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Implications of SFAS 115: Accounting for Certain Investments in Debt and Equity Securities

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NORTHERN ILLINOIS UNIVERSITY

Implications of SFAS 115: Accounting for Certain Investments in Debt and Equity Securities

A Thesis Submitted to the

University Honors Program

In Partial Fulfillment of the

Requirements of the Baccalaureate Degree

With University Honors

Department of Accountancy

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HONORS THESIS ABSTRACT
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ABSTRACT (100-200 WORDS):

The Financial Accounting Standards Board (FASB) has issued Statement of Financial Accounting Standards 115: Accounting for Certain Investments in Debt and Equity Securities in response to concerns about how to present the investments on the financial statements. The statement was meant to provide clear requirements for footnote disclosure and provide better relevance for comparisons by using the fair value instead of the lower of cost or market to value the investments. The determination of how to classify the investments is made by management. Management's intent is a subjective criteria and has caused more confusion in the industry. The purpose of this paper is investigate the impact of SFAS 115 on the industry and discover how the investments are classified by management. The information in this paper is supported by several Annual Reports and AICPA issued documents. The overwhelming result of this investigation is that the majority of Annual Reports classify the investments as Available for Sale. When management only uses one classification for the investments, the FASB's intent on clearly identifying the type of investments loses its purpose.

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INTRODUCTION TO SFAS 115

Statement of Financial Accounting Standards No. 115: Accounting for Certain Investments in Debt and Equity Securities was drafted in response to concerns about the recognition and measurement of investments and debt securities. Previously, under FASB Statement No. 12, the disclosure of investments was held at lower of cost or market. SFAS 115 changes the requirements for valuation of securities that have readily determinable fair values. This statement supersedes SFAS 12. The regulators had five major concerns with SFAS 12. As provided in the Statement of Financial Accounting Standards (15), these concerns included:

- Inconsistent literature
- Lower of Cost or Market not evenhanded
- Greater relevance of fair value information
- Gains trading
- Accounting based on intent

In an attempt to address these concerns, the American Institute of Certified Public Accountants arranged for the FASB to create new requirements for valuation. The SFAS 115 outlines an entirely different way to valuate the investments and securities.

The SFAS 115 requires that investments in debt and equity securities are classified under three categories: Held to Maturity Securities, Trading Securities, and Available for Sale Securities. These categories must be used by all cooperatives and mutual enterprises including credit unions and mutual insurance companies.

The new statement does not apply to investments in equity securities accounted for under the equity method or consolidated subsidiaries. Nor does this statement apply to businesses whose "specialized accounting practices include accounting for substantially all investments in

debt and equity securities at market value or fair value" (SFAS 115, 2). An example of this type of business would be brokers and dealers in securities, defined benefit plans, and investment companies.

Held to Maturity Securities

Investments that the business has a "positive intent" of holding until the securities reach maturity shall be classified as a Held to Maturity security. These securities shall be valued at amortized cost. If the business does not have the intent to hold the security to the maturity date, the security can not be classified in this category. The security may not be classified as Held to Maturity if the security is held for an indefinite amount of time. As stated in SFAS 115, there are two exceptions to this rule:

- if the "sale is so near the maturity or call date that changes in market interest rates would not have a significant effect on the securities fair value" (4), the security may be classified as Held to Maturity.
- if the "sale of a security occurs after the enterprise has already collected a substantial portion (at least 85%) 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 over its term" (4), the security may be classified as Held to Maturity.

Trading Securities

Debt securities and equity securities that have readily determinable fair values that are held for the principal purpose to sell them in the near future should be classified as Trading Securities. The securities that fall under this classification shall be "valued at fair value with

unrealized gains and losses included in earnings" (SFAS 115). To be classified as a Trading Security, "trading" refers to active and frequent buying and selling as the SFAS 115 defines it.

Available for Sale

This final category is a catch all category. If the securities are neither reported as Held to Maturity nor Trading, the security will be classified as Available for Sale. Like the securities classified as Trading, the Available for Sale securities are valued at fair value as of the balance sheet date. The difference between the two categories is that the unrealized gain or loss is excluded from earnings for the Available for Sale security class. The unrealized gains or losses are then reported as a separate component of shareholder's equity.

With the recent implementation of SFAS 130, a new section of the stockholder's equity portion of the balance sheet has been created. The new component, accumulated other comprehensive income, is reported after retained earnings component in stockholders' equity section of the Balance Sheet. The other comprehensive income section records foreign currency adjustments and unrealized gains and losses net of reclassification adjustments. Once the adjustments and unrealized gains and losses are netted the total is reported on the the Statement of Other Comprehensive Income as stated previously.

A situation may occur where the fair value of the security is determined to have declined below the cost basis, and this change in fair value is "judged to be other than temporary" (7). In this case, the cost is written down to the fair value.

Financial Statement Presentation

Once the classification of the securities has been made, the decision as to where the securities should be disclosed must be made. SFAS 115 requires that a business who prepares a classified statement of financial position should disclose all trading securities as current assets.

Individual Held to Maturity and Available for Sale securities should be reported as either current or noncurrent per APB No. 43.

Cash flows from the sale, purchase, and maturity of Available for Sale and Held to Maturity securities should be classified as investing activities on the Statement of Cash Flows. The cash flows resulting from the sale, purchase, and maturity of Trading securities should be classified as operating activities on the Statement of Cash Flows.

For securities classified as Available for Sale and Held to Maturity, the businesses must disclose the aggregate fair value, gross unrealized holding gains and losses, and amortized cost basis by major security type as of each date for which a statement of financial position is presented (SFAS 115 8). For securities classified as either Available for Sale or Held to Maturity, the businesses must disclose information about the contractual maturities. The information can be grouped together.

Per SFAS 115, for each period for which the results of operations are presented, a business must disclose:

- proceeds of sales of Available for Sale and gross realized gains and losses
- basis on which cost was determined in computing realized gain and loss
- gross gains and losses included in earnings from transfers
- change in net unrealized holding gain or loss for Available for Sale that has been included in the shareholder's equity component
- change in net unrealized holding gain or loss on Trading securities included in earnings for the period

The presentation of the securities shall be disclosed in the notes of the financial statements. The statement does not require presentation of the three categories on the face of the financial statements as long as the information is presented in the notes (SFAS 115 39).

ANALYSIS OF THE SUCCESS OF SFAS 115

The FASB took into consideration the five concerns involving the accounting for investment securities and created SFAS No. 115 to help eliminate some of the concerns. While the Board knows that the statement does not address all five of the concerns, the FASB believes the statement is a step in the right direction (SFAS 115 15). The statement does address the concerns over inconsistent literature and the concern about lower of cost or market method not being evenhanded. The FASB claims the statement also partially addresses the issue over greater relevance of fair value information, but admits that the concerns over gains trading and accounting based on intent is left unresolved. (SFAS 115 15).

Inconsistent Literature

The statement was issued to help provide consistency in reporting financial statements. SFAS 115 must be followed by all enterprises who choose to invest in marketable securities (SFAS 115 34). The previous accounting for investments was not clearly defined and different industries were accounting for the securities in different ways. The differences could have been causing confusion among financial statement users. The Board states in SFAS 115 that "the Statement is beneficial in avoiding the diversity and confusion resulting from the current accounting guidance" (33).

Lower of Cost or Market not Evenhanded

When the investments were previously accounted for using LOCOM, the securities were written down for diminution of the value but not for the appreciation of the securities (SFAS 115

15). With the institution of SFAS 115, the presentation will reflect the net diminution of the securities and the net appreciation, thus eliminating the uneven recording of the securities.

Greater Relevance of Fair Value Information

SFAS 115 partially addresses this concern by allowing the Available for Sale securities and Trading securities to be reported at fair value. This will help provide information about debt securities that is more relevant than amortized cost to the users of the financial statements (SFAS 115 15).

The statement addresses the three previous concerns in a decent manner. However, there are two issues that are not addressed. The FASB left those two issues to be further determined in future pronouncements. The two issues not addressed are Gains Trading and Accounting Based on Intent.

Gains Trading

As the standards are written now, an enterprise has the ability to recognize the appreciated gains on securities, but is not required to disclose the concurrent recognition of holding losses as stated in SFAS 115 (15). The Gains Trading issue allows for institution to selectively sell securities held at a gain and improve the financial statement of position without having to disclose the holding losses.

Accounting Based on Intent

The Statement does not address the issue of accounting based on management's intent. SFAS 115 is still dependent on management's intentions toward the securities. This could lead to future problems in presentation since management could report the securities as either of the three available categories. Management has the potential to report the securities as Available for Sale and have the fair market value as the valuation for the securities and not have to report the

unrealized gain or losses on the income statement. The unrealized gains and losses will, however, have to be reported on the Statement of Other Comprehensive Income, netted, and then finally reported as a component of stockholder's equity.

Recording the Transfers Between Categories

A situation may arise that the intent of management toward a security has changed and must be reclassified. Perhaps a security previously classified as Available for Sale has been changed to Held to Maturity due unfavorable interest rates. Or perhaps a security is transferred from Available for Sale to Trading or vice versa. The SFAS Statement 115 has outlined the steps for accounting for these changes. According to SFAS 115, the transfer of the investments shall be recorded at fair value on the date of the transfer. If a security is transferred from the Trading Securities, "the unrealized holding gain or loss at the date of the transfer will have already been recognized in earnings and shall not be reversed" (SFAS 115 6). If a security is transferred to the Trading Security section, a gain or loss will be recognized immediately in the earnings statement. If the investment is moving from Available for Sale to Held to Maturity, the recognition of the unrealized gain or loss will be presented in the Other Comprehensive Income portion of the stockholder's equity component of the balance sheet. The same classification of the unrealized gains or losses occurs if a security is transferred to the Held to Maturity from the Available for Sale, but additionally the unrealized gain or loss will be amortized over the remaining life of the security (SFAS 115 6).

With the amortization of the unrealized gains and losses, a question arises as to what the amortization is based on. According to the FASB's Implementation Guide, "when a security is transferred from Available for Sale to Held to Maturity, the difference between the par value of

the security and its fair value at the date of transfer is amortized as a yield adjustment in accordance with FASB Statement No. 91" (Seidman 14).

THE INDUSTRY'S OPINION

The FASB believes that the accounting for investments on a fair market value basis will help to bring financial statements into a better light when creditors, regulators, and other users read the statements (SFAS 115 18). However, the industry does not necessarily agree with this assertion. According to Thomas E. Wilson, Dan R. Ward, and Suzanne Pinac Ward of the University of Southwestern Louisiana, "many bankers, investors, and other industry leaders believe the new standard to be ill-conceived" (intro.). The belief in the industry is that SFAS 115 is a step toward the eventual goal of turning all accounting systems to market value based (Ernst & Young). A market value system is not looked favorably upon because of the instability of the market. With a market valued system, the income has the potential to fluctuate frequently, causing inappropriate comparisons between years.

In addition to the concerns already mentioned, bankers have expressed a fear that focusing on short term investments, as SFAS 115 encourages, may reduce return on equity (Mooney). The reduction in the return on equity could result if the company holds a lot of trading securities and the fair market values for the period were at a loss. Since the changes in fair market value of the securities are reported on the income statement as unrealized gains and losses, the net income would decrease. As net income decreases, so does the retained earnings of the company. Another way for the reduction of the return on equity to occur is through increasing interest rates. As Wilson, Ward, and Ward assert, the increasing interest rates would cause a reduction in value of the securities which would in turn reduce the bank's capital (Part III). The article goes on to state that with the constantly changing interest rates, the FDIC

insurance costs will become more expensive and a higher degree of regulatory oversight will be required (Part II). Ernst and Young conducted a study of the financial institutions reaction to the SFAS 115. According to Ernst and Young's survey of financial services, over 50% of the entities planned to shorten the average maturity date of the securities in their portfolio (Ernst and Young). The concern is about what other steps must be taken by the financial institutions to avoid having adverse affects from the market value classification.

It is obvious that most banking institutions are trying to shy away from long term interest rates by decreasing the maturity dates of the securities they hold. According to Wilson, Ward, and Ward, as the demand for long term securities drop, long term interest rates will increase, thus "adversely affecting the federal budget deficit" (part III). The effect of the implementation of the SFAS 115, is apparently reaching out beyond the scope of just the accounting profession.

FINANCIAL STATEMENT INVESTIGATION

From the studies done by Ernst and Young and professors such as Wilson, Ward, and Ward, it becomes obvious that companies are finding all the loopholes they can to avoid having to report the unrealized gains and losses on their income statement. If one were to look at a company's financial report, the way that each company has dealt with the classification issues should be apparent through the notes. A careful examination of the footnotes of several companies will provide insight as to how the companies are classifying their securities, and how presentation of the classifications is handled in the notes.

SFAS 115 requires that companies disclose the classification of their investments in the notes to the financial statements. As outlined in this report, SFAS 115 has five requirements of what must be presented in the notes, such as proceeds of sales, unrealized gains and losses, etc. The companies must disclose these requirements to be in accordance with GAA.P. Companies

are following these requirements, but the question is how well are they following the requirements?

The AICPA publishes a book each year that surveys the financial statements of different companies across the United States. This book, *Accounting Trends and Techniques*, shows typical note disclosures and presentation examples of different accounting policies. One of the policies illustrated is the disclosure of investments and debt securities. The AICPA analyzed 157 company's note disclosures and discovered that in 1995, 83 of the 157 companies studied disclosed the investments at fair value approximated the carrying amount, but did not show any estimating bases (AICPA 144). In the statement it is stated that the basis on which cost is determined is required to presented. Thirty-two of the companies stated that the fair value, which were based on market quotes, of the investments approximated cost, and the remaining 40 companies presented the investments at fair value (AICPA 144). From this study done by the AICPA it seems as though the statement has not helped achieve conformity in presenting the investments.

A look into several different companies also gives the same conclusion. Sears, Roebuck & Co. and J.C. Penney Company Inc. are essentially the same kind of department store. Both are retailers of a variety of products ranging from clothing to hardware. Looking into their notes of the financial statements, a user would expect to see very similar presentation. This is not the case for the disclosures of their investments. Sears, Roebuck & Company's 1996 Annual Report states that the financial instruments are stated at fair values, but those fair values are not indicative of the amounts that the company may receive if the instruments were sold (Sears 36). The fair value of the instruments presented are not exactly representative of the market value.

Once again, the SFAS 115 attempt at presenting a more realistic idea of the worth of the company has come up short.

Compare how Sears has their investments presented to the presentation of the J.C. Penney, Inc. investments. In the notes to the Annual Report for 1996, under the Summary of Accounting Policies (note 2), J.C. Penney has actually stated that their investments are classified as Available for Sale and carried at fair value. While Sears has stated that their investments are reported at fair value and has implied that their investments are reported under the Available for Sale method, there is no discrete presentation of this fact nor is there use of the title of Available for Sale in the note disclosure. While both Penney and Sears present correctly the fair value versus the cost of the investments, only Penney includes that the difference is reported for the Available for Sale securities as unrealized gains and losses and included in a separate component of Stockholder's Equity (J.C. Penney 25). Both Sears and Penney only disclose information pertaining to Available for Sale, implying that little to none of the securities held by the companies are classified as Held to Maturity or Trading.

The investigation into the Sears and Penney Annual Reports provide insight on the type of conformity that SFAS 115 is providing for companies. While Both Sears and Penney are similar companies with similar investments, each Annual Report has an entirely different way of explaining the classification of the investments. The notes should be almost identical, with the exception of the amounts, because both companies use the Available for Sale classification of the assets.

Another way of satisfying the SFAS 115 requirements is illustrated by Fuji Film. In its Annual Report, under note 6, the statements assert that SFAS 115 requires that investments and securities be reported as either Available for Sale, Held to Maturity, or Trading, but then state

that the company does not present the information on the Balance Sheet using the requirements. The 1996 Annual Report for Fuji Film merely discloses the effects had the company chosen to follow the statement. The company has tables presenting the fair values and cost comparisons as well as tables displaying the gross unrealized gains and losses resulting from the changes in fair value. The note explains that Fuji Film's securities would have been classified as Available for Sale had the company implemented SFAS 115.

Other companies such as McDonald's, Good Year, and Ameritech have chosen a method similar to Sears. Each of the company's 1996 Annual Report listed the fair value of the investment in comparison to the cost of the investment, but did not go into any further detail as to the classification of the investment. The wording of the note leads the reader to believe that there is no effect on the statement of income and therefore is classified as Available for Sale.

A trend is developing when looking at different company's Annual Reports. While each company's presentation of the investments and disclosure of the classification of the investments is different, the main classification of the investments has been Available for Sale. SFAS 115 has left room for management to determine which classification the investments would fall into. The most advantageous classification for the managers to choose is Available for Sale. The Available for Sale classification allows for management to value their investments at fair value, but has no effect on the income statement. The only statement the classification effects is the Stockholder's Equity portion of the Balance Sheet. Because of these incentives, most companies, with the exception of banks who have a lot more investments, have classified all or the majority of their investments as Available for Sale.

One example of this is ARCO. In ARCO's 1996 Annual Report SFAS 115 is referred to in note 3. ARCO discloses that the effect of the classification rules have no effect on net

income. The Annual Report also states in note 12 that ARCO does not hold any financial instruments for trading purposes. Once again, a company has chosen to use mainly the Available for Sale classification.

The Intel Corporation's 1996 Annual Report presented the investments in a table as well displaying the cost, fair value and the unrealized gains and losses that resulted. Like most of the companies studied in this report, Intel has an excellent description of the requirements for SFAS 115 and an easy to read table summarizing the changes in fair value. Intel also only has Available for Sale securities in its investments.

The same is true of Baldor Electric Company, the Tribune, and Columbus McKinnon Corporation. The 1996 Annual Report for the Tribune first states that all securities are valued at fair value except those Held to Maturity, but then it goes on to state that the company only classifies its investments as Available for Sale. The McKinnon Corporation's 1997 Annual Report also states that all of its investments are classified as Available for Sale. The same statement is made in Baldor Electric Company's 1995 Annual Report (AICPA 144). In fact, when looking into the Annual Reports of most companies, the investments have all been classified as Available for Sale.

A contrast to the types of retail companies that have been examined in this report is Allstate Corporation. This company is an insurance company and holds different types of investments. The notes to Allstate's 1996 Annual Report are extensive and the most thorough of the financial reports analyzed. The note disclosure in the second note concerning significant accounting policies and the note concerning investments (note 4) mention both Available for Sale securities and Held to Maturity securities. The gross unrealized gains and losses are outlined on a table displaying the differences between cost, fair value and the unrealized gains

and losses resulting. Another table is also included which presents the fair value of the long term Held to Maturity securities and the cost and also shows the maturity dates of these investments. Allstate did not have any Trading securities in its investments.

CONCLUSION

With the exception of banking and insurance companies, most businesses are reporting their investments as Available for Sale. When reporting which classification is used, the same disclosures are rarely used. Some companies, like Sears and McDonald's, are merely reporting that there is a difference between fair value and cost, but are not clearly stating that the investments are classified as Available for Sale. Other companies, such as Fuji Film, state in their notes that they do not apply the requirements presented in SFAS 115. Many of the companies studied for this report include the required changes from cost to fair value and also include a detailed listing in the notes of the unrealized gains and losses. Most companies stated in the notes that fair value was based off of current market rates, but according to the AICPA's Accounting Trends and Techniques the majority of businesses are not disclosing how fair value was determined.

With the many differences in the notes of the financial statements, users of the annual reports are left wondering if the new standard has helped clear the problems that had existed before the change. According to Wilson, Ward, and Ward, there is a definite concern over if the SFAS 115 has only heightened the confusion about how to account for investments and securities (unintended consequences). The confusion is apparent when differences in the reporting for the investments exist between each annual report.

The FASB knew that Statement on Accounting Standards 115: Accounting for Certain Investments in Debt and Equity Securities was not a solution for all of the valuation problems,

but it did intend it to help ease the problem of inconsistent literature, evening out the lower of cost or market problems, and partially help making the reports more relevant by using the fair value method. After looking at several reports it appears that the literature is not consistent, many companies differ in what is reported and a few are not clear in stating how things are stated. Different companies are using different measures to determine fair value. The differences in reporting fair value using different sources does not provide a good basis for comparisons with similar businesses. SFAS 115 does appear to have solved the unevenness of the LOCOM method, but to avoid having to realize the gains from increasing fair values, many companies are simply classifying their investments as Available for Sale. The classification of Available for Sale is the most advantageous for companies.

The effects of implementing SFAS 115 has not caused any major problems yet. The reason for the low amount of problems may be a result of companies not implementing the statement's requirements properly. If businesses were to follow the requirements for presentation, then the literature for investments would be more consistent. If businesses were given a source to determine fair values, the comparison value of the investments between companies would make the information more relevant. The businesses are given the freedom to classify the investments as they see fit. This freedom is causing many businesses to classify the investments as Available for Sale. If companies were to stop classifying the investments as Available for Sale, the consequences of SFAS 115 would turn out on the net income figure as the FASB intended. SFAS 115 is am excellent concept, but the implementation of the standard has had little or no effect on businesses.

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