statement?

**A—** Statement 115 does not specify the income statement classification of gains and losses for transfers involving trading securities. However, gains and losses that have accumulated prior to the time of transfer should be classified in a manner consistent with the classification of realized gains and losses for the category from which the security is being transferred, not the category into which the security is being transferred. As indicated in paragraph 15, transfers into or from the trading category should be rare.

45. **Q—** How is a transfer from available-for-sale to held-to-maturity accounted for?

**A—** The following chart illustrates the accounting for a transfer from available-for-sale to held-to-maturity.

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Par</th>
<th>(Amor)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/X1</td>
<td>Bond purchased, 6 years from maturity, classified as available for sale</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>19X1</td>
<td>Amortization of premium, bringing amortized cost to 105</td>
<td></td>
<td></td>
</tr>
<tr>
<td>19X1</td>
<td>Bond appreciates to 120</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>12/31/X1</td>
<td>Balances</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>1/1/X2</td>
<td>Bond transferred to held-to-maturity at fair value</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>19X2</td>
<td>Amortization of premium and equity component</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/31/X2</td>
<td>Balances</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>19X3</td>
<td>Amortization of premium and equity component</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/31/X3</td>
<td>Balances</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>19X4</td>
<td>Amortization of premium and equity component</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Note: For illustrative purposes, amortization of the premium and the unrealized holding gain was computed on a straight-line basis. Premiums and discounts on debt securities should be amortized pursuant to Statement 91. Paragraph 15(d) of Statement 115 requires that the unrealized holding gain or loss at the date of transfer be amortized in a manner consistent with any premium or discount. The "Cumulative Effect on Interest Income" column above represents the difference between the amortization of the premium and the unrealized holding gain over the life of the security, and does not reflect any coupon interest received.

[Revised 12/98.]

13 The offsetting accounting entry would be to record or adjust a deferred tax liability.

Impairment of Securities—Paragraph 16

46. Q—Paragraph 16 provides an example of when a decline in the fair value of a debt security is other than temporary. What other factors indicate that impairment is other than temporary? How is an equity security evaluated for other-than-temporary impairment?

A—Statement 115 does not specifically address these questions, but refers to two other sources of literature that should be considered in evaluating impairment: SEC Staff Accounting Bulletin No. 59, Accounting for Noncurrent Marketable Equity Securities, and AICPA Statement on Auditing Standards (SAS) No. 92, Auditing Derivative Instruments, Hedging Activities, and Investments in Securities. SAB 59 has been reproduced in the appendix to this implementation guide (see page 241). Although paragraph 16 of Statement 115 mentions a decline in a security's value due to a deterioration in the issuer's creditworthiness, recognition of other-than-temporary impairment also may be required if the decline in a security's value is due to an increase in market interest rates or a change in foreign exchange rates since acquisition. Examples of when a decline in the fair value of a debt security may be other than temporary include situations where the security will be disposed of before it matures or the investment is not realizable (also see paragraph 47 of SAS 92 and paragraph 6.39 of the AICPA Audit Guide, Auditing Derivative Instruments, Hedging Activities, and Investments, in Securities. [Revised 9/99; 9/01.]

47. Q—Should an enterprise recognize other-than-temporary impairment when it decides to sell a specific available-for-sale debt security at a loss shortly after the balance sheet date?

A—Generally, yes, if the enterprise does not expect the fair value of the security to recover prior to the expected time of sale. In that case, the write-down for other-than-temporary impairment would be recognized in earnings in the period in which the decision to sell is made, not the period in which the sale occurs. Refer to EITF Topic No. D-44, "Recognition of Other-Than-Temporary Impairment upon the Planned Sale of a Security Whose Cost Exceeds Fair
Value," and the two documents in the appendix to this implementation guide for additional information.

48. **Q**—May a valuation allowance be used to recognize impairment on securities subject to Statement 115?

**A**—No. ◇ Paragraph 16 requires that each individual security be evaluated for impairment and, when impairment is identified, "the cost basis of the individual security shall be written down to fair value as a new cost basis and the amount of the write-down shall be included in earnings." Providing a general allowance for unidentified impairment in a portfolio of securities is not appropriate.

49. **Q**—After other-than-temporary impairment has been recognized on an available-for-sale security, how should subsequent recoveries be accounted for?

**A**—◇ Paragraph 16 states that after a security has been written down for other-than-temporary impairment, "the new cost basis shall not be changed for subsequent recoveries in fair value" (emphasis added). Subsequently, an unrealized holding gain or loss is determined by comparing an available-for-sale security's fair value with its new cost basis; increases and decreases in fair value are accounted for in accordance with paragraph 16. A recovery in fair value should not be recorded in earnings until the security is sold.

50. **Q**—Does the guidance in Statement 115 with respect to impairment of securities apply to a purchased or retained beneficial interest in securitized financial assets such as an investment in a collateralized mortgage obligation instrument or in a mortgage-backed interest-only certificate? [Revised 9/01.]

**A**—Yes, unless the beneficial interest represents an equity security (as defined in paragraph 137) that does not have a readily determinable fair value. Refer to ◇ EITF Issue No. 99-20, "Recognition Interest Income and of Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets," for additional information. [Revised 9/01; 6/06.]

Financial Statement Presentation—◇ Paragraphs 17 and 18

51. **Q**—Must the statement of cash flows show purchases, sales, and maturities of securities reported as cash equivalents?

**A**—No. Statement 115 did not change the requirements of FASB Statement No. 95, Statement of Cash Flows, which permits reporting activity in cash equivalents as a net change. However, securities that are considered cash equivalents are subject to the accounting and disclosure requirements of Statement 115, such as disclosure of amortized cost and fair value by major security types. ◇ Paragraph 117 of Statement 115 indicates that enterprises should provide a note explaining what portion of each category of securities is reported as cash equivalents in the statement of financial position and the statement of cash flows.

Disclosures—◇ Paragraphs 19-22

52. **Q**—Must the disclosures required in ◇ paragraphs 19-22 be included in interim financial statements?

**A**—The disclosures are required to be made in all complete sets of financial statements for interim periods, for example, in conjunction with a securities registration statement. The minimum disclosure requirements for summarized interim financial information issued by publicly traded
entities are established by APB Opinion No. 28, *Interim Financial Reporting*. Because the provisions of Statement 115 did not amend Opinion 28, summarized financial information need not include the disclosures.

53. **Q—** Paragraph 21(e) requires disclosure of the portion of trading gains and losses for the period related to trading securities still held at the reporting date. How is that amount calculated? [Revised 12/98.]

**A—** The amount to be disclosed would be calculated as follows:

Net gains and losses recognized during the period on trading securities
Less: Net gains and losses recognized during the period on trading securities sold during the period
Unrealized gains and losses recognized during the reporting period on trading securities still held at the reporting date

[Revised 12/98]

Deferred Tax Accounting

54. **Q—** If an enterprise recognizes a deferred tax asset relating only to a net unrealized loss on available-for-sale securities and at the same time concludes that it is more likely than not that some or all of that deferred tax asset will not be realized, is the offsetting entry to the valuation allowance reported in other comprehensive income related to the unrealized loss under Statement 115 or as an item in determining income from continuing operations? [Revised 12/98.]

**A—** The offsetting entry to the valuation allowance is reported in the Statement 115 component of other comprehensive income because the valuation allowance is directly related to the unrealized holding loss on the available-for-sale securities. The offsetting entry to the valuation allowance also would be reported in the Statement 115 component of other comprehensive income if the enterprise reaches its conclusion on the need for a valuation allowance in a later interim period of the same fiscal year in which the deferred tax asset is initially recognized. [Revised 12/98.]

55. **Q—** Assume an enterprise has recognized a deferred tax asset relating to other deductible temporary differences in a previous fiscal year and at the same time concluded that no valuation allowance was warranted. If in the current year an enterprise recognizes a deferred tax asset relating to a net unrealized loss on available-for-sale securities that arose in the current year and at the same time concludes that a valuation allowance is warranted, is the offsetting entry reported in the Statement 115 component of other comprehensive income or as an item in determining income from continuing operations? [Revised 12/98.]

**A—** Management needs to determine the extent to which the valuation allowance is directly related to the unrealized loss and the other deductible temporary differences, such as an accrual for other postemployment benefits. The offsetting entry to the valuation allowance is reported in the Statement 115 component of other comprehensive income only to the extent the valuation allowance is directly related to the unrealized loss on the available-for-sale securities that arose in the current year. [Revised 12/98.]

56. **Q—** If an enterprise does not need to recognize a valuation allowance at the same time that it establishes a deferred tax asset relating to a net unrealized loss on available-for-sale securities but in a subsequent fiscal year concludes that it is more likely than not that some or all of that deferred tax asset will not be realized, is the offsetting entry to the valuation allowance reported in the Statement 115 component of other comprehensive income or as an item in determining income
from continuing operations? [Revised 12/98.]

A—If an enterprise initially decided that no valuation allowance was required at the time the unrealized loss was recognized but in a subsequent fiscal year decides that it is more likely than not that the deferred tax asset will not be realized, a valuation allowance is required to be recognized. The offsetting entry should be included as an item in determining income from continuing operations. It should not be included in other comprehensive income. [Revised 12/98.]

57. Q—If an enterprise recognizes a deferred tax asset relating to a net unrealized loss on available-for-sale securities and at the same time concludes that a valuation allowance is warranted and in a subsequent fiscal year makes a change in judgment about the level of future years' taxable income such that all or a portion of that valuation allowance is no longer warranted, is the offsetting entry reported in the Statement 115 component of other comprehensive income or as an item in determining income from continuing operations? [Revised 12/98.]

A—Any reversals in the valuation allowance due to such a change in judgment in subsequent fiscal years should be included as an item in determining income from continuing operations, even though initial recognition of the valuation allowance affected the Statement 115 component of other comprehensive income. If, rather than a change in judgment about future years' taxable income, the enterprise generates taxable income in the current year that can utilize the benefit of the deferred tax asset, the elimination (or reduction) of the valuation allowance is allocated to that taxable income. ¶ Paragraphs 26 and 35-38 of FASB Statement No. 109, Accounting for Income Taxes, provide additional information. [Revised 12/98.]

Determining Fair Value

58. Q—If a company has a significant investment in a particular security and believes that an attempt to sell the entire investment at one time would significantly affect the security's market price, should the size of the investment be considered in determining the fair value of the security?

A—No. Statement 115 does not permit the adjustment of quoted market prices in the determination of fair value. The definition of fair value in ¶ paragraph 137, as amended by Statement 133, states, "If a quoted market price is available (for an instrument) the fair value is the product of the number of trading units times that market price." [Revised 12/98.]

59. Q—How should an enterprise determine the fair value of a debt security when quoted market prices are not available?

A—The definition of fair value in ¶ paragraph 137, as amended by Statement 133, provides guidance on estimating fair values for debt securities that do not trade regularly or that trade only in principal-to-principal markets.

... If a quoted market price is not available, the estimate of fair value should be based on the best information available in the circumstances. The estimate of fair value should consider prices for similar assets and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis.

... [Revised 12/98.]
Effect of Planned Sales on Pooling-of-Interests Treatment

60. [Deleted 10/02 because Statement 141 prohibits the use of the pooling-of-interests method of accounting for all business combinations initiated after June 30, 2001.]

Q—Does the planned sale of securities following a major business combination preclude accounting for the combination as a pooling of interests?

A—A planned sale of held-to-maturity securities that meets the conditions of paragraph 8(c), or a planned sale of available-for-sale securities, would not preclude accounting for the combination as a pooling of interests. Refer to EITF Topic No. D-40, "Planned Sale of Securities following a Business Combination Expected to Be Accounted for as a Pooling of Interests," for additional information. Statement 144 prohibits the use of pooling-of-interests method of accounting for all business combinations initiated after June 30, 2001. [Revised 9/01.]

Transition

61. [Question deleted 12/98 because the effective date of Statement 115 has passed.]

Q—How should an enterprise that adopted Statement 115 prior to the issuance of this Special Report account for the effects (other than a correction of an error), if any, of initially complying with the subsequently issued implementation guidance?

A—An enterprise that adopted Statement 115 in financial statements issued prior to the issuance of this Special Report is not permitted to restate the financial statements of prior periods for which Statement 115 was applied to reflect the effects of initially adopting the implementation guidance in this Special Report. If the effects of initially adopting this implementation guidance result in reclassifications of securities between categories, they should be accounted for as transfers in accordance with paragraph 15 and disclosed in accordance with paragraph 22. Other effects of complying with this implementation guidance may be reported prospectively.

In addition, concurrent with the initial adoption of this implementation guidance but no later than December 31, 1995, an enterprise may reassess the appropriateness of the classifications of all securities held at that time and account for any resulting reclassifications at fair value in accordance with paragraph 15. Those reclassifications should occur no later than December 31, 1995, and be disclosed in accordance with paragraph 22. Reclassifications from the held-to-maturity category that result from this one-time reassessment will not call into question the intent of an enterprise to hold other debt securities to maturity in the future. If an enterprise has previously sold or transferred held-to-maturity securities for reasons that call into question its intent to hold other debt securities to maturity in the future, this one-time reassessment does not remove any existing limitation on an enterprise's use of the held-to-maturity category (refer to questions 11-14).

The one-time reassessment described in the preceding paragraph also applies to an enterprise whose fiscal year does not correspond to the calendar year provided that the reassessment and any related reclassifications occur no later than December 31, 1995. 15(11)

Appendix A—OTHER INTERPRETATIONS OF STATEMENT 115

♦ FASB Technical Bulletin No. 94-1, Application of Statement 115 to Debt Securities Restructured in a Troubled Debt Restructuring
♦ EITF Issue No. 93-18, "Recognition of Impairment for an Investment in a Collateralized Mortgage
Appendix B—ADDITIONAL GUIDANCE ON IMPAIRMENT OF SECURITIES

SEC Staff Accounting Bulletin No. 59, Accounting for Noncurrent Marketable Equity Securities

**Question 1:** Does the staff believe that the phrase "other than temporary" should be interpreted to mean "permanent"?

**Interpretive Response:** No. The staff believes that the FASB consciously chose the phrase "other than temporary" because it did not intend that the test be "permanent impairment," as has been used elsewhere in accounting practice. 1(12)

The value of investments in marketable securities classified as noncurrent assets may decline for various reasons. The market price may be affected by general market conditions which reflect prospects for the economy as a whole or by specific information pertaining to an industry or an individual company. Such declines require further investigation by management. Acting upon the premise that a write-down may be required, management should consider all available evidence to evaluate the realizable value of its investment.

There are numerous factors to be considered in such an evaluation and their relative significance will vary from case to case. The staff believes that the following are only a few examples of the factors which, individually or in combination, indicate that a decline is other than temporary and that a write-down of the carrying value is required:

a. The length of the time and the extent to which the market value has been less than cost;
b. The financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer such as changes in technology that may impair the earnings potential of the investment or the discontinuance of a segment of the business that may affect the future earnings potential; or

The intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value.

Unless evidence exists to support a realizable value equal to or greater than the carrying value of the investment, a write-down accounted for as a realized loss should be recorded. In accordance with the guidance of ♦ paragraph 11 of Statement No. 12, such loss should be recognized in the determination of net income of the period in which it occurs. The written down value of the investment in the company becomes the new cost basis of the investment.

Superseded by the FASB Accounting Standards Codification on July 1, 2009.
Question 2: When management determines that a write-down, accounted for as a realized loss, is necessary, how should the amount of the write-down be determined?

Interpretive Response: The carrying value of the investment should be written down to reflect realizable value. The particular facts and circumstances dictate the amount of realized loss to be recognized on a case by case basis.

[Issue Date: September 1985]

AICPA Statement of Auditing Standards No. 81, Auditing Investments *(13)

Introduction and Applicability
.01 This section provides guidance to auditors in auditing investments in securities, that is, debt securities and equity securities, investments accounted for under Accounting Principles Board (APB) Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock [AC section 182].

Audit Objectives and Approach
.02 The auditor should ascertain whether investments are accounted for in conformity with generally accepted accounting principles, including adequate disclosure of material matters. Section 312, Audit Risk and Materiality in Conducting an Audit, provides guidance on the auditor's consideration of audit risk when planning and performing an audit of financial statements. The auditor considers audit risk in determining the nature, timing, and extent of the auditing procedures to be performed for financial statement assertions about investments.

.03 Section 326, Evidential Matter, states that most of the auditor's work in forming an opinion on financial statements consists of obtaining and evaluating evidential matter related to assertions in the financial statements. This section provides guidance concerning substantive auditing procedures to be performed in gathering evidential matter related to assertions about investments.

Existence, Ownership, and Completeness
.04 The procedures the auditor performs to obtain evidence about the existence, ownership, and completeness of investments will vary depending on the types of investments involved and the auditor's assessment of audit risk. These procedures should include one or more of the following:

- Physical inspection
- Confirmation with the issuer
- Confirmation with the custodian
- Confirmation of unsettled transactions with the broker-dealer
- Confirmation with the counterparty
- Reading executed partnership or similar agreements

Furthermore, the auditor should consider the guidance in section 324, Reports on the Processing of Transactions by Service Organizations, if the entity obtains either or both of the following services from another organization:

a. Executing investment transactions and maintaining the related accountability
b. Recording investment transactions and processing the related data

Appropriateness of Accounting Policy
.05 The auditor should ascertain whether the accounting policies adopted by the entity for investments are in conformity with generally accepted accounting principles. Certain investments require the application of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 115, Accounting for Certain Investments in Debt and Equity Securities [AC...
section I80], or FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations* [AC section No5]. Other investments may require the application of the cost or equity methods of accounting.

.06 Certain entities, such as state and local governmental entities, follow accounting standards issued by the Governmental Accounting Standards Board and certain other pronouncements issued by the American Institute of Certified Public Accountants. Also, certain entities, such as broker-dealers, employee benefit plans, and investment companies follow specialized industry accounting policies.

**FASB Statement No. 115**

.07 For entities required to follow FASB Statement No. 115 [AC section I80], the accounting policy for an investment in a security depends on its classification. Specifically, the Summary of FASB Statement No. 115 [AC section I80] states the following:

- 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.

.08 The appropriate classification of investments depends on management's intent in purchasing and holding the investment, on the entity's actual investment activities, and, for certain debt securities, on the entity's ability to hold the investment to maturity. In determining the nature, timing, and extent of the auditor's substantive procedures, the auditor should obtain an understanding of the process used by management to classify investments.

.09 In evaluating management's intent related to an investment, the auditor should consider whether investment activities corroborate or conflict with management's stated intent. For example, sales of investments classified in the held-to-maturity category, for reasons other than those identified in paragraphs 8 and 11 of FASB Statement No. 115 [AC section I80.105 and .108], should cause the auditor to question the appropriateness of management's classification of other investments classified in that category, as well as future classifications of investments into that category. When considering investment activities, the auditor ordinarily should examine evidence such as written and approved records of investment strategies, records of investment activities, instructions to portfolio managers, and minutes of meetings of the board of directors or the investment committee.

.10 In evaluating an entity's ability to hold a debt security to maturity, the auditor gathers evidence that tends to either corroborate or conflict with such ability. The auditor should consider factors such as the entity's financial position, working capital needs, operating results, debt agreements, guarantees, and other relevant contractual obligations, as well as laws and regulations. The auditor also should consider whether existing operating and cash flow projections or forecasts provide relevant information about an entity's ability to hold an investment to maturity.

.11 In addition to performing other auditing procedures, the auditor ordinarily should obtain written representations from management confirming that the entity has properly classified securities as held-to-maturity, trading, or available-for-sale, and, with respect to held-to-maturity debt securities, that management has the intent and the entity has the ability to hold such investments to maturity. 5(18)

**FASB Statement No. 124**

.12 For entities required to follow FASB Statement No. 124 [AC section No5], the accounting policy for investments in equity securities with readily determinable fair values and all investments in debt securities is that they be measured at fair value.
.13 ♦ Paragraph 17 of APB Opinion 18 [AC section I82.104] states that the equity method of accounting for an investment in common stock should be used by an investor whose investment in voting stock gives it the ability to exercise significant influence, but not control, over an investee. That paragraph also provides criteria to be considered in determining whether an investor has the ability to exercise significant influence.

.14 The auditor should obtain evidence about the appropriateness of the accounting method adopted for investments in common stock of an investee. 6(19) Inquiry should be made of the investor's management as to (a) whether the investor has the ability to exercise significant influence over the operating and financial policies of the investee under the criteria set forth in ♦ paragraph 17 of APB Opinion 18 [AC section I82.104] 7(20) and (b) the attendant circumstances that serve as a basis for management's conclusion. The auditor should evaluate the information received on the basis of facts otherwise obtained by him or her in the course of the audit.

.15 If an investor accounts for an investment in an investee contrary to the applicable presumption contained in ♦ paragraph 17 of APB Opinion 18 [AC section I82.104], the auditor should obtain sufficient competent evidential matter about whether that presumption has been overcome and whether appropriate disclosure is made regarding the reasons for not accounting for the investment in keeping with the presumption. 8(21)

.16 The refusal of an investee to furnish necessary financial data to the investor is evidence (but not necessarily conclusive evidence) that the investor does not have the ability to exercise significant influence over the investee to justify the application of the equity method of accounting.

.17 Financial statements of the investee generally constitute sufficient evidential matter as to the equity in the underlying net assets and the results of operations of the investee if such statements have been audited by an auditor whose report is satisfactory for this purpose, to the investor's auditor. Section 543, Part of Audit Performed by Other Independent Auditors, paragraph .14, provides guidance to the investor's auditor in determining (a) whether to make reference to the report of the other auditor and (b) what additional procedures may be necessary.

.18 Unaudited financial statements, reports issued on examination by regulatory bodies and taxing authorities, and similar data provide evidence but are not by themselves sufficient as evidential matter. An investor may include its proportionate share of the results of operations of an investee based on the investee's unaudited interim financial statements. An example of this would be a situation in which an investor whose year ends on June 30 includes its equity in earnings of an investee based on the investee's financial statements for the six-month period ended December 31 and the six-month period ended June 30. In such situations, the auditor for the investor should recognize that, although the investee's financial statements for the year ended December 31 may have been audited, the financial statements as of June 30 and for the year then ended represent unaudited data because neither six-month period is covered by an auditor's report. If the financial statements of the investee are not audited, the auditor should apply or should request that the investor arrange with the investee to have the investee's auditor apply, appropriate auditing procedures to such financial statements, considering the materiality of the investment in relation to the financial statements of the investor.

.19 If the carrying amount of an investment reflects (a) factors (such as goodwill or other intangibles) that are not recognized in the financial statements of the investee or (b) fair values of assets that are materially different from the investee's carrying amounts, the auditor should consider obtaining current evaluations of these amounts. Although evaluations made by persons within the investor or within the investee may be acceptable, evaluations made by persons independent of these companies usually provide greater assurance of reliability. If such evaluations are made by third parties, the auditor should consider the applicability of section 336, Using the Work of a Specialist.

.20 There may be a time lag in reporting between the date of the financial statements of the investor and that of the investee. A time lag in reporting should be consistent from period to period. If a change in time lag occurs that has a material effect on the investor's financial statements, an explanatory paragraph should be added to the auditor's report because of the change in reporting period. 9(22)
With respect to subsequent events and transactions of the investee occurring after the date of the investee's financial statements but before the date of the report of the investor's auditor, the auditor should read available interim financial statements of the investee and make appropriate inquiries of the investor to identify subsequent events and transactions that are material to the investor's financial statements. Such events or transactions of the type contemplated in section 560, Subsequent Events, paragraphs .05 and .06, should be disclosed in the notes to the investor's financial statements and (where applicable) labeled as unaudited information. For the purpose of recording the investor's share of the investee's results of operations, recognition should be given to events or transactions of the type contemplated in section 560.03.

Evidence relating to material transactions between the investor and investee should be obtained to evaluate the propriety of the elimination of unrealized intercompany profits and losses and the adequacy of the disclosures about material related-party transactions. Normally, information about unrealized intercompany profits and losses is not shown separately in the investee's financial statements and, therefore, may have to be obtained from the investee. If the amounts of unrealized intercompany profits or losses are or could reasonably be expected to be material in relation to the investor's financial position or results of operations, unaudited data obtained from the investee ordinarily should be subjected to auditing procedures.

Valuation and Presentation

Cost

The auditor should obtain evidence about the cost of investments if the entity carries its investments at cost or amortized cost or is required to make certain disclosures about the cost basis of investments carried at fair value and realized and unrealized gains and losses. The procedures performed to obtain evidence about cost may include inspection of documentation indicating the purchase price of the security, confirmation with the issuer or custodian, and recomputation of discount or premium amortization.

Fair Value

If investments are carried at fair value or if fair value is disclosed for investments carried at other than fair value, the auditor should obtain evidence corroborating the fair value. In some cases, the method for determining fair value is specified by generally accepted accounting principles. For example, generally accepted accounting principles may require that the fair value of an investment be determined using quoted market prices or quotations as opposed to estimation techniques. In those cases, the auditor should evaluate whether the determination of fair value is consistent with the required valuation method. The following paragraphs provide guidance on audit evidence that may be used to corroborate assertions about fair value; the guidance should be considered in the context of specific accounting requirements.

Quoted market prices for investments listed on national exchanges or over-the-counter markets are available from sources such as financial publications, the exchanges, or the National Association of Securities Dealers Automated Quotations System (NASDAQ). For certain other investments, quoted market prices may be obtained from broker-dealers who are market makers in those investments. If quoted market prices are not available, estimates of fair value frequently can be obtained from third-party sources based on proprietary models or from the entity based on internally developed or acquired models.

Quoted market prices obtained from financial publications or from national exchanges and NASDAQ are generally considered to provide sufficient evidence of the fair value of investments. However, for certain investments, such as securities that do not trade regularly, the auditor should consider obtaining estimates of fair value from broker-dealers or other third-party sources. In some situations, the auditor may determine that it is necessary to obtain fair-value estimates from more than one pricing source. For example, this may be appropriate if a pricing source has a relationship with an entity that might impair its objectivity.

For fair-value estimates obtained from broker-dealers and other third-party sources, the
The auditor should consider the applicability of the guidance in section 336 or section 324. The auditor's decision as to whether such guidance is applicable and which guidance is applicable will depend on the circumstances. The guidance in section 336 may be applicable if the third-party source derives the fair value of a security by using modeling or similar techniques. If an entity uses a pricing service to obtain prices of listed securities in the entity's portfolio, the guidance in section 324 may be appropriate.

.28 In the case of investments valued by the entity using a valuation model, the auditor does not function as an appraiser and is not expected to substitute his or her judgment for that of the entity's management. Rather, the auditor generally should assess the reasonableness and appropriateness of the model. The auditor also should determine whether the market variables and assumptions used are reasonable and appropriately supported. Estimates of expected future cash flows should be based on reasonable and supportable assumptions. Further, the auditor should determine whether the entity has made appropriate disclosures about the method(s) and significant assumptions used to estimate the fair values of such investments.

.29 The evaluation of the appropriateness of valuation models and each of the variables and assumptions used in the models may require considerable judgment and knowledge of valuation techniques, market factors that affect value, and market conditions, particularly in relation to similar investments that are traded. Accordingly, in some circumstances, the auditor may consider it necessary to involve a specialist in assessing the entity's fair-value estimates or related models.

.30 Negotiable securities, real estate, chattels, or other property is often assigned as collateral for investments in debt securities. If the collateral is an important factor in evaluating fair value and collectibility of the investment, the auditor should obtain evidence regarding the existence, fair value, and transferability of such collateral as well as the investor's rights to the collateral.

**Impairment**

.31 Generally accepted accounting principles require management to determine whether a decline in fair value below the amortized cost basis of certain investments is other than temporary. Such determinations often involve estimation of the outcome of future events. Accordingly, judgment is required in determining whether an other-than-temporary impairment condition exists at the date of the financial statements. These judgments are based on subjective as well as objective factors, including knowledge and experience about past and current events and assumptions about future events.

.32 The auditor should evaluate whether management has considered relevant information in determining whether an other-than-temporary impairment condition exists. Examples of factors that may indicate an other-than-temporary impairment condition include the following:

- Fair value is significantly below cost.
- The decline in fair value is attributable to specific adverse conditions affecting a particular investment.
- The decline in fair value is attributable to specific conditions, such as conditions in an industry or in a geographic area.
- Management does not possess both the intent and the ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in fair value.
- The decline in fair value has existed for an extended period of time.
- A debt security has been downgraded by a rating agency.
- The financial condition of the issuer has deteriorated.
- Dividends have been reduced or eliminated, or scheduled interest payments on debt securities have not been made.

.33 The auditor should evaluate management's conclusions about the existence of an other-than-temporary impairment condition. In evaluating management's conclusions, the auditor should obtain evidence about conditions, such as those listed in paragraph .32, that tend to corroborate or
conflict with such conclusions.

Effective Date

34 This section is effective for audits of financial statements for periods ending on or after December 15, 1997. Early application of the provisions of this section is permissible.
Endnotes

1 (Popup - Footnote *)
Q&A 115 Footnote *—At the date of issuance of this implementation guide, Leslie French Seidman was an industry fellow at the FASB and Robert C. Wilkins was a project manager at the FASB. The positions and opinions expressed in this implementation guide were theirs. Revisions to this implementation guide have been made by current members of the FASB staff. Official positions of the FASB are determined only after extensive due process and deliberation.

2 (Popup - Footnote 1)
Q&A 115 Footnote 1—Questions and answers about the definition of a security are included in this section, as they relate primarily to the scope of Statement 115.

3 (Popup - Footnote 2)
Q&A 115 Footnote 2—[Footnote deleted 12/98 because of the issuance of FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, which was later replaced by FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.

4 (Popup - Footnote 3)
Q&A 115 Footnote 3—FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises, as amended by Statement 115, requires that enterprises within its scope report investments in equity securities that do not have readily determinable fair values at fair value, with changes in fair value reported, net of applicable income taxes, in other comprehensive income. [Revised 12/98.]

5 (Popup - Footnote 4a)

6 (Popup - Footnote 8)
Q&A 115 Footnote 8—[Footnote deleted 12/98 because of the issuance of Statement 125, which was later replaced by Statement 140.

7 (Popup - Footnote 9)
Q&A 115 Footnote 9—[Footnote deleted 12/98 because of the issuance of Statement 125, which was later replaced by Statement 140.]

8 (Popup - Footnote 10)
Q&A 115 Footnote 10—Paragraph 41 of FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, provides guidance on identifying a component of an entity. [Revised 5/03.]

9 (Popup - Footnote 11)
Q&A 115 Footnote 11—Paragraph 3(e) of FASB Statement No. 141 (revised 2007), Business Combinations, defines a business combination as “a transaction or other event in which the acquirer obtains control of one or more businesses” (footnote references omitted). Statement 141(R), which replaces Statement 141, continues to prohibit the use of the pooling-of-interests method of accounting for all business combinations. [Revised 12/07.]

10 (Popup - Footnote 13)
Q&A 115 Footnote 13—The offsetting accounting entry would be to record or adjust a deferred tax liability.

11 (Popup - Footnote 15)
Q&A 115 Footnote 15—[Footnote deleted 12/98 because the corresponding text was revised or deleted.]

At its October 18, 1995 meeting, the Board directed the staff to provide the guidance in this answer. Without that direction, the staff would be able to provide only the answers that Opinion 20 and Statement 115 would require. It is the Board’s intent that this answer not be used to justify either the
manner in which the effect of any other change in accounting method is recognized or the accounting treatment for reclassification of securities under Statement 115 in response to any other events or circumstances.

12 (Popup - Footnote 1)
Q&A 115, Appendix B, (SAB 59) Footnote 1—Footnote 8 to Statement No. 12 refers to an Auditing Interpretation published by the staff of the Auditing Standards Division, AICPA, "Evidential Matter for the Carrying Amount of Marketable Securities," in The Journal of Accountancy, April 1975, for a discussion of considerations applicable to a determination as to whether a decline in market value below cost, at a particular point in time, is other than temporary.

13 (Popup - Footnote *)
Q&A 115, Appendix B Footnote *—Statement of Auditing Standards No. 81, Auditing Investments, copyright (c) 1997 by the American Institute of Certified Public Accountants, New York, NY is included with permission.

14 (Popup - Footnote 1)
Q&A 115, (SAS 81) Footnote 1—The terms securities, debt securities, and equity securities are defined in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 115, Accounting for Certain Investments in Debt and Equity Securities [AC section I80].

15 (Popup - Footnote 2)
Q&A 115, (SAS 81) Footnote 2—The guidance in this section is also applicable to audits of presentations covered by section 623, Special Reports, that include assertions about investments.

16 (Popup - Footnote 3)
Q&A 115, (SAS 81) Footnote 3—Evidential Matter, uses the terminology rights and obligations in describing financial statement assertions about ownership.

17 (Popup - Footnote 4)
Q&A 115, (SAS 81) Footnote 4—Section 330, The Confirmation Process, provides guidance to the auditor concerning the use of confirmations in audits of financial statements.

18 (Popup - Footnote 5)
Q&A 115, (SAS 81) Footnote 5—Section 333A, Client Representations, provides guidance to the auditor concerning written representations from management in an audit of an entity's financial statements.

19 (Popup - Footnote 6)

20 (Popup - Footnote 7)
Q&A 115, (SAS 81) Footnote 7—Paragraph 17 of APB Opinion 18 [AC section I82.104] states that "an investment (direct or indirect) of 20% or more of the voting stock of an investee should lead to a presumption that in the absence of evidence to the contrary an investor has the ability to exercise significant influence over an investee. Conversely, an investment of less than 20% of the voting stock of an investee should lead to a presumption that an investor does not have the ability to exercise significant influence unless such ability can be demonstrated."

21 (Popup - Footnote 8)
Q&A 115, (SAS 81) Footnote 8—See footnotes 13 and 14 of paragraph 20 in APB Opinion 18 [AC section I82.110].

22 (Popup - Footnote 9)
Q&A 115, (SAS 81) Footnote 9—See section 508, Reports on Audited Financial Statements, paragraphs .16 through .18.