Certain investments in debt and equity securities
(before the adoption of ASU 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities)
June 2019
To our clients and other friends

The accounting for investments in debt and equity securities continues to be an area of focus by preparers, financial statement users, auditors and regulators. Questions continue to arise about other-than-temporary impairment (OTTI), accounting for sales of held-to-maturity securities, transfers between categories of investments and other topics.

This publication summarizes the guidance on the accounting for certain investments in debt and equity securities and includes excerpts from and references to the Accounting Standards Codification (ASC or Codification), interpretive guidance and examples. We have updated this publication primarily to provide an update of certain standard-setting activities.

This publication does not address the accounting for debt and equity securities under Accounting Standards Update (ASU) 2016-01, which will significantly change the recognition and measurement guidance for equity securities. ASU 2016-01 is effective for calendar-year public business entities (PBEs) on 1 January 2018 and other calendar-year entities on 1 January 2019. Refer to our Financial reporting developments (FRD) publication, Certain investments in debt and equity securities (after the adoption of ASU 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities), for further guidance on accounting for debt and equity securities after adopting ASU 2016-01. Appendix A of this publication also summarizes the guidance.

This publication also doesn’t address the accounting for credit impairment of debt securities under the new guidance in ASU 2016-13. Refer to Appendix A for a summary of the changes that guidance will make to the credit impairment model for held-to-maturity and available-for-sale debt securities. Additional guidance related to ASU 2016-13 can be found in our FRD publication, Credit impairment under ASC 326. The earliest effective date for ASU 2016-13 is in 2020.

Although we expect to periodically update this publication as practice issues emerge or additional guidance is issued, readers should closely monitor developments.

Ernst & Young LLP

June 2019
Contents

1 Overview and scope ............................................................................................................................................... 1
  1.1 Overview ...................................................................................................................................................... 1
  1.2 Scope and scope exceptions – entities .......................................................................................................... 1
  1.3 Scope and scope exceptions – instruments .................................................................................................... 2
    1.3.1 Equity securities ...................................................................................................................................... 2
      1.3.1.1 Readily determinable fair value ............................................................................................................ 3
        1.3.1.1.1 Cost method investments .............................................................................................................. 4
        1.3.1.1.2 Restricted stock ............................................................................................................................ 5
        1.3.1.1.3 Insurance entities and equity securities without readily determinable fair values .................. 5
      1.3.1.2 Options and warrants ........................................................................................................................... 5
        1.3.1.2.1 Certain purchased options and forward contracts ........................................................................ 6
  1.3.2 Debt securities ........................................................................................................................................... 7
    1.3.2.1 Definition of a security ........................................................................................................................ 8
      1.3.2.1.1 Loans .............................................................................................................................................. 9
    1.3.2.2 Preferred stock ........................................................................................................................................ 9
    1.3.2.3 Beneficial interests in securitized financial assets ............................................................................. 10
      1.3.2.3.1 Securities in the scope of ASC 325-40 ............................................................................................ 12
        1.3.2.3.2 Applicability of ASC 325-40 to trading securities ...................................................................... 13
    1.3.2.4 Options on debt securities .................................................................................................................... 14
  1.3.3 Instruments not in the scope of ASC 320 .................................................................................................... 14
    1.3.3.1 Derivatives ........................................................................................................................................... 14
    1.3.3.2 Cost method investments ..................................................................................................................... 15
  1.3.4 Other common issues related to scope ....................................................................................................... 15
    1.3.4.1 Cash and cash equivalents .................................................................................................................. 15
    1.3.4.2 Short sales of securities ....................................................................................................................... 15
    1.3.4.3 Contractual prepayment or settlement in such a way that the holder would not recover substantially all of its recorded investment ......................................................................................... 15

2 Classification and measurement .............................................................................................................................. 16
  2.1 Overview ......................................................................................................................................................... 16
    2.1.1 Summary table of classification and measurement .................................................................................. 17
  2.2 Recognition and initial measurement ................................................................................................................ 17
    2.2.1 Premiums and discounts .......................................................................................................................... 18
    2.2.2 Transaction costs ........................................................................................................................................ 19
    2.2.3 Recognition date ....................................................................................................................................... 19
    2.2.4 Initial carrying amount of equity securities that become marketable .................................................... 21
    2.2.5 Initial carrying amount of equity securities previously accounted for under the equity method ........... 21
    2.2.6 Nonmonetary exchange of equity securities ............................................................................................ 21
    2.2.7 Equity securities received in exchange for goods or services from a non-employer ............................. 23
  2.3 Trading securities ............................................................................................................................................. 24
    2.3.1 Entities with classified balance sheets ..................................................................................................... 25
2.3.2 Subsequent measurement ................................................................. 25
  2.3.2.1 Interest income ........................................................................ 25
  2.3.3 Foreign currency gains and losses ...................................................... 25
  2.3.4 Hedging securities classified as trading .............................................. 25
  2.3.5 Considerations for mortgage banking entities ...................................... 25
2.4 Held-to-maturity securities .................................................................. 26
  2.4.1 Ability and intent to hold to maturity .................................................. 26
    2.4.1.1 Considerations for regulated entities ........................................... 27
    2.4.1.2 Considerations for specific instruments ....................................... 27
    2.4.1.2.1 Prepayable debt securities ...................................................... 27
    2.4.1.2.2 Pledged securities ............................................................... 27
    2.4.1.2.3 Repurchase agreements and similar arrangements .................. 27
    2.4.1.2.4 Convertible debt ................................................................. 28
    2.4.1.2.5 Put and call features ............................................................ 28
    2.4.1.2.6 Interest-only securities and other securities with principal risk .... 28
  2.4.2 Additional considerations when assessing whether held-to-maturity classification is appropriate .................................................. 29
    2.4.2.1 Asset-liability management programs .......................................... 29
    2.4.2.2 Hedging programs .................................................................... 29
    2.4.2.3 Investment management policies ............................................... 29
    2.4.2.4 Future business plans ............................................................... 29
    2.4.2.5 Tax-planning strategies ............................................................. 29
  2.4.3 Entities with classified balance sheets .................................................. 30
  2.4.4 Subsequent measurement ................................................................. 30
  2.4.5 Foreign currency considerations ........................................................ 30
  2.4.6 Hedging securities classified as held to maturity .................................. 30
2.5 Available-for-sale securities ................................................................. 30
  2.5.1 Entities with classified balance sheets .................................................. 31
  2.5.2 Subsequent measurement ................................................................. 32
  2.5.3 Foreign currency considerations ........................................................ 32
  2.5.4 Hedging securities classified as available for sale ................................ 32
  2.5.5 Effect of available-for-sale security unrealized gains and losses on certain insurance-related assets and liabilities of insurance companies .......................................... 32
2.6 Structured notes ..................................................................................... 33

3 Transfers between categories of investments ............................................ 34
  3.1 Overview ............................................................................................ 34
    3.1.1 Summary table of accounting requirements for transfers between categories .................................................. 35
  3.2 Transfers from available for sale to held to maturity .................................. 36
  3.3 Transfers from held to maturity to available for sale .................................. 38
    3.3.1 Transfers of held-to-maturity securities among members of a consolidated group .................................................. 39
  3.4 Transfers involving trading securities ...................................................... 39
  3.5 Equity method investments ................................................................... 40
    3.5.1 Loss of significant influence ........................................................... 40
    3.5.2 Changing from ASC 320 accounting to the equity method of accounting .................................................. 41
  3.6 Cost method investments ...................................................................... 41
  3.7 Conversions of convertible bonds ........................................................... 41
  3.8 Disclosures about transfers between categories ........................................ 42
4 Sales of securities ................................................................. 43
  4.1 Overview ................................................................................. 43
  4.2 Sales of trading securities ......................................................... 43
  4.3 Sales of available-for-sale securities ......................................... 43
    4.3.1 Gain recognition on sales of securities with an arrangement to reacquire them ................................................................... 44
  4.4 Sales of held-to-maturity securities ........................................... 44
    4.4.1 Evaluation of the remaining portfolio following a sale or transfer ......................................................................................... 45
      4.4.1.1 SEC staff views on sales or transfers of held-to-maturity securities .................................................. 45
    4.4.2 Permitted sales or transfers ................................................... 46
      4.4.2.1 Credit deterioration ............................................................ 47
      4.4.2.2 Change in tax law ............................................................... 48
      4.4.2.3 Major business combination or disposition ...................... 48
      4.4.2.4 Change in statutory or regulatory requirements regarding permissible investments ............................................. 49
      4.4.2.5 Significant change in regulatory capital requirements .......... 49
      4.4.2.6 Isolated, nonrecurring and unusual events ...................... 50
        4.4.2.6.1 Tender offers for held-to-maturity securities ................ 50
    4.4.3 Sales deemed to be at maturity ............................................. 51
    4.4.4 Secured borrowings ............................................................ 52
  4.5 Disclosure requirements for sales of securities ......................... 52

5 Impairment ................................................................................. 54
  5.1 Overview and scope ............................................................... 54
    5.1.1 General valuation allowances .............................................. 55
  5.2 Debt securities ........................................................................ 55
    5.2.1 Overview .............................................................................. 55
    5.2.2 Determining whether a debt security is impaired .................. 56
    5.2.3 Evaluating whether an impairment is other than temporary .... 56
      5.2.3.1 Entity intends to sell the debt security ............................... 58
        5.2.3.1.1 Sales after the balance sheet date ................................. 59
        5.2.3.1.2 Third-party management of investment portfolio .......... 59
        5.2.3.1.3 Securities classified as held to maturity ..................... 60
      5.2.3.2 More likely than not the entity will be required to sell prior to recovery of cost basis ................................................ 60
      5.2.3.3 Entity does not expect to recover the entire amortized cost basis .............................................................. 60
        5.2.3.3.1 Need for detailed cash flow analysis each report date ...... 62
    5.2.4 Measuring and recognizing an OTTI .................................... 63
      5.2.4.1 Best estimate of present value of expected cash flows ...... 63
        5.2.4.1.1 Variable rate debt securities ....................................... 64
        5.2.4.1.2 Use of practical expedients in ASC 310-10 .................. 64
        5.2.4.1.3 Single best estimate versus probability-weighted estimate .............................................................. 64
        5.2.4.1.4 Examples of measuring the credit loss of a debt security ........................................................................ 65
          5.2.4.1.4.1 Measuring the credit loss of a security not in the scope of ASC 325-40 ................................................. 65
          5.2.4.1.4.2 Measuring the credit loss of a debt security in the scope of ASC 325-40 .................................................. 66
          5.2.4.1.4.3 Variable rate debt securities not in the scope of ASC 325-40 ............................................................... 68
<table>
<thead>
<tr>
<th>Section</th>
<th>Topic</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.2.4.1.4.4</td>
<td>Fair value of previously impaired debt security increases but expected cash flows decrease</td>
</tr>
<tr>
<td>5.2.4.1.4.5</td>
<td>Total decline in fair value is less than decline in expected cash flows</td>
</tr>
<tr>
<td>5.2.5</td>
<td>Foreign currency considerations</td>
</tr>
<tr>
<td>5.2.6</td>
<td>Accounting after an OTTI</td>
</tr>
<tr>
<td>5.2.7</td>
<td>Presentation of OTTI for debt securities</td>
</tr>
<tr>
<td>5.2.7.1</td>
<td>Presentation of subsequent changes in fair value of available-for-sale securities after an OTTI</td>
</tr>
<tr>
<td>5.2.7.2</td>
<td>Presentation of noncredit portions of OTTI for available-for-sale and held-to-maturity securities</td>
</tr>
<tr>
<td>5.3</td>
<td>Equity securities</td>
</tr>
<tr>
<td>5.3.1</td>
<td>Determining whether an equity security is impaired</td>
</tr>
<tr>
<td>5.3.2</td>
<td>Evaluating whether an impairment is other than temporary</td>
</tr>
<tr>
<td>5.3.2.1</td>
<td>Recovery in value</td>
</tr>
<tr>
<td>5.3.2.1.1</td>
<td>Period for recovery in value</td>
</tr>
<tr>
<td>5.3.2.2</td>
<td>Intent and ability to hold to recovery</td>
</tr>
<tr>
<td>5.3.2.2.1</td>
<td>Outsourced portfolio management arrangements</td>
</tr>
<tr>
<td>5.3.2.3</td>
<td>Sales of impaired equity securities</td>
</tr>
<tr>
<td>5.3.3</td>
<td>Measuring and recognizing an OTTI</td>
</tr>
<tr>
<td>5.3.4</td>
<td>Foreign currency considerations</td>
</tr>
<tr>
<td>5.3.5</td>
<td>Documentation considerations</td>
</tr>
<tr>
<td>5.4</td>
<td>OTTI model for perpetual preferred securities</td>
</tr>
<tr>
<td>6</td>
<td>Presentation and disclosure</td>
</tr>
<tr>
<td>6.1</td>
<td>Overview</td>
</tr>
<tr>
<td>6.2</td>
<td>Balance sheet presentation</td>
</tr>
<tr>
<td>6.3</td>
<td>Income statement presentation</td>
</tr>
<tr>
<td>6.3.1</td>
<td>Dividend and interest income</td>
</tr>
<tr>
<td>6.3.2</td>
<td>Other-than-temporary impairment</td>
</tr>
<tr>
<td>6.4</td>
<td>Other comprehensive income presentation</td>
</tr>
<tr>
<td>6.5</td>
<td>Cash flow presentation and disclosure</td>
</tr>
<tr>
<td>6.6</td>
<td>Disclosures</td>
</tr>
<tr>
<td>6.6.1</td>
<td>Unrealized loss disclosures</td>
</tr>
<tr>
<td>6.6.2</td>
<td>Credit loss rollforward disclosures</td>
</tr>
<tr>
<td>6.6.3</td>
<td>Disclosing fair value</td>
</tr>
</tbody>
</table>

A Summary of relevant accounting standards updates
A.1 ASU 2016-01
A.2 ASU 2016-13

B Glossary

C ASC references

D ASC abbreviations

E Summary of important changes
Notice to readers:

This publication includes excerpts from and references to the Financial Accounting Standards Board (FASB) Accounting Standards Codification. The Codification uses a hierarchy that includes Topics, Subtopics, Sections and Paragraphs. Each Topic includes an Overall Subtopic that generally includes pervasive guidance for the topic and additional Subtopics, as needed, with incremental or unique guidance. Each Subtopic includes Sections that in turn include numbered Paragraphs. Thus, a Codification reference includes the Topic (XXX), Subtopic (YY), Section (ZZ) and Paragraph (PP).

Throughout this publication references to guidance in the codification are shown using these reference numbers. References are also made to certain pre-codification standards (and specific sections or paragraphs of pre-Codification standards) in situations in which the content being discussed is excluded from the Codification.

This publication has been carefully prepared but it necessarily contains information in summary form and is therefore intended for general guidance only; it is not intended to be a substitute for detailed research or the exercise of professional judgment. The information presented in this publication should not be construed as legal, tax, accounting, or any other professional advice or service. Ernst & Young LLP can accept no responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. You should consult with Ernst & Young LLP or other professional advisors familiar with your particular factual situation for advice concerning specific audit, tax or other matters before making any decisions.
1 Overview and scope

1.1 Overview

ASC 320 establishes standards of financial accounting and reporting for investments in:

- Equity securities that have readily determinable fair values (i.e., securities that are marketable)
- All investments in debt securities, including debt instruments that have been securitized

While the guidance is typically thought of as affecting the financial services industry (e.g., banks, savings and loan associations, savings banks, credit unions, finance companies, insurance entities), it applies to entities in almost all industries.

1.2 Scope and scope exceptions – entities

| Excerpt from Accounting Standards Codification |
| Investments – Debt and Equity Securities – Overall |
| Scope and scope exceptions |
| Entities |

320-10-15-2

The guidance in the Investments – Debt and Equity Securities Topic applies to all entities, including the following entities that are not deemed to belong to specialized industries for purposes of this Topic:

a. Cooperatives and mutual entities (such as credit unions and mutual insurance entities)
b. Trusts that do not report substantially all of their securities at fair value.

320-10-15-3

The guidance in this Topic does not apply to the following entities:

a. Entities in certain specialized industries. Entities whose specialized accounting practices include accounting for substantially all investments in debt securities and equity securities at fair value, with changes in value recognized in earnings (income) or in the change in net assets.

Unless they are excluded from the scope (as discussed below) of ASC 320, all entities are subject to the guidance, including commercial entities, financial institutions, cooperatives and mutual entities and trusts that do not report substantially all of their securities at fair value.
The following table lists certain specialized industries that are excluded from the scope of the guidance in ASC 320 for investments in debt and equity securities.

<table>
<thead>
<tr>
<th>Industry</th>
<th>Applicable guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brokers and dealers in securities</td>
<td>ASC 940-320, Financial Services – Brokers and Dealers – Investments – Debt and Equity Securities</td>
</tr>
<tr>
<td>Defined benefit pension plans</td>
<td>ASC 960-325, Plan Accounting – Defined Benefit Pension Plans – Investments – Other</td>
</tr>
<tr>
<td>Investment companies</td>
<td>ASC 946-320, Financial Services – Investment Companies – Investments – Debt and Equity Securities</td>
</tr>
<tr>
<td>Not-for-profit entities</td>
<td>ASC 958-320, Not-for-Profit Entities – Investments – Debt and Equity Securities, for guidance on accounting for investments, except impairment</td>
</tr>
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<td></td>
<td>ASC 320-10-35-17 through 35-34, for guidance on identifying and accounting for impairment of certain securities (see section 5, Impairment)</td>
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</table>

1.3 Scope and scope exceptions – instruments

The scope of ASC 320 includes:

- Equity securities that have readily determinable fair values (refer to section 1.3.1, Equity securities)
- All investments in debt securities, including (1) debt instruments that have been securitized and (2) loans that meet the definition of a security (refer to section 1.3.2, Debt securities)

1.3.1 Equity securities

An equity security represents an ownership interest in an entity (e.g., common stock, preferred stock, other capital stock) or the right to acquire (e.g., warrant, call option) or dispose of (e.g., put options) an ownership interest in an entity at a fixed or determinable price. To determine the appropriate accounting, an investor holding these or similar types of equity investments should understand the legal form of the entity that issued the investment (e.g., a partnership, LLP, LLC) as well as the terms and nature of the investment.

The scope of ASC 320 includes only those equity securities that have readily determinable fair values (e.g., equity securities issued by a public company). However, the guidance does not apply to equity securities issued by a public company that are restricted and the restriction does not terminate within one year of the reporting date.

Equity securities with readily determinable fair values are subject to ASC 320 and as such are to be carried at fair value. When determining whether a security is in the scope of ASC 320, an entity should not look through the form of its investment to the nature of the securities held by an investee.
Illustration 1-1: Determining whether a security is in scope

Company A holds an interest in an unconsolidated entity and the form of the interest meets the definition of an equity security but it does not have a readily determinable fair value. If substantially all of the investee’s assets consist of investments in debt securities and/or equity securities that have readily determinable fair values, it would not be appropriate for Company A to look through the form of the investment to the nature of the securities held by the investee. The investment would be considered an equity security that does not have a readily determinable fair value, and ASC 320 would not apply to that type of investment.

The following EY FRD publications provide guidance for equity investments not covered by ASC 320:

- **Consolidation: Determination of a controlling financial interest and accounting for changes in ownership interests** includes guidance on interests that represent controlling financial interests that require consolidation under ASC 810.

- **Equity method investments and joint ventures** includes guidance on investments accounted for under ASC 323 and investments in general partnerships, limited partnerships, limited liability companies, trusts and other entities that maintain specific ownership accounts. It also includes guidance on arrangements and strategic ventures with other parties to manage risk, enter new markets and perform other similar activities.

1.3.1.1 Readily determinable fair value

**Excerpt from Accounting Standards Codification**

**Master Glossary**

**Readily Determinable Fair Value**

An equity security has a readily determinable fair value if it meets any of the following conditions:

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 U.S. 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 Securities Dealers Automated Quotations systems or by OTC Markets Group Inc. Restricted stock 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 equity security that is an investment in a mutual fund or in a structure similar to a mutual fund (that is, a limited partnership or a venture capital entity) is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions.

The fair value of an equity security is readily determinable if it meets any of the conditions listed in the Master Glossary. The key factor is whether sales prices or bid-and-asked quotations are currently available. The determination of whether an equity security has a readily determinable fair value is made as of each balance sheet date. But there doesn’t necessarily have to be a trade on the balance sheet date. Price quotations available a few days before or after that date are considered currently available.
The third condition of the definition addresses investments in a mutual fund or in a structure similar to a mutual fund and states that they have readily determinable fair values if the fair value per share (unit) is determined and published and is the basis for current transactions. The FASB added the reference to an investment in a structure “similar to a mutual fund” to ASU 2015-10.¹

The amended definition incorporates a concept from Question 5 of the FASB Special Report, *A Guide to Implementation of Statement 115 on Accounting for Certain Investments in Debt and Equity Securities* (FAS 115 Q&A). The question implied that an investment in a limited partnership interest (or a venture capital fund) could have a readily determinable fair value.

The revised definition includes investments in a limited partnership or venture capital fund (consistent with the fact pattern in the FAS 115 Q&A), but ASU 2015-10 did not provide guidance on how these types of investments could meet the amended definition. That is, the FASB did not provide guidance on what it meant by “published” and “basis for current transactions” or “similar to a mutual fund.”

Unlike price quotes for mutual funds, price quotes for investments in most hedge funds, private equity funds and venture capital funds are generally not available on a securities exchange or in an over-the-counter market. Further, paragraph BC2 in the Basis for Conclusions of ASU 2009-12² acknowledges that many investments in hedge funds, private equity funds, real estate funds, venture capital funds and funds of funds do not have readily determinable fair values. However, because the amended definition applies to investments in entities “similar to a mutual fund,” investors need to consider the facts and circumstances of their alternative investments to determine whether they have readily determinable fair values. Refer to section 18 of our FRD publication, *Fair value measurement*, for further discussion.

### 1.3.1.1

**Cost method investments**

Equity securities that do not have readily determinable fair values (i.e., non-marketable equity securities), do not result in consolidation of the investee and are not required to be accounted for under the equity method, are typically carried at cost (i.e., cost method investments), as described in ASC 325-20.

An equity investment is accounted for under the cost method if, in addition to not having a readily determinable fair value, it:

- Does not provide the investor with a controlling investment
- Does not provide the investor with the ability to exercise significant influence
- Is not subject to other industry-specific guidance

Under the cost method of accounting for investments in common stock, an investor recognizes income from an investment when dividends are received (ASC 325-20-35-1). Dividends are recognized as income only to the extent they are distributed from net accumulated earnings of the investee after the date of acquisition. Dividends that exceed earnings after the acquisition date are considered a return of investment and are recorded as reductions of the cost of the investment.

Cost method investments are subject to the impairment guidance in ASC 320 (see section 5, *Impairment*). Because the fair value of a cost-method investment is not readily determinable, the evaluation of whether an investment’s fair value is less than cost (i.e., whether the investment is impaired) is determined by using an entity’s estimate of fair value if such an estimate is available (e.g., for disclosure under ASC 825-10-50). For periods in which an entity has not estimated the fair value of a cost method investment, an entity should evaluate whether an event or change in circumstances has occurred that may have a significant adverse effect on the fair value of the investment (an impairment indicator).

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¹ ASU 2015-10, *Technical Corrections and Improvements*.
² ASU 2009-12, *Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*.
1.3.1.2 **Restricted stock**

Restricted stock does not meet the readily determinable fair value criterion, unless the restriction terminates within one year of the reporting date. A security is a restricted security if its sale is contractually or governmentally prohibited. Restricted securities are sometimes acquired in unregistered form through private placement offerings, but they also may be acquired in registered form restricted by contract (e.g., securities subject to a “lockup” provision in an underwriting agreement). Securities that can reasonably be expected to qualify for sale within one year, such as under Rule 144 or similar rules of the Securities and Exchange Commission (SEC), should not be considered restricted.

The fair value of restricted stock with a restriction that terminates within one year should 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 ASC 820. Refer to section 5 of our FRD publication, *Fair value measurement*, for further discussion.

Arrangements entered into after acquisition that limit an investor’s ability to sell securities (otherwise subject to the provisions of ASC 320) do not cause the securities to be “restricted.” Those limitations are considered analogous to pledging the securities as collateral, which is accounted for under ASC 860-30-25.

1.3.1.1.3 **Insurance entities and equity securities without readily determinable fair values**

<table>
<thead>
<tr>
<th>Excerpt from Accounting Standards Codification</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Financial Services – Insurance</strong></td>
</tr>
<tr>
<td><strong>Initial Measurement</strong></td>
</tr>
<tr>
<td><strong>Certain Equity Securities</strong></td>
</tr>
<tr>
<td>944-325-30-1</td>
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<tr>
<td>Investments in equity securities that are not within the scope of Subtopic 320-10 or 958-320 because they do not have readily determinable fair values shall be reported at fair value.</td>
</tr>
</tbody>
</table>

All insurance entities subject to the requirements of ASC 944 must measure investments in equity securities at fair value, regardless of whether an equity security has a readily determinable fair value (i.e., regardless of whether it is in the scope of ASC 320). Changes in the fair values of the securities are recognized in other comprehensive income (OCI), net of applicable income taxes.

1.3.1.2 **Options and warrants**

The definition of equity security includes more than just an ownership interest in an entity. It also includes rights to acquire (e.g., warrants, call options) or dispose of (e.g., put options) an ownership interest in an entity. The definition of equity security does not include the following:

- Written equity options, because they represent obligations of the writer, not investments
- Cash-settled options on equity securities or options on equity-based indexes, because those instruments do not represent ownership interests in an entity

Rights to acquire or dispose of ownership interests in an entity may meet the criteria to be considered derivative instruments (i.e., meet the definition of a derivative, including the criteria for net settlement), regardless of whether the rights have readily determinable fair values. In these circumstances, the rights are accounted for under the requirements of ASC 815-10.

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 ASC 320.

The authoritative literature does not address the accounting for rights to acquire or dispose of ownership interests that do not have readily determinable fair values and fail to meet the definition of a derivative instrument. In these cases, presuming the fair value option is not elected, we believe the accounting defaults to cost basis (e.g., options with physical settlement features in securities that are not publicly traded are not covered by either ASC 320 or ASC 815), with appropriate consideration given to impairment.
1.3.1.2.1 Certain purchased options and forward contracts

Options and forward contracts not in the scope of ASC 320 (i.e., they are contracts to acquire debt securities or contracts to acquire equity securities but the contracts do not have readily determinable fair values) that have all of the following characteristics should be designated as held to maturity, available for sale or trading pursuant to ASC 320 (see ASC 815-10-15-140):

- The contract is entered into to purchase securities that will be accounted for pursuant to ASC 320
- The contract's terms require physical settlement (e.g., the securities will be delivered)
- The contract is not a derivative pursuant to ASC 815
- If a purchased option, the contract has no intrinsic value upon purchase.

The following table summarizes the subsequent measurement and other considerations for these types of purchased options and forward contracts.

<table>
<thead>
<tr>
<th>Held-to-maturity securities</th>
<th>Available-for-sale securities</th>
<th>Trading securities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Changes in the fair value of the forward contract or purchased option should not be recognized unless a decline in the fair value of the underlying securities is other than temporary</td>
<td>Changes in the fair value of the forward contract or purchased option should be recognized in OCI as they occur unless a decline in the fair value of the underlying securities is other than temporary</td>
<td>Changes in the fair value of the forward contract or purchased option should be recognized in net income as they occur</td>
</tr>
<tr>
<td>Debt securities purchased under a forward contract should be recorded at the forward contract price at the settlement date</td>
<td>Securities purchased under a forward contract should be recorded at their fair values at the settlement date</td>
<td>Securities purchased under a forward contract or by exercising an option should be recorded at their fair values at the settlement date</td>
</tr>
<tr>
<td>Debt securities purchased by exercising an option should be recorded at the option strike price plus any remaining carrying amount for the option premium at the exercise date</td>
<td>Securities purchased by exercising an option should be recorded at the option strike price plus the fair value of the option at the exercise date</td>
<td></td>
</tr>
<tr>
<td>If an option expires worthless and the same security is purchased in the market, the security should be recorded at its market price plus any remaining carrying amount for the option premium</td>
<td>If the option expires worthless and the same security is purchased in the market, the security should be recorded at its market price plus any remaining carrying amount for the option premium</td>
<td></td>
</tr>
<tr>
<td>If an entity does not take delivery under the forward contract or purchase the same security in the market if the option expires worthless, the entity's intent to hold other debt securities to maturity will be called into question</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
1.3.2  Debt securities

ASC 320 applies to all debt securities. A debt security is defined as any security representing a creditor relationship with an entity. In addition to this broad definition, the ASC Master Glossary lists instruments that are, by definition, debt securities. The Master Glossary also lists certain instruments that do not meet the definition of a debt security.

<table>
<thead>
<tr>
<th>Excerpt from Accounting Standards Codification</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Master Glossary</strong></td>
</tr>
<tr>
<td><strong>Debt Security</strong></td>
</tr>
<tr>
<td>Any security representing a creditor relationship with an entity. The term debt security also includes all of the following:</td>
</tr>
<tr>
<td>a. Preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor</td>
</tr>
<tr>
<td>b. A collateralized mortgage obligation (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</td>
</tr>
<tr>
<td>c. U.S. Treasury securities</td>
</tr>
<tr>
<td>d. U.S. government agency securities</td>
</tr>
<tr>
<td>e. Municipal securities</td>
</tr>
<tr>
<td>f. Corporate bonds</td>
</tr>
<tr>
<td>g. Convertible debt</td>
</tr>
<tr>
<td>h. Commercial paper</td>
</tr>
<tr>
<td>i. All securitized debt instruments, such as collateralized mortgage obligations and real estate mortgage investment conduits</td>
</tr>
<tr>
<td>j. Interest-only and principal-only strips.</td>
</tr>
<tr>
<td>The term debt security excludes all of the following:</td>
</tr>
<tr>
<td>a. Option contracts</td>
</tr>
<tr>
<td>b. Financial futures contracts</td>
</tr>
<tr>
<td>c. Forward contracts</td>
</tr>
<tr>
<td>d. Lease contracts</td>
</tr>
<tr>
<td>e. Receivables that do not meet the definition of security and, so, are not debt securities, for example:</td>
</tr>
<tr>
<td>1. Trade accounts receivable arising from sales on credit by industrial or commercial entities</td>
</tr>
<tr>
<td>2. Loans receivable arising from consumer, commercial, and real estate lending activities of financial institutions.</td>
</tr>
</tbody>
</table>
The definition of debt security in ASC 320 includes instruments beyond legal form debt. For example, preferred stock that is either mandatorily redeemable or redeemable at the option of the investor is considered a debt security under ASC 320, even though preferred stock is considered equity in legal form.

1.3.2.1 Definition of a security

Excerpt from Accounting Standards Codification

Master Glossary

Security

A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:

a. It is either 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. It 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.

c. It 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.

Certain debt instruments must be evaluated carefully to determine whether they meet the definition of a security, which requires that they meet all three characteristics listed in the ASC Master Glossary. For example, while most certificates of deposit (CDs) do not meet the ASC 320 definition of a security, some negotiable “jumbo” CDs may meet the definition of a security. Likewise, certain guaranteed investment contracts (GICs) meet the definition of a security while others do not. When considering whether an instrument meets the ASC 320 definition of a security, the following should be considered:

- The ASC 320 definition of security, although modeled after the definition in the Uniform Commercial Code (UCC), is not the same as the UCC definition because the UCC definition has changed since the issuance of this guidance.

- The FASB indicated in the basis for conclusions that when deciding how to define a security for GAAP purposes, it decided not to use the definition in the Securities Exchange Act of 1934 because that definition was considered to be too broad. For example, that definition of a security includes instruments such as notes for routine personal bank loans, which the FASB believed should not be included in the scope of ASC 320.

- The determination of whether an investment meets the definition of a security is not a legal determination and does not require a legal analysis.

- When considering whether an instrument is a security, there is rarely one overriding characteristic that is determinative. For example, an instrument could meet the second criterion in the ASC 320 definition (a medium for investment) even if the instrument includes certain transfer restrictions. Consideration should be given to all of the facts and circumstances.

The SEC staff has also reiterated that ASC 320 provides its own definition of a security and does not depend on whether the investment meets the UCC definition.³

³ Speech by SEC staff (Robert Uhl), Remarks before the Twenty-Fifth AICPA National Conference on Current SEC Developments, 10 December 1997.
1.3.2.1.1 Loans

**Excerpt from Accounting Standards Codification**

**Master Glossary**

**Loan**

A contractual right to receive money on demand or on fixed or determinable dates that is recognized as an asset in the creditor's statement of financial position. Examples include but are not limited to accounts receivable (with terms exceeding one year) and notes receivable. This definition encompasses loans accounted for as debt securities.

Only loans that meet the definition of a security are in the scope of ASC 320. Although certain loans can be readily converted into securities (e.g., loans insured by the Federal Housing Administration, conforming mortgage loans), a loan is not within the scope of ASC 320 until it has been securitized.

For transferors, beneficial interests received as consideration for transferred loans may not be classified as investment securities unless the transfer of the loans meets ASC 860's conditions for sale accounting.

Loans that do not meet the definition of a security are generally in the scope of ASC 310-10, unless they are acquired with deteriorated credit quality, in which case they are in the scope of ASC 310-30. ASC 310-10 applies to a variety of instruments and transactions, including trade account receivables, loans, loan syndications, factoring arrangements, standby letters of credit, financing receivables (e.g., notes receivables, credit cards) and rebates.

1.3.2.2 Preferred stock

An investment in preferred stock that must be redeemed by the issuing entity or is redeemable at the investor’s option is considered a debt security under ASC 320, despite its legal form. This is the case, regardless of the determination made by the issuer. If preferred stock is determined to be a debt security, ASC 320 would apply to the instrument, regardless of whether it has a readily determinable fair value.

Preferred stock that is considered a debt security may be carried at amortized cost if it meets the held-to-maturity (HTM) criteria. For example, when preferred stock has a fixed redemption date and the investor has the intent and ability to hold the instrument until that redemption date, that instrument can be classified as HTM. If the preferred stock is not mandatorily redeemable (i.e., there is no stated redemption date) and the investor does not have the unilateral right to ultimately redeem the stock, the stock is considered an equity security and would be subject to the provisions of ASC 320 if it has a readily determinable fair value.

In some cases, the terms of preferred stock give the investor the option to redeem it, but only in certain circumstances (e.g., when an event occurs that is not certain to occur) or only when a certain percentage (e.g., a majority, two-thirds) of investors elect to redeem their preferred shares. The following illustrations show how the determination of whether an investor has a unilateral right to redemption can affect the determination of whether preferred stock is classified as debt or equity securities.
**Illustration 1-2: Preferred stock classified as an equity security**

ABC Corporation is a publicly traded entity that issued preferred stock on 1 January 20X1. The preferred stock is not mandatorily redeemable by ABC Corporation (that is, there is no stated redemption date). However, beginning on 1 January 20X7, the preferred stock may be redeemed if a majority of the preferred stockholders vote to redeem it. Investor XYZ holds approximately 19% of the outstanding preferred shares.

Investor XYZ does not consider the preferred stock to be debt securities because it is not mandatorily redeemable and may only be redeemed if a majority of preferred stockholders vote to redeem it, beginning on 1 January 20X7. Because Investor XYZ holds less than a majority of the outstanding preferred shares, it does not have the unilateral right to redeem the preferred shares. Therefore, Investor XYZ classifies its investment in the preferred stock as equity securities.

**Illustration 1-3: Preferred stock classified as a debt security**

Assume the same facts as above, except that Investor XYZ acquires an additional 40% of the outstanding preferred stock, so that it now owns 59% of the outstanding shares.

In this case, the preferred stock meets the definition of a debt security because Investor XYZ owns more than 50% of the outstanding preferred shares and therefore has the unilateral right to redeem its preferred stock, as long as it continues to hold a majority interest until 1 January 20X7. Therefore, Investor XYZ classifies its investment in the preferred stock as debt securities as of the day it acquires the additional 40% of outstanding shares.

**1.3.2.3 Beneficial interests in securitized financial assets**

Beneficial interests are defined as rights to receive all or portions of specified cash inflows received by a trust or other entity. They include senior and subordinated shares of interest, principal, or other cash inflows to be passed-through or paid-through and residual interests. Beneficial interests may be created in connection with securitization transactions such as those involving collateralized debt obligations or collateralized loan obligations.

Entities must determine whether beneficial interests are in the scope of ASC 320 or ASC 325-40. Beneficial interests subject to ASC 325-40’s guidance can be either (1) beneficial interests retained in securitization transactions and accounted for as sales under ASC 860 or (2) purchased beneficial interests in securitized financial assets.
The following flowchart provides a framework for determining whether ASC 325-40 applies to an asset:

**Illustration 1-4: Determining whether an asset is in the scope of ASC 325-40**

1. **Is the beneficial interest an investment in an entity that is consolidated by the holder of the beneficial interest?**
   - Yes: Beneficial interests are eliminated in consolidation.
   - No:
     1. **Does the beneficial interest, in its entirety, meet the definition of a derivative under ASC 815?**
        - Yes: Apply guidance under ASC 815.
        - No:
          1. **Is the beneficial interest a debt security under ASC 320 or required to be accounted for as one under ASC 860-2-35-2?**
             - Yes: Apply guidance under ASC 310.\(^A\)
             - No: Determine what other guidance applies
               - Apply guidance under ASC 310-30.\(^A\)
               - Apply guidance under ASC 323.\(^A\)
          2. **Is the beneficial interest in the scope of ASC 310-30?\(^B\)**
             - Yes: Apply guidance under ASC 310-30.\(^A\)
             - No:
               1. **Does the beneficial interest involve securitized financial assets?**
                  - Yes:
                    1. **Do the securitized financial assets have contractual cash flows?**
                       - Yes: Apply the guidance in ASC 320-10-35-38 through 35-43.\(^A\)
                       - No:
                         1. **Is the beneficial interest of high credit quality?**
                            - Yes:
                              1. **Can the beneficial interest be contractually prepaid or otherwise settled in a way that the holder would not recover substantially all of its recorded investment?**
                                 - Yes: Apply guidance under ASC 320-10, and for interest income recognition the guidance under ASC 310-20.\(^A\)
                                 - No: Apply guidance under ASC 325-40.\(^A\)
                              2. **Determine what other guidance applies**
                                 - Apply guidance under ASC 323.\(^A\)
                         2. **Apply guidance under ASC 815.**
                            - Apply guidance under ASC 815.
               2. **Does the beneficial interest involve securitized financial assets?**
                  - Yes:
                    1. **Do the securitized financial assets have contractual cash flows?**
                       - Yes: Apply the guidance in ASC 320-10-35-38 through 35-43.\(^A\)
                       - No:
                         1. **Is the beneficial interest of high credit quality?**
                            - Yes:
                              1. **Can the beneficial interest be contractually prepaid or otherwise settled in a way that the holder would not recover substantially all of its recorded investment?**
                                 - Yes: Apply guidance under ASC 320-10, and for interest income recognition the guidance under ASC 310-20.\(^A\)
                                 - No: Apply guidance under ASC 325-40.\(^A\)
                              2. **Determine what other guidance applies**
                                 - Apply guidance under ASC 323.\(^A\)
                            2. **Apply guidance under ASC 815.**
                               - Apply guidance under ASC 815.
                  2. **Is the beneficial interest of high credit quality?**
                     - Yes:
                      1. **Can the beneficial interest be contractually prepaid or otherwise settled in a way that the holder would not recover substantially all of its recorded investment?**
                         - Yes: Apply guidance under ASC 320-10, and for interest income recognition the guidance under ASC 310-20.\(^A\)
                         - No: Apply guidance under ASC 325-40.\(^A\)
                      2. **Determine what other guidance applies**
                         - Apply guidance under ASC 323.\(^A\)
                     2. **Apply guidance under ASC 815.**
                        - Apply guidance under ASC 815.
         3. **Determine what other guidance applies**
            - Apply guidance under ASC 320-10, and for interest income recognition the guidance under ASC 310-20.\(^A\)
            2. **Apply guidance under ASC 815.**
                - Apply guidance under ASC 815.
      2. **Is the beneficial interest a debt security under ASC 320 or required to be accounted for as one under ASC 860-2-35-2?**
         - Yes:
          1. **Is the beneficial interest of high credit quality?**
             - Yes:
              1. **Can the beneficial interest be contractually prepaid or otherwise settled in a way that the holder would not recover substantially all of its recorded investment?**
                 - Yes: Apply guidance under ASC 320-10, and for interest income recognition the guidance under ASC 310-20.\(^A\)
                 - No: Apply guidance under ASC 325-40.\(^A\)
              2. **Determine what other guidance applies**
                 - Apply guidance under ASC 323.\(^A\)
             2. **Apply guidance under ASC 815.**
                - Apply guidance under ASC 815.
          2. **Is the beneficial interest of high credit quality?**
             - Yes:
              1. **Can the beneficial interest be contractually prepaid or otherwise settled in a way that the holder would not recover substantially all of its recorded investment?**
                 - Yes: Apply guidance under ASC 320-10, and for interest income recognition the guidance under ASC 310-20.\(^A\)
                 - No: Apply guidance under ASC 325-40.\(^A\)
              2. **Determine what other guidance applies**
                 - Apply guidance under ASC 323.\(^A\)
             2. **Apply guidance under ASC 815.**
                - Apply guidance under ASC 815.
      2. **Is the beneficial interest of high credit quality?**
         - Yes:
          1. **Can the beneficial interest be contractually prepaid or otherwise settled in a way that the holder would not recover substantially all of its recorded investment?**
             - Yes: Apply guidance under ASC 320-10, and for interest income recognition the guidance under ASC 310-20.\(^A\)
             - No: Apply guidance under ASC 325-40.\(^A\)
          2. **Determine what other guidance applies**
             - Apply guidance under ASC 323.\(^A\)
         2. **Apply guidance under ASC 815.**
            - Apply guidance under ASC 815.
      2. **Is the beneficial interest in the scope of ASC 310-30?\(^B\)**
         - Yes: Apply guidance under ASC 310-30.\(^A\)
         2. **Apply guidance under ASC 815.**
            - Apply guidance under ASC 815.
      2. **Apply guidance under ASC 815.**
         - Apply guidance under ASC 815.

\(^A\) If the beneficial interest is not subsequently measured at fair value through earnings, evaluate whether the beneficial interest has embedded derivatives that require bifurcation in accordance with ASC 815-15.
1.3.2.3.1 Securities in the scope of ASC 325-40

**Excerpt from Accounting Standards Codification**

**Investments – Other – Beneficial Interests in Securitized Financial Assets**

**Scope and Scope Exceptions**

325-40-15-3

The guidance in this Subtopic applies to beneficial interests that have all of the following characteristics:

a. Are either debt securities under Subtopic 320-10 or required to be accounted for like debt securities under that Subtopic pursuant to paragraph 860-20-35-2.

b. Involve securitized financial assets that have contractual cash flows (for example, loans, receivables, debt securities, and guaranteed lease residuals, among other items). Thus, the guidance in this Subtopic does not apply to securitized financial assets that do not involve contractual cash flows (for example, common stock equity securities, among other items). See paragraph 320-10-35-38 for guidance on beneficial interests involving securitized financial assets that do not involve contractual cash flows.

c. Do not result in consolidation of the entity issuing the beneficial interest by the holder of the beneficial interests.

d. Are not within the scope of Subtopic 310-30.

e. Are not beneficial interests in securitized financial assets that have both of the following characteristics:
   1. Are of high credit quality (for example, guaranteed by the U.S. government, its agencies, or other creditworthy guarantors, and loans or securities sufficiently collateralized to ensure that the possibility of credit loss is remote)
   2. Cannot contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment.

ASC 325-40 does not apply to beneficial interests that (1) are of high credit quality and (2) cannot be contractually prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment.

ASC 325-40 states that beneficial interests guaranteed by the US government, its agencies or other creditworthy guarantors and loans or securities that are sufficiently collateralized to ensure that the possibility of credit loss is remote are considered to be of high credit quality.

Although ASC 325-40 does not specify a minimum credit rating, the SEC staff believes that only beneficial interests rated AA or higher should be considered of "high credit quality." ⁴

There are situations when a beneficial interest may have a so-called split rating, in which one credit rating agency has rated the instrument as AA or higher, but another credit rating agency has rated the instrument below AA. In these situations, we understand the SEC staff would not consider the beneficial instrument to be of high credit quality for purposes of applying ASC 325-40 (i.e., the instrument would be in ASC 325-40's scope).

To evaluate whether an investor might not recover substantially all its recorded investment due to a prepayment or other settlement, an entity considers the contractual terms of the beneficial interest, rather than the likelihood of prepayments or other settlements occurring. If the underlying borrowers

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(i.e., the debtors in the securitized debt instruments) could exercise contractual rights permitting them to prepay or otherwise settle their debt instruments in a way that would cause the holder of a beneficial interest in those underlying debt instruments to not recover substantially all of its recorded investment, this criterion is met. The likelihood of the event occurring that could cause the investor in the beneficial interest to not recover substantially all of its recorded investment is not considered.

For example, an interest-only strip could meet the definition of “high credit quality” if the structure is supported by a guarantee from a creditworthy guarantor (e.g., a government-sponsored enterprise). However, because the holder of the strip only receives cash flows when underlying loans are outstanding, loan prepayments could result in the holder of the security not recovering substantially all of its recorded investment.

How we see it

ASC 325-40 does not address whether an entity should reevaluate the scope criteria, including the evaluation of whether a beneficial interest is of high credit quality, after the acquisition date of the beneficial interest. Some entities evaluate ASC 325-40’s scope criteria at acquisition and in connection with the recognition of any other-than-temporary impairment while others perform a continual reassessment. An entity should consistently apply its elected accounting policy.

1.3.2.3.2

Applicability of ASC 325-40 to trading securities

Excerpt from Accounting Standards Codification

Investments – Other – Beneficial Interests in Securitized Financial Assets

Scope and Scope Exceptions

Instruments

Beneficial Interests Classified as Trading

325-40-15-7

For income recognition purposes, beneficial interests classified as trading are included in the scope of this Subtopic because it is practice for certain industries (such as banks and investment companies) to report interest income as a separate item in their income statements, even though the investments are accounted for at fair value.

Host Contract Portion of a Hybrid Beneficial Interest

325-40-15-8

Included in the scope of this Subtopic are the host contract portion of a hybrid beneficial interest that requires separate accounting for an embedded derivative under paragraphs 815-15-25-1; 815-15-25-11 through 25-14; and 815-15-25-26 through 25-29 when the host contract otherwise meets the scope of this Subtopic. The issue of when and how a hybrid contract is to be separated into its component parts is an implementation issue of Topic 815 and, therefore, not within the scope of this Subtopic.

325-40-15-9

The guidance in this Subtopic does not apply to hybrid beneficial interests measured at fair value pursuant to paragraphs 815-15-25-4 through 25-6 for which the transferor does not report interest income as a separate item in its income statements.

ASC 325-40 applies to beneficial interests that are classified as trading or that have been designated to be measured at fair value with changes in fair value recognized in earnings under the fair value option in ASC 825-10 (not the fair value option in ASC 815-15, which is discussed below) or that are accounted for that way under industry-specific guidance. For example, investment companies are generally required...
Financial reporting developments Certain investments in debt and equity securities (before the adoption of ASU 2016-01)

by ASC 946 to report their investments at fair value with changes in fair value reported in earnings. Some of those entities elect to report interest income separately from other changes in fair value in a separate line item in their income statements.

The host contract portion of a hybrid beneficial interest that requires separate accounting for the embedded derivative under ASC 815 may be in the scope of ASC 325-40. However, this guidance does not apply to a hybrid beneficial interest if the entire instrument is measured at fair value with changes in fair value recognized in earnings under the fair value option in ASC 815-15 and the entity does not separately report interest income. An entity that presents interest income separately for these hybrid beneficial interests applies ASC 325-40, consistent with assets measured at fair value with changes in fair value recognized in earnings, as discussed in the preceding paragraph.

1.3.2.4 Options on debt securities

Unlike options on equity securities, options on debt securities are not within the scope of ASC 320. They would generally be included within the scope of ASC 815 as derivative financial instruments. Refer to section 1.3.1.2.1 for further guidance on certain purchased options and forward contracts.

1.3.3 Instruments not in the scope of ASC 320

Excerpt from Accounting Standards Codification

Investments – Debt and Equity Securities – Overall

Scope and Scope Exceptions

Instruments

320-10-15-7

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

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

b. Equity securities accounted for under the cost method in accordance with Subtopic 325-20, except with respect to the impairment guidance in Section 320-10-35.

c. Equity securities that, absent the election of the fair value option under paragraph 825-10-25-1, would be required to be accounted for under the equity method.

d. Investments in consolidated subsidiaries.

1.3.3.1 Derivatives

Hybrid financial instruments should be analyzed to determine whether any embedded derivatives should be bifurcated under ASC 815-15. This analysis will include determining whether the host instrument is considered a debt host or an equity host and evaluating whether the embedded feature is clearly and closely related to the host instrument and, if not, whether it meets the definition of a derivative on a freestanding basis. This analysis need not be performed for hybrid financial instruments classified as trading (or when the fair value option is elected) since the entire instrument is marked to market through earnings. For more information on analyzing embedded derivatives, see our FRD publications, Derivatives and hedging (after the adoption of ASU 2017-12, Targeted Improvements to Accounting for Hedging Activities) or Derivatives and hedging (before the adoption of ASU 2017-12), as applicable.
Any embedded derivative that is bifurcated is not in the scope of ASC 320. However, when the hybrid financial instrument would otherwise be in the scope of ASC 320, the host instrument that remains after an embedded derivative is bifurcated remains subject to ASC 320.

1.3.3.2 Cost method investments
ASC 325-20 addresses the accounting for cost method investments. Refer to section 1.3.1.1.1, Cost method investments, for when the cost method is appropriate.

1.3.4 Other common issues related to scope
1.3.4.1 Cash and cash equivalents
Cash equivalents are short-term, highly liquid investments that are both:
- Readily convertible to known amounts of cash
- So close to maturity that they present insignificant risk of changes in value because of changes in interest rates

Generally, only short-term, highly liquid investments with original maturities of three months or less qualify for treatment as cash equivalents. Examples of short-term investments commonly considered to be cash equivalents are US Treasury bills, commercial paper and federal funds sold (for an entity with banking operations). Equity securities generally do not meet the definition of a cash equivalent because they do not have stated maturities.

Even if they are determined to be cash equivalents, investments in debt securities and equity securities (e.g., interests in certain money market funds) that are in the scope of ASC 320-10 are subject to all of ASC 320-10's accounting and disclosure requirements. However, since cash equivalent items represent short-term, highly liquid investments that are readily convertible to known amounts of cash, their amortized cost would generally be expected to approximate their respective fair value.

1.3.4.2 Short sales of securities
Short sales of securities represent obligations to deliver securities and are not investments. However, such transactions are generally marked to market, with changes in fair value recorded in earnings as they occur, under either AICPA Audit and Accounting Guides for certain industries or ASC 815-10-55-57, if they meet the definition of a derivative.

1.3.4.3 Contractual prepayment or settlement in such a way that the holder would not recover substantially all of its recorded investment
Financial assets (except those that are derivatives in the scope of ASC 815-10) that can contractually be prepaid or otherwise settled in a way that the holder would not recover substantially all of its recorded investment should be measured like investments in debt securities classified as available for sale or trading (and not held to maturity), even if they do not meet the definition of a security (ASC 320-10-25-5a). However, if interest-only strips and similar instruments are not in the form of securities, only ASC 320’s recognition and measurement provisions apply and ASC 320’s disclosures are not required to be applied (ASC 860-20-35-3). If the interest-only strips and similar instruments meet the definition of securities, ASC 320’s disclosure requirements apply.
2 Classification and measurement

2.1 Overview

At acquisition, an entity must classify each acquired security within the scope of ASC 320 into one of three categories:

- **Trading** – Debt and equity securities bought and held primarily to be sold in the near term
- **Held to maturity** – Debt securities for which management has both the positive intent and ability to hold until the maturity of the security
- **Available for sale** – The residual category for debt securities not classified as held to maturity or trading and equity securities not classified as trading

The classification of each security will determine the subsequent measurement basis (i.e., amortized cost versus fair value) of the security and how it will be presented and disclosed in the financial statements.

An entity’s future business plans or opportunities may affect its investment classification decisions. As such, entities should give careful consideration to how it classifies its investment securities. For example, an entity should consider the possibility that it might have to sell some of its securities to take advantage of potential future business or investment opportunities.

Such decisions also should be weighed against all other factors, including regulatory capital requirements for certain financial institutions and the increased volatility in earnings or OCI that could result from temporary fluctuations in the market value of securities classified as trading or available for sale, respectively, and the effect of that volatility on the entity. For example, such volatility could result in debt covenant violations arising from unrealized holding losses when shareholders’ equity is included in debt covenant computations. To address this issue, many entities’ loan documents exclude OCI from debt covenant computations. Additionally, certain regulated financial institutions may be subject to additional regulatory capital requirements depending on the amount of securities classified as trading.

This section describes the accounting and reporting requirements of each category.
2.1.1 Summary table of classification and measurement

A summary of the three classifications of investments in marketable equity securities and debt securities and the related accounting treatment for each of the three categories defined by ASC 320 follows:

<table>
<thead>
<tr>
<th>Classification of securities</th>
<th>Description of securities</th>
<th>Carrying value in the statement of financial position</th>
<th>Classified statement of financial position</th>
<th>Unrealized gains and losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Held-to-maturity securities</td>
<td>Debt securities that the entity has both the positive intent and ability to hold to maturity</td>
<td>Amortized cost (i.e., cost as adjusted for accretion, amortization, collection of cash, previous other-than-temporary impairment recognized in earnings, less any cumulative-effect adjustments, foreign exchange and hedging, if any)</td>
<td>Classified as current or noncurrent, based on maturity or redemption date (refer to section 2.4.3)</td>
<td>Disclosed in the notes to the financial statements but not recognized in the financial statements until realized⁵</td>
</tr>
<tr>
<td>Trading securities</td>
<td>Debt and marketable equity securities bought and held principally for the purpose of selling them in the near term⁶</td>
<td>Fair value</td>
<td>Classified as current or noncurrent,⁷ as appropriate (refer to section 2.3.1)</td>
<td>Included in earnings immediately</td>
</tr>
<tr>
<td>Available-for-sale securities</td>
<td>Investments not classified as either held to maturity or trading</td>
<td>Fair value</td>
<td>Classified as current or noncurrent,⁷ as appropriate (refer to section 2.5.1)</td>
<td>Included in accumulated other comprehensive income, net of tax effect, until realized⁸</td>
</tr>
</tbody>
</table>

2.2 Recognition and initial measurement

ASC 320 provides guidance on the subsequent measurement of securities but is silent on recognition and initial measurement. The Codification provides certain industry-specific guidance on the initial measurement of securities. For example, ASC 946-320 clarifies that investment companies should initially measure all of their investments in debt and equity securities at the transaction price, including transaction costs.

Generally, in practice, securities are initially measured at the transaction price plus transaction costs. In many cases, the transaction price (excluding transaction costs discussed below) equals the fair value at acquisition.

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⁵ Certain unrealized losses that are determined to be other-than-temporary should be recognized in earnings (see further discussion in section 5, Impairment).

⁶ Classification of debt securities and certain equity securities as trading is not precluded because the entity does not intend to sell in the near term.

⁷ Trading securities maturing more than one year after the report date may be classified as noncurrent assets if the company has no intention of selling those securities in the next 12 months (refer to section 2.3).

⁸ Certain unrealized losses that are determined to be other-than-temporary should be recognized in earnings (see further discussion in section 5, Impairment).
2.2.1 Premiums and discounts

Securities are often purchased at a discount to or premium above the instruments’ par amount or face value. Prior to the adoption of ASU 2017-08, premiums and discounts related to all debt securities classified as available for sale or held to maturity should be accounted for as a yield adjustment over the life of the related security, pursuant to ASC 310-20. Premiums and discounts for debt securities classified as trading are not in the scope of ASC 310-20 and are generally considered part of the security’s fair value.

ASU 2017-08 amends the guidance in ASC 310-20 for certain callable debt securities held at a premium. The ASU defines a premium as the amount by which the amortized cost basis of the security exceeds the amount repayable at the earliest call date. After an entity adopts ASU 2017-08, it must amortize to the earliest call date the premium on purchased debt securities that have explicit noncontingent call features and are callable at a fixed price and on a preset date, unless the entity applies the guidance in ASC 310-20 allowing it to consider estimated prepayments. The entity must perform a reassessment at each call date. If the call option is not exercised at the earliest call date, the effective yield is reset prospectively. That is, after the first call date, the entity amortizes any excess of the amortized cost basis over the next call price to the next call date. If there are no other call dates, or if the amortized cost basis does not exceed the next call price, the entity amortizes any excess of the amortized cost basis over par to maturity.

Municipal bonds are often callable at a fixed price “on or after” a specific date. In response to a technical inquiry, the FASB staff said that ASU 2017-08 applies to these bonds if their amortized cost basis is above the call amount at the next call date. The following example illustrates this point.

Illustration 2-1: Municipal bonds callable at a fixed price on or after a specific date

An entity purchases 10-year municipal bonds with a par value of $100 for $110 on 1 January 20X1 that are callable at $105 on or after 31 December 20X2 and at $103 on or after 31 December 20X5.

Under ASU 2017-08, the entity must amortize the $5 excess of the amortized cost basis over the next call price ($110 - $105) over the first two years (ending 31 December 20X2). If that first call is not exercised, the entity must amortize the $2 excess of the amortized cost basis over the next call price ($105 - $103) over the next three years (ending 31 December 20X5). If the bonds are not called on the second call date, the entity must amortize the remaining $3 premium ($103 - $100) over the remaining five years (i.e., to maturity).

The guidance in ASU 2017-08 does not affect the period over which discounts are amortized. Discounts will continue to be amortized to maturity (i.e., over the contractual life of the security). While the guidance in ASU 2017-08 is not required to be applied to premiums on debt securities classified as trading, it does apply to premiums on debt securities purchased by investment companies that are accounted for under ASC 946.

ASU 2017-08 is effective for PBEs for fiscal years beginning after 15 December 2018, and interim periods within those years. For all other entities, it is effective for fiscal years beginning after 15 December 2019, and interim periods within fiscal years beginning after 15 December 2020. Early adoption is permitted.

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9 ASU 2017-08, Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities.
2.2.2 *Transaction costs*

ASC 320 does not provide guidance on how to account for transaction costs related to investments in debt and equity securities. For securities classified as available for sale or held to maturity, some entities may have a policy of applying the guidance in ASC 310-20 to these costs. This results in transaction costs being deferred and accounted for as yield adjustments over the life of the related securities. Generally, transaction costs for trading securities are recognized in net income in the first reporting period after acquisition as a result of the period-end adjustment to measure trading securities at fair value.

There is diversity in practice for the treatment of transaction costs, but entities should be consistent in their treatment of these costs across all investments in debt and equity securities. The Codification provides certain industry-specific guidance on the treatment of transaction costs. For example, ASC 946-320-30-1, which provides guidance for investment companies, states that the transaction price of a debt and equity security should include commissions and other charges that are part of the purchase transaction. Because investment companies are required to subsequently measure all investments at fair value and recognize changes in fair value in earnings, transaction costs are immediately recognized as unrealized losses (i.e., in earnings).

2.2.3 *Recognition date*

ASC 320 does not provide guidance on when an entity should recognize the acquisition of a security. Entities recognize purchased securities on either the trade date or the settlement date. Agreements to purchase or sell a security should be evaluated to determine whether they are derivatives under ASC 815.

In general, ASC 815 provides a scope exception for regular-way securities trades. Regular-way securities trades are defined as contracts that provide for delivery of a security within a period of time (after the trade date) generally established by regulations or conventions in the marketplace or exchange in which the transaction is being executed. For example, in the US, most corporate securities are regularly settled in three business days. The regular settlement cycle length may vary by country, exchange, instrument or issuer.

<table>
<thead>
<tr>
<th>Excerpt from Accounting Standards Codification</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Derivatives and Hedging — Overall</strong></td>
</tr>
<tr>
<td><strong>Scope and Scope Exceptions</strong></td>
</tr>
<tr>
<td><strong>Regular-Way Security Trades</strong></td>
</tr>
<tr>
<td><strong>815-10-15-15</strong></td>
</tr>
</tbody>
</table>

Regular-way security trades are defined as contracts that provide for delivery of a security within the period of time (after the trade date) generally established by regulations or conventions in the marketplace or exchange in which the transaction is being executed. For example, a contract to purchase or sell a publicly traded equity security in the United States customarily requires settlement within three business days. If a contract for purchase of that type of security requires settlement in three business days, the regular-way security trades scope exception applies, but if the contract requires settlement in five days, the regular-way security trades scope exception does not apply unless the reporting entity is required to account for the contract on a trade-date basis.

Trades that are settled after the established convention (e.g., three business days for equity securities in the US) should be accounted for as forward contracts in accordance with ASC 815. In addition, a contract for an existing security does not qualify for the regular-way security trade exception if the contract requires or permits net settlement and a market mechanism exists to facilitate net settlement.
Contracts to purchase or sell when-issued securities (securities that have been authorized but not yet issued) or other securities that do not yet exist qualify for the regular-way security trade exception if all of the following are met:

- There is no other way to purchase or sell that security.
- Delivery of that security and settlement will occur within the shortest period possible for that type of security.
- It is probable at inception and throughout the contract that the contract will not settle net and will result in physical delivery of a security when it is issued.

In all cases, the scope exception would also be applied when an entity is required, or has a policy, to account for purchases and sales of existing securities, when-issued securities or other securities that do not yet exist on a trade-date basis (ASC 815-10-15-17).

US GAAP requires entities in the following industries to record regular-way purchases and sales of securities on the trade date:

- Defined benefit plans (ASC 960-325-25-1)
- Depository and lending financial institutions (ASC 942-325-25-2)
- Brokers and dealers in securities (ASC 940-320-25-1)
- Employee benefit plans (ASC 962-325-25-1 and ASC 965-320-25-1)
- Investment companies (ASC 946-320-25-1)

As indicated above, entities outside of these industries can elect, as an accounting policy, to account for purchases and sales of securities on a trade-date or settlement-date basis. For example, Statements of Statutory Accounting Principles issued by the National Association of Insurance Commissioners require certain insurance entities to apply trade date accounting in their statutory financial statements. As such, most property and casualty insurance entities and life and health insurance entities have adopted an accounting policy to account for purchases and sales of securities in their GAAP financial statements on a trade-date basis, consistent with their statutory reporting.

The following example illustrates the difference between recognizing an investment on the trade date and the settlement date.

<table>
<thead>
<tr>
<th>Illustration 2-2: Trade date accounting versus settlement date accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Journal entries</strong></td>
</tr>
<tr>
<td>Trade date</td>
</tr>
<tr>
<td>Settlement date</td>
</tr>
</tbody>
</table>
2.2.4 Initial carrying amount of equity securities that become marketable

Excerpt from Accounting Standards Codification

<table>
<thead>
<tr>
<th>Investments – Debt and Equity Securities – Overall</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Initial Measurement</strong></td>
</tr>
<tr>
<td><strong>Cost-Method Equity Securities Subsequently Become Marketable</strong></td>
</tr>
<tr>
<td>320-10-30-3</td>
</tr>
</tbody>
</table>

If a previously nonmarketable equity security becomes marketable (for example, due to a change in circumstances, it now has a fair value that is readily determinable), the cost basis of the nonmarketable security (reduced by any other-than-temporary impairment that has been recognized) shall become the basis of the security. If a change in marketability provides evidence that an other-than-temporary impairment has occurred, a write-down shall be recorded before applying the guidance in this Subtopic, and the loss shall be classified consistently with other write-downs of similar investments. (This presumes that the nonmarketable security had not been accounted for under the equity method.)

The initial ASC 320 carrying amount of a nonmarketable equity security (i.e., a cost method investment) that becomes marketable (i.e., its fair value becomes readily determinable) is the cost basis of the nonmarketable security, reduced by any previously recognized other-than-temporary impairment (320-10-30-3). A change in marketability may provide evidence that an other-than-temporary impairment has occurred. If that is the case, any impairment should be recorded prior to determining the initial carrying amount of the marketable security.

An unrealized gain or loss may need to be recorded through OCI or net income for available-for-sale or trading securities, respectively, on the date the security becomes marketable if the initial cost basis is different than fair value.

2.2.5 Initial carrying amount of equity securities previously accounted for under the equity method

When an investment no longer qualifies for the equity method (e.g., due to a decrease in the level of ownership) and is then determined to be in the scope of ASC 320, the investment’s initial ASC 320 cost basis should be the carrying amount of the equity method investment prior to the decrease in ownership. The equity method earnings or losses should remain as part of the initial cost basis of the security (i.e., the carrying amount should not be adjusted retroactively).

An unrealized gain or loss may need to be recorded through OCI or net income for available-for-sale or trading securities, respectively, on the date the security no longer qualifies for the equity method if the initial cost basis is different than fair value.

2.2.6 Nonmonetary exchange of equity securities

Excerpt from Accounting Standards Codification

<table>
<thead>
<tr>
<th>Investments – Other – Cost Method Investments</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Nonmonetary Exchange of Cost Method Investments</strong></td>
</tr>
<tr>
<td>325-20-30-2</td>
</tr>
</tbody>
</table>

The following fact pattern is used as a basis for providing guidance for certain nonmonetary exchanges of cost method investments:

a. Entity A enters into a business combination with Entity B in which shares of one entity are exchanged for all outstanding shares of the other.
b. After the combination, former Entity A shareholders own a majority of the shares of the combined entity, and Entity A will be considered the acquiror pursuant to paragraphs 805-10-25-4 through 25-5. Shares of the combined entity will continue to be publicly traded subsequent to the business combination. The guidance for identifying an acquiring entity is provided in paragraphs 805-10-55-10 through 55-15.

325-20-30-3
A cost method investor that accounts for an investment in Entity B (the acquired entity) by the cost method shall record the transaction at fair value. Entity B’s recording the transaction at fair value shall involve establishing a new cost basis for the investment and recognizing any gain or loss in earnings.

325-20-30-4
A cost method investor that accounts for an investment in Entity A (the acquiring entity) by the cost method shall not record the transaction at fair value, but shall continue to carry the investment in Entity A at historical cost.

325-20-30-5
If the investor in Entity B also held a cost-method investment in Entity A before the business combination, the conclusions reached in the preceding two paragraphs shall not change. In that case, fair value shall be used to account for the exchange of the investment in Entity B, and the investor shall continue to carry the investment in Entity A at historical cost.

325-20-30-6
The preceding references to cost method investor will apply to an investor accounting for its investments in equity securities under Subtopic 320-10.

ASC 325-20-30-2 through paragraph 30-6 address the accounting for nonmonetary exchanges of cost method investments when shares of one entity are exchanged for all outstanding shares of the other in a business combination. This guidance also applies to nonmonetary exchanges of equity securities in the scope of ASC 320 (e.g., available-for-sale equity securities). ASC 325-20-30-3 requires an investor to account for this type of exchange at fair value and record the securities received at their fair value.

For investments accounted for under the cost method, this treatment will result in the recognition of a gain or loss if the fair value of the securities received differs from the investor’s basis in the securities it gives up. For equity securities accounted for under ASC 320, any unrealized gains or losses previously recognized in other comprehensive income for the securities given up are recognized in earnings.

The following example illustrates a nonmonetary exchange of available-for-sale equity securities.

**Illustration 2-3: Exchange of available-for-sale securities in a business combination**

Entity X (the acquirer) enters into a business combination with Entity Y (the acquiree). Shares of Entity X are exchanged for all of the outstanding shares of Entity Y. Prior to the exchange, Investors A, B and C have the following equity investments in Entity X and Entity Y:

- Investor A owns shares of Entity X
- Investor B owns shares of Entity Y
- Investor C owns shares of Entity X and Entity Y
Pursuant to ASC 320, all three investors classify their investments as available-for-sale securities and record their investments at fair value with the unrealized holding gains or losses recorded in other comprehensive income.

Based on the guidance in ASC 325-20-30, each investor accounts for the exchange of Entity Y stock for Entity X stock as follows:

**Investor A**
Investor A continues to hold shares in Entity X and continues to record any unrealized gain or loss on its investment in other comprehensive income, not in earnings.

**Investor B**
Investor B accounts for the exchange of its shares of Entity Y for shares of Entity X at fair value. A new cost basis is established for Investor B’s investment, and any gain or loss previously recorded in other comprehensive income for Investor B’s investment in Entity Y is recognized in earnings. Any future holding gain or loss on Investor B’s new investment in Entity X is recorded in other comprehensive income until realized.

**Investor C**
Investor C recognizes any gain or loss previously recorded in other comprehensive income for its investment in Entity Y in earnings at the time of the exchange. However, the unrealized gain or loss associated with the shares of Entity X that were owned by Investor C prior to the exchange continues to be recorded in other comprehensive income.

### 2.2.7 Equity securities received in exchange for goods or services from a non-employer

Before the adoption of ASU 2014-09, ASC 505-50 requires that the fair value of equity securities received in exchange for goods or services be measured on the earlier of the following dates (the measurement date):

- Performance commitment date
- Date the entity has completed the services required under the arrangement

Equity securities received in exchange for goods or services should continue to be accounted for under ASC 505-50 until the measurement date, which may be after the date of grant (e.g., when the arrangement has a performance condition). Subsequent to the measurement date, the equity securities should be classified and measured according to ASC 320 if they have a readily determinable fair value. If the equity securities do not have a readily determinable fair value, they should be accounted for as a cost method investment pursuant to ASC 325-20.

Generally, the fair value of goods or services delivered or the fair value of the equity securities received, whichever is more reliably measurable, is used to measure the value of the goods or services delivered. In practice, however, the fair value of the equity securities is typically more reliably measurable than the fair value of the goods or service delivered. As with share-based awards to employees, vesting conditions should not be considered in the measurement of fair value. Non-vesting conditions, including market conditions, should be factored into the measurement of fair value.

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10 ASU 2014-09, Revenue from Contracts with Customers (Topic 606)
After the adoption of ASU 2014-09, ASC 606 will apply to the receipt of equity securities in exchange for goods or services with customers. Refer to section 5.6 of our FRD publication, *Revenue from contracts with customers (ASC 606)*, for further details.

### 2.3 Trading securities

**Excerpt from Accounting Standards Codification**

**Investments – Debt and Equity Securities – Overall**

**Classification of Investment Securities**

**320-10-25-1**

At acquisition, an entity shall classify debt securities and equity securities into one of the following three categories:

- a. Trading securities. If a security is acquired with the intent of selling it within hours or days, the security shall be classified as trading. However, at acquisition an entity is not precluded from classifying as trading a security it plans to hold for a longer period. Classification of a security as trading shall not be precluded simply because the entity does not intend to sell it in the near term.

**Subsequent Measurement**

**320-10-35-1**

Investments in debt securities and equity securities shall be measured subsequently as follows:

- a. Trading securities. Investments in debt securities that are classified as trading and equity securities that have readily determinable fair values that are classified as trading shall be measured subsequently at fair value in the statement of financial position. Unrealized holding gains and losses for trading securities shall be included in earnings.

Trading securities include both debt and marketable equity securities bought and held primarily to be sold in the near term. Trading activities typically involve active and frequent buying and selling to generate profits on short-term movements in market prices or spreads. ASC 320 does not specify how long securities in this category can be held, because the length of time will vary between investors and the nature of the securities.

The Master Glossary defines trading securities as those that are sold in the near term and held for only a short period of time. This phrase contemplates 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 should be classified as trading.

However, at acquisition, an entity is not precluded from classifying as trading a security it plans to hold for a longer period or one it acquires without the intent to sell in the near term. The terms generally and principally were deliberately used to describe the trading category. However, the decision to classify a security as trading should occur and should be documented at acquisition. If an entity elects to classify a security in the trading category, it should be prepared to maintain such classification until the security is sold or matures. Transfers into or out of the trading category should be rare.

The FASB has indicated that fair value is the preferred method of accounting for investments in debt and marketable equity securities. The classification as trading for securities not anticipated to be sold in the near term may be appropriate for entities that want to better match changes in the fair value of any liabilities required to be measured at fair value with changes in fair value recognized in the statement of operations.

ASC 825 also permits an entity to irrevocably elect the fair value option for certain financial instruments. Securities measured under the fair value option are considered trading.
2.3.1 Entities with classified balance sheets

An entity that presents a classified statement of financial position should report all trading securities as either current or noncurrent, as appropriate. Investments in debt and equity securities classified as trading are often presented as current assets because they represent the investment of cash available for current operations. However, an entity may hold certain securities (including debt securities maturing more than one year after the reporting date) within its trading portfolio that it does not intend to sell in the next 12 months. In these situations, the trading securities should be reported as noncurrent.

2.3.2 Subsequent measurement

Trading securities should be subsequently measured at fair value. The entire change in the fair value of a security classified as trading should be reported in net income in the period the change occurs. Because unrealized holding losses are included in earnings, it is not necessary to evaluate trading securities for impairment.

Dividends, interest income and unrealized holding gains and losses should be included in earnings.

2.3.2.1 Interest income

ASC 320 provides no specific guidance for determining and reporting interest income for trading securities. ASC 325-40 provides for a consistent interest income recognition model for certain beneficial interests within its scope classified as held to maturity, available for sale and trading; however, ASC 310’s interest income recognition models specifically exclude from its scope loans and debt securities measured at fair value with changes reported in earnings. As such, except for investments subject to ASC 325-40, there is no specific guidance in US GAAP for determining interest income for assets measured at fair value with changes reported in earnings.

An interest recognition model based solely on the stated coupon rate of the instrument would not be prohibited, and we believe this approach is commonly applied today in practice. Alternatively, a method that takes into account the effective yield of a debt instrument may better portray the economic substance of the transaction. Given the lack of specific guidance, entities have some flexibility in determining the effective yield on an interest-bearing trading security.

2.3.3 Foreign currency gains and losses

For investments in securities denominated in a currency other than the entity's functional currency, unrealized gains and losses for ASC 320 purposes include changes resulting from both movements in foreign exchange rates and movements in other market factors. A holder may report the entire change in fair value of a foreign currency-denominated trading security in a single line item in the income statement, without separately reporting any foreign exchange component of the overall change in the fair value of the security.

2.3.4 Hedging securities classified as trading

ASC 815 prohibits hedge accounting if the hedged item is remeasured (or will be remeasured subsequent to acquisition) to fair value with changes in fair value attributed to the hedged risk reported in earnings. As such, hedge accounting (both fair value and cash flow) is not permitted for securities classified as trading and cash flow hedge accounting is not permitted for forecasted acquisitions of securities that will be classified as trading upon acquisition.

2.3.5 Considerations for mortgage banking entities

A mortgage banking entity should classify as trading any retained mortgage-backed securities that it commits to sell before or during the securitization process. Those mortgage-backed securities held for investment should be classified into one of the three ASC 320 categories.
2.4 Held-to-maturity securities

**Excerpt from Accounting Standards Codification**

**Investments – Debt and Equity Securities – Overall**

**Classification of Investment Securities**

**320-10-25-1**

At acquisition, an entity shall classify debt securities and equity securities into one of the following three categories:

c. Held-to-maturity securities. Investments in debt securities shall be classified as held-to-maturity only if the reporting entity has the positive intent and ability to hold those securities to maturity.

**Subsequent Measurement**

**320-10-35-1**

Investments in debt securities and equity securities shall be measured subsequently as follows:

c. Held-to-maturity securities. Investments in debt securities classified as held to maturity shall be measured subsequently at amortized cost in the statement of financial position. A transaction gain or loss on a held-to-maturity foreign-currency-denominated debt security shall be accounted for pursuant to Subtopic 830-20.

2.4.1 Ability and intent to hold to maturity

Equity securities cannot be classified as held to maturity because they do not have a stated maturity date.

Individual debt securities should be classified as held to maturity only if, at acquisition, management has both the positive intent and ability to hold the individual debt securities until maturity. A positive intent and ability to hold a security to maturity is different from the mere absence of an intent to sell. If an entity is uncertain of its intention to hold a debt security to maturity, it should not classify that investment as held to maturity.

The FASB made the held-to-maturity category restrictive because it believes the use of amortized cost must be justified for each investment in a debt security. This highly restrictive definition has resulted in relatively few debt securities classified in this category.

The held-to-maturity category does not include securities an entity intends to hold for only an indefinite period. As a result, an entity may not classify a security as held to maturity if, for example, the entity considers that the security would be available for sale in response to changes in any of the following:

- Market interest rates
- Prepayment risk
- Liquidity needs
- Availability of and the yield on alternative investments
- Funding sources and terms
- Foreign currency risk

In establishing intent, an entity should consider its historical experience, such as sales and transfers of debt securities classified as held to maturity. Past sales or transfers of held-to-maturity debt securities are inconsistent with an expressed intent to hold debt securities to maturity. Refer to section 3, *Transfers between categories of investments*, and section 4, *Sales of securities*, for further discussion of sales and transfers of held-to-maturity securities that would call into question (or “taint”) an entity’s assertion that it has the intent and ability to hold the remaining portfolio to maturity.
When assessing whether an entity has the intent and ability to hold to maturity, an entity does not need to consider extremely remote “disaster scenarios” that it could not have anticipated, such as a run on a bank or an insurance entity. We generally believe that very few events would qualify for this exception.

### 2.4.1.1 Considerations for regulated entities

Regulators of financial institutions can, under certain circumstances, conclude that the continued ownership of any asset represents an undue safety and soundness risk to an institution and, accordingly, require a financial institution to dispose of that asset. The federal banking regulatory agencies note that only in rare circumstances have examiners required a financial institution to dispose of mortgage securities that have become high-risk after acquisition. However, an examiner has the authority to require a financial institution to dispose of any security or asset.

The FASB did not intend that a regulator’s overall divestiture authority be considered as an automatic constraint of an institution’s ability to hold a debt security to maturity, because such a conclusion would have precluded any use of the held-to-maturity category by regulated financial institutions. However, the FASB recognized that facts and circumstances could indicate than an institution does not have the ability to hold a debt security to maturity. Refer to section 4, Sales of securities, for a discussion of sales of held-to-maturity securities that would call into question (or “taint”) an entity's assertion that is has the intent and ability to hold the remaining portfolio to maturity.

### 2.4.1.2 Considerations for specific instruments

#### 2.4.1.2.1 Prepayable debt securities

A debt security should not be classified as held to maturity if that security can contractually be prepaid or otherwise settled in a way that the holder of the security would not recover substantially all of its recorded investment. Securities with those types of characteristics should be evaluated under ASC 815-15 to determine whether the security has an embedded derivative that must be accounted for separately. If a security with those characteristics does not contain an embedded derivative that must be accounted for separately, the security should be subsequently classified as available-for-sale or trading.

#### 2.4.1.2.2 Pledged securities

Companies often pledge debt securities as collateral to borrow funds at reduced interest rates. Pledging debt securities as collateral for an obligation can be consistent with an entity's assertion that it has the intent and ability to hold the security to maturity if the transaction is not considered a sale under ASC 860-10-20 and the entity intends and expects to satisfy the obligation without surrendering the debt security. An entity should make an ongoing assessment as to whether it is probable that the securities will be used to repay the related obligation. If an entity determines that the securities will not be needed to repay the related obligation, the securities can be classified as held to maturity, as long as the entity has the positive intent and ability to hold the securities to maturity.

If the transaction is considered a sale under ASC 860-10-40-5 and the held-to-maturity security is transferred for a reason other than those specified in ASC 320-10-25-6, ASC 320-10-25-9 and ASC 320-10-25-14, the transfer would taint the held-to-maturity portfolio. Refer to section 3, Transfers between categories of investments, for further guidance.

#### 2.4.1.2.3 Repurchase agreements and similar arrangements

A held-to-maturity security can be subject to a repurchase agreement or a securities lending agreement as long as the transaction is accounted for as a secured borrowing under ASC 860-20 and the entity intends and expects to be able to satisfy the obligation and recover access to its collateral (ASC 320-10-25-18(e)).
A repurchase agreement that does not meet the criteria to be treated as a sale under ASC 860 is treated as a collateralized borrowing (secured) transactions. ASC 320-10-25-18(e) states that a seller-borrower can classify a debt security subject to a repurchase agreement accounted for as a secured borrowing under ASC 860-20 as a held-to-maturity security, as long as the institution has the positive intent and ability to repay the borrowing and recover access to its collateral.

Additional guidance related to ASC 860 can be found in our FRD publication, *Transfers and servicing of financial assets*.

### 2.4.1.2.4 Convertible debt

Convertible debt securities should not be classified as held to maturity. Classifying a security as held to maturity means that the entity 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 the 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 forgo the opportunity to exercise the conversion feature.

The exercise of a conversion feature on a security classified as held to maturity would call into question an investor's stated intent to hold other debt securities to maturity in the future. If convertible debt is bifurcated into an equity option and a host debt instrument under the requirements of ASC 815-15, it generally would be contradictory to assert the positive intent and ability to hold the debt host contract to maturity and forgo the opportunity to exercise the conversion feature because the entire hybrid instrument (including the host contract classified as held to maturity) would be tendered in the conversion.

### 2.4.1.2.5 Put and call features

A debt security with a put feature (i.e., one that allows the holder to redeem the instrument for cash at a specified price) may be classified as held to maturity only if the entity determines at acquisition that the security meets the requirements to do so, including expected recovery of substantially all of the entity's recorded investment in the security. However, exercising the put feature on a security classified as held to maturity would call into question the entity's stated intent to hold other debt securities to maturity in the future. As such, management should carefully consider whether to classify such securities as held to maturity. We generally believe that the maturity date of the instrument should not be considered the date the put feature becomes exercisable; rather, it should be the instrument's stated maturity date.

A debt security with a call feature that allows the issuer to repurchase the security at a specified price can generally be classified as held to maturity. The issuer's exercise of a call feature effectively accelerates the debt security's maturity and should not be viewed as inconsistent with classification in the held-to-maturity category. However, a callable debt security purchased by the investor at a significant premium might be precluded from held-to-maturity classification under ASC 860-20-35-2 if it can be prepaid or otherwise settled in a way that the holder of the security would not recover substantially all of its investment.

### 2.4.1.2.6 Interest-only securities and other securities with principal risk

Securitized debt instruments, including interest-only strips and principal-only strips, are in the scope of ASC 320. A security cannot be designated as held to maturity if it can be prepaid or otherwise settled in a way that the holder of the security would not recover substantially all of its recorded investment. Interest-only securities and securities that have principal risk (e.g., some structured notes) should not be classified as held to maturity because of the inherent prepayment uncertainty and potential loss of principal.
For example, a holder of an interest-only strip on a mortgage-backed security may not recover its entire investment if the underlying mortgages prepay at a faster rate than anticipated. Accordingly, mortgage-backed interest-only certificates are prohibited from being classified as held to maturity by ASC 320-10-25-5(a). In addition, certain interest-only securities and other securities with principal risk may be derivative instruments that are required to be accounted for under ASC 815.

2.4.2 Additional considerations when assessing whether held-to-maturity classification is appropriate

2.4.2.1 Asset-liability management programs

An entity’s decision to classify a security as held to maturity means that, during the term of the security, its intentions with respect to that security will not be affected by interest rate changes or prepayment expectations. Thus, entities that use an active asset-liability management program to manage interest rate risk will find it difficult to classify securities as held to maturity if those securities are subject to sale in response to the asset-liability program. In this regard, ASC 320 requires management to classify as available for sale or trading all securities that might be sold to achieve the desired mix of asset and liability maturity dates and interest rates. An entity may decide that it can achieve its desired mix of asset and liability maturity dates and interest rates without having all of its debt securities available for disposition. Debt securities designated as unavailable to be sold could still qualify for held-to-maturity classification.

2.4.2.2 Hedging programs

An entity 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. However, entities may designate certain debt securities as unavailable to be sold to accomplish those ongoing adjustments deemed necessary under its dynamic hedging program, thereby enabling these debt securities to be accounted for at amortized cost because the entity has a positive intent and ability to hold them to maturity.

2.4.2.3 Investment management policies

When evaluating whether it has an intent to hold a security to maturity, an entity should consider its operating policies regarding investments. For example, a policy to consider selling any security 24 months before maturity, regardless of its previous classification, would be inconsistent with an entity’s assertion that it had the intent to hold a security to maturity. Therefore, such a policy would preclude an entity from classifying any debt security as held to maturity.

2.4.2.4 Future business plans

An entity should also consider future business plans and expected cash flow needs. For example, assume that an entity holds a $10 million debt security that matures in five years and has outstanding an $8 million long-term note payable that matures in three years. If the entity intends to sell the security to extinguish the debt, it should not classify the security as held to maturity. Furthermore, if the entity classifies the security as held to maturity, it should be able to demonstrate an alternative means of repayment.

2.4.2.5 Tax-planning strategies

An entity may also consider certain securities available for sale to implement tax-planning strategies (e.g., to generate capital gains so existing capital losses can be used) to support the assertion that a valuation allowance is not necessary for a deferred tax asset. Securities that are available for sale to implement tax planning strategies now or in the future should not be classified as held to maturity.
2.4.3 **Entities with classified balance sheets**

Held-to-maturity securities should be classified as current or noncurrent based on the maturity date (or call date if exercise of the call within the next operating period or fiscal year is probable) of the individual debt securities. The classification of a held-to-maturity security as current that does not have a maturity or redemption date within the next year would be inconsistent with an entity's ability and intent to hold the security until maturity.

The balance sheet classification for held-to-maturity securities generally should agree with the disclosure of maturities included in the notes to the financial statements. However, differences might result from an entity using expected repayments (i.e., expected call option exercise) in the balance sheet classification and contractual maturities in the notes to the financial statements.

2.4.4 **Subsequent measurement**

Investments in debt securities classified as held to maturity should be subsequently measured at amortized cost in the statement of financial position. Dividend and interest income, including amortization of the premium and discount arising at acquisition, should be included in earnings. Entities should consider whether a decline in fair value below the amortized cost basis is other than temporary. Refer to section 5, *Impairment*, for further guidance.

2.4.5 **Foreign currency considerations**

Foreign currency denominated debt securities classified as held to maturity are considered monetary assets because their settlement amounts are fixed and do not depend on future prices. Any change in exchange rates between the functional currency of the holder (of the debt security) and the currency in which the debt security is denominated will cause an increase or decrease in expected functional currency cash flows. Pursuant to ASC 830-20-35-1, this represents a foreign currency transaction gain or loss, which should generally be included in net income for the period in which the exchange rate changes.

2.4.6 **Hedging securities classified as held to maturity**

ASC 815 prohibits hedges of interest rate risk for held-to-maturity securities. However, a held-to-maturity security can be hedged for credit risk or foreign currency risk in a fair value hedge. In these cases, the carrying value of the held-to-maturity security should be adjusted for changes in its fair value attributable solely to the risk eligible to be hedged.

2.5 **Available-for-sale securities**

**Excerpt from Accounting Standards Codification**

*Classifications of Investment Securities*

**Classification of Investment Securities**

320-10-25-1

At acquisition, an entity shall classify debt securities and equity securities into one of the following three categories:

b. Available-for-sale securities. Investments in debt securities and equity securities that have readily determinable fair values not classified as trading securities or as held-to-maturity securities shall be classified as available-for-sale securities.
Subsequent Measurement

320-10-35-1

Investments in debt securities and equity securities shall be measured subsequently as follows:

b. Available-for-sale securities. Investments in debt securities that are classified as available for sale and equity securities that have readily determinable fair values that are classified as available for sale shall be measured subsequently at fair value in the statement of financial position. 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 paragraphs 815-25-35-1 through 35-4.

The available-for-sale category is the default or residual security classification. That is, debt securities not classified as either held to maturity or trading and equity securities that have readily determinable fair values and are not classified as trading should be classified as available for sale.

The intent of management and the existence of trading activity are the overriding factors that should be considered in determining whether a security should be classified as trading or available for sale, not the type of security or the period of time it is expected to be held. Securities should not be classified as available for sale if the entity intends to trade those securities. Further, an entity that decides to sell a security that it has classified as available for sale should not transfer the security to trading prior to disposition. Available-for-sale securities should not be transferred to a trading category because the passage of time has caused the maturity date to be within one year.

2.5.1 Entities with classified balance sheets

Debt securities classified as available for sale generally should be classified as current or noncurrent, based on maturities and the entity’s expectations of sales and redemptions in the following year. Classification as current or noncurrent should be consistent with the assertions regarding the determination of other-than-temporary impairments (i.e., a decision to sell results in current classification). ASC 210-10-45-1(f) states that entities should generally classify as current assets marketable securities that are available to be converted into cash to fund current operations. Thus, we generally believe that if an entity views its available-for-sale portfolio as available for use in its current operations, it may classify marketable equity securities as current, even if it does not necessarily intend to dispose of the securities in the following year.

Because the classifications of available-for-sale securities are based on management’s intentions rather than actual maturity dates, the balance sheet classification may not be consistent with the disclosure of contractual maturities of debt securities included in the notes to the financial statements. Management should consider disclosing material differences between the balance sheet and the notes to the financial statements to help readers understand the information presented.

To ease preparation of the required disclosures in the notes to the financial statements (see section 6, Presentation and disclosure) and to track the components of a security’s carrying amount, entities should consider maintaining separate accounts for the par value, fair value adjustments and unamortized discount or premium. That is, rather than charging or crediting the investment directly for the change in fair value, the entity would use a separate account. For statement of financial position purposes, the fair value adjustment account would be a component of the carrying amount of the security, not a separate account.
2.5.2 Subsequent measurement

The subsequent measurement basis for both available-for-sale securities and trading securities is fair value. But any unrealized gains and losses on available-for-sale securities are included in OCI rather than in net income, as they are for trading securities. The deferred income tax consequences of unrealized holding gains and losses reported in OCI should also be included in OCI, resulting in a net presentation within OCI.

Dividend and interest income, including amortization of the premium and discount arising at acquisition, as well as realized gains and losses, should be included in earnings.

While available-for-sale securities are carried at fair value, entities still need to consider whether a decline in fair value below the amortized cost basis is other than temporary. A detailed discussion of identifying and measuring impairment of securities is included in section 5, Impairment.

2.5.3 Foreign currency considerations

For investments in securities denominated in a foreign currency, unrealized gains and losses for ASC 320 purposes include changes resulting from both movements in foreign exchange rates and movements in other market factors. A holder of an available-for-sale security should account for the entire change in fair value of a foreign currency-denominated security in accordance with ASC 320 (i.e., include it in OCI, net of tax effects), without separating any foreign exchange component of the change in the fair value of the security.

2.5.4 Hedging securities classified as available for sale

Available-for-sale securities, if not hedged, are carried at fair value with changes in fair value recognized in OCI (after adjusting for deferred taxes). ASC 815 prohibits hedge accounting if the hedged item is remeasured (or will be remeasured after acquisition) to fair value with changes in fair value attributed to the hedged risk reported in earnings. Because changes in the fair value of an available-for-sale security are recognized in OCI, those securities can be designated as the hedged item under ASC 815.

If an available-for-sale security is designated as a hedged item in a fair value hedge, the changes in fair value of the security attributable to the hedged risk will be reflected in net income (not OCI) for as long as hedge accounting can be applied. However, the changes in fair value of the available-for-sale security attributable to other risks not being hedged will continue to be accounted for under ASC 320 and will be reflected in OCI.

If an available-for-sale security has a bifurcated derivative (e.g., the conversion feature in an available-for-sale convertible bond), ASC 320 continues to govern accounting for the host security but ASC 815 governs accounting for the bifurcated derivative.

2.5.5 Effect of available-for-sale security unrealized gains and losses on certain insurance-related assets and liabilities of insurance companies

ASC 944 requires the measurement of certain insurance-related assets and liabilities to take into consideration investment returns. These assets and liabilities include deferred policy acquisition costs (DPAC), intangible assets arising from insurance contracts acquired in business combinations (i.e., present value of future profits (PVFP)) and certain policyholder liabilities. The investment returns included in the measurement of these assets and liabilities are those gains and losses recorded in the income statement, such as realized gains and losses from sale of securities and unrealized gains and losses from trading securities. However, the effect of unrealized gains and losses from available-for-sale securities is not addressed in ASC 944.
ASC 320-10-S99-2\(^{11}\) provides guidance on the treatment of unrealized gains and losses from available-for-sale securities to these assets and liabilities. This guidance indicates that, to the extent unrealized gains and losses from securities classified as available for sale would result in adjustments to those assets and liabilities had those gains and losses actually been realized, then the balance sheet amounts should be adjusted with corresponding offsets reported directly in OCI.

As an example, DPAC for universal-life type contracts is amortized using estimated gross profits over the life of the insurance contracts and unrealized gains and losses from available-for-sale securities are not included in the amortization model. In this circumstance, the insurance entity would update the estimated gross profits as if the unrealized gains and losses from the available-for-sale securities were realized and re-estimate the balance sheet amount with the corresponding adjustment recorded in OCI.

Although not specifically addressed by the above guidance, we generally believe that any such adjustments cannot result in an increase to DPAC or PVFP beyond their original levels, plus accrued interest.

\section*{2.6 Structured notes}

\begin{center}
\begin{tabular}{l}
\textbf{Excerpt from Accounting Standards Codification} \\
\textbf{Master Glossary} \\
\textbf{Structured Note} \\
A debt instrument whose cash flows are linked to the movement in one or more indexes, interest rates, foreign exchange rates, commodities prices, prepayment rates, or other market variables. Structured notes are issued by U.S. government-sponsored enterprises, multilateral development banks, municipalities, and private entities. The notes typically contain embedded (but not separable or detachable) forward components or option components such as caps, calls, and floors. Contractual cash flows for principal, interest, or both can vary in amount and timing throughout the life of the note based on nontraditional indexes or nontraditional uses of traditional interest rates or indexes.
\end{tabular}
\end{center}

Most structured notes are subject to the embedded derivative bifurcation requirements of ASC 815-15 because they often contain embedded components that are not clearly and closely related to a debt instrument and that meet the definition of a derivative. As such, the embedded derivative component would be bifurcated pursuant to ASC 815 and the host instrument would be subject to ASC 320. Any structured notes not subject to ASC 815-15 should follow ASC 320-10-35-40 and be classified into one of the three categories of debt securities.

Because of their terms, some structured notes can contractually be prepaid or otherwise settled in a way that the holder of the security would not recover substantially all of its recorded investment. Such securities should not be classified as held to maturity.

If structured note securities are issued together to achieve a certain strategic investment result for the investor (e.g., two structured notes with opposite interest rate reset provisions), the investor should account for the securities as a single unit of account until one of the securities is sold. Upon sale, the previous carrying amount should be allocated between the security sold and the security retained, based on the relative fair values of the notes at the date of sale.

Refer to section 5, \textit{Impairment}, for further discussion on other-than-temporary declines in value of structured notes.

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\(^{11}\) SEC Staff Announcement, \textit{Adjustments in Assets and Liabilities for Holding Gains and Losses as Related to the Implementation of Subtopic 320-10}. 

\texttt{Financial reporting developments} Certain investments in debt and equity securities (before the adoption of ASU 2016-01) | 33
3 Transfers between categories of investments

3.1 Overview

Excerpt from Accounting Standards Codification

<table>
<thead>
<tr>
<th>Investments – Debt and Equity Securities – Overall</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subsequent Measurement</td>
</tr>
<tr>
<td>Reassessment of Classification</td>
</tr>
<tr>
<td>320-10-35-5</td>
</tr>
</tbody>
</table>

At each reporting date, the appropriateness of the classification of an entity's investments in debt and equity securities shall be reassessed. For example, if an entity no longer has the ability to hold securities to maturity, their continued classification as held-to-maturity would not be appropriate.

ASC 320 requires entities to determine, at acquisition, how to classify a security and to document that decision. They may not wait until a later date. Entities are then required to reassess the appropriateness of their initial classifications at each report date. This requirement is based on the concept that circumstances can change throughout the holding period of an investment security (e.g., an entity may no longer be able to hold a debt security to maturity). For example, if after initially classifying a debt security as available for sale, an entity is able to demonstrate that it has both the ability to hold the security to maturity and the intent to do so, it could transfer the security to the held-to-maturity category.

Because an entity is not expected to change its intent about a held-to-maturity security, the requirement to reassess the appropriateness of a held-to-maturity security's classification focuses on the entity's ability to hold a security to maturity. ASC 320 acknowledges that facts and circumstances can change; however, that acknowledgment in no way diminishes the restrictive nature of the held-to-maturity category. In practice, transfers between categories do not occur frequently and some transfers between categories are only allowed in rare circumstance.

Transfers of securities between categories of investments are accounted for at fair value as of the transfer date, but the accounting treatment of the unrealized holding gains and losses and related income tax effects on any temporary differences is determined by the category into which the security is transferred.
3.1.1 Summary table of accounting requirements for transfers between categories

The table below is a summary of the accounting and disclosure requirements following a transfer of securities:

<table>
<thead>
<tr>
<th>Measurement basis</th>
<th>Effect of transfer on shareholder’s equity</th>
<th>Effect of transfer on net income</th>
<th>Presentation and disclosure requirements</th>
<th>Transfer allowed?</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Transfer from available for sale to held to maturity</strong></td>
<td>The security is transferred at fair value at the date of transfer. The unrealized gain or loss component of the carrying value at the date of transfer is amortized over the remaining life of the security as a yield adjustment.</td>
<td>The unrealized gain or loss at the date of transfer carried as a separate component of shareholders’ equity is amortized over the remaining life of the security as a yield adjustment.</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td><strong>Transfer from held to maturity to available for sale</strong></td>
<td>The security is transferred at fair value at the date of transfer. The investment accounts in total will increase or decrease because the unrealized gain or loss is recognized.</td>
<td>The separate component of shareholders’ equity is increased or decreased by the amount of the unrealized gain or loss at the date of transfer, net of tax effect.</td>
<td>None</td>
<td>Disclose in the notes to the financial statements the net carrying amount, unrealized gain or loss at the date of transfer and the circumstances leading to the decision to transfer.</td>
</tr>
<tr>
<td><strong>Transfer from trading to available for sale</strong></td>
<td>The security is transferred at fair value at the date of transfer. This amount is the new cost basis of the security.</td>
<td>None</td>
<td>None</td>
<td>Disclosure of the noncash transfer, if significant, between operating and investing activities is required.</td>
</tr>
<tr>
<td><strong>Transfer from available for sale to trading</strong></td>
<td>The security is transferred at fair value at the date of transfer. This amount is the new cost basis of the security.</td>
<td>The unrealized gain or loss at the date of transfer carried as a separate component of shareholders’ equity is reversed into net income.</td>
<td>The unrealized gain or loss at the date of transfer is recognized in net income.</td>
<td>Disclosure of the noncash transfer, if significant, between operating and investing activities is required. Disclose in the notes to the financial statements the gross unrealized gains and losses included in net income resulting from such transfers.</td>
</tr>
</tbody>
</table>
### Transfers from available for sale to held to maturity

#### Excerpt from Accounting Standards Codification

**Investments – Debt and Equity Securities – Overall**

**Subsequent Measurement**

**Transfers of Securities Between Categories**

320-10-35-10

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

a. [EY note: Guidance omitted; see section 3.4, Transfers involving trading securities]

b. [EY note: Guidance omitted; see section 3.4, Transfers involving trading securities]

c. [EY note: Guidance omitted; see section 3.3, Transfers from held to maturity to available for sale]

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 unrealized 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 the following sentence) for that held-to-maturity security. For 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 Subtopic 310-20.

When a security is transferred from available for sale to held to maturity, the difference between its amortized cost and fair value at the date of transfer (including any other-than-temporary impairment previously recognized in OCI) is amortized as a yield adjustment in accordance with ASC 310-20. The fair value at date of transfer, adjusted for subsequent amortization, becomes the security's amortized cost basis.

An example of a transfer from the available-for-sale category to the held-to-maturity category follows (note that the income tax effect has not been considered):

<table>
<thead>
<tr>
<th>Illustration 3-1: Transfer of securities from available for sale to held to maturity</th>
</tr>
</thead>
<tbody>
<tr>
<td>A corporate bond with a par value of $1,000, amortized cost of $940 and a fair value of $1,120 is transferred from the available-for-sale category to the held-to-maturity category. At the date of transfer, the carrying amount on the statement of financial position and in OCI will remain the same.</td>
</tr>
</tbody>
</table>

The unamortized discount of $60 (par value of $1,000 less an amortized cost of $940), the fair value adjustment at the date of the transfer of $180 (fair value of $1,120 less an amortized cost of $940), and the unrealized gain of $180 included in OCI would be amortized in accordance with ASC 310-20, so that at maturity, the amortized cost of the security would be equal to its par value and the unrealized gain or loss included in OCI would be reduced to zero.

To illustrate, assume the debt security in this example has three years remaining to maturity at the date of transfer. The net annual financial statement impact would be as follows. (Note: While the effective interest method is required, the following example is shown using the straight-line method for simplicity.)
Transfers between categories of investments

Financial reporting developments

Certain investments in debt and equity securities (before the adoption of ASU 2016-01)

Increase (decrease) in net income

<table>
<thead>
<tr>
<th>Description</th>
<th>At date of transfer</th>
<th>1 year later</th>
<th>2 years later</th>
<th>At maturity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amortization of initial discount ($60 divided by 3 years)</td>
<td>$ 20</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amortization of the fair value adjustment ($180 divided by 3 years)</td>
<td>(60)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amortization of other comprehensive income ($180 divided by 3 years)</td>
<td>60</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$ 20</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Following the transfer, the relevant balances in the statement of financial position, income statement and disclosure in the notes to the financial statements would be as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>At date of transfer</th>
<th>1 year later</th>
<th>2 years later</th>
<th>At maturity</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Statement of Financial Position</strong></td>
<td>$ 1,000</td>
<td>$ 1,000</td>
<td>$ 1,000</td>
<td>$ 1,000</td>
</tr>
<tr>
<td>Held-to-maturity securities</td>
<td>180</td>
<td>120</td>
<td>60</td>
<td>—</td>
</tr>
<tr>
<td>Fair value adjustment</td>
<td>(60)</td>
<td>(40)</td>
<td>(20)</td>
<td>—</td>
</tr>
<tr>
<td>Unamortized discount</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Carrying amount</td>
<td>$ 1,120</td>
<td>$ 1,080</td>
<td>$ 1,040</td>
<td>$ 1,000</td>
</tr>
<tr>
<td>Accumulated other comprehensive income – unrealized (gains) and losses</td>
<td>$ (180)</td>
<td>$ (120)</td>
<td>$ (60)</td>
<td>—</td>
</tr>
<tr>
<td><strong>Income statement</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Discount accretion</td>
<td>—</td>
<td>$ 20</td>
<td>$ 20</td>
<td>$ 20</td>
</tr>
<tr>
<td><strong>Footnote disclosure</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net carrying amount</td>
<td>$ 940</td>
<td>$ 960</td>
<td>$ 980</td>
<td>$ 1,000</td>
</tr>
</tbody>
</table>

This example excludes the effect of income taxes. If taxes had been considered, the balance in OCI at the date of the transfer would have been net of the estimated tax effect. As the balance in OCI is amortized, the tax effect of the unrealized holding gain or loss previously recorded should be reversed through the reconciliation of such accounts. The amortization of the balance in OCI coupled with the reversal of the related tax effect should be offset by the amortization of the security’s fair value adjustment account, with no effect on net income. However, it is possible that the amounts would not offset each other entirely (e.g., if tax rates change, if capital gains are available to offset capital losses).

Entities also should consider the effect of transfers into the held-to-maturity category on their accounting policy and investment disclosures. In the example above, it would be potentially confusing to users of the financial statements to state that investments classified as held to maturity are carried at amortized cost when, in fact, the security in this example is presented in the statement of financial position at a value in excess of cost. In another potentially confusing result, the disclosure of amortized cost in the notes to the financial statements would not be equal to the carrying value presented on the face of the statement of financial position because the statement of financial position amount includes securities presented at other than amortized cost.

Entities in this circumstance may want to provide a reconciliation between the amounts in the notes to the financial statements and those in the statement of financial position. These entities may also want to modify their accounting policy with a statement such as the following:

“Transfers of debt securities into the held-to-maturity category from the available-for-sale category are made at fair value at the date of transfer. The unrealized holding gain or loss at the date of transfer is retained in other comprehensive income and in the carrying value of the held-to-maturity securities. Such amounts are amortized over the remaining life of the security.”
Transfers from held to maturity to available for sale

Excerpt from Accounting Standards Codification
Investments – Debt and Equity Securities – Overall
Subsequent Measurement
Transfers of Securities Between Categories
320-10-35-10
The transfer of a security between categories of investments shall be accounted for at fair value. At the date of the transfer, the security's unrealized holding gain or loss shall be accounted for as follows:

a. [EY note: Guidance omitted; see section 3.4, Transfers involving trading securities]

b. [EY note: Guidance omitted; see section 3.4, Transfers involving trading securities]

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. [EY note: Guidance omitted; see section 3.2, Transfers from available for sale to held to maturity]

320-10-35-11
Transfers from the held-to-maturity category should be rare, except for transfers due to the changes in circumstances identified in paragraph 320-10-25-6(a) through (f).

Transfers from the held-to-maturity category should be rare.12 When a security is transferred from the held-to-maturity category to available-for-sale category, the security's amortized cost basis carries over to the available-for-sale category for the following purposes:

- Subsequent amortization of the historical premium or discount
- Comparisons of fair value and amortized cost for the purpose of determining unrealized holding gains and losses
- Required disclosures of amortized cost

The difference between the security's amortized cost and fair value at the date of transfer should be recognized as an unrealized gain or loss recorded in OCI. An entity would also cease accreting any other-than-temporary impairment of the held-to-maturity security previously recognized in OCI.

Transferring a security out of the held-to-maturity category is inconsistent with an expressed intent to hold similar debt securities to maturity and would call into question (or “taint”) the entity's assertion that it has

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12 In August 2017, the FASB issued ASU 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities, to enable entities to better portray the economics of their risk management activities in the financial statements and enhance the transparency and understandability of hedge results. The amendments also simplify the application of hedge accounting in certain situations. Upon adoption, ASU 2017-12 allows an entity to make a one-time election to reclassify a prepayable debt security from held-to-maturity to available-for-sale if the debt security is eligible to be hedged in accordance with paragraph 815-20-25-12A (last-of-layer method). Any unrealized gain or loss at the date of the transfer must be recorded in accumulated other comprehensive income in accordance with paragraph 320-10-35-10(c). The ASU is effective for PBEs for fiscal years beginning after 15 December 2018, including interim periods within those years. For all other entities, it is effective for fiscal years beginning after 15 December 2019, and interim periods within fiscal years beginning after 15 December 2020. Early adoption is permitted. Refer to our FRD publication, Derivatives and hedging (after the adoption of ASU 2017-12, Targeted Improvements to Accounting for Hedging Activities), for further discussion.
the intent and ability to hold the remaining portfolio to maturity. This could necessitate the transfer of all of the remaining held-to-maturity securities to the available-for-sale category. The FASB originally discussed the idea of permitting entities to sell or transfer a small percentage of securities from the held-to-maturity category without “tainting” the classification of the remaining securities in this category. However, the FASB decided not to allow this because it would contradict the premise underlying the use of amortized cost. That is, management intends to hold each security classified as held to maturity until maturity.

ASC 320-10-25-6(a) through (f) describes a number of circumstances where an entity’s change in intent to hold a security to maturity would not call into question its intent to hold other debt securities to maturity currently or in the future. These circumstances are further discussed in section 4.4.2.

3.3.1 Transfers of held-to-maturity securities among members of a consolidated group

Some entities transfer securities to other entities within a consolidated group (e.g., between subsidiaries, between a parent and subsidiary, to special purpose vehicles). Because these transfers have no effect on the consolidated financial statements, they do not create a potential tainting problem under ASC 320. However, a transfer of a held-to-maturity security by an entity to another entity in the consolidated group may taint all held-to-maturity securities for the standalone financial statements of the transferring entity.

3.4 Transfers involving trading securities

Excerpt from Accounting Standards Codification

Investments – Debt and Equity Securities – Overall

Subsequent Measurement

Transfers of Securities Between Categories

320-10-35-10

The transfer of a security between categories of investments shall be accounted for at fair value. 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. [EY note: Guidance omitted; see section 3.3, Transfers from held to maturity to available for sale]

d. [EY note: Guidance omitted; see section 3.2, Transfers from available for sale to held to maturity]

320-10-35-12

In addition, given the nature of a trading security, transfers into or from the trading category also should be rare.

Given the nature of a trading security, transfers to or from the trading category should be rare. The SEC staff has noted that the term “rare” establishes a very high threshold. The SEC staff has also stated that changes in investment strategies, achieving accounting results more closely matching economic

hedging activities and repositioning the portfolio due to anticipated changes in the economic outlook are not consistent with the notion of “rare” as contemplated in ASC 320. That is, they occur frequently. However, the SEC staff has indicated that transfers between the trading and available-for-sale categories may be acceptable for any of the following reasons:

- A change in regulatory or statutory requirements
- Significant business combinations
- Other events that greatly alter the company’s liquidity position or investing strategy

Other facts and circumstances might also exist that would make such transfers acceptable, but those facts and circumstances would need to involve an event that is unusual and highly unlikely to recur in the near term.

Available-for-sale securities should not be transferred to the trading category when management has decided to sell the security or because the passage of time has caused the maturity date to be within one year of the report date. The definition of available for sale implies the ability to sell the security without transferring it to another category.

The income statement classification of gains and losses for transfers involving trading securities is not specified in ASC 320. 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.

3.5

Equity method investments

3.5.1

Loss of significant influence

Excerpt from Accounting Standards Codification

<table>
<thead>
<tr>
<th>Investments – Debt and Equity Securities – Overall</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial Measurement</td>
</tr>
<tr>
<td>Equity Method Is No Longer Appropriate</td>
</tr>
<tr>
<td>320-10-30-4</td>
</tr>
</tbody>
</table>

If it is determined that a marketable equity security should no longer be accounted for under the equity method (for example, due to a decrease in the level of ownership), the security's initial basis shall be the previous carrying amount of the investment. Paragraph 323-10-35-36 states that the earnings or losses that relate to the stock retained shall remain as a part of the carrying amount of the investment and that the investment account shall not be adjusted retroactively. Subsequently, the security shall be accounted for pursuant to paragraph 320-10-35-1.

When an investor loses the ability to exercise significant influence over an investee, the investor should stop using the equity method of accounting on the date it determines that it no longer has the ability to exercise significant influence. The investor must then determine the appropriate accounting method for the investment (i.e., whether the investment meets the definition of an equity security with a readily determinable fair value or whether it should be accounted for using the cost method). See section 7.4 of our FRD publication, Equity method investments and joint ventures, for additional guidance.
3.5.2 Changing from ASC 320 accounting to the equity method of accounting

Excerpt from Accounting Standards Codification

Investments – Equity Method and Joint Ventures – Overall

Subsequent Measurement

323-10-35-33

Paragraph 323-10-15-12 explains that an investment in common stock of an investee that was previously accounted for on other than the equity method may become qualified for use of the equity method by an increase in the level of ownership described in paragraph 323-10-15-3 (that is, acquisition of additional voting stock by the investor, acquisition or retirement of voting stock by the investee, or other transactions). If an investment qualifies for use of the equity method (that is, falls within the scope of this Subtopic), the investor shall add the cost of acquiring the additional interest in the investee (if any) to the current basis of the investor’s previously held interest and adopt the equity method of accounting as of the date the investment becomes qualified for equity method accounting. If the investment was previously accounted for as an available-for-sale security, an entity shall recognize in earnings the unrealized holding gain or loss from accumulated other comprehensive income at the date the investment becomes qualified for the equity method.

An investor may obtain the ability to exercise significant influence over an investment that it has been accounting for under the cost method or pursuant to ASC 320. An investor also may lose control over an investment that it has been consolidating but retain the ability to exercise significant influence over that investment. See section 5.6 of our FRD publication, Equity method investments and joint ventures, for additional guidance.

3.6 Cost method investments

If a cost method investment becomes marketable, the cost basis of the nonmarketable security becomes the basis of the marketable security. Subsequent changes in value should be accounted for in accordance with the security’s new classification as trading or available for sale. If a change in marketability indicates that an other-than-temporary impairment has occurred, a write-down should be recorded prior to applying ASC 320 and the loss would be classified in a manner consistent with other write-downs of similar investments.

If an investment accounted for pursuant to ASC 320 no longer has a readily determinable fair value due to a change in circumstances, the carrying value of the security becomes the “cost” of the cost method investment.

3.7 Conversions of convertible bonds

A convertible bond meets the definition of a debt security under ASC 320. As discussed in section 2.4.1.2.4, a convertible bond should not be classified as held to maturity and therefore should be classified as available for sale or trading. Depending on the bond’s terms, the holder will receive, upon conversion, cash or equity securities of the issuer or a combination of the two.

There is some diversity in practice in accounting for these types of conversions. Some believe that a conversion should not result in the recognition of a realized gain, and the cost basis shouldn’t change. Under this view, the classification of the equity securities generally should be the same as that of the bond, and the cost basis of the bond should be carried over to the equity securities. Any difference between the fair value of the bond before conversion and the fair value of the equity securities received upon conversion is recognized as an unrealized gain or loss in OCI.
Transfers between categories of investments

Financial reporting developments

Certain investments in debt and equity securities

(before the adoption of ASU 2016-01)

Others believe a realized gain or loss should be recognized for a bond conversion. Under this view, the entity should determine the appropriate classification of the new securities based on its intent on the date of the conversion, and the fair value of the equity securities on that date becomes the cost basis of the securities, with any difference between that basis and the cost basis of the bond before conversion recognized as a realized gain or loss in net income.

Given the lack of specific guidance for these transactions, we generally believe either view is acceptable as an accounting policy election that should be consistently applied.

3.8 Disclosures about transfers between categories

Excerpt from Accounting Standards Codification

| Investments — Debt and Equity Securities — Overall |
| Disclosure |
| Sales, Transfers, and Related Matters that Occurred During the Period |
| 320-10-50-9 |
| For each period for which the results of operations are presented, an entity shall disclose all of the following: |
| c. The gross gains and gross losses included in earnings from transfers of securities from the available-for-sale category into the trading category |

| 320-10-50-10 |
| For any sales of or transfers from securities classified as held-to-maturity, an entity shall disclose all of the following in the notes to the financial statements for each period for which the results of operations are presented: |
| a. The net carrying amount of the sold or transferred security |
| b. The net gain or loss in accumulated other comprehensive income for any derivative that hedged the forecasted acquisition of the held-to-maturity security |
| c. The related realized or unrealized gain or loss |
| d. The circumstances leading to the decision to sell or transfer the security. (Such sales or transfers should be rare, except for sales and transfers due to the changes in circumstances identified in paragraph 320-10-25-6(a) through (f).) |

In addition to the disclosures of transfers described in ASC 320, transfers involving trading securities may represent a noncash investing activity for statement of cash flows purposes. ASC 230 requires disclosure of amounts and information about noncash investing and financing activities.
4 Sales of securities

4.1 Overview
ASC 320-10-40 provides guidance on how to account for sales of debt and equity securities. ASC 320 permits sales of held-to-maturity debt securities only when one of the following changes in circumstances occur:

- The debt security issuer's creditworthiness significantly deteriorates.
- Tax laws are changed in a way that eliminates or reduces the tax-exempt status of interest on the debt security.
- The entity executes a significant business combination or sells a significant component that requires the sale or transfer of held-to-maturity securities to maintain the entity's existing interest rate risk position or credit risk policy.
- Statutory or regulatory requirements are significantly modified as to what constitutes a permissible investment or the maximum level of investments in certain kinds of securities, thereby causing an entity to dispose of a held-to-maturity security.
- A significant increase by the regulator in the industry's capital requirements that causes the entity to downsize by selling held-to-maturity securities.
- A significant increase in the risk weights of debt securities used for regulatory risk-based capital purposes.

Entities that sell or transfer held-to-maturity securities for reasons other than those that are permitted may (1) need to reclassify all of their held-to-maturity securities to the available-for-sale category and (2) be restricted from classifying future purchases of investment securities as held to maturity. As such, entities need to understand the restrictions on selling held-to-maturity securities before classifying securities as held to maturity or selling any securities from their held-to-maturity portfolios.

4.2 Sales of trading securities
The sale of a trading security generally does not give rise to a gain or loss on the date of sale since all changes in a trading security's fair value are generally reported in earnings as they occur. However, if an entity does not recognize changes in fair value daily, the entity would need to record a final mark-to-market on the security to recognize any final fair value adjustments prior to the sale of the security.

Entities that report realized gains and losses separately from unrealized gains and losses would reverse the unrealized gain or loss and recognize a realized gain or loss on the date of sale. In that case, an entity should record the security's change in fair value up to the point of sale as an unrealized gain or loss (i.e., adjust the carrying amount of the security to its fair value immediately before the sale).

4.3 Sales of available-for-sale securities
For a sale of an available-for-sale security, a gain or loss should be recognized in net income for the difference between the sale proceeds and the security's (amortized) cost basis. In addition, the unrealized gain or loss recorded in accumulated other comprehensive income (AOCI) is reversed on the date of the sale. This reversal should be presented as a reclassification adjustment in the statement of comprehensive income. If the entity is not taxed on a mark-to-market basis, the deferred tax accounts would also be adjusted on the date of sale.
We generally believe that an entity should record the security's change in value up to the point of sale. That is, the entity should adjust the carrying amount of the security to its fair value immediately before the sale, with a corresponding adjustment to OCI and related deferred tax amounts, if any.

### 4.3.1 Gain recognition on sales of securities with an arrangement to reacquire them

ASC 860 states that a transferor maintains effective control over the transferred assets during the period they have been sold, when there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee. As a result, when there is any contractual arrangement (including an oral agreement) between the parties to buy back the securities, the transaction should be accounted for as a financing (i.e., in substance it is a repurchase agreement). Therefore, gain recognition is inappropriate. On the other hand, wash sales would be accounted for as sales. See our FRD publication, *Transfers and Servicing of Financial Assets*, for additional guidance.

### 4.4 Sales of held-to-maturity securities

**Excerpt from Accounting Standards Codification**

**Investments – Debt and Equity Securities – Overall**

**Subsequent Measurement**

**Sales and Transfers that Taint the Entity's Held-to-Maturity Intent**

**320-10-35-8**

A sale or transfer of a security classified as held-to-maturity that occurs for a reason other than those specified in paragraphs 320-10-25-6, 320-10-25-9, and 320-10-25-14, calls into question (taints) the entity's intent about all securities that remain in the held-to-maturity category. The entity 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. Only a sale or transfer in response to certain changes in conditions will not call into question an entity's intent to hold other debt securities to maturity in the future.

**320-10-35-9**

When a sale or transfer of held-to-maturity securities 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, any remaining held-to-maturity securities shall be reclassified to available-for-sale. The reclassification shall be recorded in the reporting period in which the sale or transfer occurred and accounted for as a transfer under the following paragraph.

A sale of a security classified as held to maturity will result in a gain or loss recognized in net income. The gain or loss will be measured as the difference between the sales proceeds and the security's amortized cost.

Entities that sell or transfer held-to-maturity securities for reasons other than those that are described in section 4.4.2 may (1) need to reclassify all of their held-to-maturity securities to the available-for-sale category and (2) be restricted from classifying future purchases of investment securities as held to maturity.
4.4.1 Evaluation of the remaining portfolio following a sale or transfer

**Excerpt from Accounting Standards Codification**

| Investments – Debt and Equity Securities – Overall |
| Subsequent Measurement |
| Reassessment of Classification |
| 320-10-35-7 |

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.

An entity should document the circumstances of every sale or transfer of debt securities classified as held to maturity and consider how the rest of the held-to-maturity portfolio will be affected, regardless of whether the sale is permitted under ASC 320. For example, assume a financial institution sells securities from its held-to-maturity portfolio to meet a significant and unanticipated increase in loan demand or a commercial entity sells certain of its corporate bonds in response to the availability of a higher-grade investment with a better yield. Those reasons conflict with management’s previous intent to hold the securities to maturity and create a rebuttable presumption that the entity will not hold remaining held-to-maturity securities to maturity. The burden of proof is placed on the entity to overcome that presumption.

Even sales that the entity believes are permitted may potentially taint the remaining held-to-maturity portfolio or a portion of that portfolio. Consider the following example: Because of a change in tax law that eliminates the current exemption on income earned on certain securities, an entity sells a portion, but not all, of its holdings of that type of security. The sale raises a question about the entity’s intent to hold the remaining investments in similar securities (i.e., the remaining securities affected by the change in tax law) to maturity.

If the sale of a held-to-maturity security occurs without justification (i.e., for a reason other than those explicitly permitted in ASC 320) the materiality of that contradiction of intent must be evaluated.

**How we see it**

Entities contemplating sales of securities classified as held-to-maturity for reasons other than those permitted in ASC 320 should carefully consider the consequences (i.e., the effect on its other held-to-maturity securities and on future transactions).

Once an entity has “tainted” its held-to-maturity classification, it can’t assert that it has the intent and ability to hold any newly acquired debt securities to maturity until circumstances change so management can make that assertion with a greater degree of credibility. ASC 320 does not prescribe a minimum time frame or criteria for determining when those circumstances have changed. Instead, ASC 320 requires judgment be applied to such situations.

**4.4.1.1 SEC staff views on sales or transfers of held-to-maturity securities**

The SEC staff strictly interprets ASC 320’s requirements for held-to-maturity securities. Any sales or transfers of securities from the held-to-maturity portfolio, other than in the limited circumstances described in section 4.4.2, will lead to a presumption by the SEC staff that the entire portfolio of held-to-maturity securities should be reevaluated for reclassification to the available-for-sale or trading portfolios. Although that presumption may be overcome in rare situations, each additional sale or transfer from the held-to-maturity portfolio will serve to strengthen the presumption that the entire portfolio should be reclassified.
The FASB indicated in the basis for conclusions that “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.” As a result, the SEC staff has said sales of held-to-maturity securities for reasons other than those described in ASC 320-10-25-6 will result in the staff’s challenge of management’s:

- Previous assertions regarding the classification of these securities
- Assertions regarding the classification of other held-to-maturity securities
- Future assertions regarding the classification of securities as held to maturity for an extended time after the sale

In certain cases, the SEC staff has concluded that an entity is precluded from classifying securities as held to maturity for up to two years until the entity re-establishes the credibility of its classification policy.14

The SEC staff also has indicated that segregation (compartmentalization) of securities for purposes of analyzing the effect of sales or transfers of held-to-maturity securities is not acceptable.15 For example, entities should not separate US Treasury securities from corporate bonds in the held-to-maturity category for purposes of evaluating management’s assertions about the intent to hold US Treasury securities to maturity. The entire held-to-maturity security portfolio would be considered tainted if any prohibited sales or transfers occur.

### 4.4.2 Permitted sales or transfers

ASC 320 provides six exceptions to the rule that held-to-maturity securities should not be sold or transferred to other classifications. Other situations should not be analogized to these exceptions.

**Excerpt from Accounting Standards Codification**

**Investments – Debt and Equity Securities – Overall**

**Recognition**

**Circumstances Consistent with Held-to-Maturity Classification**

**320-10-25-6**

The following changes in circumstances may cause the entity 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. The sale or transfer of a held-to-maturity security due to one of the following changes in circumstances shall not be considered inconsistent with its original classification:

- Evidence of a significant deterioration in the issuer’s creditworthiness (for example, a downgrading of an issuer's published credit rating)
- 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)
- 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 entity’s existing interest rate risk position or credit risk policy

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14 Speech by SEC staff (Tracey C. Barber), Remarks before the Twenty-Second Annual National Conference on Current SEC Developments, 10 January 1995.

15 Speech by SEC staff (Tracey C. Barber), Remarks before the Twenty-Second Annual National Conference on Current SEC Developments, 10 January 1995.
4.4.2.1 Credit deterioration

ASC 320-10-25-6(a) allows an entity to sell a security classified as held to maturity prior to its scheduled maturity date in the event of a significant deterioration in the issuer's creditworthiness. ASC 320 does not define what constitutes a significant deterioration. Significance should be measured in relation to the individual security rather than in relation to the security portfolio or the entity's financial position. We believe an entity may conclude that a significant deterioration has occurred when it is reasonably possible that all amounts due will not be collected.

Although entities are not restricted from making prudent investment decisions, basing a sale on speculation of deterioration would not be consistent with the held-to-maturity concept. Evidence of credit deterioration might include published sources such as reports of a downgrade in the investment rating by rating agencies (e.g., Standard & Poor’s, Moody’s). In addition, ASC 320-10-25-5(d) allows an entity to sell a held-to-maturity security prior to a downgrade in the issuer’s published credit rating or inclusion on a “credit watch” list provided that the sale is in response to an actual deterioration of the issuer’s creditworthiness.

The evidence of credit deterioration could also consist of the entity’s internal credit evaluation that documents factors such as the following:

- Issuer’s historical financial performance
- Forecasts for the issuer’s industry
- A continued decline in the security’s market value that is not consistent with the decline in the market value of similar securities
- An indication that the issuer may file for protection under federal bankruptcy laws

If the evidence supporting the deterioration of an issuer’s creditworthiness is primarily a continued decline in the security’s fair value, the entity should consider whether the security has been other-than-temporarily impaired as discussed in section 5, Impairment.

The assessment of the deterioration of the issuer’s creditworthiness of purchased securities should be based on the credit quality on the date of purchase, not the credit deterioration since the date of issuance. For example, an entity would not be able to sell a purchased credit impaired held-to-maturity security without calling into question management’s intent to hold the remaining portfolio to maturity unless the security experienced additional credit deterioration after the holder’s acquisition date.

The determination that significant deterioration has occurred will require an evaluation of the facts and circumstances regarding the entity’s ability to recover all amounts due under the terms of the security.

The SEC staff has not objected to sales or transfers of held-to-maturity securities based on concerns about the issuer’s creditworthiness when entities develop and apply policies and procedures for documenting their basis for determining significant deterioration of an issuer’s creditworthiness. The SEC staff believes that an entity’s creditworthiness evaluation process must involve its accounting personnel.
4.4.2.2 Change in tax law

The attractiveness of certain debt securities to investors is directly related to the tax treatment of the securities. This aspect of the security is so significant that there could be a justifiable change in management's intent to hold the security to maturity if a change in tax law affects that type of debt security (e.g., if the US Congress repealed the current law making certain small issue state and municipal bonds “bank eligible”). However, this provision was not intended to cover sales or transfers of securities in response to broader changes in the tax law that revise the marginal tax rate applicable to interest income, such as an increase or decrease in the federal income tax rate.

4.4.2.3 Major business combination or disposition

Generally, sales or transfers of debt securities that occur concurrent with or shortly after a major business combination or disposition and are intended to maintain the entity's existing risk exposure would not call into question management's intent to hold the remaining held-to-maturity portfolio to maturity. However, this provision applies only if the business combination or disposition is “major,” and the securities held prior to the business combination or that remain after a disposition are not consistent with the entity's existing credit risk policy or interest rate risk position. While ASC 320 does not define a “major” business combination or disposition, we generally believe that such an event must be significant enough to warrant disclosure in the financial statements under US GAAP or SEC requirements.

It is important to emphasize that sales of held-to-maturity securities are permitted 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 are inconsistent with a stated positive intent and ability to hold securities to maturity.

The exception provided in ASC 320-10-25-6(c) does not apply to sales of held-to-maturity securities in anticipation of a major business combination or disposition, and such sales would taint the entity's other securities classified as held-to-maturity. Although the sale of a component of an entity is an example of a major disposition, a purchase or sale of a large pool of financial assets (e.g., conforming mortgages) or liabilities (e.g., deposit liabilities) would not be considered a major business combination or disposition that would justify the sale of held-to-maturity securities.

An entity that consummates a business combination and plans to transfer or sell securities to maintain its risk profile should evaluate the classification of held-to-maturity securities concurrent with or shortly after a major business combination or disposition. The term “shortly” is not defined in ASC 320; however, as time passes, it is increasingly difficult to demonstrate that the business combination or disposition necessitated the transfer or sale rather than other events or circumstances.

ASC 320 does not distinguish between sales of securities obtained in a business combination and those held prior to the business combination. We understand from discussion with the FASB staff that securities obtained in a business combination should be classified based on the intent and ability of the acquiring entity. Accordingly, the sale or transfer of a security previously classified by the acquired entity as held to maturity would not taint the held-to-maturity portfolio of the acquiring entity. However, the acquiring entity will need to demonstrate that any sales of its held-to-maturity securities owned prior to a business combination are no longer within the entity's existing credit and interest rate risk policy.

Management must evaluate the facts and circumstances to determine whether the securities held prior to a business combination or that remain following a disposition are consistent with the entity's existing credit or interest rate risk policy. The following examples illustrate the thought process (which should be documented) that management should go through following a major business combination or disposition.
Illustration 4-1:  Sales or transfers of held-to-maturity securities after a business combination

Example 1
Company A acquires Company B. Company A has an existing policy (formal or informal) of not issuing any variable-rate debt that would expose it to interest rate risk. If Company A sells certain of its held-to-maturity securities to provide funds to extinguish the outstanding variable-rate long-term debt of Company B, the sale would not bring into question Company A’s intent to hold its remaining portfolio to maturity.

Example 2
Assume the same facts as in Example 1, except that Company A sells certain of its securities classified as held to maturity to provide funds to extinguish outstanding fixed-rate long-term debt of Company B. Because the fixed-rate debt does not appear to be inconsistent with Company A’s existing credit or interest rate exposure policies, the sale could taint the remaining held-to-maturity portfolio of the combined company.

Example 3
Company C, a multi-line insurance company, disposes of its individual annuity business. Included in its held-to-maturity investment portfolio is a block of securities purchased with the intent of matching the interest rate risk associated with the annuity contracts outstanding. If, shortly after the disposition of the annuities, Company C sells those designated securities that are not transferred to the company that acquired the annuities, the sale generally would not call into question Company C’s intent to hold the remaining portfolio to maturity.

4.4.2.4 Change in statutory or regulatory requirements regarding permissible investments

If an institution is required to dispose of held-to-maturity securities because of a significant change in regulatory requirements for debt security holdings (i.e., permissible investments or concentration limits on investments), that disposition would not call into question management’s intent to hold the remaining securities in that category to maturity. The change in regulations must apply to all entities affected by the legislation or regulatory action.

If a regulator directs a particular institution (rather than all institutions supervised by that regulator) to sell or transfer held-to-maturity securities to increase liquid assets (or for similar purposes), that institution would generally not be relieved of the presumption that all of its held-to-maturity securities are tainted unless the event precipitating the regulatory requirement was “isolated, nonrecurring, and unusual that could not have been reasonably anticipated,” as discussed in section 4.4.2.6.

It should also be noted that regulatory capital requirements exist concerning recourse, direct credit substitutes and residual interests in asset securitizations. Entities should consider any impact these regulations may have on their investment classification or other investment decisions.

4.4.2.5 Significant change in regulatory capital requirements

In the early 1990s, the banking industry’s capital requirements changed dramatically as a result of the passage of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). These Acts required institutions to adopt capital adequacy measures that established risk distinctions among various types of investments (specifically loans and securities), which substantially changed the ground rules by which depository institutions operated.
Clearly, FIRREA and FDICIA were major banking regulations that significantly increased the industry’s capital requirements. Changes like these (i.e., significant industry-wide changes as opposed to a regulatory order for a particular institution to increase its capital base) are what the FASB considered when it provided the two “change in circumstances” provisions related to regulatory capital requirements. These provisions stipulated that if an institution disposed of held-to-maturity securities in response to significant increases in capital requirements, such sales would not call into question the classification of the institution’s remaining held-to-maturity securities. On the other hand, sales of held-to-maturity securities to replenish capital to meet existing or increased regulatory requirements imposed on an individual institution would not be consistent with the held-to-maturity concept.

4.4.2.6 Isolated, nonrecurring and unusual events

Excerpt from Accounting Standards Codification

<table>
<thead>
<tr>
<th>Investments – Debt and Equity Securities – Overall</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recognition</td>
</tr>
<tr>
<td>Circumstances Consistent with Held-to-Maturity Classification</td>
</tr>
</tbody>
</table>

320-10-25-9

In addition to the changes in circumstances listed in paragraph 320-10-25-6(a) through (f), certain other events may cause the entity to sell or transfer a held-to-maturity security without necessarily calling into question (tainting) its intent to hold other debt securities to maturity. Such events must meet all of the following four conditions to avoid tainting its intent to hold other debt securities to maturity in the future:

a. The event is isolated.

b. The event is nonrecurring.

c. The event is unusual for the reporting entity.

d. The event could not have been reasonably anticipated.

In addition to the six exceptions described above, ASC 320 includes a general provision that exempts sales or transfers resulting from other events that are isolated, nonrecurring and unusual for the reporting entity that could not have been reasonably anticipated. Other than remote disaster scenarios (such as a run on a bank or an insurance entity), very few events would meet all of those conditions.

4.4.2.6.1 Tender offers for held-to-maturity securities

A tender offer is an offer generally made to all holders of a particular class of security of a company by the issuer or another bidder. This offer is often subject to the tendering of a minimum or maximum number of securities, but it is still an offer to buy at a specific price or premium.

ASC 320-10-25-13(d) states that a sale of held-to-maturity securities in response to an unsolicited tender offer from the issuer is not an event that is isolated, nonrecurring and unusual, and therefore this type of sale would taint the classification of the remaining held-to-maturity securities. This would also be true if a third party initiates the tender offer. However, if the holder is forced to sell the security in a tender offer, then the sale of the security would not call into question the entity’s intent to hold remaining securities to maturity.
Sales deemed to be at maturity

Excerpt from Accounting Standards Codification
Investments – Debt and Equity Securities – Overall

Recognition
Sale After a Substantial Portion of Principal Is Collected
320-10-25-14
Sales of debt securities that meet either of the following conditions may be considered as maturities for purposes of the classification of securities and the disclosure requirements under this Subtopic:

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 entity 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.

Some entities routinely dispose of (1) debt securities shortly before maturity and (2) mortgage-backed securities after a substantial portion of the principal has been recovered through collections and prepayments. Such sales prior to maturity could have resulted in the tainting of the remaining held-to-maturity portfolio even though the security was held substantially to maturity. Accordingly, the FASB concluded for practical reasons that selling a debt security prior to maturity should be considered equivalent to holding the security to maturity if one of the two conditions described in ASC 320-10-25-14 (see above) is met.

Determining the point at which a security is near enough to maturity that changes in interest rates would not significantly affect its fair value largely depends on the type of security. To promote the consistent application of this provision, the FASB added an example time frame of three months. While the three-month guideline is provided only as an example, it is generally considered reasonable. Because the security is close to the maturity or call date, the carrying value in most cases (i.e., in a functioning market) should approximate the fair value, which would not be significantly affected by changes in the market interest rate. Therefore, any realized gains or losses generally would not be significant.

How we see it

Entities that sell securities with more than three months to maturity may have difficulty supporting the assertion that the securities were in substance held to maturity, unless they meet the other allowable exception discussed below.

ASC 320 defines a substantial portion of collection as at least 85% of the principal outstanding at acquisition (not the principal outstanding at issuance for securities purchased in the secondary market) from either scheduled payments or unscheduled prepayments. This provision was included principally to address the sale of the tail portion of mortgage-backed securities.

The limited practical exception in ASC 320-10-25-14(b) applies to debt securities that are payable in equal installments that comprise both principal and interest such as 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 and to securities with changes in scheduled payments that result from unscheduled prepayments.
It is not appropriate to apply this 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. Accordingly, the exception does not apply to investments in collateralized mortgage obligation or real estate mortgage investment conduit tranches or similar securities that do not receive scheduled payments in equal installments.

4.4.4 Secured borrowings

If a transfer of a held-to-maturity debt security is accounted for as a sale under ASC 860-20 and it is transferred for a reason other than those specified in the exceptions above, the transfer would taint the held-to-maturity portfolio.

Transactions involving held-to-maturity securities that are not accounted for as sales under ASC 860-20 (i.e., those accounted for as secured borrowings) would not contradict an entity's stated intent to hold a security to maturity and, therefore, would not call into question the entity's intent to hold other debt securities to maturity.

Held-to-maturity securities pledged as collateral or subject to repurchase or securities lending agreements accounted for as secured borrowings would not call into question the entity's intent as long as the entity intends and expects to be able to satisfy the obligation without surrendering the security.

Beneficial interests classified as held to maturity that are desecuritized in a transaction that is not accounted for as a sale would also not call into question the entity's intent if the financial assets received in or that continue to be held after the desecuritization are held to maturity. Unless the debt instrument received or retained as a result of the transaction is held to maturity, the transaction would call into question the entity's intent to hold other debt securities to maturity.

Additional guidance related to ASC 860 can be found in our FRD publication, Transfers and servicing of financial assets.

4.5 Disclosure requirements for sales of securities

<table>
<thead>
<tr>
<th>Excerpt from Accounting Standards Codification</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investments – Debt and Equity Securities – Overall</td>
</tr>
<tr>
<td>Disclosure</td>
</tr>
<tr>
<td>Sales, Transfers, and Related Matters that Occurred During the Period</td>
</tr>
<tr>
<td>320-10-50-9</td>
</tr>
<tr>
<td>For each period for which the results of operations are presented, an entity shall disclose all of the following:</td>
</tr>
<tr>
<td>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</td>
</tr>
<tr>
<td>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)</td>
</tr>
<tr>
<td>c. The gross gains and gross losses included in earnings from transfers of securities from the available-for-sale category into the trading category</td>
</tr>
</tbody>
</table>
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.

**320-10-50-10**

For any sales of or transfers from securities classified as held-to-maturity, an entity shall disclose all of the following in the notes to the financial statements for each period for which the results of operations are presented:

a. The net carrying amount of the sold or transferred security

b. The net gain or loss in accumulated other comprehensive income for any derivative that hedged the forecasted acquisition of the held-to-maturity security

c. The related realized or unrealized gain or loss

d. The circumstances leading to the decision to sell or transfer the security. (Such sales or transfers should be rare, except for sales and transfers due to the changes in circumstances identified in paragraph 320-10-25-6(a) through (f).)

All of the disclosures for held-to-maturity securities are required, even if the sales and/or transfers were made within the permitted circumstances. The SEC staff believes that it is especially important to disclose, in reasonably specific terms, the reasons for any sales or transfers of held-to-maturity securities.

The requirements for held-to-maturity securities are potentially burdensome because they require disclosure for each sale or transfer, regardless of the reasons for the transaction(s). The disclosure requirements again illustrate the FASB’s belief that sales or transfers of held-to-maturity securities should be rare. If an entity should decide not to disclose a sale or transfer of a security from the held-to-maturity portfolio because of materiality considerations (e.g., the effect is de minimis), it is not relieved of the requirement to evaluate whether such a sale or transfer taints the remaining portfolio.
5 Impairment

5.1 Overview and scope

Excerpt from Accounting Standards Codification

Investments — Debt and Equity Securities — Overall
Subsequent Measurement
Steps for Identifying and Accounting for Impairment
320-10-35-18

For individual securities classified as either available for sale or held to maturity, an entity shall determine whether a decline in fair value below the amortized cost basis is other than temporary. Providing a general allowance for unidentified impairment in a portfolio of securities is not appropriate.

ASC 320 requires investors to determine whether declines in the fair value below the cost basis (i.e., impairments) of debt and equity securities classified as either available for sale or held to maturity are other than temporary. There is no need to assess trading securities for other-than-temporary impairment as all changes in fair value related to those securities are recorded directly in net income each period. ASC 320 also provides guidance for the accounting subsequent to the recognition of an OTTI and requires certain disclosures about unrealized losses that have not been recognized as an OTTI. This publication does not address matters related to determining fair value. Additional information related to determining fair value may be found in our FRD publication, Fair value measurement.

The impairment guidance in ASC 320 applies to the following instruments:

- Debt and equity securities within the scope of ASC 320
- Bifurcated host instruments pursuant to ASC 815-15, as long as the host instrument is within the scope of ASC 320
- All equity securities held by insurance entities, even if the equity securities are not within the scope of ASC 320
- Debt and equity securities that are within the scope of ASC 958-320 (i.e., not-for-profit entities) and held by an entity that reports a performance indicator pursuant to ASC 954-220-45-4 to -7
- Cost method investments

Entities should not look through the form of an investment to the nature of the securities held by an underlying investment vehicle. For example, an investment in shares of a mutual fund that invests primarily in debt securities should be assessed for impairment as an equity security.

The determination of whether an other-than-temporary decline in value exists requires considerable judgment and monitoring to comply with the requirements of ASC 320 and related literature. ASC 320 does not provide “bright lines” or “safe harbors” to identify securities that may have an OTTI. Rather, an entity should consider all relevant evidence when determining whether a security has been other-than-temporarily impaired.

ASC 320 outlines a three-step approach for identifying and accounting for an OTTI for individual securities classified as either available for sale or held to maturity. The three-step approach includes:

- Determining when an investment is considered impaired (Step 1)
- Evaluating whether an impairment is other than temporary (Step 2)
- Measuring and recognizing an OTTI (Step 3)
Step 1 is the same for both marketable equity and debt securities – that is, an investment is impaired if its fair value is less than its (amortized) cost. However, differences exist in how an entity evaluates whether an impairment is other than temporary (Step 2) and how to recognize an OTTI (Step 3) for debt and equity securities.

5.1.1 **General valuation allowances**  
The OTTI assessment should be performed at the individual security level, even if the securities are managed at a portfolio level. General valuation allowances to provide for impairment losses not attributable to specific securities in a securities portfolio are not permitted.

5.2 **Debt securities**  
5.2.1 **Overview**  
Below are decision trees that illustrate how the OTTI model for debt securities classified as available for sale and held to maturity. The sections that follow these decision trees provide additional guidance and considerations.

<table>
<thead>
<tr>
<th>Illustration 5-1: OTTI decision tree for available-for-sale debt securities</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Is the fair value less than cost?</strong></td>
</tr>
<tr>
<td><strong>No</strong></td>
</tr>
<tr>
<td><strong>No impairment</strong></td>
</tr>
<tr>
<td><strong>Investor will continue to recognize unrealized gain in OCI</strong></td>
</tr>
<tr>
<td><strong>Yes</strong></td>
</tr>
<tr>
<td><strong>Recognize OTTI</strong></td>
</tr>
<tr>
<td><strong>Impairment loss must be recognized in current earnings equal to the difference between amortized cost and fair value</strong></td>
</tr>
<tr>
<td><strong>Does the investor intend to sell?</strong></td>
</tr>
<tr>
<td><strong>Yes</strong></td>
</tr>
<tr>
<td><strong>Recognize OTTI</strong></td>
</tr>
<tr>
<td><strong>Credit loss recognized in current earnings</strong></td>
</tr>
<tr>
<td><strong>No</strong></td>
</tr>
<tr>
<td><strong>Recognize OTTI</strong></td>
</tr>
<tr>
<td><strong>Portion of loss related to other factors will continue to be recognized in OCI</strong></td>
</tr>
<tr>
<td><strong>Does the investor expect to recover the entire cost basis?</strong></td>
</tr>
<tr>
<td><strong>Yes</strong></td>
</tr>
<tr>
<td><strong>No OTTI</strong></td>
</tr>
<tr>
<td><strong>Investor will continue to recognize unrealized loss in OCI</strong></td>
</tr>
<tr>
<td><strong>No</strong></td>
</tr>
<tr>
<td><strong>Recognize OTTI</strong></td>
</tr>
</tbody>
</table>

**Financial reporting developments Certain investments in debt and equity securities (before the adoption of ASU 2016-01) | 55**
5.2.2 Determining whether a debt security is impaired

An individual debt security is impaired when the fair value of the investment is less than its cost. An entity should assess whether an impaired debt security is other-than-temporarily impaired at every reporting period (i.e., quarterly for public companies).

Investments in the same instrument, even if purchased on different dates, may be aggregated for evaluating impairment if the entity aggregates the securities for purposes of measuring realized and unrealized gains and losses. For example, debt securities with the same CUSIP number that were purchased on separate dates may be aggregated by an entity on an average cost basis if that is the basis the entity uses to measure realized and unrealized gains and losses on the securities.

Debt securities should not be combined with separate contracts (e.g., guarantees, other credit enhancements) that are not embedded in the security when evaluating impairment.

5.2.3 Evaluating whether an impairment is other than temporary

Excerpt from Accounting Standards Codification

<table>
<thead>
<tr>
<th>Investments – Debt and Equity Securities – Overall</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subsequent Measurement</td>
</tr>
</tbody>
</table>

Step 2: Evaluate Whether an Impairment Is Other Than Temporary

320-10-35-30

If the fair value of an investment is less than its amortized cost basis at the balance sheet date of the reporting period for which impairment is assessed, the impairment is either temporary or other than temporary. In addition to the guidance in this Section, an entity shall apply other guidance that is pertinent to the determination of whether an impairment is other than temporary, such as the guidance in Sections 323-10-35 and 325-40-35, as applicable. Other than temporary does not mean permanent.
### Debt Securities

**320-10-35-33A**
If an entity intends to sell the debt security (that is, it has decided to sell the security), an other-than-temporary impairment shall be considered to have occurred.

**320-10-35-33B**
If an entity does not intend to sell the debt security, the entity shall consider available evidence to assess whether it more likely than not will be required to sell the security before the recovery of its amortized cost basis (for example, whether its cash or working capital requirements or contractual or regulatory obligations indicate that the security will be required to be sold before a forecasted recovery occurs). If the entity more likely than not will be required to sell the security before recovery of its amortized cost basis, an other-than-temporary impairment shall be considered to have occurred.

**320-10-35-33C**
If an entity does not expect to recover the entire amortized cost basis of the security, the entity would be unable to assert that it will recover its amortized cost basis even if it does not intend to sell the security. Therefore, in those situations, an other-than-temporary impairment shall be considered to have occurred. In assessing whether the entire amortized cost basis of the security will be recovered, an entity shall compare the present value of cash flows expected to be collected from the security with the amortized cost basis of the security. If the present value of cash flows expected to be collected is less than the amortized cost basis of the security, the entire amortized cost basis of the security will not be recovered (that is, a credit loss exists), and an other-than-temporary impairment shall be considered to have occurred.

Under ASC 320, an impaired debt security will be considered other-than-temporarily impaired if any of the following criteria are met:

<table>
<thead>
<tr>
<th>Criterion</th>
<th>Impairment accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td>The holder has the intention to sell the impaired debt security</td>
<td>Impairment loss must be recognized in net income in an amount that is equal to the difference between amortized cost and fair value</td>
</tr>
<tr>
<td>It is more likely than not the holder will be required to sell the impaired debt security before recovery</td>
<td>Impairment loss must be recognized in net income at an amount that is equal to the difference between amortized cost and fair value</td>
</tr>
</tbody>
</table>
| The holder does not expect to recover the entire amortized cost basis of the security – even if it does not intend to sell the security\(^\text{16}\) | Impairment loss is recognized as follows:  
\(\text{• Credit loss recognized in current net income}\)  
\(\text{• Portion of loss related to other factors will continue to be recognized in OCI}\) |

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\(^{16}\) This criterion only applies when the holder does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery.
5.2.3.1 Entity intends to sell the debt security

**Excerpt from Accounting Standards Codification**

<table>
<thead>
<tr>
<th>Investments – Debt and Equity Securities – Overall</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Subsequent Measurement</strong></td>
</tr>
<tr>
<td><strong>Recognition of an Other-Than-Temporary Impairment</strong></td>
</tr>
</tbody>
</table>

**Debt Securities: Determination of the Amount of an Other-Than-Temporary Impairment Recognized in Earnings and Other Comprehensive Income**

320-10-35-34A

If an other-than-temporary impairment has occurred, the amount of the other-than-temporary impairment recognized in earnings depends on whether an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss.

320-10-35-34B

If an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment shall be recognized in earnings equal to the entire difference between the investment’s amortized cost basis and its fair value at the balance sheet date. In assessing whether the entity more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit losses, the entity shall consider the factors in paragraph 320-10-35-33F.

An impairment is considered other than temporary if the entity has decided to sell the debt security. In these situations, an impairment loss must be recognized in net income in an amount that is equal to the difference between amortized cost and fair value.

An intent to sell in the future does not result in an OTTI. That is, an investor is not required to look into the future to identify scenarios in which it might sell the debt security (e.g., when the debt security recovers 80% or 90% of its cost basis) and assess the likelihood of the events occurring. All that is required is that an investor determines whether it has made a decision to sell the impaired debt security as of the balance sheet date.

**How we see it**

ASC 320 is explicit that the phrase “intends to sell the debt security” means a decision has been made to sell the debt security. While ASC 320 does not provide guidance on what constitutes a decision to sell, it is clear that it is more than a decision not to hold. We generally believe a sale of a security with a readily determinable fair value should occur shortly following a decision to sell to be consistent with the guidance in ASC 320. For example, for actively traded stocks and bonds, the decision date may be the same day or within a few days of the trade date.

For debt securities that lack a readily determinable fair value, and that are not actively traded in a secondary market, the period of time between a decision to sell and an actual sale may be measured in weeks or months rather than minutes or days. The difference may reflect the time necessary to organize a private sale or auction, but the decision to sell must be final. For example, a decision to sell that is predicated on the seller’s ability to realize a sales price that is the same or substantially the same as its estimate of fair value generally would not be consistent with a decision to sell as intended in ASC 320.
5.2.3.1.1  
**Sales after the balance sheet date**

In order for an impairment to be considered temporary, management must assert that it does not intend to sell and it is not more likely than not that it will be required to sell prior to recovery of the debt security's amortized cost basis. Subsequent sales of a debt security\(^{17}\) at a loss may call into question management's assertion on other debt securities that are in an unrealized loss position or for which an OTTI was recognized and only the amount related to a credit loss was recognized in earnings.

Whether a subsequent sale at a loss calls into question management's assertion will depend on the facts and circumstances surrounding those subsequent sales. An entity's intention to sell or hold a debt security may change over time as may the likelihood of whether an entity will be required to sell a debt security before recovery of its amortized cost basis. By setting the threshold at “intends to sell” and “more likely than not the entity will be required to sell,” we believe the FASB intends for OTTI losses to be recognized only when those thresholds are attained or the present value of the cash flows expected to be collected is less than amortized cost. When evaluating subsequent sales at a loss to determine whether those sales affect management’s assertion at the balance sheet date, it is important to consider facts and circumstances of the sale in order to make a judgment about (1) what period the decision to sell was made or (2) whether the entity was required to sell and the period in which it became more likely than not that the entity would be required to sell.

Even though management asserted it was not more likely than not that it would be required to sell a debt security as of the balance sheet date, the fact that it subsequently sold the debt security does not necessarily call into question management’s assertion. For example, the sale might not have been executed in response to a requirement to sell. We believe a subsequent sale in these circumstances will only call management’s assertion into question when it can be demonstrated that the circumstances around the subsequent sale were specifically considered by management that incorrectly concluded that the likelihood of being required to sell in such circumstances was not more likely than not.

For sales at a loss shortly after the balance sheet date, entities should document when the decision to sell was made and by whom. In documenting this decision, the entity should also describe the factors that drove the decision to sell and when the entity became aware of those factors, although we believe that the date of the decision generally will determine the date of the OTTI. That documentation should also indicate the debt securities that are available to be sold in response to a requirement to sell. If any of the debt securities identified are currently impaired, an OTTI is deemed to exist and the OTTI should be recognized in net income at an amount that is equal to the entire difference between the debt security’s amortized cost basis and its fair value.

5.2.3.1.2  
**Third-party management of investment portfolio**

An entity may have engaged a third party to actively manage its investment portfolio. In these cases, a question arises as to whether an entity can assert that it has no intention to sell (i.e., that no decision to sell has been made) or that it will not be more likely than not required to sell impaired debt securities. The mere existence of an outsourced portfolio management arrangement does not indicate whether the entity intends to sell or whether it is more likely than not it will be required to sell the impaired debt security before its anticipated recovery. We generally believe that it may be possible for an entity to assert that it does not intend to sell or it will not be more likely than not required to sell impaired debt securities in those circumstances.

With this in mind, the consideration of whether there is an intention to sell or the entity more likely than not will be required to sell should be the same for assets managed internally as for assets managed by a third party. An entity will need to have processes in place to determine whether the third-party manager has made a decision at the balance sheet date to sell any debt securities it manages. In addition, while

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\(^{17}\) If the debt security is held-to-maturity, refer also to section 4.4, *Sales of held-to-maturity securities*, for further considerations.
the third-party manager may sell an impaired debt security, the sale might not be due to a circumstance that existed at the date of the previous assertion that would have “required” the debt security to be sold. In any event, an entity needs to carefully evaluate the facts and circumstances that may cause the entity to be required to sell a debt security and document whether it is more likely than not such a sale will be required. That documentation should indicate the debt securities that are available to be sold in order to meet any “requirement.” If any of the debt securities identified (both those managed internally and those managed by third-party managers) are currently impaired, an OTTI is deemed to exist and the OTTI should be recognized in net income at an amount that is equal to the entire difference between the debt security’s amortized cost basis and its fair value.

5.2.3.1.3 Securities classified as held to maturity

If a debt security is classified as held to maturity, an entity has asserted that is has the positive intent and ability to hold the debt security until maturity. Therefore, we would expect that the debt security would be considered other-than-temporarily impaired only when a credit loss exists. If an entity were to recognize an OTTI loss for a held-to-maturity debt security because it intends to sell or because it is more likely than not it will be required to sell, this would contradict management’s assertion that it will hold the debt security to maturity. Unless the circumstances regarding such intended or required sales are consistent with the circumstances described in ASC 320-10-25-6, ASC 320-10-25-9 and ASC 320-10-25-14, such a change in intent may call into question the entity’s intent to hold other debt securities to maturity.

5.2.3.2 More likely than not the entity will be required to sell prior to recovery of cost basis

An entity should estimate the period over which the security is expected to recover and whether its cash or working capital requirements and contractual or regulatory obligations may indicate that the security may need to be sold before the forecasted recovery occurs. If the entity more likely than not will be required to sell the security before recovery of its cost basis, an OTTI exists. In these situations, an impairment loss must be recognized in net income at an amount that is equal to the difference between amortized cost and fair value.

Determining whether it is more likely than not that an entity will be required to sell a debt security before recovery of its amortized cost basis is a matter of judgment, which needs to consider all facts and circumstances including the entity’s legal and contractual obligations and operational, regulatory and liquidity needs.

5.2.3.3 Entity does not expect to recover the entire amortized cost basis

Excerpt from Accounting Standards Codification
In the event of an Other-Than-Temporary Impairment, the entity shall separate the amount of the impairment recognized in earnings from the amount recognized in other comprehensive income as follows:

- **Debt Securities: Determination of the Amount of an Other-Than-Temporary Impairment Recognized in Earnings and Other Comprehensive Income**

**320-10-35-34C**

If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment shall be separated into both of the following:

a. The amount representing the credit loss
b. The amount related to all other factors.
The amount of the total other-than-temporary impairment related to the credit loss shall be recognized in earnings. The amount of the total other-than-temporary impairment related to other factors shall be recognized in other comprehensive income, net of applicable taxes.

If an entity has not made a decision to sell the security and it is not more likely than not the entity will be required to sell the security prior to recovery of its cost basis, the entity should assess whether it expects to recover the entire amortized cost basis of the security, even if it does not intend to sell the security. An entity should determine whether the entire amortized cost basis of the security will be recovered by comparing the present value of cash flows expected to be collected to the amortized cost basis of the debt security. If the present value of the cash flows expected to be collected is less than the amortized cost basis of the security, a credit loss exists and consequently, an OTTI is considered to have occurred. In these situations, the difference between the OTTI is recognized as follows:

- The credit loss is recognized in net income (refer to section 5.2.4 for guidance on measuring the credit loss)
- The portion of loss related to other factors will continue to be recognized in OCI

To determine whether a credit loss exists, an entity should use its best estimate of the present value of cash flows expected to be collected from the debt security, among other factors. See section 5.2.4.1 for a discussion of calculating the best estimate of the present value of cash flows expected to be collected from the debt security.

ASC 320 enumerates several factors an investor may consider to determine whether a credit loss exists and the period over which the security is expected to recover.

**Excerpt from Accounting Standards Codification**

**Investments — Debt and Equity Securities — Overall**

**Subsequent Measurement**

**Step 2: Evaluate Whether an Impairment Is Other Than Temporary**

**Debt Securities**

**320-10-35-33F**

There are numerous factors to be considered when estimating whether a credit loss exists and the period over which the debt security is expected to recover. The following list is not meant to be all inclusive. All of the following factors shall be considered:

a. The length of time and the extent to which the fair value has been less than the amortized cost basis
b. Adverse conditions specifically related to the security, an industry, or geographic area; for example, changes in the financial condition of the issuer of the security, or in the case of an asset-backed debt security, changes in the financial condition of the underlying loan obligors. Examples of those changes include any of the following:
   1. Changes in technology
   2. The discontinuance of a segment of the business that may affect the future earnings potential of the issuer or underlying loan obligors of the security
   3. Changes in the quality of the credit enhancement.
c. The historical and implied volatility of the fair value of the security

d. The payment structure of the debt security (for example, nontraditional loan terms as described in paragraphs 825-10-55-1 through 55-2 and 310-10-50-25) and the likelihood of the issuer being able to make payments that increase in the future

e. Failure of the issuer of the security to make scheduled interest or principal payments

f. Any changes to the rating of the security by a rating agency

g. Recoveries or additional declines in fair value after the balance sheet date.

320-10-35-33G

In making its other-than-temporary impairment assessment, an entity shall consider all available information relevant to the collectibility of the security, including information about past events, current conditions, and reasonable and supportable forecasts, when developing the estimate of cash flows expected to be collected. That information shall include all of the following:

a. The remaining payment terms of the security

b. Prepayment speeds

c. The financial condition of the issuer(s)

d. Expected defaults

e. The value of any underlying collateral.

Entities should consider all available data points in documenting their analysis, including industry analysis, credit ratings and other relevant market data. An entity is required to consider how other credit enhancements that are not separate contracts affect the expected performance of the security, including consideration of the current financial condition of the guarantor of a security and/or whether any subordinated interests are capable of absorbing estimated losses on the loans underlying the security.

An entity should also consider how the value of any collateral would affect the expected performance of the security. If the fair value of the collateral has declined, an entity should determine whether that decline will affect its ability to collect future cash flows.

5.2.3.3.1 Need for detailed cash flow analysis each report date

ASC 320 requires an entity to determine whether it expects to recover the entire amortized cost basis of the impaired debt security — that is, whether the present value of the cash flows expected to be collected is less than the amortized cost of the impaired debt security. Based on an evaluation of the qualitative factors discussed above, an entity may determine it will recover the entire amortized cost basis of the impaired debt security and that a credit loss does not exist without performing a detailed cash flow analysis each report date. However, ASC 325-40 requires a holder of in-scope debt securities to periodically update (e.g., at least quarterly for public entities) its estimate of cash flows to be collected over the life of the debt security for the purpose of interest income recognition and determining OTTI.

An entity should consider all available information relevant to the collectibility of the cash flows of a debt security, including information about past events, current conditions and reasonable and supportable forecasts. If an entity's qualitative assessment suggests a credit loss may exist, the entity would be required to perform a detailed cash flow analysis to determine whether a credit loss exists and, if so, how to measure such a credit loss.
5.2.4  Measuring and recognizing an OTTI

In instances when an entity intends to sell an impaired debt security or it is more likely than not that the registrant will be required to sell prior to recovery of its amortized cost basis, an OTTI loss should be recognized in earnings equal to the difference between the debt security’s amortized cost basis and its fair value at the balance sheet date.

When an entity does not intend to sell an impaired debt security and it is not more likely than not that it will be required to sell the security prior to recovery of the amortized cost basis, the OTTI amount representing the credit loss is recognized in net income while the amount related to all other factors is recognized in OCI, net of applicable taxes. This is the case for both available-for-sale and held-to-maturity securities.

Total OTTI should be presented in the statement of earnings with an offset for the amount of the OTTI that is recognized in OCI, if any, resulting in the net amount that is recognized in net income. See section 5.2.7, Presentation of OTTI for debt securities, for additional guidance.

5.2.4.1  Best estimate of present value of expected cash flows

ASC 320 states that one way of estimating the credit loss amount is to measure it according to the guidance related to accounting by creditors for impairment of a loan in ASC 310 — that is, by measuring an impairment on the basis of the entity’s best estimate of the present value of expected future cash flows discounted at the effective interest rate implicit in the security at the date the security was purchased. The implementation guidance in ASC 310-30-55 provides useful guidance when using this method. However, the use of this methodology is not required, and other methods may be appropriate.

In any event, the entity should compare the present value of the cash flows expected to be collected from the debt security with the amortized cost basis of the debt security. Whatever method is chosen, the result should be a new measurement of amortized cost that reflects cash flows expected to be collected. That is, “cash flows expected to be collected” should represent cash flows that an entity is likely to collect after a careful assessment of all available information. An appropriate discount rate should be used in determining the present value of such cash flows expected to be collected. We do not believe it is appropriate to consider changes in market rates of interest in measuring the amount of credit loss. That is, expected cash flows should be discounted at the security’s original effective interest rate and then compared with the carrying amount with the difference between the two recognized as the credit component of the OTTI for debt securities not in the scope of ASC 325-40.

When measuring an impairment that is other than temporary, if the debt securities are beneficial interests in securitized financial assets and are in the scope of ASC 325-40, the amount of the credit loss is measured as the difference between the current amortized cost of the security and the new estimate of future cash flows, discounted at a rate equal to the current yield used to accrete the beneficial interest. That is, a decrease in cash flows expected to be collected on an asset-backed security that results from an increase in prepayments on the underlying assets should be considered in the estimate of the present value of cash flows expected to be collected.

Additionally, for debt securities accounted for in accordance with ASC 310-30, the entity should consider that standard in estimating the present value of cash flows expected to be collected from the debt security.
5.2.4.1.1 **Variable rate debt securities**

ASC 320 does not provide guidance on how to determine whether there is a decrease in cash flows expected to be collected for variable rate securities and if so, how to measure that credit loss. However, ASC 320 notes that a credit loss exists when the present value of cash flows expected to be collected is less than the amortized cost basis of the debt security. For a debt security with a contractual interest rate that varies based on subsequent changes in an independent factor, such as an index or rate (e.g., the prime rate, LIBOR, the US Treasury bill weekly average), we believe the most appropriate method to calculate the cash flows expected to be collected is to base them on the variable rate that exists as of the date the cash flow estimate is being made. Under this approach, projections of future changes in the factor should not be made for purposes of estimating cash flows expected to be collected. This approach is consistent with the requirements of ASC 310 and ASC 325-40.

In calculating the present value of such cash flows for purposes of determining whether a credit loss exists and in measuring any credit loss, we believe that the discount rate used should be the rate used in the determination of the cash flows expected to be collected. This approach is consistent with the concept in ASC 320 that credit losses are not caused by changes in interest rates.

Subsequent changes in cash flows expected to be collected as a result of a change in the contractual interest rate (as opposed to a decrease attributable to credit issues) should be recognized prospectively as a yield adjustment. Thus, for a decrease in cash flows expected to be collected resulting directly from a change in the contractual interest rate, the effect will be to reduce prospectively the yield recognized rather than recognize a credit loss.

5.2.4.1.2 **Use of practical expedients in ASC 310-10**

ASC 310-10-35 provides practical expedients that allow a creditor to measure impairment based on either (1) a loan’s observable market price or (2) the fair value of any collateral (if the loan is collateral dependent\(^{18}\)). It is not appropriate to make use of these practical expedients when determining whether a credit loss exists on a debt security and in measuring the amount any such credit loss, pursuant to ASC 320. Comparing the fair value of the debt security to its amortized cost basis gives only an indication of the amount of the impairment, not whether there has been a decrease in the amount of cash flows expected to be collected. The fair value of a debt security changes over time (from acquisition) due to changes in a market participant’s view of the amount and timing of future cash flows (which is not explicitly observable) as well as changes in the market interest rate, which includes changes in the risk premium demanded by investors for bearing uncertainty in the cash flows.

We do not believe it is appropriate to consider changes in market rates of interest in determining whether a credit loss exists and when measuring the amount of any credit loss. Rather, we believe an investor should focus only on decreases in future cash flows expected to be collected in determining whether a credit loss exists and in measuring the amount of any credit loss.

5.2.4.1.3 **Single best estimate versus probability-weighted estimate**

ASC 320 does not explicitly require a particular approach to determine the best estimate of the present value of cash flows expected to be collected from the debt security. Rather, it suggests that one way of estimating that amount would be to consider the methodology of measuring impairment losses for loans, which is described in ASC 310-10-35. In practice, we believe most entities use a single best estimate in applying ASC 310. However, ASC 310 suggests that a probability-weighted measure may also be appropriate. We believe the decision to use either a best estimate or a probability-weighted estimate of cash flows is an accounting policy election, and entities should document and disclose their policy.

\(^{18}\) The Master Glossary defines a collateral dependent loan as “a loan for which the repayment is expected to be provided solely by the underlying collateral.”
If a single best estimate of cash flows is used, the effective yield implicit in the debt security at the date of acquisition (or for securities within the scope of ASC 325-40, the current yield used to accrete the beneficial interest) is used to calculate the present value of those cash flows.

If a probability-weighted estimate of cash flows is used, it would not be appropriate to discount these cash flows at the same discount rate used to calculate the present value of a single best estimate of cash flows, because the probability-weighted estimated cash flows incorporate potential variability directly in the expected outcomes, rather than in the discount rate. Therefore, it is important to use an effective yield that appropriately considers the risk inherent in the expected cash flows used in the analysis. ASC 820-10-55 discusses the relationship between cash flow uncertainty and discount rates under various present value techniques.

Credit impairment should reflect only a deterioration of credit quality, which is evidenced by a decrease in the estimate of future cash flows expected to be received. Changes in market rates of interest or other factors that would not ultimately affect the cash flows expected to be received are therefore excluded from the impairment analysis under ASC 310. Discounting cash flows expected to be received using the effective yield as of the acquisition date, effectively limits the change in “value” to changes in the amount and timing of cash flows that the entity ultimately expects to receive.

Consistent with this view, we do not believe it is appropriate to consider changes in market rates of interest in determining whether a credit loss exists. If an entity chooses to use probability-weighted estimates of cash flows to determine whether there has been a decrease in cash flows expected to be collected, it will be necessary for an entity to have a probability-weighted estimate of cash flows that supports the amortized cost balance of the debt security at acquisition. The interest rate used to discount the probability-weighted cash flows at acquisition should also be used to discount the end of period probability-weighted cash flows in determining whether the entire amortized cost basis of the debt security will be recovered.

5.2.4.1.4 Examples of measuring the credit loss of a debt security

5.2.4.1.4.1 Measuring the credit loss of a security not in the scope of ASC 325-40

Using the methodology in ASC 310 and a single best estimate of expected cash flows, an entity would measure the credit impairment as the difference between the current amortized cost and the present value of revised cash flows discounted at the original effective rate (at the debt security’s purchase).

Illustration 5-3: Measuring an OTTI of a debt security not in the scope of ASC 325-40

Assume an entity purchases a five-year, $10,000 par bond with a 5% coupon (a market rate at the time of purchase) on 1 January 2013. The bond is accounted for under ASC 320 and is classified as an available-for-sale debt security. As of 31 December 2013, the expectation of cash flows to be collected for the years 2016 and 2017 changes such that only $250 of interest is expected to be collected in 2016 and only $9,000 of the principal balance and no interest is expected to be collected in 2017. As of 31 December 2013, the fair value of the debt security is $6,000, which implies an effective yield or discount rate of approximately 16% based on the new estimate of cash flows expected to be collected. Also, assume that the entity does not intend to sell the debt security and it is not more likely than not the investor will be required to sell the debt security before recovery of its amortized cost basis. The table below shows the original and revised cash flows expected to be collected and illustrates how the credit and noncredit components of an OTTI loss are determined:
5.2.4.1.4.2 Measuring the credit loss of a debt security in the scope of ASC 325-40

For debt securities accounted for in accordance with ASC 325-40, the credit impairment is measured...
by comparing the present value of the remaining cash flows as estimated at the initial transaction date (or at the last date previously revised) against the present value of the cash flows expected to be collected at the current financial reporting date, both discounted using the same effective rate from the previous period. In other words, the cash flows estimated at the current financial reporting date should be discounted at a rate equal to the current yield used to accrete the beneficial interest.

Illustration 5-4: Measuring an OTTI of a debt security in the scope of ASC 325-40

Assume an entity purchases a beneficial interest within the scope of ASC 325-40 on 1 January 2013 for $5,000. As of 1 January 2013, the expectation of cash flows to be collected over the five-year life of the investment is illustrated in the table below. Based on the cost and cash flow projections, the effective rate (i.e., the internal rate of return on the investment over its life) for the year ended 31 December 2013 is 11%. Assume the entity collects the 2013 expected cash flows of $800. Applying the 11% effective rate, $550 of this amount is recognized as interest income for the year ending 31 December 2013 and the remaining $250 is accounted for as a reduction of the investment’s amortized cost.

As of 31 December 2013, the fair value of the investment is $4,350, which implies a market yield or discount rate of approximately 14% based on the new estimate of cash flows expected to be collected. That amount is compared with the investment’s calculated amortized cost (after the recognition of interest income) of $4,750 to arrive at an impairment of $400. Assume that the entity does not intend to sell the debt security and it is not more likely than not that the investor will be required to sell the debt security before recovery of its amortized cost basis. As illustrated in the application of the guidance of ASC 325-40 below, the entity updates its estimates of expected cash flows as of 31 December 2013. Using the effective rate of 11%, which is used to recognize interest income on the beneficial interest for 2013, the entity determines the net present value of the estimated cash flows has adversely changed by $100.

Therefore, the entity will recognize an OTTI in earnings of $100 for the adverse change in cash flows (i.e., credit loss) and recognize the remaining impairment loss of $300 (total impairment of $400 less $100 of credit loss) separately in OCI. After recognition of the OTTI, the investment’s adjusted amortized cost basis will be $4,650 (i.e., the amortized cost basis at the end of the year before any impairments of $4,750, less the OTTI amount of $100 recognized in net income) and its carrying value will be $4,350 (i.e., fair value).

<table>
<thead>
<tr>
<th>Year</th>
<th>Original cash flows expected to be collected</th>
<th>Revised cash flows expected to be collected</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>$800 (collected)</td>
<td></td>
</tr>
<tr>
<td>2014</td>
<td>600</td>
<td>600</td>
</tr>
<tr>
<td>2015</td>
<td>1,400</td>
<td>1,700</td>
</tr>
<tr>
<td>2016</td>
<td>2,400</td>
<td>2,200</td>
</tr>
<tr>
<td>2017</td>
<td>2,000</td>
<td>1,700</td>
</tr>
<tr>
<td>Total remaining gross cash flows</td>
<td>$7,200</td>
<td>$6,200</td>
</tr>
</tbody>
</table>

Original cash flows expected to be collected
- 2013: $800 (collected)
- 2014: $600
- 2015: $1,400
- 2016: $2,400
- 2017: $2,000

Revised cash flows expected to be collected
- 2013: $600
- 2014: $1,700
- 2015: $2,200
- 2016: $1,700

Amortized cost – 1 January 2013 (present value of gross cash flows discounted at 11%)
- $5,000

Interest income ($5,000 x 11% effective rate)
- $550

Cash collected
- (800)

Amortized cost – 31 December 2013 (before impairment analysis)
- $4,750

OTTI – credit loss
- (100)

Adjusted amortized cost – 31 December 2013 (after impairment analysis)
- $4,650

Financial reporting developments Certain investments in debt and equity securities (before the adoption of ASU 2016-01) | 67
5.2.4.1.4.3 Variable rate debt securities not in the scope of ASC 325-40

When an entity calculates the present value of expected cash flows of a variable rate debt security to determine whether a credit loss exists and to measure any such loss, we believe that the entity should use the same discount rate it uses to determine the cash flows expected to be collected. This approach is consistent with the concept in ASC 320 that credit losses are not caused by changes in interest rates.

**Illustration 5-5: Measuring an OTTI of a variable rate debt security**

Assume an entity purchases a five-year, $10,000 par bond with a coupon of Prime plus 2% (a market rate at the time of purchase) on 1 January 2013. The Prime rate on 1 January 2013 was 3% (i.e., the total coupon is 5%). The bond is accounted for under ASC 320 and is classified as an available-for-sale debt security. As of 31 December 2013, the Prime rate rose to 4% (i.e., the total coupon is 6%). In addition, the expectation of cash flows to be collected for the years 2016 and 2017 changes, and only $300 of interest is expected to be collected in 2016, no interest is expected to be collected in 2017, and only $8,500 of the principal balance is expected to be collected in 2017.

As of 31 December 2013, the fair value of the debt security is $7,800, which implies an effective yield or discount rate of approximately 7% (because the credit spread widened) based on the new estimate of cash flows expected to be collected. Also, assume that the entity does not intend to sell the debt security and it is not more likely than not the investor will be required to sell the debt security before recovery of its amortized cost basis. The table below shows the original and revised cash flows expected to be collected and illustrates how the credit and noncredit components of an OTTI loss are determined:
As illustrated above, the entity separates the total impairment of $2,200 (the cost basis of $10,000 less the fair value of $7,800 as of 31 December 2013) into the following two parts:

- The amount representing the decrease in cash flows expected to be collected (i.e., the credit impairment) of $1,915, which is discounted at the revised variable rate of 6% (used to determine the expected cash flows)
- The amount related to all other factors of $285 (i.e., the noncredit component)

Therefore, the entity will recognize an OTTI in earnings of $1,915 for the credit loss and recognize the remaining impairment loss of $285 separately in OCI.

Note that on the face of the statement of earnings, the entire $2,200 impairment will be presented, with the $285 noncredit impairment deducted from that amount in a separate line to arrive at the net credit impairment recognized in earnings of $1,915. After recognition of the OTTI, the debt security’s adjusted cost basis will be $8,085 (i.e., the previous cost basis of $10,000 less the OTTI amount of $1,915 recognized in earnings) and its carrying value will be $7,800 (i.e., fair value).

If the debt security in the example above were classified as held to maturity, the entity would recognize an OTTI similar to that of a security classified as available for sale. That is, the credit loss of $1,915 would be recognized in earnings, the noncredit impairment of $285 would be separately recognized in OCI, the amortized cost basis would be $8,085 and the carrying value would be $7,800 (i.e., fair value). See section 5.2.6 for how an entity should account for held-to-maturity securities after recognition of an OTTI loss, including the amortization of the OTTI amount included in accumulated other comprehensive income.
5.2.4.1.4.4 Fair value of previously impaired debt security increases but expected cash flows decrease

An investment is impaired if the fair value of the investment is less than cost. When the fair value of an investment is not below the investment’s cost basis, there can be no OTTI. Therefore, even in circumstances in which there has been a decrease in expected cash flows to be collected from a debt security, but the fair value of the debt security is not below the debt security’s amortized cost, no OTTI has occurred.

For example, assume a debt security was purchased at a significant discount due to the demand by market participants for large liquidity premiums. If the investor believes that the cash flows expected to be collected has decreased, but the fair value of that debt security is above the debt security’s amortized cost basis (because the liquidity premium being demanded by market participants has decreased by more than market participants’ expectations about an increase in credit losses), no OTTI is considered to have occurred. That is, Step 1 of the impairment evaluation is not failed, and no further analysis is required.

However, when the fair value of a previously other-than-temporarily impaired debt security increases and there is a decrease in expected cash flows expected to be collected, the increase in the estimated credit loss should be recognized in earnings in circumstances in which the fair value of the debt security remains below its amortized cost. Consider the following examples:

<table>
<thead>
<tr>
<th>Illustration 5-6: Increase in fair value with a decrease in expected cash flows following an OTTI</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Facts and analysis for the year 2013</strong></td>
</tr>
<tr>
<td>1. A debt security is purchased at par on 1 January 2013 for $1,000 and is classified as available for sale</td>
</tr>
<tr>
<td>2. At 31 December 2013, the fair value of the debt security is $600</td>
</tr>
<tr>
<td>3. The impairment is deemed to be other than temporary</td>
</tr>
<tr>
<td>4. The credit portion of the OTTI is $100 and the noncredit portion is $300</td>
</tr>
<tr>
<td>5. The entity does not intend to sell the debt security and it is not more likely than not the entity will be required to sell the debt security before recovery of its amortized cost</td>
</tr>
</tbody>
</table>

To summarize:

<table>
<thead>
<tr>
<th></th>
<th>Amortized cost</th>
<th>Fair value</th>
<th>Unrealized loss</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1 Before recognition of the 2013 OTTI</strong></td>
<td>$ 1,000</td>
<td>$ 600</td>
<td>$ 400</td>
</tr>
</tbody>
</table>

The OTTI is presented on the face of the income statement as follows:

<table>
<thead>
<tr>
<th></th>
<th>Total other-than-temporary impairment losses</th>
<th>Portion of loss recognized in other comprehensive income (before taxes)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$ 400</td>
<td>(300)</td>
</tr>
</tbody>
</table>

Net impairment losses recognized in earnings $ 100

A rollforward of amortized cost, cumulative OTTI recognized in earnings and accumulated OCI is as follows [Dr. (Cr.)]:

<table>
<thead>
<tr>
<th></th>
<th>Amortized cost</th>
<th>Cumulative OTTI in earnings</th>
<th>Unrealized gain/loss</th>
<th>OTTI loss in OCI</th>
<th>Total accumulated OCI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance at 1 January 2013</td>
<td>$ 1,000</td>
<td>$ -</td>
<td>$ -</td>
<td>$ -</td>
<td>$ -</td>
</tr>
<tr>
<td>OTTI recognized</td>
<td>(100)</td>
<td>100</td>
<td>$ -</td>
<td>300</td>
<td>300</td>
</tr>
<tr>
<td>Balance at 31 December 2013</td>
<td>$ 900</td>
<td>$ 100</td>
<td>$ -</td>
<td>$ 300</td>
<td>$ 300</td>
</tr>
</tbody>
</table>
Facts and analysis for the year 2014

- At 31 December 2014, the fair value of the debt security is $700
- There is an additional credit loss of $100
- The entity does not intend to sell the debt security and it is not more likely than not the entity will be required to sell the debt security before recovery of its amortized cost

To summarize:

<table>
<thead>
<tr>
<th></th>
<th>Amortized cost</th>
<th>Fair value</th>
<th>Unrealized loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance at 1 January 2014</td>
<td>$900</td>
<td>$700</td>
<td>$200</td>
</tr>
</tbody>
</table>

Before recognition of the 2014 OTTI

The OTTI is presented on the face of the income statement as follows:

| Total other-than-temporary impairment losses | $          |
| Portion of loss recognized in other comprehensive income (before taxes) | $100      |
| Net impairment losses recognized in earnings | $100      |

Because of the increase in fair value in 2014, there is nothing to be recognized on the “Total other-than-temporary impairment losses” line. Rather, the nature of the OTTI recognized in OCI in 2013 has changed from noncredit to credit in 2014, resulting in a reclassification from OCI to earnings.

A rollforward of amortized cost, cumulative OTTI recognized in earnings and accumulated OCI is as follows [Dr. (Cr.)]:

<table>
<thead>
<tr>
<th>Balance at 1 January 2014</th>
<th>Amortized cost</th>
<th>Cumulative OTTI in earnings</th>
<th>Unrealized gain/loss</th>
<th>OTTI loss in OCI</th>
<th>Total accumulated OCI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrealized gain recognized in 2014</td>
<td>-</td>
<td>-</td>
<td>(100)</td>
<td>-</td>
<td>(100)</td>
</tr>
<tr>
<td>Reclassification to earnings</td>
<td>(100)</td>
<td>100</td>
<td>-</td>
<td>(100)</td>
<td>(100)</td>
</tr>
<tr>
<td>Balance at 31 December 2014</td>
<td>$800</td>
<td>$200</td>
<td>$ (100)</td>
<td>$200</td>
<td>$100</td>
</tr>
</tbody>
</table>

Facts and analysis for the year 2015– Scenario 1

- At 31 December 2015, the fair value of the debt security is $800
- There is an additional credit loss of $50

To summarize:

<table>
<thead>
<tr>
<th></th>
<th>Amortized cost</th>
<th>Fair value</th>
<th>Unrealized loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance at 31 December 2015</td>
<td>$800</td>
<td>$800</td>
<td>-</td>
</tr>
</tbody>
</table>

Because the fair value of the debt security is not below amortized cost, no incremental OTTI is recognized. Although this scenario is unlikely to occur, it is useful to illustrate the point that even when there is a decrease in cash flows expected to be collected, unless the fair value of the debt security is below its amortized cost, the additional credit loss is not recognized currently.
A rollforward of amortized cost, cumulative OTTI recognized in earnings and accumulated OCI is as follows [Dr. (Cr.)]:

<table>
<thead>
<tr>
<th></th>
<th>Amortized cost</th>
<th>Cumulative OTTI in earnings</th>
<th>Unrealized gain/loss</th>
<th>OTTI loss in OCI</th>
<th>Total accumulated OCI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance at 1 January 2015</td>
<td>$ 800</td>
<td>$ 200</td>
<td>$(100)</td>
<td>$ 200</td>
<td>$ 100</td>
</tr>
<tr>
<td>Unrealized gain recognized in 2015</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(100)</td>
</tr>
<tr>
<td>Reclassification to earnings</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Balance at 31 December 2015</td>
<td>$ 800</td>
<td>$ 200</td>
<td>$(200)</td>
<td>$ 200</td>
<td>$ -</td>
</tr>
</tbody>
</table>

**Facts and analysis for the year 2015 – Scenario 2**

- At 31 December 2015, the fair value of the debt security is $775
- There is an additional credit loss of $150
- The entity does not intend to sell the debt security and it is not more likely than not the entity will be required to sell the debt security before recovery of its amortized cost

To summarize:

<table>
<thead>
<tr>
<th></th>
<th>Dr. (Cr.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amortized cost</td>
<td>$ 800</td>
</tr>
<tr>
<td>Fair value</td>
<td>775</td>
</tr>
<tr>
<td>Unrealized loss</td>
<td>$ 25</td>
</tr>
</tbody>
</table>

3 Before recognition of the 2015 OTTI

The OTTI is presented on the face of the income statement as follows:

- Total other-than-temporary impairment losses $ -
- Portion of loss recognized in other comprehensive income (before taxes) $ 150
- Net impairment losses recognized in earnings $ 150

In this scenario, the fair value of the debt security is below cost, resulting in an unrealized loss at 31 December 2015, albeit one that is less than the amount of the credit loss. In this case, the amount of the credit loss is recognized in earnings. Because the total amount of noncredit OTTI recognized on this debt security in 2013 was $300, and only $100 was reclassified to date from noncredit to credit in 2014, the $150 of additional credit loss recognized in 2015 is also a reclassification as the nature of the OTTI recognized in OCI in 2013 has changed from noncredit to credit in 2015. Although this scenario is unlikely to occur, it is useful to illustrate the point that it is possible for a debt security’s amortized cost to be written down below fair value, with a portion of the credit loss recognized in net income offset by an unrealized gain in OCI.

A rollforward of amortized cost, cumulative OTTI recognized in earnings and accumulated OCI is as follows [Dr. (Cr.)]:

<table>
<thead>
<tr>
<th></th>
<th>Amortized cost</th>
<th>Cumulative OTTI in earnings</th>
<th>Unrealized gain/loss</th>
<th>OTTI loss in OCI</th>
<th>Total accumulated OCI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance at 1 January 2015</td>
<td>$ 800</td>
<td>$ 200</td>
<td>$(100)</td>
<td>$ 200</td>
<td>$ 100</td>
</tr>
<tr>
<td>Unrealized gain recognized in 2015</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(100)</td>
</tr>
<tr>
<td>Reclassification to earnings</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Balance at 31 December 2015</td>
<td>$ 650</td>
<td>$ 350</td>
<td>$(175)</td>
<td>$ 50</td>
<td>$(125)</td>
</tr>
</tbody>
</table>
5.2.4.1.4.5 Total decline in fair value is less than decline in expected cash flows

In certain circumstances the total decline in fair value of a debt security below its amortized cost basis (i.e., the impaired amount) is less than a decline in cash flows expected to be collected. As previously discussed, when the fair value of a debt security is below the debt security's cost basis, a decrease in cash flows expected to be collected is an indication that an OTTI has occurred. The amount of the total OTTI (the excess of the debt security's amortized cost basis over its fair value at the balance sheet date) recognized in earnings depends on whether an entity intends to sell the debt security or whether it is more likely than not it will be required to sell the debt security before recovery of its amortized cost basis less any current period credit loss.

In circumstances in which an entity does not intend to sell the debt security and it is not more likely than not it will be required to sell the debt security before recovery of its amortized cost basis less any current-period credit loss, the OTTI is separated into the amount related to the credit loss (i.e., the decrease in cash flows expected to be collected), which is recognized in net income, and the amount related to all other factors, which is recognized in OCI.

Where the total decline in fair value of a debt security below its amortized cost is less than the decline in cash flows expected to be collected and the entity does not intend to sell the debt security and it is not more likely than not it will be required to sell the debt security before recovery of its amortized cost basis less any current period credit loss, the total amount of the credit loss should be recognized in net income, which will be greater than the total impaired amount (i.e., greater than the decline in fair value below amortized cost). Consider the following example:

<table>
<thead>
<tr>
<th>Illustration 5-7: Credit losses in excess of total decline in fair value below amortized cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>A debt security with a $1,000 par value is purchased at a $300 discount on 1 January 2013 for $700 and is classified as available for sale</td>
</tr>
<tr>
<td>The original effective yield is 20%, which reflects a significant discount due to the demand by market participants for large liquidity premiums</td>
</tr>
<tr>
<td>At 31 December 2013, the net present value of the estimated cash flows, discounted at the original effective yield (20%), is $600</td>
</tr>
<tr>
<td>At 31 December 2013, the fair value of the debt security has decreased to only $660 (i.e., the liquidity premium being demanded by market participants has decreased to offset a portion of the entity’s estimate of the increase in credit loss)</td>
</tr>
<tr>
<td>The impairment is deemed to be other than temporary</td>
</tr>
<tr>
<td>No previous OTTI was recognized for this security, and thus there is no noncredit OTTI recognized in accumulated OCI</td>
</tr>
<tr>
<td>The entity does not intend to sell the debt security and it is not more likely than not the entity will be required to sell the debt security before recovery of its amortized cost</td>
</tr>
</tbody>
</table>

To summarize:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amortized cost</td>
<td>$700</td>
</tr>
<tr>
<td>Fair value</td>
<td>$660</td>
</tr>
<tr>
<td>Unrealized loss</td>
<td>$40</td>
</tr>
</tbody>
</table>

1 Before recognition of the current period OTTI

The OTTI would be presented on the face of the income statement as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total other-than-temporary impairment losses</td>
<td>$40</td>
</tr>
<tr>
<td>Portion of loss recognized in other comprehensive income (before taxes)</td>
<td>$60</td>
</tr>
<tr>
<td>Net impairment losses recognized in earnings</td>
<td>$100</td>
</tr>
</tbody>
</table>

2 This item is typically a loss representing other noncredit factors of the OTTI.
The amount of the total OTTI related to the credit loss should be recognized in net income. In this example, the credit loss is $100 (i.e., the difference between the present value of the expected future cash flows discounted at the original effective interest rate of 20% ($600) and the amortized cost basis of the debt security ($700)). Because the total OTTI amount is the difference between the amortized cost basis of the debt security and the fair value of the debt security (i.e., $40), we believe the remaining $60 difference should be recognized and presented as an unrealized gain in equity. Although this scenario is unlikely to occur, it is useful to illustrate the point that it is possible to recognize a credit loss in earnings in excess of the total cumulative OTTI recognized on a particular security. We generally believe the “negative noncredit OTTI” would be presented with other unrealized gains and losses in accumulated other comprehensive income and not included with noncredit OTTI in accumulated other comprehensive income.

A rollforward of amortized cost, cumulative OTTI recognized in earnings and accumulated OCI would be shown as follows [Dr. (Cr.)]:

<table>
<thead>
<tr>
<th></th>
<th>Amortized cost</th>
<th>Cumulative OTTI in earnings</th>
<th>Unrealized gain/loss</th>
<th>OTTI loss in OCI</th>
<th>Total accumulated OCI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance at 1 January 2013</td>
<td>$ 700</td>
<td>$ –</td>
<td>$ –</td>
<td>$ –</td>
<td>$ –</td>
</tr>
<tr>
<td>OTTI recognized</td>
<td>(100)</td>
<td>100</td>
<td>(60)</td>
<td>–</td>
<td>(60)</td>
</tr>
<tr>
<td>Balance at 31 December 2013</td>
<td>$ 600</td>
<td>$ 100</td>
<td>$ (60)</td>
<td>$ –</td>
<td>$ (60)</td>
</tr>
</tbody>
</table>

**5.2.5 Foreign currency considerations**

Under ASC 320, debt securities are considered impaired when their fair value is below their cost basis. For available-for-sale debt securities denominated in a foreign currency, a company should compare the functional-currency-equivalent fair value measured at the current exchange rate to the cost basis measured at the historical exchange rate (i.e., the rate on the day the security was acquired). When a security is impaired, an entity should assess whether the impairment is other than temporary.

An impaired available-for-sale debt security is considered other-than-temporarily impaired if (1) the holder has the intent to sell the impaired debt security, (2) it is more likely than not the holder will be required to sell the impaired debt security before recovery or (3) the holder does not expect to recover the entire amortized cost basis of the security – even if it does not intend to sell the security.

In the first two situations, the amount of OTTI recognized in net income is equal to the difference between the impaired debt security’s amortized cost basis and its functional-currency-equivalent fair value.

In the third situation, the resulting OTTI is separated into the amount representing credit loss (which is recognized in net income) and the amount related to all other factors – including a decline in fair value attributed to changes in exchange rates that is considered to be temporary (which is recognized in OCI). Importantly, a decline in fair value attributed to changes in exchange rates that the holder does not expect to recover should be recognized in net income.

The model for determining whether foreign currency-denominated held-to-maturity debt securities are impaired is the same as that for available-for-sale debt securities, except for the treatment of changes in value attributed to changes in currency exchange rates. As explained further in section 2.4.5, foreign currency transaction gains or losses related to debt securities classified as held-to-maturity are recognized in earnings in the period in which exchange rates change. As a result, the current exchange rate is used to measure both the functional-currency-equivalent fair value and amortized cost basis of the held-to-maturity debt security when determining whether the security is impaired.
5.2.6 Accounting after an OTTI

**Excerpt from Accounting Standards Codification**

**Investments – Debt and Equity Securities – Overall**

**Subsequent Measurement**

**Accounting for Debt Securities After an Other-Than-Temporary Impairment**

320-10-35-35

In periods after the recognition of an other-than-temporary impairment loss for debt securities, an entity shall account for the other-than-temporarily impaired debt security as if the debt security had been purchased on the measurement date of the other-than-temporary impairment at an amortized cost basis equal to the previous amortized cost basis less the other-than-temporary impairment recognized in earnings. For debt securities for which other-than-temporary impairments were recognized in earnings, the difference between the new amortized cost basis and the cash flows expected to be collected shall be accreted in accordance with existing applicable guidance as interest income. An entity shall continue to estimate the present value of cash flows expected to be collected over the life of the debt security. For debt securities accounted for in accordance with Subtopic 325-40, an entity should look to that Subtopic to account for changes in cash flows expected to be collected. For all other debt securities, if upon subsequent evaluation, there is a significant increase in the cash flows expected to be collected or if actual cash flows are significantly greater than cash flows previously expected, such changes shall be accounted for as a prospective adjustment to the accretable yield in accordance with Subtopic 310-30 even if the debt security would not otherwise be within the scope of that Subtopic. Subsequent increases and decreases (if not an other-than-temporary impairment) in the fair value of available-for-sale securities shall be included in other comprehensive income. (This Section does not address when a holder of a debt security would place a debt security on nonaccrual status or how to subsequently report income on a nonaccrual debt security.)

320-10-35-35A

The other-than-temporary impairment recognized in other comprehensive income for debt securities classified as held-to-maturity shall be accreted over the remaining life of the debt security in a prospective manner on the basis of the amount and timing of future estimated cash flows. That accretion shall increase the carrying value of the security and shall continue until the security is sold, the security matures, or there is an additional other-than-temporary impairment that is recognized in earnings. If the security is sold, Section 320-10-25 provides guidance on the effect of changes in circumstances that would not call into question the entity’s intent to hold other debt securities to maturity in the future.

After the recognition of an OTTI, the previous amortized cost basis less the OTTI amount recognized in net income becomes the holder’s new amortized cost basis of the debt security. The difference between the new amortized cost basis and the cash flows expected to be collected should be accreted as interest income. Accordingly, an entity should continue to estimate the present value of cash flows expected to be collected over the life of the debt security.

If there is a significant increase in the cash flows expected to be collected or if actual cash flows are significantly greater than cash flows previously expected, such changes must be accounted for as a prospective adjustment to the accretable yield in accordance with ASC 310-30, except for securities in the scope of ASC 325-40, which should continue to follow the guidance in that standard. An OTTI recognized in earnings should not be reversed.
The OTTI impairment recognized in OCI for debt securities classified as held to maturity should be accreted from OCI to the carrying value of the debt security over the remaining life of the debt security in a prospective manner based on the amount and timing of future estimated cash flows. That accretion will increase the carrying value of the security until the debt security is sold, the security matures or there is an additional OTTI that is recognized in net income. This accretion does not affect earnings.

For debt securities classified as available for sale, accounting for subsequent increases and decreases (if not determined at that date to be an OTTI) in fair value remains the same – that is, they should be included in OCI.

5.2.7 Presentation of OTTI for debt securities

As noted above, total OTTI should be presented in the statement of earnings with an offset for the amount of the OTTI that is recognized in OCI, if any. Entities should also separately present in OCI (and in the financial statement where the components of accumulated OCI are reported) amounts related to held-to-maturity and available-for-sale debt securities for which a portion of an OTTI has been recognized in net income.

5.2.7.1 Presentation of subsequent changes in fair value of available-for-sale securities after an OTTI

US GAAP does not indicate how an entity should present subsequent changes in fair value for available-for-sale debt securities for which a previous noncredit OTTI loss was recognized in OCI. That is, US GAAP does not specify whether to report:

- The noncredit OTTI amount together with all subsequent changes in the fair value (positive and negative) of available-for-sale debt securities for which non-credit OTTI was previously recognized in OCI in a single line item but separate from unrealized gains and losses on securities for which an OTTI was not recognized in OCI

- The subsequent changes in fair value of available-for-sale debt securities for which a previous noncredit OTTI loss was recognized in OCI together with the changes in fair value of available-for-sale debt securities for which no OTTI losses were previously recognized (i.e., the noncredit portion of an OTTI is presented in a separate line item and is not adjusted for subsequent changes in fair value of the related debt securities)

Rather, ASC 320 simply states that subsequent increases and decreases (if not an additional OTTI) in the fair value of available-for-sale securities should be included in OCI.

How we see it

We generally believe reporting subsequent changes in fair value of available-for-sale debt securities in accordance with either of the methods described above is acceptable. Whichever method an entity selects should be consistently applied.

5.2.7.2 Presentation of noncredit portions of OTTI for available-for-sale and held-to-maturity securities

Separate presentation of the OTTI amounts related to held-to-maturity securities from the OTTI amounts related to available-for-sale debt securities is not required in the financial statement where the components of accumulated OCI are reported. However, separate presentation of these amounts is not precluded. Regardless of how the OTTI amounts related to held-to-maturity and available-for-sale debt securities are reported, ASC 320 requires an entity to disclose separately for available-for-sale and for held-to-maturity securities the total OTTI recognized in accumulated OCI, by major security type as of each date for which a statement of financial position is presented.
5.3 Equity securities

Below is a decision tree that illustrates how an entity should apply the OTTI model for equity securities classified as available for sale.

<table>
<thead>
<tr>
<th>Illustration 5-8: OTTI decision tree for available-for-sale equity securities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Is the fair value less than cost?</td>
</tr>
<tr>
<td>No</td>
</tr>
<tr>
<td>Yes</td>
</tr>
<tr>
<td>No</td>
</tr>
<tr>
<td>Yes</td>
</tr>
<tr>
<td>No</td>
</tr>
<tr>
<td>Yes</td>
</tr>
</tbody>
</table>

5.3.1 Determining whether an equity security is impaired

An individual equity security is impaired if the fair value of the investment is less than its cost. An entity should assess whether an impaired investment is other-than-temporarily impaired at every reporting period (i.e., quarterly for public companies).

Equity investments in the same instrument, even if purchased on different dates, may be aggregated for evaluating impairment if the entity aggregates the securities for purposes of measuring realized and unrealized gains and losses. For example, equity securities with the same CUSIP number that were purchased on separate dates may be aggregated by an entity on an average cost basis if that corresponds to the basis used to measure realized and unrealized gains and losses on the securities.
5.3.2 Evaluating whether an impairment is other than temporary

**Excerpt from Accounting Standards Codification**

*Investments – Debt and Equity Securities – Overall*

**Subsequent Measurement**

**Step 2: Evaluate Whether an Impairment Is Other Than Temporary**

**Equity Securities**

320-10-35-32A

For equity securities, an entity shall apply guidance that is pertinent to the determination of whether an impairment is other than temporary, such as Sections 323-10-35 and 325-40-35.

320-10-35-33

In applying that guidance, questions sometimes arise about whether an entity shall recognize an other-than-temporary impairment only when it intends to sell a specifically identified available-for-sale equity security at a loss shortly after the balance sheet date. When an entity has decided to sell an impaired available-for-sale security and the entity does not expect the fair value of the security to fully recover before the expected time of sale, the security shall be deemed other-than-temporarily impaired in the period in which the decision to sell is made, not in the period in which the sale occurs. However, an entity shall recognize an impairment loss when the impairment is deemed other than temporary even if a decision to sell has not been made.

**SEC Materials**

**General**

320-10-S99-1

The value of investments in equity securities classified as available-for-sale 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 in equity securities classified as available-for-sale.

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 in value of an equity security classified as available-for-sale 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

c. 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 in equity securities classified as available-for-sale, a write-down to fair value accounted for as a realized loss should be recorded. Such loss should be recognized in the determination of net income of the period in which it occurs and the written down value of the investment in the company becomes the new cost basis of the investment.
When an entity has decided to sell an impaired available-for-sale equity security and the entity does not expect the fair value of the security to fully recover before the expected time of sale, the entity should recognize an OTTI in the period in which the decision to sell was made, not in the period in which the sale occurred.

An entity should also recognize an OTTI when the impairment is deemed other than temporary even if a decision to sell has not been made. For a marketable equity security, the evaluation of whether an impairment is (or is not) other than temporary is based on two key assessments:

- Whether and when an equity security will recover in value – factors that should be considered in this assessment include, the duration and severity of the impairment and the financial condition and near-term prospects of the issuer
- Whether the investor has the positive intent and ability to hold that equity security until the anticipated recovery in value occurs

These key assessments are discussed further below.

SEC Staff Accounting Bulletin Topic 5.M, Other Than Temporary Impairment of Certain Investments in Equity Securities (subsequently codified in ASC 320-10-S99-1), provides the SEC staff’s interpretive guidance for determining when a decline in fair value below cost for an available-for-sale equity security is other than temporary. ASC 320-10-S99-1 clarifies that the term “other than temporary” should not be interpreted to mean “permanent,” meaning that the eventual recovery in fair value of an investment should not preclude the recognition of an other-than-temporary loss. In determining when an impairment of an equity security is other than temporary, the following are example indicators that should be considered:

- Fair value is significantly below cost
- The decline in fair value has existed for an extended period of time
- The financial condition of the issuer has deteriorated as evidenced by significant or recurring operating losses, poor cash flows and/or deteriorating liquidity ratios
- The issuer had a going concern qualification in the independent auditors’ report
- 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 related to the issuer, including the issuer’s industry or geographic area of operation
- Dividends have been reduced or eliminated
- Changes in tax laws, regulations or other governmental policies have significantly affected the issuer

### 5.3.2.1 Recovery in value

A general premise in making an assessment of whether an OTTI of an equity security exists is that the greater the decline in value and the duration of the decline, the more persuasive the evidence will have to be to conclude that an OTTI has not occurred. That is, the greater the decline in value and the longer the duration of such decline, the less likely it is that the equity security will recover its value within the anticipated period.

Evaluating the potential for an impaired equity security to recover in value requires significant judgment. However, the evidence supporting the anticipated recovery in value should be objective. Such evidence need not be literal proof (e.g., a recovery in market value subsequent to the balance sheet date) but rather could consist of an accumulation of factors about the issuer, the issuer’s industry or the specific security under consideration.
How we see it

Some entities review for impairment equity securities whose fair values are below cost by a certain percentage and for a set period of time. While establishing thresholds for identifying the at-risk population may be useful, additional procedures should be in place to identify equity securities for which there are issuer-specific concerns (e.g., troubled entities).

5.3.2.1.1  Period for recovery in value

To conclude that an impairment is temporary, the investor would need to support, with observable market information, that a recovery in the fair value to at least the cost basis of the equity security is expected to occur in an acceptable forecast period. As such, the investor’s ability to hold the equity security until a more favorable market develops and until the issuer-specific uncertainties are resolved is relevant only if persuasive evidence exists that those changes will occur in the near term. What is deemed to be “near term” is a matter of professional judgment. The SEC staff frequently asks issuers about their judgments around this topic.

5.3.2.2  Intent and ability to hold to recovery

Once an entity has determined that the fair value of the equity security is expected to recover to at least cost in the near term, the entity must demonstrate that it has the positive intent and ability to hold the impaired equity security to the expected date of the anticipated recovery. This requires corroborating evidence beyond a simple commitment not to sell the impaired equity security. The evaluation also requires judgment. If an entity cannot demonstrate the ability and intent to hold to anticipated recovery, the entity should recognize an OTTI.

The entity needs to carefully evaluate the facts and circumstances, including its prior activity with respect to impaired equity securities and any long-term plans that may affect its intent and ability to hold the equity securities. For example, the entity should evaluate its intent and ability to hold assertion in light of its current liquidity position and working capital needs, debt covenant arrangements, contractual constraints, hedging strategies, investment strategies, tax strategies and overall business plans.

Factors indicating that an entity does not have the intent and ability to hold an impaired equity security until fair value recovers include:

- A history of selling equity securities at a loss
- A tax strategy of selling equity securities at a loss to offset capital gains
- Changes in tax laws, regulations or other governmental policies that may negatively impact the value of investments held and which are inconsistent with the entity’s original investment objectives
- Plans to rebalance the portfolio to achieve an overall goal with respect to return, portfolio concentration or other factors
- Cash flow forecasts that indicate a planned sale of equity securities (possibly at a loss) is needed to meet working capital needs, to comply with regulatory capital requirements or to fund ongoing business initiatives
- Debt covenant violations or liquidity issues
5.3.2.2.1  Outsourced portfolio management arrangements

Many outsourced portfolio management arrangements give the external investment manager discretion to buy and sell securities as it deems necessary to achieve a maximum yield subject to certain risk tolerances and investment criteria. Such arrangements may contain restrictions on the sale of impaired securities to make sure that portfolio management activities are consistent with the entity’s assertion of its intent and ability to hold impaired equity securities to recovery.

If proper restrictions are included in the agreement and the entity has proper controls and documentation in place to support its assertion of holding the equity security until anticipated recovery, including approving and monitoring the external manager’s sales activity, the outsourcing arrangement would not, in and of itself, contradict the entity’s assertion. If these restrictions and controls are not in place, the external portfolio manager’s sales activity could be inconsistent with the entity’s assertion that it has the intent and ability to hold the impaired equity securities until anticipated recovery.

5.3.2.3  Sales of impaired equity securities

Sales of impaired equity securities should be carefully evaluated to determine whether such sales are consistent with the entity’s prior assertion to hold impaired equity securities to full recovery. When equity securities that were previously accounted for as temporarily impaired are sold prior to recovery, the entity should document the facts and circumstances that prompted the sale. Sales in response to significant, unanticipated changes in market conditions or business plans may justify a change in the entity’s intent. However, sales that are not based on significant, unanticipated changes in circumstances may indicate that the entity’s past and current assertions (i.e., intent and ability to hold to anticipated recovery) are insufficient to conclude that impairments related to other equity securities are temporary.

How we see it

While turbulence in markets may lead to the conclusion that a significant, unanticipated change has occurred, an entity’s facts and circumstances must be assessed to determine whether its intent assertion remains valid. To support conclusions that impairments are temporary when changes to the entity’s intent related to an impaired equity security occur, the entity should prepare contemporaneous documentation describing the significant, unanticipated changes in the circumstances that gave rise to the change in intent. This documentation should also include a reassessment of equity securities that were not sold and why the sale does not alter the intent and ability to hold to recovery the impaired securities that were retained.

In addition, the entity should evaluate the facts and circumstances associated with equity security sale activity between the most recent balance sheet date and key subsequent financial reporting dates (e.g., press release and SEC filing dates) to determine whether any losses on the sale of impaired equity securities should have been reported in a prior period. The closer a subsequent sale is to the end of the prior reporting period, the more difficult it will be for the entity to support that the sale was due to a significant, unanticipated change in circumstances since the balance sheet date and that the OTTI did not occur in a prior period.
5.3.3 Measuring and recognizing an OTTI

**Excerpt from Accounting Standards Codification**

**Investments – Debt and Equity Securities – Overall**

**Subsequent Measurement**

**Recognition of an Other-Than-Temporary Impairment**

**Equity Securities – If the Impairment Is Other Than Temporary, Recognize an Impairment Loss Equal to the Difference between the Investment’s Cost Basis and Its Fair Value**

320-10-35-34

If it is determined in Step 2 that the impairment is other than temporary, then an impairment loss shall be recognized in earnings equal to the entire difference between the investment’s cost and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment shall not include partial recoveries after the balance sheet date. The fair value of the investment would then become the new amortized cost basis of the investment and shall not be adjusted for subsequent recoveries in fair value.

If an OTTI is determined to be present, an entity should recognize the difference between the cost basis of the impaired equity security and the fair value on the measurement date as an OTTI loss through net income, with the fair value becoming the equity security's new cost basis. Unrealized gains and losses previously recorded through OCI, including the tax effects, should also be reversed.

The new cost basis should not be changed for subsequent increases in fair value. After an impairment loss is recognized for individual equity securities classified as available for sale, future increases or decreases in fair value (presuming no additional OTTI) are included in OCI.

5.3.4 Foreign currency considerations

ASC 320 requires an evaluation of whether and when an available-for-sale equity security will recover in value and whether the investor has the intent and ability to hold that equity security until it recovers in value. As declines in fair value become more severe, a company must do more analysis and collect more objective evidence to support an assertion that it anticipates a recovery in fair value and has the intent and ability to hold the security until it recovers. If an impairment of an equity security denominated in a foreign currency is other than temporary, the cost basis (measured at the historical exchange rate) of the impaired equity security would be written down to the functional-currency-equivalent fair value (measured at the current exchange rate) and the loss should be recognized in net income.

5.3.5 Documentation considerations

Regardless of whether an entity determines that a decline in fair value of an equity security below cost is temporary or other than temporary, it must document how it arrived at this conclusion. At a minimum, appropriate documentation would include an analysis of the equity security’s fair value (e.g., amount and duration of decline), the financial performance of the issuer and trends in the issuer’s industry. The entity should also document its expectations about the security’s performance (i.e., when and why its value will recover), based on the information available as well as their intentions and ability to hold the security until anticipated recovery. The entity should be mindful that as the forecasted recovery period lengthens, the uncertainties inherent in its estimate increase, meaning more persuasive evidence would be required to conclude that an impairment is temporary. The documentation should include an indication of the timing of the review and the principal reasons for the decision.
### 5.4 OTTI model for perpetual preferred securities

Perpetual preferred securities (PPSs) may have either variable or fixed dividend rates but they have no contractual maturity or redemption date. PPSs are often perceived in the marketplace to be similar to debt securities because they frequently provide periodic cash flows in the form of dividends, contain call features, are rated similar to debt securities and are priced like other long-term callable bonds. However, PPSs are defined as equity securities if they are not required to be redeemed by the issuing entity or are not redeemable at the option of the investor. As equity securities, PPSs (that are marketable as defined in the ASC Master Glossary) may be classified either as available-for-sale or trading securities.

On 14 October 2008, the SEC's staff in the Office of the Chief Accountant issued a letter (SEC OTTI Release) to the FASB providing clarifying guidance on how to assess impairments of PPSs under the existing OTTI model in ASC 320.

Although industry practice had been to evaluate PPSs as equity securities for purposes of determining whether an impairment of a PPS is other than temporary, the SEC staff acknowledged that the accounting literature is ambiguous on this point because ASC 320 does not specifically address the effect, if any, of the debt-like characteristics of PPSs in an OTTI assessment. After consultation with and concurrence of the FASB staff, the SEC staff has concluded that it will not object to an issuer treating a PPS similar to a debt security in an OTTI evaluation (including an anticipated recovery period), provided there has been no evidence of a deterioration in the credit of the issuer (e.g., a decline in the cash flows from holding the investment or a downgrade of the rating of the security below investment grade).

This guidance from the SEC staff represented a significant change in practice due to the difference in how OTTI is assessed for equity securities and debt securities. For equity securities, an OTTI is recognized unless it is expected that the value of the security will recover in the near term (which is a relatively short period). However, in circumstances in which it is deemed appropriate to evaluate a perpetual preferred security for OTTI using the debt security model, an entity would apply the requirement to assess whether (1) the investor has the intent to sell the PPS or (2) it is more likely than not the investor will be required to sell the PPS before its anticipated recovery.

However, the guidance in the SEC OTTI Release can be applied only in circumstances in which there has been no evidence of deterioration in the credit of the issuer and should not be used when an entity anticipates a decrease in cash flows expected to be collected from the PPSs. When an entity anticipates a decrease in cash flows expected to be collected from the PPSs, the OTTI model for debt securities should not be used. Rather, the entity should use the OTTI model for equity securities and recognize an OTTI loss on the PPSs through net income equal to the entire difference between the PPS’s cost basis and its fair value at the balance sheet date.

In the SEC OTTI Release, the SEC staff emphasized its expectation that an issuer provide adequate disclosure about its PPS holdings if the cost exceeds the current fair value. This disclosure should include sufficient detail to allow investors to understand the factors considered in reaching the conclusion that the impairment is not other than temporary and there was no evidence of credit deterioration in the PPSs.
6 Presentation and disclosure

6.1 Overview

ASC 320 provides extensive presentation and disclosure requirements at both annual and quarterly reporting periods.

6.2 Balance sheet presentation

Excerpt from Accounting Standards Codification

Investments – Debt and Equity Securities – Overall

Other Presentation Matters

Balance Sheet Classification

320-10-45-1
An entity 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 do either of the following:

a. Present the aggregate of those fair value and non-fair-value amounts in the same line item and parenthetically disclose the amount of fair value included in the aggregate amount

b. Present two separate line items to display the fair value and non-fair-value carrying amounts.

320-10-45-2
An entity 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 guidance of Section 210-10-45.

320-10-45-13
This Subtopic does not 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 disclosed in the notes. Thus, entities that report certain investments in debt securities as cash equivalents in accordance with the provisions of Topic 230 can continue that practice, provided that the notes reconcile the reporting classifications used in the statement of financial position.

ASC 320 requires entities to present the individual amounts of the three categories of investments on either the face of the balance sheet or in the notes to the financial statements. Thus, entities that report certain investments in debt securities as cash equivalents or that include investments in equity securities as a component of other assets, may do so, as long as they reconcile the reporting classifications used in the balance sheet to the disclosures in the notes to the financial statements. In practice, entities with material amounts of investments generally present each category separately on the face of the balance sheet.

An entity with a classified balance sheet and a significant investment portfolio could have six different investment captions – trading securities (current and noncurrent), available-for-sale securities (current and noncurrent) and held-to-maturity securities (current and noncurrent). In these cases, it may be more appropriate to present the detailed disclosures in the notes to the financial statements.
6.3 Income statement presentation

6.3.1 Dividend and interest income

Dividend income is included in net income. There is no general guidance on which date (i.e., declaration date or ex-dividend date) should be used to accrue dividends. The recognition date should be an accounting policy election that is consistently applied.

Distributions that represent returns of capital should be credited to investment cost rather than to dividend income. Dividends-in-kind (distribution of assets other than stock) should be recorded at fair value and reported as income.

Stock dividends and stock splits are not recorded as income (ASC 505-20-30-7). The cost basis of shares previously held should be allocated equitably to the total shares held after the stock dividend or split. The adjusted basis should be used to calculate realized and unrealized gains and losses.

Interest income, including amortization of the premium and discount on debt securities for all three categories of investments, is included in net income. See section 2, Classification and measurement, for additional guidance on interest income for each security classification.

6.3.2 Other-than-temporary impairment

Excerpt from Accounting StandardsCodification

Investments – Debt and Equity Securities – Overall

Other Presentation Matters

Income Statement Classification

Other-Than-Temporary Impairment

320-10-45-8A

In periods in which an entity determines that a security's decline in fair value below its amortized cost basis is other than temporary, the entity shall present the total other-than-temporary impairment in the statement of earnings with an offset for the amount of the total other-than-temporary impairment that is recognized in other comprehensive income, in accordance with paragraph 320-10-35-34D, if any. Example 2A (see paragraph 320-10-55-21A) illustrates the application of this guidance.

OTTI should be presented in the statement of earnings with an offset for the amount of the total OTTI that is recognized in OCI, if any. The following is an example of the presentation:

<table>
<thead>
<tr>
<th>Illustration 6-1: Presentation of OTTI in the statement of earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total other-than-temporary impairment losses</td>
</tr>
<tr>
<td>Portion of loss recognized in other comprehensive income (before taxes)</td>
</tr>
<tr>
<td>Net impairment losses recognized in earnings</td>
</tr>
</tbody>
</table>
### 6.4 Other comprehensive income presentation

**Excerpt from Accounting Standards Codification**

<table>
<thead>
<tr>
<th>Comprehensive Income – Overall</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Other Presentation Matters</strong></td>
</tr>
<tr>
<td>Reporting Comprehensive Income</td>
</tr>
<tr>
<td>220-10-45-1</td>
</tr>
</tbody>
</table>

This Subtopic requires an entity to report comprehensive income either in a single continuous financial statement or in two separate but consecutive financial statements.

**Reclassification Adjustments**

220-10-45-15

Reclassification adjustments shall be made to avoid double counting of items in comprehensive income that are presented as part of net income for a period that also had been presented as part of other comprehensive income in that period or earlier periods. For example, gains on investment securities that were realized and included in net income of the current period that also had been included in other comprehensive income as unrealized holding gains in the period in which they arose must be deducted through other comprehensive income of the period in which they are included in net income to avoid including them in comprehensive income twice (see paragraph 320-10-40-2). Example 3 (see paragraphs 220-10-55-18 through 55-27) illustrates the presentation of reclassification adjustments in accordance with this paragraph.

Unrealized holding gains and losses on available-for-sale securities (including gains and losses on securities classified as current assets) should be reported in OCI until realized.

ASC 220 requires the components of OCI and net income be reported in a single continuous financial statement of comprehensive income or in two separate but consecutive financial statements of net income and comprehensive income. Entities do not have the option to present components of OCI in the statement of shareholders’ equity.

Reclassification adjustments are required to avoid double-counting in comprehensive income. For example, unrealized gains and losses for available-for-sale securities and the noncredit portion of OTTIs are recorded in OCI. When a realized gain or loss occurs or a portion of noncredit OTTI is recognized in earnings, the amounts previously recorded in OCI should be deducted through OCI in the current period to arrive at comprehensive income. The following is an example of this presentation:

**Illustration 6-2: Presentation of reclassification adjustments**

On 1 January 2012, Company A purchased 1,000 shares of equity securities at $10 per share, which it classified as available for sale. The fair value of the securities at 31 December 2012, and 31 December 2013, was $12 and $15, respectively. There were no dividends declared on the securities, which were all sold on 31 December 2013. Tax effects are ignored in this example:

<table>
<thead>
<tr>
<th>Net income:</th>
<th>For the year ended December 31, 2012</th>
<th>For the year ended December 31, 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gain on sale of securities</td>
<td>$ 5,000</td>
<td>$ 3,000</td>
</tr>
<tr>
<td>Net income</td>
<td>5,000</td>
<td>3,000</td>
</tr>
</tbody>
</table>

**Other comprehensive income:**

| Unrealized gains on available-for-sale securities | $ 2,000 | 3,000 |
| Reclassification adjustment for gains included in net income | (5,000) |
| Other comprehensive income | (2,000) |
| Comprehensive income | $ 2,000 | $ 3,000 |
6.5 Cash flow presentation and disclosure

**Excerpt from Accounting Standards Codification**

*Investments – Debt and Equity Securities – Overall*

**Other Presentation Matters**

**Cash Flow Presentation**

*320-10-45-11*

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.

*320-10-45-12*

Paragraph 230-10-45-8 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 this Subtopic, such as disclosure of amortized cost and fair value by major security types.

ASC 320 requires separate classification of cash flow activity in the held-to-maturity, available-for-sale and trading portfolios in the statement of cash flows. Cash flow activity from purchases, sales and maturities of available-for-sale and held-to-maturity securities should be classified as investing activities and reported on a gross basis. Cash flow activity from purchases, sales and maturities of trading securities should be classified based on the nature and purpose for which the securities were acquired and are generally reported on a net basis. Cash flows from interest and returns on investment should be considered cash inflows from operating activities.

Some securities that are short-term at the time of purchase are classified as cash and cash equivalents in accordance with ASC 230-10. The cash flows from purchases, sales or maturities of those securities should not be classified as investing activities in the statement of cash flows. Rather, those cash flows should be included in the cash and cash equivalents line in the statement of cash flows.

As discussed in section 4, *Sales of securities*, certain sales of debt securities before maturity (e.g., sales within three months of maturity) are deemed to have occurred at maturity. We believe the proceeds received on such sales may be classified as cash received on maturity in the statement of cash flows.

Transfers between held to maturity or available for sale and trading generally result in a non-cash transfer between investing and operating activities. Under the provisions of ASC 230-10, those activities affect recognized assets, even though they do not result in cash receipts or cash payments in the current period. Therefore, such activity, if significant, should be included in the disclosures of non-cash activity.

Refer to our FRD publication, *Statement of cash flows*, for additional guidance.

6.6 Disclosures

ASC 320 requires disclosures in all complete sets of financial statements for both annual and interim periods. The minimum disclosure requirements for summarized interim financial information issued by publicly traded entities are established by ASC 270-10.

The following summarizes certain practice issues related to the required disclosures.
6.6.1 Unrealized loss disclosures

Excerpt from Accounting Standards Codification
Investments – Debt and Equity Securities – Overall

Disclosure

320-10-50-6
For all investments in an unrealized loss position, including those that fall within the scope of Subtopic 325-40, for which other-than-temporary impairments have not been recognized in earnings (including investments for which a portion of an other-than-temporary impairment has been recognized in other comprehensive income), an entity shall disclose all of the following in its interim and annual financial statements:

a. As of each date for which a statement of financial position is presented, quantitative information, aggregated by category of investment—each major security type that the entity discloses in accordance with this Subtopic and cost-method investments—in tabular form:
   1. The aggregate related fair value of investments with unrealized losses
   2. The aggregate amount of unrealized losses (that is, the amount by which amortized cost basis exceeds fair value).

320-10-50-7
The disclosures in (a)(1) through (a)(2) in the preceding paragraph shall be segregated by those investments that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer.

When an OTTI is recognized but only the credit loss is recognized in net income and the noncredit OTTI remains in OCI, the “clock” does not reset for purposes of preparing the unrealized loss disclosures required by ASC 320-10-50-7. That is, the length of time that the unrealized loss exists does not change simply because the character of the unrealized loss changed to noncredit OTTI. In other words, the recognition of an OTTI does not “refresh” the unrealized loss (i.e., the noncredit OTTI) that remains in OCI.

6.6.2 Credit loss rollforward disclosures

Excerpt from Accounting Standards Codification
Investments – Debt and Equity Securities – Overall

Disclosure

320-10-50-8B
For each interim and annual reporting period presented, an entity shall disclose a tabular rollforward of the amount related to credit losses recognized in earnings in accordance with paragraph 320-10-35-34D, which shall include at a minimum, all of the following:

a. The beginning balance of the amount related to credit losses on debt securities held by the entity at the beginning of the period for which a portion of an other-than-temporary impairment was recognized in other comprehensive income
b. Additions for the amount related to the credit loss for which an other-than-temporary impairment was not previously recognized
c. Reductions for securities sold during the period (realized)
d. Reductions for securities for which the amount previously recognized in other comprehensive income was recognized in earnings because the entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis.

e. If the entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis, additional increases to the amount related to the credit loss for which an other-than-temporary impairment was previously recognized.

f. Reductions for increases in cash flows expected to be collected that are recognized over the remaining life of the security (see paragraph 320-10-35-35).

g. The ending balance of the amount related to credit losses on debt securities held by the entity at the end of the period for which a portion of an other-than-temporary impairment was recognized in other comprehensive income.

The amount of credit losses to be rolled forward each period in accordance with ASC 320-10-50-8B is the cumulative credit loss amount recognized in net income on impaired debt securities for which a portion of the impairment was recognized in OCI. Subsequent increases in cash flows on debt securities for which OTTI was previously recognized in net income for credit losses are recognized as a prospective yield adjustment. As such, the amount to be included in the rollforward for the “reduction for increases in cash flows expected to be collected that are recognized over the remaining life of the security” (i.e., item (f)) should include only amounts recognized in net income in the current period related to the increase in the yield.

For example, if an increase in cash flows expected to be collected results in the yield increasing from 8% to 9%, it is the effect on current-period income of the 1% increase in the yield that is included in the rollforward. However, there is nothing that prohibits an entity from also disclosing the entire amount of the increase in cash flows expected to be collected during the period.

6.6.3 Disclosing fair value

While ASC 320 applies only to equity securities with readily determinable fair values, it applies to all investments in debt securities, regardless of whether their fair value is readily determinable. Even though held-to-maturity securities are carried at amortized cost in the statement of financial position, entities must disclose their fair value in the notes to the financial statements. Fair value is also used in the other-than-temporary assessment. As a result, entities must determine the fair value of all debt securities. ASC 820 discusses fair value measurements. Refer to our FRD publication, *Fair value measurement*, for additional information.
A Summary of relevant accounting standards updates

A.1 ASU 2016-01

ASU 2016-01, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities (ASU 2016-01) will change how entities recognize, measure, present and make disclosures about certain financial assets and financial liabilities. Under the new guidance:

- Entities will be required to measure equity investments (except those accounted for under the equity method, those that result in consolidation of the investee and certain other investments) at fair value and recognize any changes in fair value in net income. Entities will no longer be able to classify equity investments as trading or available for sale, and they will no longer recognize unrealized holding gains and losses on equity securities they classify today as available for sale in other comprehensive income.

- Entities will be able to elect a measurement alternative for equity investments that do not have readily determinable fair values and do not qualify for the practical expedient in ASC 820 to estimate fair value using the net asset value per share. Under the alternative, they will measure these investments at cost, less any impairment, plus or minus changes resulting from observable price changes in orderly transactions for an identical or similar investment of the same issuer.

- An entity that uses the measurement alternative for an eligible equity investment will be required to make a qualitative assessment of whether the investment is impaired. If a qualitative assessment indicates that the investment is impaired, the entity will have to estimate the investment’s fair value in accordance with ASC 820 and recognize an impairment loss (if any) in net income equal to the difference between carrying value and fair value. The entity will no longer be able to consider whether the decline is other than temporary, as is required under current US GAAP.

- Entities that are not PBEs will no longer have to disclose the fair value of financial instruments that are not measured at fair value (e.g., those measured at amortized cost), and PBEs will have to make fewer fair value disclosures.

ASU 2016-01 does not change the guidance for classifying and measuring investments in debt securities.

Effective date

ASU 2016-01 is effective for PBEs for annual periods beginning after 15 December 2017, and interim periods therein. For all other entities, it is effective for fiscal years beginning after 15 December 2018, and interim periods within fiscal years beginning after 15 December 2019. Non-PBEs can adopt the standard at the same time as PBEs, and both PBEs and non-PBEs can early adopt certain provisions.

Additional information

For additional information, refer to our FRD publication, Certain investments in debt and equity securities (after the adoption of ASU 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities).
A.2  

**ASU 2016-13**

ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments* (ASU 2016-13) changes how entities will measure credit losses for most financial assets and certain other instruments that aren't measured at fair value through net income. ASU 2016-13 will also require new disclosures.

The new guidance will require entities to use the following impairment models:

- A new “expected credit loss” model that will apply to most financial assets measured at amortized cost and certain other instruments, including held-to-maturity debt securities
- An available-for-sale debt security model that is a modification of today’s other-than-temporary impairment model
- The existing model for beneficial interests that are not of high credit quality (ASC 325-40), amended to conform to the new impairment models for held-to-maturity and available-for-sale debt securities

ASU 2016-13 also eliminates today’s accounting model for purchased credit impaired loans and debt securities. Instead, entities will gross up the initial amortized cost for so-called purchased financial assets with credit deterioration (PCD assets). Under this approach, an entity will record as the initial amortized cost the sum of (1) the purchase price and (2) the estimate of credit losses as of the date of acquisition. Thereafter, the entity will account for PCD assets using the models listed above.

**Held-to-maturity debt securities**

The new guidance will require an entity to estimate its lifetime “expected credit loss” and record an allowance that, when deducted from the amortized cost basis of the debt security, presents the net amount expected to be collected. That is, the allowance represents the portion of the amortized cost basis the entity doesn't expect to collect. The new guidance does not define “expected credit loss,” but it describes several core concepts to illustrate it.

**Available-for-sale debt securities**

For available-for-sale debt securities with unrealized losses, entities will measure credit losses in a manner similar to current guidance, except that the losses will be recognized as allowances rather than reductions in the amortized cost of the securities. As a result, entities will recognize improvements to estimated credit losses on available-for-sale debt securities immediately in earnings rather than as interest income over time, as they do today. The new guidance also indicates that management may not use the length of time a security has been in an unrealized loss position as a factor in concluding whether a credit loss exists.

**Effective date**

For PBEs that meet the definition of an SEC filer, the guidance is effective for annual periods beginning after 15 December 2019, and interim periods therein. For other PBEs, the guidance is effective for annual periods beginning after 15 December 2020, and interim periods therein. For all other entities, the standard is effective for annual periods beginning after 15 December 2020, and interim periods within annual periods beginning after 15 December 2021.

**Additional information**

Refer to our FRD publication, *Credit impairment under ASC 326.*
Glossary

This appendix defines terms used in ASC 320, which are also included in the ASC Master Glossary.

**Amortized cost basis**

The amount at which an investment is acquired, adjusted for accretion, amortization, collection of cash, previous other-than-temporary impairments recognized in earnings (less any cumulative-effect adjustments), foreign exchange, and fair value hedge accounting adjustments.

**Available-for-sale securities**

Investments not classified as either trading securities or as held-to-maturity securities.

**Cash equivalents**

Cash equivalents are short-term, highly liquid investments that have both of the following characteristics:

a. Readily convertible to known amounts of cash

b. So near their maturity that they present insignificant risk of changes in value because of changes in interest rates.

Generally, only investments with original maturities of three months or less qualify under that definition. Original maturity means original maturity to the entity holding the investment. For example, both a three-month U.S. Treasury bill and a three-year U.S. Treasury note purchased three months from maturity qualify as cash equivalents. However, a Treasury note purchased three years ago does not become a cash equivalent when its remaining maturity is three months. Examples of items commonly considered to be cash equivalents are Treasury bills, commercial paper, money market funds, and federal funds sold (for an entity with banking operations).

**Debt security**

Any security representing a creditor relationship with an entity. The term debt security also includes all of the following:

a. Preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor

b. A collateralized mortgage obligation (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

c. US Treasury securities
d. US government agency securities
e. Municipal securities
f. Corporate bonds
g. Convertible debt
h. Commercial paper
i. All securitized debt instruments, such as collateralized mortgage obligations and real estate mortgage investment conduits
j. Interest-only and principal-only strips
The term debt security excludes all of the following:

- Option contracts
- Financial futures contracts
- Forward contracts
- Lease contracts
- Receivables that do not meet the definition of security and, so, are not debt securities, for example:
  1. Trade accounts receivable arising from sales on credit by industrial or commercial entities
  2. Loans receivable arising from consumer, commercial, and real estate lending activities of financial institutions.

**Equity security**

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

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

**Fair value**

The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

**Holding gain or loss**

The net change in fair value of a security. The holding gain or loss does not include dividend or interest income recognized but not yet received or write-downs for other-than-temporary impairment.

**Readily determinable fair value**

An equity security has a readily determinable fair value if it meets any of the following conditions:

- 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 U.S. 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 Securities Dealers Automated Quotations systems or by OTC Markets Group Inc. Restricted stock meets that definition if the restriction terminates within one year.
- 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 equity security that is an investment in a mutual fund or in a structure similar to a mutual fund (that is, a limited partnership or a venture capital entity) is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions.

**Security**

A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:

a. It is either 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. It 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.

c. It 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.

**Structured note**

A debt instrument whose cash flows are linked to the movement in one or more indexes, interest rates, foreign exchange rates, commodities prices, prepayment rates, or other market variables. Structured notes are issued by U.S. government-sponsored enterprises, multilateral development banks, municipalities, and private entities. The notes typically contain embedded (but not separable or detachable) forward components or option components such as caps, calls, and floors. Contractual cash flows for principal, interest, or both can vary in amount and timing throughout the life of the note based on nontraditional indexes or nontraditional uses of traditional interest rates or indexes.

**Trading**

An activity involving securities sold in the near term and held for only a short period of time. The term trading contemplates a holding period generally measured in hours and days rather than months or years. See paragraph 948-310-40-1 for clarification of the term trading for a mortgage banking entity.

**Trading security**

Securities that are bought and held principally for the purpose of selling them in the near term and therefore held for only a short period of time. 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.
ASC references

<table>
<thead>
<tr>
<th>ASC Paragraph</th>
<th>Section</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>210-10-45-1(f)</td>
<td>2.5.1</td>
<td>Entities with classified balance sheets</td>
</tr>
<tr>
<td>220-10-45-1</td>
<td>6.4</td>
<td>Other comprehensive income presentation</td>
</tr>
<tr>
<td>220-10-45-15</td>
<td>6.4</td>
<td>Other comprehensive income presentation</td>
</tr>
<tr>
<td>320-10-15-2</td>
<td>1.2</td>
<td>Scope and scope exceptions – entities</td>
</tr>
<tr>
<td>320-10-15-3</td>
<td>1.2</td>
<td>Scope and scope exceptions – entities</td>
</tr>
<tr>
<td>320-10-15-7</td>
<td>1.3.3</td>
<td>Instruments not in the scope of ASC 320</td>
</tr>
<tr>
<td>320-10-25-1</td>
<td>2.3</td>
<td>Trading securities</td>
</tr>
<tr>
<td>320-10-25-1</td>
<td>2.4</td>
<td>Held-to-maturity securities</td>
</tr>
<tr>
<td>320-10-25-1</td>
<td>2.5</td>
<td>Available-for-sale securities</td>
</tr>
<tr>
<td>320-10-25-5(a)</td>
<td>1.3.4.3</td>
<td>Contractual prepayment or settlement in such a way that the holder would not</td>
</tr>
<tr>
<td></td>
<td></td>
<td>recover substantially all of its recorded investment</td>
</tr>
<tr>
<td>320-10-25-5(a)</td>
<td>2.4.1.2.6</td>
<td>Interest-only securities and other securities with principal risk</td>
</tr>
<tr>
<td>320-10-25-5(d)</td>
<td>4.4.2.1</td>
<td>Credit deterioration</td>
</tr>
<tr>
<td>320-10-25-6</td>
<td>2.4.1.2.2</td>
<td>Pledged securities</td>
</tr>
<tr>
<td>320-10-25-6(a)</td>
<td>3.3</td>
<td>Transfers from held to maturity to available for sale</td>
</tr>
<tr>
<td>through (f)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>320-10-25-6</td>
<td>4.4.1.1</td>
<td>SEC staff views on sales or transfers of held-to-maturity securities</td>
</tr>
<tr>
<td>320-10-25-6</td>
<td>4.4.2</td>
<td>Permitted sales or transfers</td>
</tr>
<tr>
<td>320-10-25-6(a)</td>
<td>4.4.2.1</td>
<td>Credit deterioration</td>
</tr>
<tr>
<td>320-10-25-6(c)</td>
<td>4.4.2.3</td>
<td>Major business combination or disposition</td>
</tr>
<tr>
<td>320-10-25-6</td>
<td>5.2.1</td>
<td>Overview</td>
</tr>
<tr>
<td>320-10-25-6</td>
<td>5.2.3.1.3</td>
<td>Securities classified as held to maturity</td>
</tr>
<tr>
<td>320-10-25-9</td>
<td>2.4.1.2.2</td>
<td>Pledged securities</td>
</tr>
<tr>
<td>320-10-25-9</td>
<td>4.4.2.6</td>
<td>Isolated, nonrecurring and unusual events</td>
</tr>
<tr>
<td>320-10-25-9</td>
<td>5.2.1</td>
<td>Overview</td>
</tr>
<tr>
<td>320-10-25-9</td>
<td>5.2.3.1.3</td>
<td>Securities classified as held to maturity</td>
</tr>
<tr>
<td>320-10-25-13(d)</td>
<td>4.4.2.6.1</td>
<td>Tender offers for held-to-maturity securities</td>
</tr>
<tr>
<td>320-10-25-14</td>
<td>2.4.1.2.2</td>
<td>Pledged securities</td>
</tr>
<tr>
<td>320-10-25-14</td>
<td>4.4.3</td>
<td>Sales deemed to be at maturity</td>
</tr>
<tr>
<td>320-10-25-14</td>
<td>5.2.1</td>
<td>Overview</td>
</tr>
<tr>
<td>320-10-25-14</td>
<td>5.2.3.1.3</td>
<td>Securities classified as held to maturity</td>
</tr>
<tr>
<td>320-10-25-18(e)</td>
<td>2.4.1.2.3</td>
<td>Repurchase agreements and similar arrangements</td>
</tr>
<tr>
<td>ASC Paragraph</td>
<td>Section</td>
<td>Description</td>
</tr>
<tr>
<td>---------------</td>
<td>---------</td>
<td>-------------</td>
</tr>
<tr>
<td>320-10-30-3</td>
<td>2.2.4</td>
<td>Initial carrying amount of equity securities that become marketable</td>
</tr>
<tr>
<td>320-10-30-4</td>
<td>3.5.1</td>
<td>Loss of significant influence</td>
</tr>
<tr>
<td>320-10-35-1</td>
<td>2.3</td>
<td>Trading securities</td>
</tr>
<tr>
<td>320-10-35-1</td>
<td>2.4</td>
<td>Held-to-maturity securities</td>
</tr>
<tr>
<td>320-10-35-1</td>
<td>2.5</td>
<td>Available-for-sale securities</td>
</tr>
<tr>
<td>320-10-35-5</td>
<td>3.1</td>
<td>Overview</td>
</tr>
<tr>
<td>320-10-35-7</td>
<td>4.4.1</td>
<td>Evaluation of the remaining portfolio following a sale or transfer</td>
</tr>
<tr>
<td>320-10-35-8</td>
<td>4.4</td>
<td>Sales of held-to-maturity securities</td>
</tr>
<tr>
<td>320-10-35-9</td>
<td>4.4</td>
<td>Sales of held-to-maturity securities</td>
</tr>
<tr>
<td>320-10-35-10</td>
<td>3.2</td>
<td>Transfers from available-for-sale to held-to-maturity</td>
</tr>
<tr>
<td>320-10-35-10</td>
<td>3.3</td>
<td>Transfers from held to maturity to available for sale</td>
</tr>
<tr>
<td>320-10-35-10</td>
<td>3.4</td>
<td>Transfers involving trading securities</td>
</tr>
<tr>
<td>320-10-35-11</td>
<td>3.3</td>
<td>Transfers from held to maturity to available for sale</td>
</tr>
<tr>
<td>320-10-35-12</td>
<td>3.4</td>
<td>Transfers involving trading securities</td>
</tr>
<tr>
<td>320-10-35-17</td>
<td>1.2</td>
<td>Scope and scope exceptions – entities</td>
</tr>
<tr>
<td>320-10-35-18</td>
<td>5.1</td>
<td>Overview and scope</td>
</tr>
<tr>
<td>320-10-35-30</td>
<td>5.2.3</td>
<td>Evaluating whether an impairment is other than temporary</td>
</tr>
<tr>
<td>320-10-35-32A</td>
<td>5.3.2</td>
<td>Evaluating whether an impairment is other than temporary</td>
</tr>
<tr>
<td>320-10-35-33</td>
<td>5.3.2</td>
<td>Evaluating whether an impairment is other than temporary</td>
</tr>
<tr>
<td>320-10-35-33A</td>
<td>5.2.3</td>
<td>Evaluating whether an impairment is other than temporary</td>
</tr>
<tr>
<td>320-10-35-33B</td>
<td>5.2.3</td>
<td>Evaluating whether an impairment is other than temporary</td>
</tr>
<tr>
<td>320-10-35-33C</td>
<td>5.2.3</td>
<td>Evaluating whether an impairment is other than temporary</td>
</tr>
<tr>
<td>320-10-35-33F</td>
<td>5.2.3.3</td>
<td>Entity does not expect to recover the entire amortized cost basis</td>
</tr>
<tr>
<td>320-10-35-33G</td>
<td>5.2.3.3</td>
<td>Entity does not expect to recover the entire amortized cost basis</td>
</tr>
<tr>
<td>320-10-35-34</td>
<td>5.3.3</td>
<td>Measuring and recognizing an OTTI</td>
</tr>
<tr>
<td>320-10-35-34A</td>
<td>5.2.3.1</td>
<td>Entity intends to sell the debt security</td>
</tr>
<tr>
<td>320-10-35-34B</td>
<td>5.2.3.1</td>
<td>Entity intends to sell the debt security</td>
</tr>
<tr>
<td>320-10-35-34C</td>
<td>5.2.3.3</td>
<td>Entity does not expect to recover the entire amortized cost basis</td>
</tr>
<tr>
<td>320-10-35-34D</td>
<td>5.2.3.3</td>
<td>Entity does not expect to recover the entire amortized cost basis</td>
</tr>
<tr>
<td>320-10-35-35</td>
<td>5.2.6</td>
<td>Accounting after an OTTI</td>
</tr>
<tr>
<td>320-10-35-35A</td>
<td>5.2.6</td>
<td>Accounting after an OTTI</td>
</tr>
<tr>
<td>320-10-35-40</td>
<td>2.6</td>
<td>Structured notes</td>
</tr>
<tr>
<td>320-10-45-1</td>
<td>6.2</td>
<td>Balance sheet presentation</td>
</tr>
<tr>
<td>ASC Paragraph</td>
<td>Section</td>
<td>Description</td>
</tr>
<tr>
<td>---------------</td>
<td>---------</td>
<td>-------------</td>
</tr>
<tr>
<td>320-10-45-2</td>
<td>6.2</td>
<td>Balance sheet presentation</td>
</tr>
<tr>
<td>320-10-45-8A</td>
<td>6.3.2</td>
<td>Other-than-temporary impairment</td>
</tr>
<tr>
<td>320-10-45-11</td>
<td>6.5</td>
<td>Cash flow presentation and disclosure</td>
</tr>
<tr>
<td>320-10-45-12</td>
<td>6.5</td>
<td>Cash flow presentation and disclosure</td>
</tr>
<tr>
<td>320-10-45-13</td>
<td>6.2</td>
<td>Balance sheet presentation</td>
</tr>
<tr>
<td>320-10-50-6</td>
<td>6.6.1</td>
<td>Unrealized loss disclosures</td>
</tr>
<tr>
<td>320-10-50-7</td>
<td>6.6.1</td>
<td>Unrealized loss disclosures</td>
</tr>
<tr>
<td>320-10-50-8B</td>
<td>6.6.2</td>
<td>Credit loss rollforward disclosures</td>
</tr>
<tr>
<td>320-10-50-9</td>
<td>3.8</td>
<td>Disclosures about transfers between categories</td>
</tr>
<tr>
<td>320-10-50-9A</td>
<td>4.5</td>
<td>Disclosure requirements for sales of securities</td>
</tr>
<tr>
<td>320-10-50-10</td>
<td>3.8</td>
<td>Disclosures about transfers between categories</td>
</tr>
<tr>
<td>320-10-50-10A</td>
<td>4.5</td>
<td>Disclosure requirements for sales of securities</td>
</tr>
<tr>
<td>320-10-S99-1</td>
<td>5.3.2</td>
<td>Evaluating whether an impairment is other than temporary</td>
</tr>
<tr>
<td>320-10-S99-2</td>
<td>2.5.5</td>
<td>Effect of available-for-sale security unrealized gains and losses on certain insurance-related assets and liabilities of insurance companies</td>
</tr>
<tr>
<td>323-10-35-33</td>
<td>3.5.2</td>
<td>Changing from ASC 320 accounting to the equity method of accounting</td>
</tr>
<tr>
<td>323-10-35-36</td>
<td>3.5.1</td>
<td>Loss of significant influence</td>
</tr>
<tr>
<td>325-20-35-1</td>
<td>1.3.1.1.1</td>
<td>Cost method investments</td>
</tr>
<tr>
<td>325-20-30-2 through 30-6</td>
<td>2.2.6</td>
<td>Nonmonetary exchange of equity securities</td>
</tr>
<tr>
<td>325-40-15-3</td>
<td>1.3.2.3.1</td>
<td>Securities in the scope of ASC 325-40</td>
</tr>
<tr>
<td>325-40-15-7</td>
<td>1.3.2.3.2</td>
<td>Applicability of ASC 325-40 to trading securities</td>
</tr>
<tr>
<td>325-40-15-8A</td>
<td>1.3.2.3.2</td>
<td>Applicability of ASC 325-40 to trading securities</td>
</tr>
<tr>
<td>325-40-15-9A</td>
<td>1.3.2.3.2</td>
<td>Applicability of ASC 325-40 to trading securities</td>
</tr>
<tr>
<td>505-20-30-7</td>
<td>6.3.1</td>
<td>Dividend and interest income</td>
</tr>
<tr>
<td>815-10-15-15</td>
<td>2.2.3</td>
<td>Recognition date</td>
</tr>
<tr>
<td>815-10-15-17</td>
<td>2.2.3</td>
<td>Recognition date</td>
</tr>
<tr>
<td>815-10-15-8</td>
<td>1.3.1.2.1</td>
<td>Certain purchased options and forward contracts</td>
</tr>
<tr>
<td>815-10-55-57</td>
<td>1.3.4.2</td>
<td>Short sales of securities</td>
</tr>
<tr>
<td>815-20-25-12A</td>
<td>3.3</td>
<td>Transfers from held to maturity to available for sale</td>
</tr>
<tr>
<td>830-20-35-1A</td>
<td>2.4.5</td>
<td>Foreign currency considerations</td>
</tr>
<tr>
<td>860-10-40-5</td>
<td>2.4.1.2.2</td>
<td>Pledged securities</td>
</tr>
<tr>
<td>860-20-35-2</td>
<td>2.4.1.2.5</td>
<td>Put and call features</td>
</tr>
<tr>
<td>860-20-35-3</td>
<td>1.3.4.3</td>
<td>Contractual prepayment or settlement in such a way that the holder would not recover substantially all of its recorded investment</td>
</tr>
<tr>
<td>940-320-25-1</td>
<td>2.2.3</td>
<td>Recognition date</td>
</tr>
<tr>
<td>ASC Paragraph</td>
<td>Section</td>
<td>Description</td>
</tr>
<tr>
<td>---------------</td>
<td>---------</td>
<td>-------------</td>
</tr>
<tr>
<td>942-325-25-2</td>
<td>2.2.3</td>
<td>Recognition date</td>
</tr>
<tr>
<td>944-325-30-1</td>
<td>1.3.1.1.3</td>
<td>Insurance entities and equity securities without readily determinable fair values</td>
</tr>
<tr>
<td>946-320-25-1</td>
<td>2.2.3</td>
<td>Recognition date</td>
</tr>
<tr>
<td>946-320-30-1</td>
<td>2.2.2</td>
<td>Transaction costs</td>
</tr>
<tr>
<td>954-220-45-4</td>
<td>5.1</td>
<td>Overview and scope</td>
</tr>
<tr>
<td>through 45-7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>960-325-25-1</td>
<td>2.2.3</td>
<td>Recognition date</td>
</tr>
<tr>
<td>962-325-25-1</td>
<td>2.2.3</td>
<td>Recognition date</td>
</tr>
<tr>
<td>965-320-25-1</td>
<td>2.2.3</td>
<td>Recognition date</td>
</tr>
</tbody>
</table>
D

### ASC abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>FASB Accounting Standards Codification</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASC 210-10</td>
<td>FASB ASC Topic 210-10, Balance Sheet – Overall</td>
</tr>
<tr>
<td>ASC 220</td>
<td>FASB ASC Topic 220, Comprehensive Income</td>
</tr>
<tr>
<td>ASC 230</td>
<td>FASB ASC Topic 230, Statement of Cash Flows</td>
</tr>
<tr>
<td>ASC 230-10</td>
<td>FASB ASC Topic 230-10, Statement of Cash Flows – Overall</td>
</tr>
<tr>
<td>ASC 270-10</td>
<td>FASB ASC Topic 270-10, Interim Reporting – Overall</td>
</tr>
<tr>
<td>ASC 310</td>
<td>FASB ASC Topic 310, Receivables</td>
</tr>
<tr>
<td>ASC 310-10</td>
<td>FASB ASC Topic 310-10, Receivables – Overall</td>
</tr>
<tr>
<td>ASC 310-30</td>
<td>FASB ASC Topic 310-30, Receivables – Loans and Debt Securities Acquired with Deteriorated Credit Quality</td>
</tr>
<tr>
<td>ASC 320</td>
<td>FASB ASC Topic 320, Investments – Debt and Equity Securities</td>
</tr>
<tr>
<td>ASC 320-10</td>
<td>FASB ASC Topic 320, Investments – Debt and Equity Securities – Overall</td>
</tr>
<tr>
<td>ASC 323</td>
<td>FASB ASC Topic 323, Investments – Equity Method and Joint Ventures</td>
</tr>
<tr>
<td>ASC 325-20</td>
<td>FASB ASC Topic 325-20, Investments – Cost Method Investments</td>
</tr>
<tr>
<td>ASC 325-40</td>
<td>FASB ASC Topic 325-40, Investments – Beneficial Interests in Securitized Financial Assets</td>
</tr>
<tr>
<td>ASC 505-20</td>
<td>FASB ASC Topic 505-20, Equity – Stock Dividends and Stock Splits</td>
</tr>
<tr>
<td>ASC 505-50</td>
<td>FASB ASC Topic 505-50, Equity – Equity-Based Payments to Non-Employees</td>
</tr>
<tr>
<td>ASC 805-10</td>
<td>FASB ASC Topic 805-10, Business Combinations – Overall</td>
</tr>
<tr>
<td>ASC 606</td>
<td>FASB ASC Topic 606, Revenue from Contracts with Customers</td>
</tr>
<tr>
<td>ASC 810</td>
<td>FASB ASC Topic 810, Consolidation</td>
</tr>
<tr>
<td>ASC 815</td>
<td>FASB ASC Topic 815, Derivatives and Hedging</td>
</tr>
<tr>
<td>ASC 815-10</td>
<td>FASB ASC Topic 815-10, Derivatives and Hedging – Overall</td>
</tr>
<tr>
<td>ASC 815-15</td>
<td>FASB ASC Topic 815-15, Derivatives and Hedging – Embedded Derivatives</td>
</tr>
<tr>
<td>ASC 820</td>
<td>FASB ASC Topic 820, Fair Value Measurements</td>
</tr>
<tr>
<td>ASC 825</td>
<td>FASB ASC Topic 825, Financial Instruments</td>
</tr>
<tr>
<td>ASC 830-20</td>
<td>FASB ASC Topic 830-20, Foreign Currency Matters – Foreign Currency Transactions</td>
</tr>
<tr>
<td>ASC 860</td>
<td>FASB ASC Topic 860, Transfers and Servicing</td>
</tr>
<tr>
<td>ASC 860-10</td>
<td>FASB ASC Topic 860-10, Transfers and Servicing – Overall</td>
</tr>
<tr>
<td>ASC 860-20</td>
<td>FASB ASC Topic 860-20, Transfers and Servicing – Sales of Financial Assets</td>
</tr>
<tr>
<td>ASC 860-30</td>
<td>FASB ASC Topic 860-30, Transfers and Servicing – Secured Borrowing and Collateral</td>
</tr>
<tr>
<td>ASC 940-320</td>
<td>FASB ASC Topic 940-320, Financial Services – Brokers and Dealers – Investments–Debt and Equity Securities</td>
</tr>
<tr>
<td>ASC 942-325</td>
<td>FASB ASC Topic 942-325, Financial Services – Depository and Lending – Investments–Other</td>
</tr>
<tr>
<td>ASC 944</td>
<td>FASB ASC Topic 944, Financial Services – Insurance</td>
</tr>
<tr>
<td>ASC 946-320</td>
<td>FASB ASC Topic 946-320, Financial Services – Investment Companies – Investments – Debt and Equity Securities</td>
</tr>
<tr>
<td>ASC 948</td>
<td>FASB ASC Topic 948, Financial Services – Mortgage Banking</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>FASB Accounting Standards Codification</td>
</tr>
<tr>
<td>--------------</td>
<td>--------------------------------------</td>
</tr>
<tr>
<td>ASC 958-320</td>
<td>FASB ASC Topic 958-320, Not-for-Profit Entities – Investments – Debt and Equity Securities</td>
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<td>FASB ASC Topic 960-325, Plan Accounting – Defined Benefit Pension Plans – Investments – Other</td>
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<td>ASC 962-325</td>
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<th>Abbreviation</th>
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<tr>
<td>ASU 2009-12</td>
<td>FASB ASU 2009-12, Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)</td>
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<tr>
<td>ASU 2014-09</td>
<td>FASB ASU 2014-09, Revenue from Contracts with Customers (Topic 606)</td>
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<tr>
<td>ASU 2015-10</td>
<td>FASB ASU 2015-10, Technical Corrections and Improvements</td>
</tr>
<tr>
<td>ASU 2017-08</td>
<td>FASB ASU 2017-08, Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities</td>
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<td>ASU 2017-12</td>
<td>FASB ASU 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities</td>
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<td>Rule 144</td>
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<tr>
<td>Statement 115</td>
<td>FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities</td>
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Summary of important changes

The following highlights important changes to this FRD since the December 2018 edition:

Section 1: Overview and scope

- Section 1.3.2.2 was updated to enhance interpretive guidance on the classification of certain preferred stock as HTM.
- Section 1.3.2.3 was updated to (1) add a flowchart for determining whether an asset is in the scope of ASC 325-40 and (2) include interpretive guidance on recoverability of beneficial interests in securitized financial assets and the applicability of ASC 325-40 to beneficial interests classified as trading securities.

Section 2: Classification and measurement

- Section 2.2.1 was updated to enhance interpretative guidance on accounting for premiums on certain purchased callable debt securities.
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