Statement of Financial Accounting Standards No. 12

Note: This Statement has been completely superseded

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FAS12 Summary

Accounting for Certain Marketable Securities

December 1975

Financial Accounting Standards Board
of the Financial Accounting Foundation
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FAS 12: Accounting for Certain Marketable Securities

INTRODUCTION AND BACKGROUND INFORMATION

1. There has long been diversity in accounting for marketable securities. Paragraph 9, Chapter 3A, "Current Assets and Current Liabilities," of *Accounting Research Bulletin (ARB) No. 43* (originally adopted as *ARB No. 30* in 1947) narrowed practice somewhat by stating:

> . . . practice varies with respect to the carrying basis for current assets such as marketable securities and inventories. In the case of marketable securities where market value is less than cost by a substantial amount and it is evident that the decline in market value is not due to a mere temporary condition, the amount to be included as a current asset should not exceed the market value.

Chapter 3A of *ARB No. 43* did not, however, deal with the question of whether a write-up of a previous write-down might be permissible to reflect a recovery in the market. *Accounting Principles Board (APB) Opinion No. 18,* "The Equity Method of Accounting for Investments in Common Stock," dealt with accounting for investments by the equity method when the investor has "significant influence" over the investee, thus establishing accounting principles for those investments. In addition, a number of Industry Audit Guides, issued by the AICPA for certain industries, describe specialized accounting practices applied in those industries. At present, some enterprises are carrying marketable securities at cost, some at market (or variations of market), some at the lower of cost or market, and some are applying more than one of those methods to different classes of securities. During 1973 and 1974, there were substantial declines in market values of many securities. As a result, in many enterprises where securities are carried at cost, the carrying amount is in excess of current market value. In other enterprises where carrying amounts were written down to reflect the market decline, the partial recovery in the market in 1975 has given rise to a situation in which securities are being carried at amounts which are below both original cost and current market value.

2. Concern over the lack of definitive guidance in the authoritative literature with respect to certain accounting problems accentuated by these conditions led to requests for the FASB to consider those problems on an urgent basis. The issues raised were submitted to the members of the Board's Screening Committee on Emerging Problems, and their recommendations were weighed by the Board in arriving at its decision to proceed with a project of limited scope, based on the three questions stated in paragraph 3.

3. The Board has concluded that the following questions concerning financial accounting and reporting for marketable securities require resolution as soon as possible:

a. Under what circumstances should marketable equity securities that are carried on a cost basis be written down below cost?
b. Should marketable equity securities that have been written down be written back up based on market recoveries or other criteria?
c. If a parent company and one or more subsidiaries or investees follow different methods of accounting for marketable securities, should any adjustments be made to conform the subsidiaries' or investees' methods of accounting to that of the parent company in consolidated or parent company financial statements?[1]

4. An Exposure Draft of a proposed Statement on "Accounting for Certain Marketable Securities" was issued November 6, 1975, and a public hearing based on the Exposure Draft was held on December 8, 1975. The Board received 272 position papers and letters of comment in response to the Exposure Draft. Twenty presentations were made at the public hearing.

5. This Statement does not apply to not-for-profit organizations [2] or mutual life insurance companies; it does, however, apply to mutual savings banks (see paragraphs 39 and 40) as well as to other for-profit mutual enterprises. This Statement also does not apply to employee benefit plans because that subject is a separate item on the FASB's current agenda.

6. Investments accounted for by the equity method, as described in *APB Opinion No. 18,* are beyond the scope of this Statement except for the provisions of paragraph 18.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Enterprises in Industries Not Having Specialized Accounting Practices with Respect to Marketable Securities

7. For purposes of applying paragraphs 8-13 of this Statement, certain terms are defined as follows:

a. *Equity security* encompasses any instrument representing ownership shares (e.g., common, preferred, and other capital stock), or the right to acquire (e.g., warrants, rights, and call options) or dispose of (e.g., put options) ownership shares in an enterprise at fixed or determinable prices. The term does not encompass preferred stock that by its terms either must be redeemed by the issuing enterprise or is redeemable at the option of the investor, nor does it include treasury stock or convertible bonds.
b. *Marketable,* as applied to an equity security, means an equity security as to which sales prices or bid and ask prices are currently available on a national securities exchange (i.e., those registered with the Securities and Exchange Commission) or in the over-the-counter market. In the over-the-counter market, an equity security shall be considered marketable when a quotation is publicly reported by the National Association of Securities Dealers Automatic Quotations System or by the National Quotations Bureau Inc. (provided, in

the latter case, that quotations are available from at least three dealers). Equity securities traded in foreign markets shall be considered marketable when such markets are of a breadth and scope comparable to those referred to above. Restricted stock [3] does not meet this definition.

c. *Market price* refers to the price (see paragraph 7(b)) of a single share or unit of a marketable equity security.

d. *Market value* refers to the aggregate of the market price times the number of shares or units of each marketable equity security in the portfolio. When an entity has taken positions involving short sales, sales of calls, and purchases of puts for marketable equity securities and the same securities are included in the portfolio, those contracts shall be taken into consideration in the determination of market value of the marketable equity securities.

e. *Cost* refers to the original cost of a marketable equity security unless a new cost basis has been assigned based on recognition of an impairment of value that was deemed other than temporary or as the result of a transfer between current and noncurrent classifications as described in paragraph 10. In such cases, the new cost basis shall be the cost for the purposes of this Statement.

f. The *valuation allowance* for a marketable equity securities portfolio represents the net unrealized loss (the amount by which aggregate cost exceeds market value) in that portfolio.

g. The *carrying amount* of a marketable equity securities portfolio is the amount at which that portfolio of marketable equity securities is reflected in the financial statements of an enterprise.

h. A *realized gain or loss* represents the difference between the net proceeds from the sale of a marketable equity security and its cost.

i. *Net unrealized gain or loss* on a marketable equity securities portfolio represents the difference between the market value of its securities and their aggregate cost at any given date.

8. The carrying amount of a marketable equity securities portfolio shall be the lower of its aggregate cost or market value, determined at the balance sheet date. The amount by which aggregate cost of the portfolio exceeds market value shall be accounted for as the valuation allowance.

9. Marketable equity securities owned by an entity [4] shall, in the case of a classified balance sheet, be grouped into separate portfolios according to the current or noncurrent classification of the securities for the purpose of comparing aggregate cost and market value to determine carrying amount. In the case of an unclassified balance sheet, marketable equity securities shall for the purposes of this Statement be considered as noncurrent assets. The current portfolios of entities that are consolidated in financial statements and that do not follow specialized industry accounting practices with respect to marketable securities shall be treated as a single consolidated portfolio for the comparison of aggregate cost and market value; similarly, the noncurrent portfolios of entities that are consolidated in financial statements and that do not follow specialized industry accounting practices with respect to marketable securities shall be treated as a single consolidated portfolio for the comparison of aggregate cost and market value. The portfolios of marketable equity securities owned by an entity (subsidiary or investee) that is accounted for by the equity method shall not be combined with the portfolios of marketable equity securities owned by any other entity included in the financial statements.[5] However, such an entity is, itself, subject to the requirements of this Statement.

10. If there is a change in the classification of a marketable equity security between current and noncurrent, the security shall be transferred between the corresponding portfolios at the lower of its cost or market value at

date of transfer. If market value is less than cost, the market value shall become the new cost basis, and the difference shall be accounted for as if it were a realized loss and included in the determination of net income.

11. Realized gains and losses shall be included in the determination of net income of the period in which they occur. Changes in the valuation allowance for a marketable equity securities portfolio included in current assets shall be included in the determination of net income of the period in which they occur. Accumulated changes in the valuation allowance for a marketable equity securities portfolio included in noncurrent assets or in an unclassified balance sheet shall be included in the equity section of the balance sheet and shown separately.

12. The following information with respect to marketable equity securities owned shall be disclosed either in the body of the financial statements or in the accompanying notes:

a) As of the date of each balance sheet presented, aggregate cost and market value (each segregated between current and noncurrent portfolios when a classified balance sheet is presented) with identification as to which is the carrying amount.
b) As of the date of the latest balance sheet presented, the following, segregated between current and noncurrent portfolios when a classified balance sheet is presented:
   (i) Gross unrealized gains representing the excess of market value over cost for all marketable equity securities in the portfolio having such an excess.
   (ii) Gross unrealized losses representing the excess of cost over market value for all marketable equity securities in the portfolio having such an excess.
c) For each period for which an income statement is presented:
   (i) Net realized gain or loss included in the determination of net income.
   (ii) The basis on which cost was determined in computing realized gain or loss (i.e., average cost or other method used).
   (iii) The change in the valuation allowance(s) that has been included in the equity section of the balance sheet during the period and, when a classified balance sheet is presented, the amount of such change included in the determination of net income.

13. An enterprise's financial statements shall not be adjusted for realized gains or losses or for changes in market prices with respect to marketable equity securities when such gains or losses or changes occur after the date of the financial statements but prior to their issuance, except for situations covered by paragraph 21. However, significant net realized and net unrealized gains and losses arising after the date of the financial statements, but prior to their issuance, applicable to marketable equity securities owned at the date of the most recent balance sheet shall be disclosed.

Enterprises in Industries Having Specialized Accounting Practices with Respect to Marketable Securities

14. Certain industries apply specialized industry accounting practices with respect to marketable securities. Such industries include investment companies, brokers and dealers in securities, stock life insurance companies, and fire and casualty insurance companies. Except for the requirements in paragraphs 15, 21, and 22, this Statement does not alter any industry's specialized accounting practices. Paragraphs 15, 17, and 19 deal with

marketable equity securities as that term is defined in paragraph 7. Paragraphs 16, 18, and 20-22 deal with marketable securities as that term is used in the particular industries concerned, including, but not limited to, marketable equity securities.

15. Entities that carry marketable equity securities at cost shall hereafter carry them at the lower of their aggregate cost or market value.[6] In making this determination, the provisions of paragraphs 7-9 shall be applied with the exception of the third sentence of paragraph 9. The portfolios of entities that are consolidated in financial statements and that follow the same specialized industry accounting practices with respect to marketable equity securities shall be treated as a single portfolio for the comparison of aggregate cost and market value. This Statement does not alter any entity's specialized industry practice for reporting gains and losses, whether realized or unrealized, for marketable equity securities.

16. Entities that do not include unrealized gains and losses [7] on marketable securities in the determination of net income but that do include them in the equity section of the balance sheet shall disclose the following information, either in the body of the financial statements or in the accompanying notes:

a) Gross unrealized gains and gross unrealized losses as of the date of the latest balance sheet presented.
b) Change in net unrealized gain or loss (the amount by which equity has been increased or decreased as a result of unrealized gains and losses) for each period for which an income statement is presented.

17. An enterprise's financial statements shall not be adjusted for realized gains or losses or for changes in market prices with respect to marketable equity securities when such gains or losses or changes occur after the date of the financial statements, but prior to their issuance, except for situations covered by paragraph 21. However, significant net realized and net unrealized gains and losses arising after the date of the financial statements, but prior to their issuance, applicable to marketable equity securities in the portfolio at the date of the most recent balance sheet shall be disclosed.

Enterprises That Include Entities Whose Accepted Accounting Practices Differ with Respect to Marketable Securities

18. If an investee accounted for by the equity method or a subsidiary follows accepted accounting practices that are different from those of the parent or investor with respect to marketable securities, those practices shall be retained in the consolidated or parent company financial statements in which those entities are included. As an exception to this requirement, if it is the practice of the parent or investor to include realized gains and losses in the determination of net income, or would so include them if present, the accounting treatment of a subsidiary or an investee that does not follow such practice shall be conformed to that of the parent or investor in that particular respect in consolidated or parent company financial statements.

19. If the parent company in a consolidation follows specialized industry accounting practices with respect to marketable securities but two or more consolidated subsidiaries do not (and hence are subject to the provisions of paragraphs 8-13 of this Statement), the current and noncurrent portfolios of marketable equity securities of such subsidiaries shall be consolidated as separate current and noncurrent portfolios in the manner provided in

paragraph 9, exclusive of the portfolios of the parent company, for the purpose of determining carrying amounts in accordance with paragraph 9. The information required by paragraph 12 shall be disclosed in the consolidated financial statements with respect to such subsidiaries.

20. If the consolidated financial statements reflect more than one accepted practice of accounting for marketable securities, the disclosures required by this Statement and those encompassed by specialized industry practice, as applicable, shall be disclosed either in the body of the financial statements or in the accompanying notes for the marketable securities accounted for under each such practice.

Decline in Market Value Is Assessed to Be Other Than Temporary

21. For those marketable securities for which the effect of a change in carrying amount is included in stockholders' equity rather than in net income (including marketable securities in unclassified balance sheets), a determination must be made as to whether a decline in market value below cost as of the balance sheet date of an individual security is other than temporary.[8] If the decline is judged to be other than temporary, the cost basis of the individual security shall be written down to a new cost basis and the amount of the write-down shall be accounted for as a realized loss. The new cost basis shall not be changed for subsequent recoveries in market value.

Income Taxes

22. Unrealized gains and losses on marketable securities, whether recognized in net income or included in the equity section of the balance sheet, shall be considered as timing differences, and the provisions of *APB Opinion No. 11*, "Accounting for Income Taxes," shall be applied in determining whether such net unrealized gain or loss shall be reduced by the applicable income tax effect. A tax effect shall be recognized on an unrealized capital loss only when there exists assurance beyond a reasonable doubt that the benefit will be realized by an offset of the loss against capital gains.

Effective Date and Transition

23. The provisions of this Statement, other than those of paragraph 18, shall be effective for financial statements for annual and interim periods ending on or after December 31, 1975.[9] If initial application of this Statement necessitates establishment of a valuation allowance for a marketable equity securities portfolio included in current assets, the amount thereof shall be included in the determination of net income for the period in which this Statement is initially applied. If initial application of this Statement necessitates establishment of a valuation allowance for a marketable equity securities portfolio included in noncurrent assets or in an unclassified balance sheet, the amount thereof shall be reflected separately in stockholder's equity as of the end of the period in which this Statement is initially applied. For initial application of this Statement, the provisions of paragraph 10 shall not apply to transfers between current and noncurrent classifications made as of or before December 31, 1975.[10] Financial statements for annual and interim periods ending before December 31, 1975 [11] shall not be restated except as stated below. The provisions of paragraph 18 of this Statement shall be effective for financial statements for annual and interim periods ending on or after December 31, 1975.[12] Those

provisions shall be applied retroactively by prior period adjustment (described in paragraphs 18 and 26 of *APB Opinion No. 9,* "Reporting the Results of Operations"). When prior period financial statements or financial summaries or other data derived therefrom are presented, they shall be restated to conform to those provisions.

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

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

Mr. Litke and Mr. Sprouse dissent primarily because this Statement requires some enterprises in industries not having specialized accounting practices to recognize unrealized gains in the determination of net income of the period in which they occur and prohibits other similar enterprises from recognizing unrealized gains in circumstances that are in substance identical. In their view, recognition of a gain should depend on underlying economic circumstance—in this case whether or not a security's market value has increased. Under this Statement, however, recognition of an unrealized gain in the determination of net income depends on accounting relevancies such as (1) whether the security is classified in the balance sheet as a current asset or a noncurrent asset, (2) whether unrealized losses on marketable securities had previously been recognized in net income of prior periods, and (3) whether in a given accounting period an enterprise has unrealized losses in some securities that offset unrealized gains in others. Mr. Litke and Mr. Sprouse hold that accounting for similar circumstances similarly and for different circumstances differently is an important objective in establishing financial accounting standards. This Statement, in their judgment, ignores that objective.

Mr. Litke and Mr. Sprouse believe that accounting for marketable securities held as current assets on a portfolio basis has significant defects. In comparing the aggregate cost and market value of a portfolio, the Statement calls for unrealized gains to be recognized to the extent of any unrealized losses. In this way, unrealized gains may be recognized implicitly by some enterprises while the implicit or explicit recognition of similar unrealized gains by other enterprises is precluded. Also, reporting the carrying amount of a portfolio at the lower of the aggregate cost or market value may be deceptive because it may suggest that all unrealized losses have been recognized in the period in which market values have declined. Unrealized losses that are not recognized at the end of a period because they are offset by unrealized gains on other securities in the portfolio may have to be recognized in a future period when a component of the portfolio is sold. That could be the effect even in the absence of any further changes in market value. As a result, like the cost method it is intended to supplant, the lower of cost or market rule applied on a portfolio basis may cause losses from declines in market value to be recognized in the period of sale rather than in the period in which the loss in market value occurs.

Mr. Sprouse agrees that the scope of this Statement is properly confined to resolution of the three questions stated in paragraph 3. He also agrees that current assets should not be carried at amounts in excess of their net realizable value, that in the case of marketable equity securities the best measure of net realizable value is their current market value, and that unrealized losses on marketable securities classified as current assets should be included in the determination of net income of the period in which they occur. However, since the Board concluded that it is not feasible at this time to consider comprehensively the recognition of unrealized gains on marketable equity securities, in the interest of equity and comparability among enterprises Mr. Sprouse believes that no recognition of unrealized gains is preferable to the partial and arbitrary recognition required by this Statement.

Mr. Litke believes that marketable securities should not be carried in amounts in excess of their net realizable value and that the best measure of net realizable value is their current market value. He believes that this Statement should require that all marketable equity securities be carried at market value in the balance sheet. While his inclination at this time would be to recognize unrealized market value changes in the determination of net income, he believes that the Board should not take that step in this Statement given the limited scope of the project. In Mr. Litke's opinion, the solution to the emerging problem of accounting for marketable equity securities would be for the financial statements to include in income only: (1) realized gains and losses resulting from exchange transactions, and (2) provisions to recognize the effect of permanent impairment of the security's value. Under this solution, he believes all unrealized gains and losses on both current and noncurrent marketable equity securities should be added to or deducted from stockholders' equity, except that the effect of permanent impairment would be deducted from income.

Members of the Financial Accounting Standards Board:

Marshall S. Armstrong, *Chairman*
Oscar S. Gellein
Donald J. Kirk
Arthur L. Litke
Robert E. Mays
Walter Schuetze
Robert T. Sprouse

Appendix A: BASIS FOR CONCLUSIONS

24. This Appendix discusses factors deemed significant by members of the Board in reaching the conclusions in this Statement, including alternatives considered and the reasons for accepting some and rejecting others.

Scope

25. The three questions which the Board addressed as constituting financial reporting problems requiring early resolution are those listed in paragraph 3. Questions (a) and (b) relate to the determination of carrying amount for marketable equity securities, whereas question (c) relates to the issue of conformity in consolidated or parent company financial statements of different methods of accounting with respect to all marketable securities, whether or not they are equity securities.

26. Because of the urgency of resolving these questions within a limited time frame, the Board concluded that the scope of the project should be limited essentially to the questions as presented. Although a number of respondents objected to the short exposure period and the proximity of the proposed effective date, the Board determined that the problems should be resolved for application in 1975. As stated in paragraph 2, the requests that the Board deal with the problems had indicated that such a timely answer was needed. On the basis of

available information, including that obtained at the public hearing and in position papers and letters of comment, the Board concluded that it could make an informed decision on the questions as presented and that the effective date and method of transition specified herein are advisable.

27. The Board is mindful of the fact that enterprises in certain industries apply specialized accounting practices presently accepted in those industries. The Board concluded that consideration of questions (a) and (b) with respect to those particular industries should be limited to the enterprises within those industries that carry marketable equity securities on the basis of cost. The alternative bases for carrying marketable equity securities (e.g., market value, appraised value, fair value) which are permitted in certain specialized industry accounting practices with respect to marketable securities have not been considered by the Board and are not altered by this Statement. The Board further concluded that it would not, as a part of this project, examine or change specialized industry practice for reporting gains and losses, whether realized or unrealized, for marketable securities. To do so would expand the scope of the project in that consideration of the fundamental issues that led to the adoption of those specialized practices would be required. This, the Board decided, could not be done in the limited time available for the completion of this project.

28. For the reasons discussed in paragraph 27, the "Standards of Financial Accounting and Reporting" of this Statement contain separate provisions for two categories of enterprises: those in industries not having specialized accounting practices with respect to marketable securities, and those in industries having such specialized accounting practices.

Enterprises in Industries Not Having Specialized Accounting Practices with Respect to Marketable Securities

29. In considering questions (a) and (b) of paragraph 3 the Board noted that the questions pertain to marketable equity securities carried on a cost basis. The Board's conclusion that the lower of cost or market should apply in the determination of carrying amount for such securities was based on the following factors:

a) The Board excluded from its consideration market value alone as the determinant of carrying value. Consideration of that alternative would raise pervasive issues concerning the valuation of other types of assets, including the concept of historic cost versus current or realizable value. The Board concluded that it could not examine these conceptual issues in a project of such limited scope.
b) The Board noted that continuance of original cost as the carrying amount of a portfolio of marketable equity securities when its market value is lower has the effect of deferring recognition of the decline in the realizable value of such securities based on the expectation of a future recovery in market value which may or may not occur. Because of the uncertainty of such future recovery, the Board concluded that original cost is not a proper determinant of carrying amount for marketable equity securities when market value is below cost. A number of respondents advanced the argument that, in the case of securities held as long-term investments, a decline in market value viewed as temporary should not be reflected in net income. While not necessarily accepting this argument, the Board took into account the fact that this argument has considerable support in current practice, and that the Auditing Interpretation referred to in footnote 8 is consistent with it. The Board concluded that the conceptual question of whether such

differences should or should not be included in income could not be dealt with in this project, and hence no such requirement should be made at this time. However, the Board concluded that a decline in market value below cost should in all cases be reflected in the balance sheet and when such securities are classified as current assets, the decline in market value below cost should enter into the determination of net income. In the case of current assets, it is the Board's view that the realization of the loss in value of the securities should be regarded as imminent and therefore should be recognized in the determination of net income.

c) In adopting the lower of cost or market as the determinant for carrying amount, the Board required that when write-downs have been made because the market value of the portfolio has dropped below cost, if market value subsequently rises, the write-down be reversed to the extent that the resulting carrying amount does not exceed cost. The Board does not regard the reversal of the write-down as representing recognition of an unrealized gain. Rather, the Board views the write-down as establishing a valuation allowance representing the estimated reduction in the realizable value of the portfolio, and it views a subsequent market increase as having reduced or eliminated the requirement for such an allowance. In the Board's view, the reversal of the write-down represents a change in an accounting estimate of an unrealized loss (see paragraph 2 of *FASB Statement No. 5,* "Accounting for Contingencies," and paragraph 10 *of APB Opinion No. 20*).

30. The Exposure Draft required that all changes in the carrying amounts of the marketable equity securities portfolio be reflected in income currently and made no distinction in that regard between the current or noncurrent classifications of such securities. Some respondents favored the separation of the single portfolio called for by the Exposure Draft into current and noncurrent portfolios with the change in carrying amount for the noncurrent portfolio to be reflected in equity rather than in income. They argued that fluctuations in the market value of long-term investments should not be reflected in income and to do so would cause distortions which would not be understood by investors. While not necessarily agreeing with these arguments, for the reasons discussed in paragraph 29(b), the Board decided not to require in this Statement that declines in the market value below cost of noncurrent marketable equity securities be reflected in net income. In reaching this decision, the Board recognized that the present concepts of income require authoritative clarification with respect to the recognition of unrealized gains and losses on long-term assets. Such clarification, the Board noted, is beyond the scope of this Statement. For these reasons, the Board concluded that marketable equity securities classified as noncurrent assets should constitute a separate portfolio from those securities classified as current assets for the determination of carrying amount, and that changes in the carrying amount of the noncurrent portfolio should be reflected in the equity section of the balance sheet rather than included in income, provided that the decline in market value is assessed as temporary.

31. An issue inherent in the determination of carrying amount for marketable equity securities was whether the lower of cost or market method adopted by the Board should be applied on the basis of individual security holdings or on a portfolio basis. In deciding to require application on a portfolio basis (with the exceptions noted in paragraph 9), the Board considered the following factors: Many enterprises regard their portfolios of marketable equity securities (excluding long-term investments accounted for under the equity method) as collective assets. A requirement that the application of lower of cost or market be made on an individual security basis would, in the Board's view, be unduly conservative and at variance with the manner in which enterprises generally view their investment in marketable equity securities. The Board recognized that the

application of the criterion on a portfolio basis may be regarded as having the effect of offsetting the unrealized losses on one security with unrealized gains on another. However, the Board agrees with those respondents who regard the current and noncurrent portfolios of marketable equity securities each as collective assets, hence the determination of the carrying amount on a collective (portfolio) basis is in the Board's view appropriate despite the offsets referred to. The disclosures required by paragraph 12(b) are intended to inform as to the extent to which such offsets exist in the portfolio.

32. Paragraph 30 discussed the reasons for the Board's decision to change from a single portfolio basis as provided by the Exposure Draft to separate portfolios for current and noncurrent assets. The Exposure Draft noted that such a separation of portfolios would provide opportunities for transfers between portfolios simply by changing classifications and that such transfers could result in significant changes in net income. The Board had this feature in mind in requiring that transfers between the current and noncurrent portfolios be accounted for in the manner prescribed by paragraph 10. This has the effect of accounting for an unrealized loss at the date of transfer in the same manner as if it had been realized, thus reducing the incentive to cause significant changes in income by transferring securities between portfolios. The Board recognized, however, that the above requirement would not be effective in the case of a transfer from noncurrent to current classifications of a security having an excess of market value over cost which would serve to offset a reverse situation in the current portfolio, thus affecting the determination of net income. However, as mentioned in paragraph 31, the disclosures required by paragraph 12(b) should assist users of financial statements in assessing the effects of such transfers.

33. The definition of "equity security" in the Exposure Draft included convertible bonds. Many respondents believed that such inclusion was in conflict with *APB Opinion No. 14,* "Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants." It was pointed out further that the market sometimes values a convertible bond primarily on its equity characteristics and at other times primarily on its debt characteristics. The Board concluded that it was impractical to apply criteria under which a convertible bond might in some time intervals come under the definition and at other times be excluded. Accordingly, the Board decided that convertible bonds, and, for consistency, convertible preferred stock with redemption requirements, would be excluded from the definition of equity securities.

34. A number of respondents asked for clarification of what was encompassed by the term "restricted stock" with respect to the statement in the Exposure Draft that restricted stock did not meet the definition of "marketable." Footnote 3 of this Statement is intended to provide the requested clarification. The Board's decision to consider restricted stock as meeting the definition of marketable where the restriction terminates or can be terminated by the holder within one year is based on the view that current market value is relevant in applying the lower of cost or market determination to such securities, whereas in the case of longer term restrictions, the application of current market value is of lesser relevance.

35. Paragraph 9 provides, as did the Exposure Draft, that "The portfolios of marketable equity securities owned by an entity (subsidiary or investee) that is accounted for by the equity method shall not be combined with the portfolios of marketable equity securities owned by any other entity included in the financial statements.[5]" Some respondents were of the opinion that the portfolio(s) of unconsolidated subsidiaries

accounted for by the equity method should be so combined, especially in the case of 100 percent owned subsidiaries, and that failure to do so would be contrary to paragraph 19 of *APB Opinion No. 18.* Some of the respondents expressing this view acknowledged that there were both conceptual and mechanical problems involved in implementing this recommendation, but none offered specific suggestions for resolving them. The Board noted in the Exposure Draft and in footnote 5 of this Statement that the procedure called for constitutes an exception to paragraph 19 of *APB Opinion No. 18.* The Board rejected the recommendation that the portfolios of equity method subsidiaries be combined with others, because to do so could produce illogical results either with respect to the carrying amount of marketable securities as reflected in the consolidated balance sheet, or the carrying amount of the equity method subsidiary as reflected in the same balance sheet.

Enterprises in Industries Having Specialized Accounting Practices with Respect to Marketable Securities

36. Paragraph 14 states that, with the exception of paragraphs 15, 21, and 22, this Statement does not alter any industry's specialized accounting practices with respect to marketable securities.

37. Paragraph 15 requires that entities that carry marketable equity securities at cost shall hereafter carry them at the lower of their aggregate cost or market value with the following exception: entities in industries whose specialized accounting practices permit market value as an acceptable alternate carrying basis may elect that basis. The cost basis is no longer acceptable for determining carrying amount for marketable equity securities and is replaced by the lower of aggregate cost or market value.

38. The Board's decision to replace the cost basis with the lower of cost or market basis in industries having specialized accounting practices took into account the following factors:

a) Having concluded that the cost basis should be replaced in all enterprises in industries with nonspecialized accounting practices, the Board could find no justification for maintaining cost as a basis for marketable equity securities in the other industries.
b) As stated in paragraph 27, this Statement does not alter specialized industry practice for reporting gains and losses on marketable securities because to do so would involve a reconsideration of fundamental issues in those industries. However, a change in the carrying basis for marketable equity securities does not, in the Board's view, necessitate such a reconsideration.
c) Elimination of cost as a carrying basis for marketable equity securities in the industries having specialized accounting practices serves to reduce some of the disparity in practice among those industries as well as with industries not having specialized accounting practices.

Applicability

39. Numerous responses from the mutual savings bank industry urged that mutual savings banks be excluded from the scope of this Statement. The principal arguments advanced were: mutual savings banks are regulated and, in some states, are required to carry marketable securities at cost; the exclusion of not-for-profit organizations should apply to mutual savings banks; the element of mutuality (absence of shareholders) applies equally to these organizations as it does to mutual life insurance companies. The Board did not find these

arguments persuasive. When mutual savings banks, which are in an industry not having specialized accounting practices, present financial statements purporting to be in conformity with generally accepted accounting principles, the fact that they are regulated or that they do not have shareholders does not, in the Board's view, justify different accounting for marketable equity securities from that required to be followed by other entities not having specialized accounting practices. Accordingly, the provisions of this Statement apply to mutual savings banks, as well as to other for-profit mutual enterprises, except mutual life insurance companies.

40. Mutual life insurance companies were excluded from the scope of this Statement because, unlike stock life insurance companies (see paragraph 14), there is disagreement as to whether generally accepted accounting principles exist for mutual life insurance companies.[13] This coupled with the complexity of some of the issues involved in life insurance accounting caused the Board to conclude that it could not resolve these questions within this project. On the other hand, mutual savings banks, which are not excluded from the scope of this Statement, do present financial statements prepared in conformity with generally accepted accounting principles and there are no complex related accounting issues involved as is the case with mutual life insurance companies.

41. The Exposure Draft proposed that the Statement be applied retroactively by prior period restatement. That method of transition was proposed on the premise that it would afford maximum comparability among financial statements. The Board has obtained information, subsequent to the issuance of the Exposure Draft, that a number of companies have in past years made substantial reclassifications of marketable equity securities as between current and noncurrent assets. With the Board's decision to provide for separate portfolios of current and noncurrent marketable equity securities with different accounting for changes in carrying value of the two portfolios, the number of and seemingly divergent bases for reclassifications that have occurred in recent years would, in the case of retroactive restatement, result in less rather than more comparability. The new requirement that transfers between current and noncurrent portfolios be accounted for in a manner to treat reductions in market value below cost as realized losses at the date of transfer would, if applied retroactively, accentuate this effect. For these reasons, the Board concluded that the interests of users of financial statements would best be served by making the Statement effective December 31, 1975 [14] (except for paragraph 18 for which retroactive application is still required).

Appendix B: ILLUSTRATION OF DISCLOSURES REQUIRED BY PARAGRAPH 12 OF THIS STATEMENT

42. The following example illustrates the disclosure requirements of paragraph 12 for an enterprise having a classified balance sheet. For purposes of this illustration it is presumed that the only marketable securities that the enterprise owns are marketable equity securities as defined in paragraph 7. The illustration does not encompass all possible circumstances that may arise in connection with the disclosure requirements, nor does it indicate the Board's preference for a particular format.

Computational Information

The following details pertain to marketable equity securities owned at December 31:

	1975			1974		
	Cost	**Market**	**Unrealized Gain (Loss)**	**Cost**	**Market**	**Unrealized Gain (Loss)**
In Current Assets:						
Security A	$100,000	$100,000	$ —	$200,000	$250,000	$ 50,000
B	200,000	150,000	(50,000)	300,000	250,000	(50,000)
C	200,000	175,000	(25,000)	200,000	150,000	(50,000)
D	150,000	100,000	(50,000)	150,000	200,000	50,000
E	50,000	100,000	50,000	50,000	75,000	$ 25,000
F	200,000	225,000	25,000	—	—	—
Total of Portfolio	$900,000	$850,000	$ (50,000)	$900,000	$925,000	$ 25,000
Valuation Allowance—Current			$ (50,000)			Not Applicable
In Noncurrent Assets:						
Security G	$300,000	$200,000	$(100,000)	$300,000	$100,000	$(200,000)
H	100,000	190,000	90,000	100,000	250,000	150,000
I	250,000	150,000	(100,000)	250,000	150,000	(100,000)
Total of Portfolio	$650,000	$540,000	$(110,000)	$650,000	$500,000	$ 150,000)
Valuation Allowance—Noncurrent			$(110,000)			Not Applicable

During 1975 the following sales of securities took place. (There were no sales of securities in 1974.):

	Net Proceeds of Sale	Cost	Realized Gain (Loss)
Security A	$125,000	$100,000	$ 25,000
Security B	65,000	100,000	(35,000)
	$190,000	$200,000	$(10,000)

The valuation allowances required at December 31, 1975 are as follows:

	Charged Against Income	Charged Against Equity
In Current Assets:		
Cost $900,000 less market $850,000	$50,000*	
In Noncurrent Assets:		
Cost $650,000 less market $540,000		$110,000*

Disclosure Requirements

BALANCE SHEET

	December 31, 1975	December 31, 1974
Current Assets		
Marketable equity securities, carried at market in 1975 and at cost in 1974 (Note 1)	$ 850,000	$900,000
Noncurrent Assets		
Marketable equity securities, carried at market in 1975 and at cost in 1974 (Note 1)	540,000	650,000
Stockholders' Equity		
Net unrealized loss on noncurrent marketable equity securities (Note 1)	(110,000)	—

NOTES TO FINANCIAL STATEMENTS

Note 1—Marketable Equity Securities

At December 31, 1975, the current and noncurrent portfolios of marketable equity securities are each carried at their lower of cost or market at the balance sheet date. Marketable equity securities included in current and noncurrent assets had a cost of $900,000 and $650,000, respectively, at December 31, 1975.

To reduce the carrying amount of the current marketable equity securities portfolio to market, which was lower than cost at December 31, 1975, a valuation allowance in the amount of $50,000 was established with a corresponding charge to net income at that date. To reduce the carrying amount of the noncurrent marketable equity securities portfolio to market, which was lower than cost at December 31, 1975, a valuation allowance in the amount of $110,000 was established by a charge to stockholders' equity representing the net unrealized loss.

At December 31, 1974, the current and noncurrent portfolios of marketable equity securities were not required to be carried at their lower of cost or market at the balance sheet date and were carried at cost. Marketable equity securities included in current and noncurrent assets had a market value of $925,000 and $500,000, respectively, at December 31, 1974.

At December 31, 1975, gross unrealized gains and gross unrealized losses pertaining to the marketable equity securities in the portfolios were as follows:

	Gains	Losses
Current	$75,000	$125,000
Noncurrent	$90,000	$200,000

A net realized loss of $10,000 on the sale of marketable equity securities was included in the determination of net income for 1975. The cost of the securities sold was based on the average cost of all the shares of each such security held at the time of sale. There were no sales of marketable equity securities during 1974.

Footnotes

FAS12, Footnote 1--The term *parent company financial statements* as used in this Statement is limited to those parent company financial statements prepared for issuance as the financial statements of the primary reporting entity.

FAS12, Footnote 2--For this purpose, not-for-profit organizations are those described in the third sentence of paragraph 5 of the Introduction to *ARB No. 43.*

FAS12, Footnote 3--Restricted stock for purposes of this Statement shall mean securities for which sale is restricted by a governmental or contractual requirement except where such requirement terminates within one year or where the holder has the power by contract or otherwise to cause the requirement to be met within one year. Any portion of the stock which can reasonably be expected to qualify for sale within one year, such as may be the case under Rule 144 or similar rules of the Securities and Exchange Commission, is not considered restricted.

FAS12, Footnote 4--For this purpose, marketable equity securities owned by an investee accounted for by the equity method shall not be considered owned by the entity (investor).

FAS12, Footnote 5--This constitutes an exception to paragraph 19 of *APB Opinion No. 18* in those cases in which a subsidiary accounted for under the equity method has a net unrealized gain or loss on a portfolio of marketable equity securities that would serve to offset, in whole or in part, the net unrealized gain or loss on a comparable portfolio of marketable equity securities of the parent or consolidated entity. If the subsidiary were consolidated and its portfolios were combined with comparable portfolios of other entities in the consolidation in accordance with this paragraph, a different effect on consolidated net income would be produced, as compared with the equity method.

FAS12, Footnote 6--This does not preclude entities in industries in which either the cost basis or the market basis is an accepted specialized practice from electing the market basis where such election is permissible in that industry. In such an election, the provisions of paragraphs 15-17 of *APB Opinion No. 20,* "Accounting Changes," shall not apply.

FAS12, Footnote 7--For the purposes of paragraph 16, unrealized gains and losses shall have the same meaning as is presently accepted in the particular industry's specialized accounting practice.

FAS12, Footnote 8--For a recent discussion of this subject, see the Auditing Interpretation published by the staff of the Auditing Standards Division, AICPA, "Evidential Matter for the Carrying Amount of Marketable Securities," in *The Journal of Accountancy,* April 1975.

FAS12, Footnote 9--For enterprises having fiscal years of 52 and 53 weeks instead of the calendar year, this Statement shall be effective for financial statements for periods ending in late December 1975.

FAS12, Footnote 10--See footnote 9.

FAS12, Footnote 11--See footnote 9.

FAS12, Footnote 12--See footnote 9.

FAS12, Appendix A, Footnote 13--See the Preface to *AICPA Industry Audit Guide,* "Audits of Stock Life Insurance Companies."

FAS12, Appendix A, Footnote 14--See footnote 9.