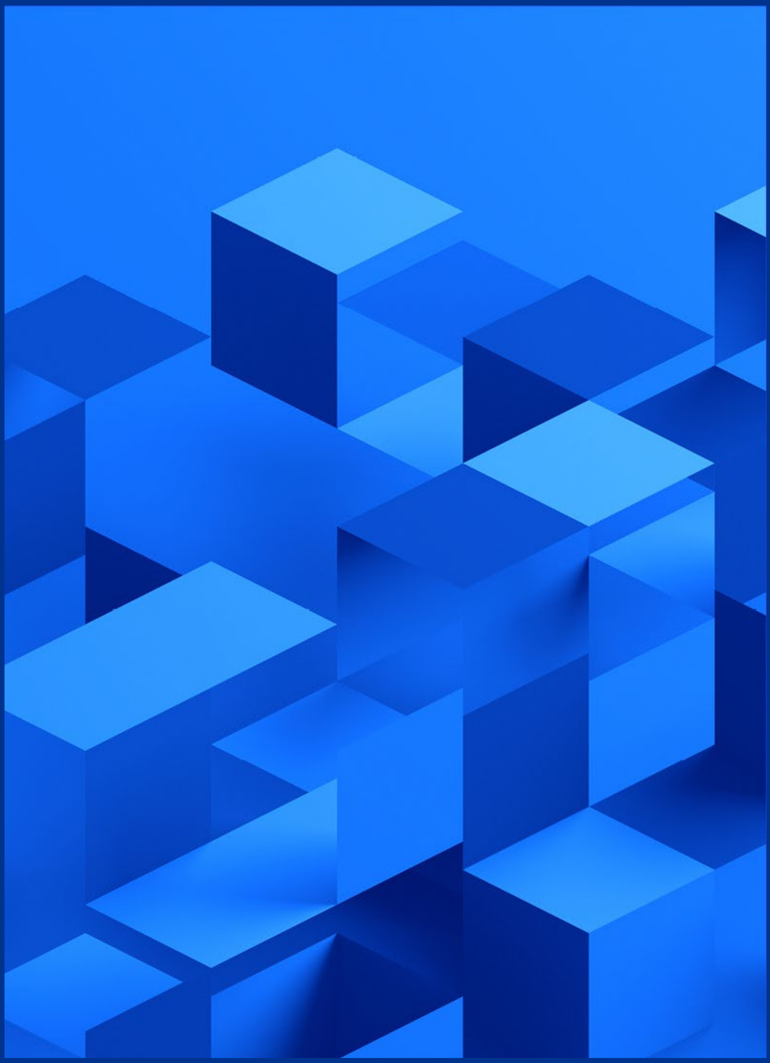
# Investments

## Executive summary



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# Perspectives on investment accounting and the fair value option

Investment accounting is how we refer to the accounting for debt and equity securities that don't fall under other accounting models, such as the equity method or consolidation. These remaining investments typically give the investor limited (if any) influence over the investee.

The first comprehensive accounting and reporting guidance on investments in debt and equity securities was issued in 1993. Nearly 30 years later, some of those requirements and concepts are still present – including the core principles for classification and accounting for debt securities. But there have been several changes (especially for equity securities) as well as challenges in applying the guidance to new facts and circumstances and new types of investments.

The fair value option can be elected for a wide range of financial assets and liabilities, including investments in debt and equity securities. It allows these instruments to be measured at fair value on a recurring basis.

In this Executive Summary, we highlight the requirements of investment accounting, including the debt and equity instruments to which they apply, as well as the relevant classification, recognition and measurement provisions. We also highlight the basics of the fair value option.

Our related Handbook, Investments, helps you effectively and efficiently identify the guidance that applies to different types of investments and understand the related accounting requirements and options. It includes insights and examples – and our perspectives based on our years of experience in this area.

# Scope

There are many models to account for investments in debt and equity securities, including consolidation and the equity method.

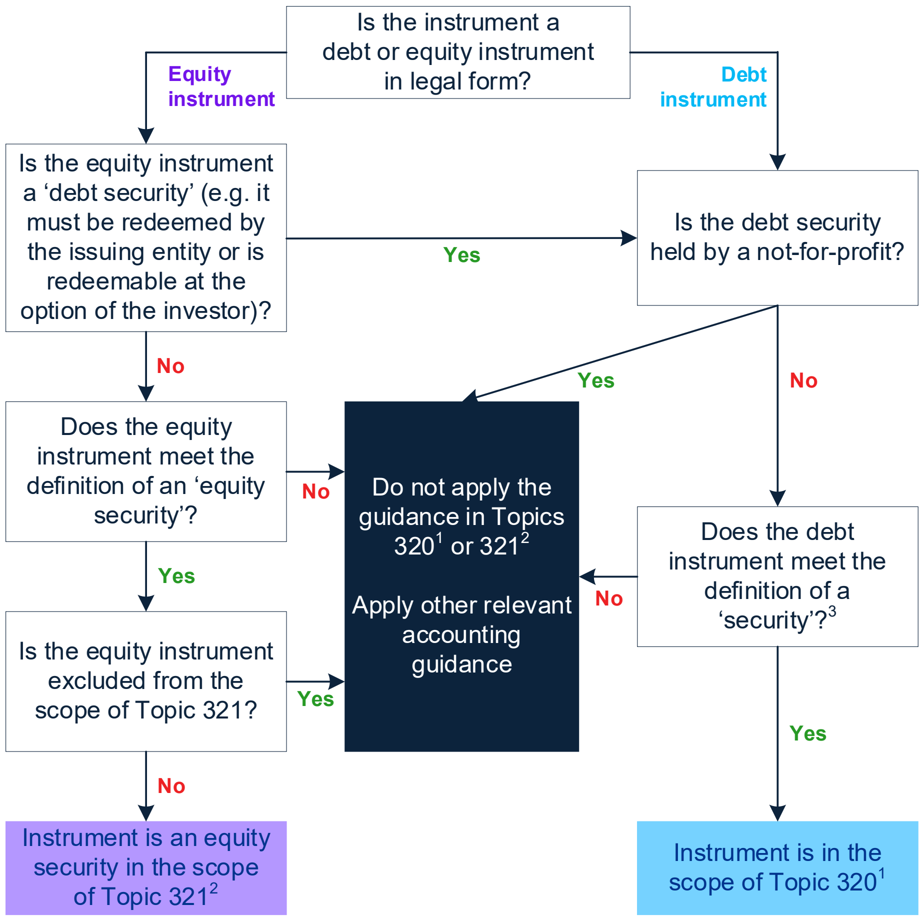
Topic 320 applies to investments in debt securities, and Topic 321 applies to investments in equity securities and other ownership interests in an entity. The models in these two Topics typically apply when other models do not. They also treat debt security investments differently than equity security investments, which has not always been the case.

The nature of investments within the scope of Topics 320 and 321 as well as explicit scope exceptions are summarized in the following table.

<table>
<tr><th>Topic 320</th><th>Topic 321</th></tr>
<tr><td>Investments in debt securities, including those resulting from the securitization of other financial instruments.</td><td>Investments in equity securities and other ownership interests in an entity.</td></tr>
<tr><th colspan="2">Scope exceptions</th></tr>
<tr><td colspan="2"><ul><li>An investment held by an entity whose specialized accounting practices include accounting for substantially all investments at fair value, with changes therein reported in earnings (or in the change in net assets).</li><li>An investment in a consolidated subsidiary.</li><li>An instrument required to be accounted for as a derivative under Topic 815.</li></ul></td></tr>
</table>

There are additional investments excluded from the scope of Topic 321 – e.g. investments accounted for under the equity method.

The following decision tree summarizes the steps for determining whether all other investments are in the scope of Topic 320 or Topic 321.




Notes:

1. Certain instruments that are not in the scope of Topic 320 are also required to follow its provisions.
2. Certain instruments that are not in the scope of Topic 321 are also required to follow its provisions.
3. We believe it is preferable to account for convertible debt that is not a 'security' under Topic 320.

# Debt securities: accounting

When acquired, a debt security is initially recognized on the balance sheet as an asset and classified into one of three categories.

**Trading** | **Held-to-maturity (HTM)** | **Available-for-sale (AFS)**

## Initial measurement and subsequent measurement

A debt security's initial measurement, subsequent measurement and the treatment of unrealized holding gains and losses depends on the classification.

| Initial measurement[1] | Subsequent measurement | Treatment of unrealized holding gains and losses |
|---|---|---|
| **Trading** | | |
| Transaction price or fair value | Fair value | Included in earnings |
| **HTM** | | |
| Transaction price | Amortized cost | Not recognized in the financial statements until realized, but disclosed in the notes to the financial statements |
| **AFS** | | |
| Transaction price or fair value | Fair value | Excluded from earnings and reported in other comprehensive income (OCI) (and included in accumulated OCI (AOCI) until realized) |

Note:
1. Unless other US GAAP applies.

# Debt securities: classification

A debt security's classification dictates its accounting treatment as well as presentation and disclosure requirements. An investor needs to determine:

- how to initially classify debt securities;
- when to reassess the classification; and
- how to account for transfers between the classification categories.

## Initial classification

At acquisition, an investor initially determines and documents its classification of debt securities into the following categories.

| | |
|---|---|
| **Trading** | Debt securities acquired that the investor generally intends to sell in the near term |
| **HTM** | Debt securities for which the investor has a positive intent and ability to hold until maturity |
| **AFS** | Debt securities that are not classified as trading or HTM |

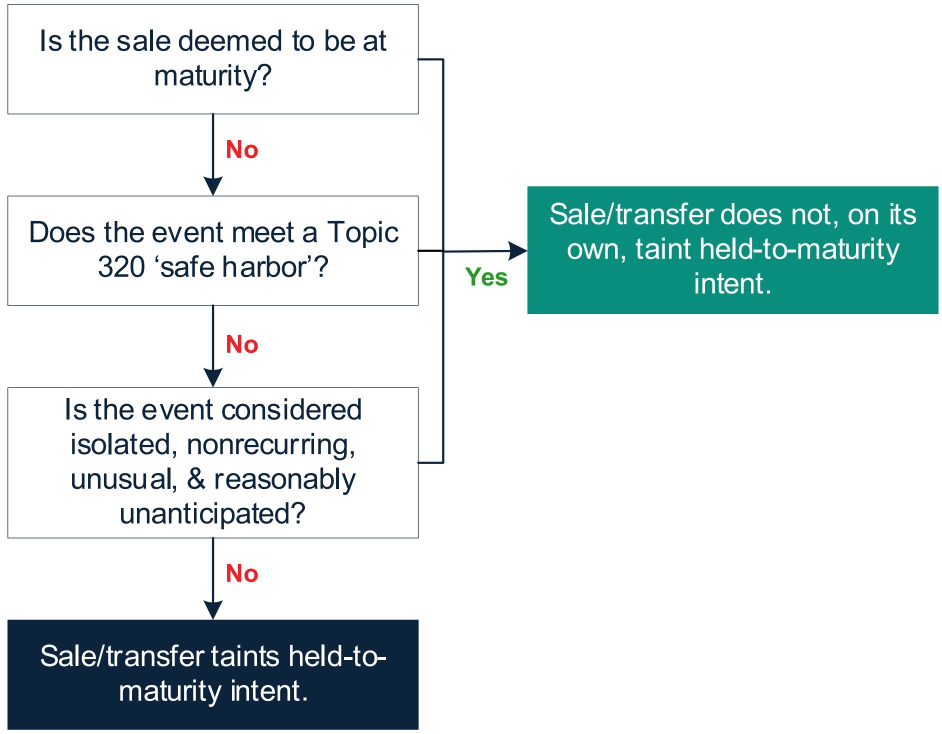
## Reassessment of classification

Classification is reassessed at each reporting date to determine whether relevant facts and circumstances have changed.

For HTM debt securities, because an entity is not expected to change its intent, the requirement to reassess classification focuses on ability to hold a security to maturity. For example, certain factors or events may impair an entity's ability to hold a debt security to maturity (e.g. capital shortage, liquidity needs). As such, we believe an entity should consider whether its classifications are consistent with its investment strategies, liquidity projections, capital adequacy, tax planning strategies, asset/liability management strategies, etc.

Outside of certain limited circumstances, sales or transfers of HTM debt securities call into question (taint) an investor's intent to hold other debt securities to maturity. When the sale or transfer of an HTM security taints the held-to-maturity intent, all securities that remain in the HTM category are affected, not just the type of security that was sold or transferred.

The following decision tree summarizes circumstances in which sales or transfers are consistent with HTM classification.




## Transfers between classification categories

A reclassification is accounted for as of the transfer date. The accounting depends on the categories a security is being transferred from and to.

<table>
<tr><th>Transfer type</th><th>Transferred at</th><th>Treatment of unrealized gain/loss at transfer date</th><th>Treatment of allowance for credit losses</th></tr>
<tr><td>Trading → AFS</td><td rowspan="3">Fair value at transfer date</td><td rowspan="2">N/A – already included in earnings and not reversed</td><td>Evaluate the AFS securities under Subtopic 326-30</td></tr>
<tr><td>Trading → HTM</td><td>Evaluate the HTM securities under Subtopic 326-20</td></tr>
<tr><td>AFS → Trading</td><td>Reverse associated AOCI and report in earnings</td><td>Reverse previously recorded amounts with an offset to credit loss expense</td></tr>
</table>

| Transfer type | Transferred at | Treatment of unrealized gain/loss at transfer date | Treatment of allowance for credit losses |
|---|---|---|---|
| **AFS → HTM** | Amortized cost[1] at transfer date plus/minus unrealized gain/loss in AOCI | Amortize amounts in AOCI over remaining life as a yield adjustment | Reverse previously recorded amounts with an offset to credit loss expense<br><br>Evaluate under Subtopic 326-20 (HTM) or Subtopic 326-30 (AFS) |
| **HTM → AFS** | Amortized cost[1] at transfer date | Report in OCI (and accumulated in AOCI) | |
| **HTM → Trading** | Fair value at transfer date | Report in earnings | Reverse previously recorded amounts with an offset to credit loss expense |

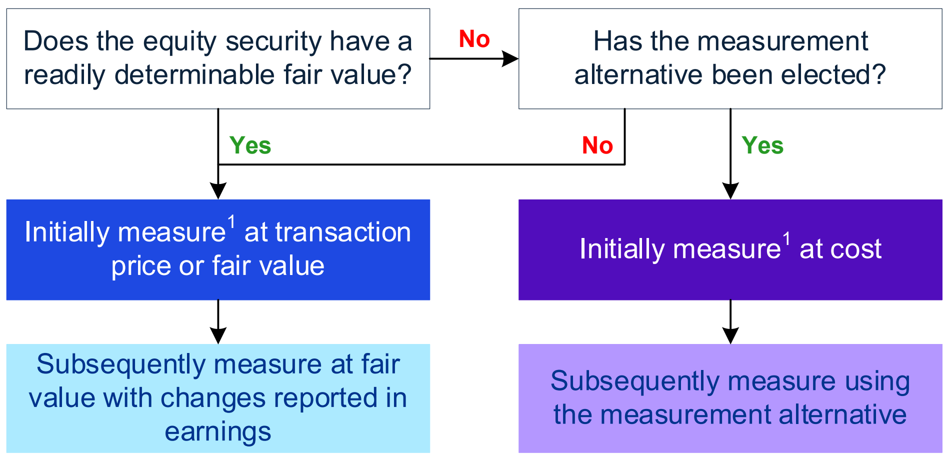
Note:

1. This amount is reduced by previous writeoffs but excludes the allowance for credit losses.

# Equity securities: accounting

## Initial and subsequent measurement

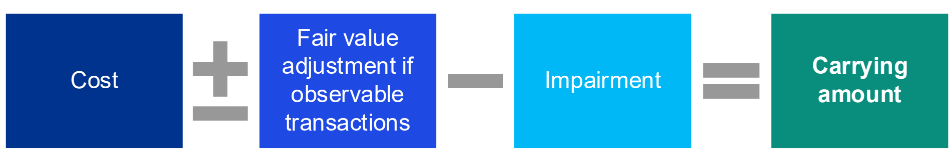
The initial and subsequent measurement of equity securities is summarized in the following decision tree. Measurement issues can require significant judgment because fair value measurement principles apply.




Note:

1. Unless other US GAAP applies.

If the measurement alternative is elected, an entity subsequently measures an equity security as follows.




If an entity identifies observable price changes in orderly transactions for the identical or a similar investment of the same issuer, the security is measured at fair value under Topic 820 – which may or may not be the observed transaction price. The fair value measurement is as of the date the observable transaction took place (the measurement date).

An entity performs a qualitative assessment each reporting period to evaluate whether it believes the fair value of the security is less than the carrying amount – i.e. whether the security is impaired. If a qualitative assessment indicates that the investment is impaired and the fair value of the investment is less than its carrying amount, the investment is written down to its fair value.

## Reassessment of classification

If an entity determines that an equity security has a readily determinable fair value, it evaluates whether the security continues to have a readily determinable fair value at each reporting period.

If an entity elects the measurement alternative, it evaluates whether the security continues to qualify for the alternative at each reporting period.

# Fair value option

An entity may irrevocably elect the fair value option for certain financial assets and liabilities upon the occurrence of certain election events. This election is made for the entire instrument and cannot be applied to only specified risks, specific cash flows or portions of an instrument.

If the fair value option is elected for a financial instrument, the instrument is initially and subsequently measured at fair value. The treatment of unrealized gains and losses depends on the nature of the financial instrument.

| Instrument | Treatment of unrealized gains and losses |
|---|---|
| **Financial liabilities** | Changes in fair value due to instrument-specific credit risk included in OCI.<br>All other changes in fair value included in earnings. |
| **All other items** | Included in earnings. |

On the balance sheet, an entity is required to distinguish financial assets and financial liabilities that are subsequently measured at fair value pursuant to the fair value option from those that are subsequently measured using another measurement attribute.

Subtopic 825-10 requires disclosures related to the fair value option as well as other financial instrument disclosures related to fair value, credit risk and market risk.

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