

## ACCOUNTING FOR MARKETABLE SECURITIES

Managers invest in securities of other companies for a variety of reasons. First, a company may have cash it would like to invest in the stocks or bonds of another company simply to generate a return. Second, a company may invest in another company so that it can influence that company's policies and performance. Third, a company may invest in another company with the objective of obtaining control of that company. From a financial reporting perspective, these diverse reasons result in three broad investment categories: (1) passive investments, (2) investments that result in significant influence, and (3) investments that result in control.

### Passive Investments

Passive investments are investments in securities of another company simply for the purpose of earning a rate of return. They can include investments in debt and equity securities. All debt securities (e.g., bonds) are considered passive investments—they generally do not result in the investing company having any significant influence or control of the company whose securities it has purchased. Although there are exceptions, investments in equity securities (e.g., stocks) are considered passive investments if the investing company owns less than 20% of the outstanding voting shares of the investee. Note that since preferred stock is typically nonvoting stock, it is usually considered a passive investment.

The accounting for a passive investment depends on management's intent with respect to that investment. Management's intent is generally classified into one of three categories: (1) hold-to-maturity investments—investments in bonds that management intends to hold until the maturity date of the bonds;<sup>1</sup> (2) trading securities—investments in either bonds or stocks that management intends to actively trade with the objective of generating profits from short-term changes in the prices of those securities; or (3) available-for-sale securities—investments in either bonds or stocks that are not classified as hold-to-maturity or trading. Management will sell them “if the time is right,” but it does not intend to actively trade them for short-term profits.

---

<sup>1</sup> Note that stocks do not have a maturity date, so investments in stocks cannot be classified as hold-to-maturity.

---

This technical note was prepared by Professor Mark Haskins and Associate Professor Luann J. Lynch. It was written as a basis for class discussion rather than to illustrate effective or ineffective handling of an administrative situation. Copyright © 2008 by the University of Virginia Darden School Foundation, Charlottesville, VA. All rights reserved. *To order copies, send an e-mail to sales@dardenbusinesspublishing.com. No part of this publication may be reproduced, stored in a retrieval system, used in a spreadsheet, or transmitted in any form or by any means—electronic, mechanical, photocopying, recording, or otherwise—without the permission of the Darden School Foundation.*

Investments in bonds classified as hold-to-maturity investments are accounted for at *amortized cost*. Investments in bonds or stocks classified as either available-for-sale or trading securities are accounted for using the *market value method* of accounting.

### Investments in Stock for Significant Influence

Investments in the stock of another company that give the investing company a significant influence over the policies (operating, investing, and financing) and performance of the company it has invested in require a method of accounting different from that for passive investments. Although there are exceptions, investments in stock are considered investments for significant influence if the investing company owns 20% to 50% of the outstanding voting shares of the investee. Other factors may lead to the investing company having significant influence over the other company's policies, such as other contractual arrangements, cross-border restrictions, and legal restrictions associated with electing members of the board of directors. These investments are accounted for using the *equity method* of accounting.

### Investments in Stock for Control

Investments in the stock of another company that give the investing company control over the policies (operating, investing, and financing) of the company it has invested in require yet a third type of accounting. Although there are exceptions, investments in stock are considered investments for control if the investing company owns more than 50% of the outstanding voting shares of the investee. Other factors may lead to the investing company having control over the other company's policies, similar to those mentioned above with respect to investments for significant influence. These investments are accounted for using the *consolidation method* of accounting.

**Table 1** and **Table 2** summarize:

Table 1. Investment in debt securities.

<b>Management intent:</b>	Hold-to-maturity	Actively trade or available for sale
<b>Accounting method:</b>	Amortized cost method	Market value method

Table 2. Investment in equity securities.

<b>Ownership % of outstanding voting shares:</b>	< 20%	20% to 50%	> 50%
<b>Category:</b>	Passive	Significant influence	Control
<b>Management intent:</b>	Actively trade or available for sale	N/A	N/A
<b>Accounting method:</b>	Market value method	Equity method	Consolidation method

This note discusses the accounting for *passive investments in equity and debt securities* (heretofore called “marketable securities”). Statement of Financial Accounting Standard No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (SFAS No. 115), addresses the accounting and reporting for marketable securities. However, because SFAS No. 115 is complex in its original form, this reading provides a simplified explanation of how to apply it.

### Marketable Equity Securities

When management invests in marketable equity securities, it classifies those securities as either trading securities or available-for-sale securities, depending on its intent with respect to those investments. Trading securities are securities a company intends to actively trade with the objective of generating short-term profits from short-term changes in prices of the securities. They are almost always classified as current assets on the balance sheet.

Available-for-sale securities are securities a company does not intend to actively trade, but in which a company invests to generate a return to use to support company operations on an ongoing basis. This classification does not mean that the company cannot sell the investment; it simply means that management’s intent is simply not to actively trade the security to generate short-term profits from short-term fluctuations in the security’s price. They are classified as current assets if management expects to sell them in the upcoming year, or noncurrent assets if not.

**Table 3** shows an example investment portfolio and provides data for all subsequent illustrations.

Table 3. Example investment portfolio.

	Year 1			Year 2		
	Cost	Market	Difference	Cost	Market	Difference
<b>Security #1</b>	\$20,000	\$22,000	\$2,000	\$20,000	\$23,000	\$3,000
<b>Security #2</b>	30,000	25,000	(5,000)	30,000	27,000	(3,000)
<b>Security #3</b>	\$25,000	\$24,000	\$(1,000)	\$25,000	\$19,000	\$(6,000)

The flowchart in **Exhibit 1** portrays a series of pertinent issues and queries to be considered with respect to equity securities in the application of SFAS No. 115. Assume (as is often the case) that these queries are made as of year end. Securities classified both as available-for-sale and trading face the same set of questions; only the required accounting entries differ.

### Temporary changes in value—Trading securities

Let's examine trading securities first. The initial step, as we see on our flowchart in **Exhibit 1**, is to compare the current market value of each separate equity security with its recorded cost. If the market value is equal to the original cost of the investment, no accounting entry is required. If the market value is less than the original cost, management must determine whether the decline is permanent or temporary—an important determination that will affect the way the decline is handled.

Temporary declines are short-term fluctuations that are expected to reverse themselves (e.g., a general decline in the stock market). If management decides that the decline in the value of an individual security is temporary, an accounting transaction must be recorded to reflect the decline in value. If the security has been classified as a trading security, this is accomplished by decreasing the security asset account and by reducing income statement profits (a retained earnings account) for the “unrealized holding loss.”<sup>2</sup> In the **Table 3** year 1 example, the market value of security #2 is \$25,000, as compared with a cost of \$30,000. Assuming that management judged the decline in the value to be temporary, the following accounting entry would be made:

Retained earnings (OE) (unrealized holding loss)	(dec.) \$5,000
Investment in trading securities—Security #2 (A) <sup>3</sup>	(dec.) \$5,000

The rationale for decreasing retained earnings in this way (i.e., recording an unrealized loss on the income statement) is that management expects to hold its trading securities only for a short time, trading them frequently to generate profits from short-term fluctuations in their prices; therefore, it is assumed that a portfolio market decline below cost is unlikely to reverse

<sup>2</sup> The gain or loss is called an “unrealized” gain or loss, because the security has not been sold—the gain or loss is simply a “paper” gain or loss. The gain or loss is called a “holding” gain or loss simply because the company is holding the security.

<sup>3</sup> Technically, the company maintains an investment allowance asset account in which it records these increases and decreases in the value of the investment during the reporting period. For simplicity, we record these increases and decreases directly to the investment asset account.

itself before the securities in the portfolio are sold. The accounting convention of conservatism thus leads to the practice of recognizing the loss in the income statement immediately, even though it has not yet been realized via an actual sale.

Applying the same process to this security at the end of year 2, we find that the value of the security is \$27,000 (only \$3,000 below its cost). The investment account, however, has a \$25,000 balance from year 1, so the account must be adjusted to reflect the \$2,000 increase in market value during the year.<sup>4</sup> The following entry would be made:

Investment in trading securities—Security #2 (A)	(inc.) \$2,000
Retained earnings (OE) (unrealized holding gain)	(inc.) \$2,000

What if the market value of the security is *higher*, however, than its cost? Take, for instance, security #1 at the end of year 1. Its market value of \$22,000 is greater than its original cost of \$20,000. In this case, an accounting transaction must be recorded to reflect the increase in value. If the security has been classified as a trading security, this is accomplished by increasing the security asset account and by increasing the retained earnings account for the “unrealized holding gain.” In the **Table 3** year 1 example, the market value of security #1 is \$22,000, as compared with a cost of \$20,000. The following accounting entry would be made:

Investment in trading securities—Security #1 (A)	(inc.) \$2,000
Retained earnings (OE) (unrealized holding gain)	(inc.) \$2,000

Applying the same process to this security at the end of year 2, we find that the value of the security is \$23,000 (\$3,000 above its original cost). The investment account, however, has a \$22,000 balance from year 1, so the account must be adjusted to reflect the additional \$1,000 increase in market value during the year.<sup>5</sup> The following entry would be made:

Investment in trading securities—Security #1 (A)	(inc.) \$1,000
Retained earnings (OE) (unrealized holding gain)	(inc.) \$1,000

### Temporary changes in value—Available-for-sale securities

For the available-for-sale securities, the same series of questions is asked as for the trading securities. In year 1, security #2’s market value is \$5,000 below its original cost. Thus, an accounting entry must be made to reflect this lower market value. The entry, however, is slightly different from the one for trading securities. Management does not expect to actively trade

<sup>4</sup> Again, the company maintains an investment allowance asset account in which it records these changes in market value of these investments. Note that this adjustment leaves a \$3,000 balance in the valuation allowance account, which represents the difference between the security’s new market value (\$27,000) and its original cost (still, \$20,000).

<sup>5</sup> Again, the company maintains an investment allowance asset account in which it records these changes in market value of these investments. Note that this adjustment leaves a \$3,000 balance in the valuation allowance account, which represents the difference between the security’s new market value (\$23,000) and its original cost (still, \$30,000).

available-for-sale securities to generate profits based on short-term fluctuations in the price of those securities. Consequently, the market decline will not be used to reduce current period's net income. It is simply reflected in a separate owners' equity account. The entry would be made:

Accumulated other comprehensive income (OE)	(dec.) \$5,000
Investment in AFS securities–Security #2 (A)	(dec.) \$5,000

This entry records the market decline and has no current period income-statement effect (unlike the entry in the preceding section related to trading securities, which included an unrealized holding loss in determining net income). If the security recovers in the future, a reversal of this entry will be recorded to the extent of the recovery. For example, in year 2, the market value of security #2 increases by \$2,000. The entry to reflect this increase would be made:

Investment in AFS securities–Security #2 (A)	(inc.) \$2,000
Accumulated other comprehensive income (OE)	(inc.) \$2,000

At the end of year 2, the investment asset account has a balance of \$27,000 (the market value of the security). The accumulated other comprehensive income account has a balance of \$3,000 related to security #2; this amount reflects the difference in the market value and the cost of security #2 at the end of year 2.<sup>6</sup> This account continues to hold the unrealized holding gain or loss on each available-for-sale security until the time such security is sold or reclassified, at which time that unrealized holding gain or loss will be recognized in current period income.

Note that reporting investments on the balance sheet at their market value is in contrast to the historical cost principle. For many assets, while it may be relevant to the financial statement reader to know the market value of those assets, it is extremely difficult to obtain a reliable estimate of that market value. Take a piece of real estate, for example. There is typically an active market in real estate in many locations. However, without selling a given piece of real estate, any attempt to obtain an estimate of the market value of that piece of real estate typically results in a range of estimates, calling into question the reliability of any one of those estimates. Accordingly, standard setters have determined that companies should report those assets on their balance sheets at their historical cost. In contrast, most equity securities are traded in arms-length transactions on an ongoing basis every day. So it is possible to obtain a very reliable estimate of the market value of most equity securities. As a result of the ability to obtain an estimate of market value that is both relevant and reliable, standard setters have determined that companies should report those assets on their balance sheets at their market value.

---

<sup>6</sup> In this reading, for the sake of simplicity, we have chosen to ignore taxes. Technically, the unrealized holding gains/losses in accumulated other comprehensive income would be reported net of income tax.

### Permanent declines in value

What happens if management deems the decline in value of a particular marketable equity security to be permanent? Such a decline would perhaps result from events that damage the long-term earnings potential of the company that issued the security—disappearing markets, adverse governmental legislation, litigation, or similar fundamental changes.

Accounting for a permanent decline is quite straightforward, regardless of the security's classification as trading or available-for-sale. Because the value is not expected to recover, a loss is recognized in the income statement immediately, even though the security has not yet been sold. For example, assume management decides at the end of year 2 that the \$6,000 decline in the market value of security #3 in **Table 1** is a permanent decline. To recognize this loss, the entry would reduce the carrying value of the security and record a loss in current period income.

If security #3 has been classified as a trading security, the entry would be made:

Retained earnings (OE) (loss on write-down of security)	(dec.) \$5,000
Investment in trading securities—Security #3 (A)	(dec.) \$5,000

Note that while there has been a \$6,000 permanent decline in the market value of security #3 from its cost, we record a loss of only \$5,000 in year 2's income. This is because \$1,000 of the decline in market value was recorded in income in the prior period as a temporary decline.

If security #3 had been classified as an available-for-sale security, the entry would be: made

Retained earnings (OE) (loss on write-down of security)	(dec.) \$6,000
Investment in AFS securities—Security #3 (A)	(dec.) \$5,000
Accumulated other comprehensive income (OE)	(inc.) \$1,000

Note that here we record the entire decrease in market value as a loss in year 2's income, because none of the decline in market value has affected income to date.

After a security is written down because of a permanent decline, it is this newly established "cost" that will be used for comparison with future years' market values.

### Reclassifications

Transfers between categories should be infrequent. Securities that were once considered available-for-sale (trading), however, can be reclassified as trading (available-for-sale) if management's intent changes. If a security is reclassified from available-for-sale to trading, that security is transferred at its market value as of the date of reclassification, and the gain or loss that has accumulated on the security to date (in the accumulated other comprehensive income account) is recognized in current period income. As an example, suppose security #2 was

reclassified from available-for-sale to trading during year 2 when its market value was \$26,000. The entry would be made:

Investment in trading securities—Security #2 (A)	(inc.) \$26,000
Retained earnings (OE) (loss on reclassification of security)	(dec.) \$4,000
Investment in AFS securities—Security #2 (A)	(dec.) \$25,000
Accumulated other comprehensive income (OE)	(inc.) \$5,000

The \$5,000 unrealized holding loss that had accumulated in AOCI as of the end of year 1 is transferred to income. However, only \$4,000 loss on reclassification is recorded in current period income. (As the market value of the security has increased by \$1,000 since the end of year 1, the effect on income is the net of the \$5,000 unrealized loss recorded as of the end of year 1 and the \$1,000 increase in market value since then.)

If, on the other hand, security #2 was originally classified as a trading security and is reclassified from trading to available-for-sale, that security is transferred at its market value as of the date of reclassification. But since all the unrealized holding loss on the security through the end of year 1 has been recorded in income already, the entry upon reclassification looks somewhat different:

Investment in AFS securities—Security #2 (A)	(inc.) \$26,000
Investment in trading securities—Security #2 (A)	(dec.) \$25,000
Retained earnings (OE) (gain on reclassification of security)	(inc.) \$1,000

Note that as of the date of the reclassification, the total gain or loss related to security #2 recorded to income is the same, regardless of its original classification as a trading or available-for-sale security. However, the timing of that income is different. In summary, the gain/(loss) recorded to income is as follows in **Table 4**:

Table 4. Summary of gain/(loss) recognized in income statement through reclassification.

<b>Original Classification:</b>	<b>Trading Security</b>	<b>AFS Security</b>
Year 1	\$(5,000)	0
Year 2 through reclassification	\$1,000	\$(4,000)
Total	\$(4,000)	\$(4,000)

## Summary

Under the market value method of accounting for marketable equity securities, the investment asset account is increased or decreased to reflect the change in the market value of the investment during the reporting period. An unrealized holding gain or loss arises when the market value of the investment changes. The account to which this unrealized holding gain or loss is booked depends on management's intent with respect to the investment. If management



intends to trade the investment for short-term profits, the unrealized holding gain or loss is recorded on the income statement and affects current period income. Alternatively, if management intends to hold the security for a while to generate returns, the unrealized holding gain or loss is recorded on the balance sheet. In this case, these unrealized holding gains or losses accumulate on the balance sheet until the security is sold or reclassified, at which time they affect income.

### **Marketable Debt Securities**

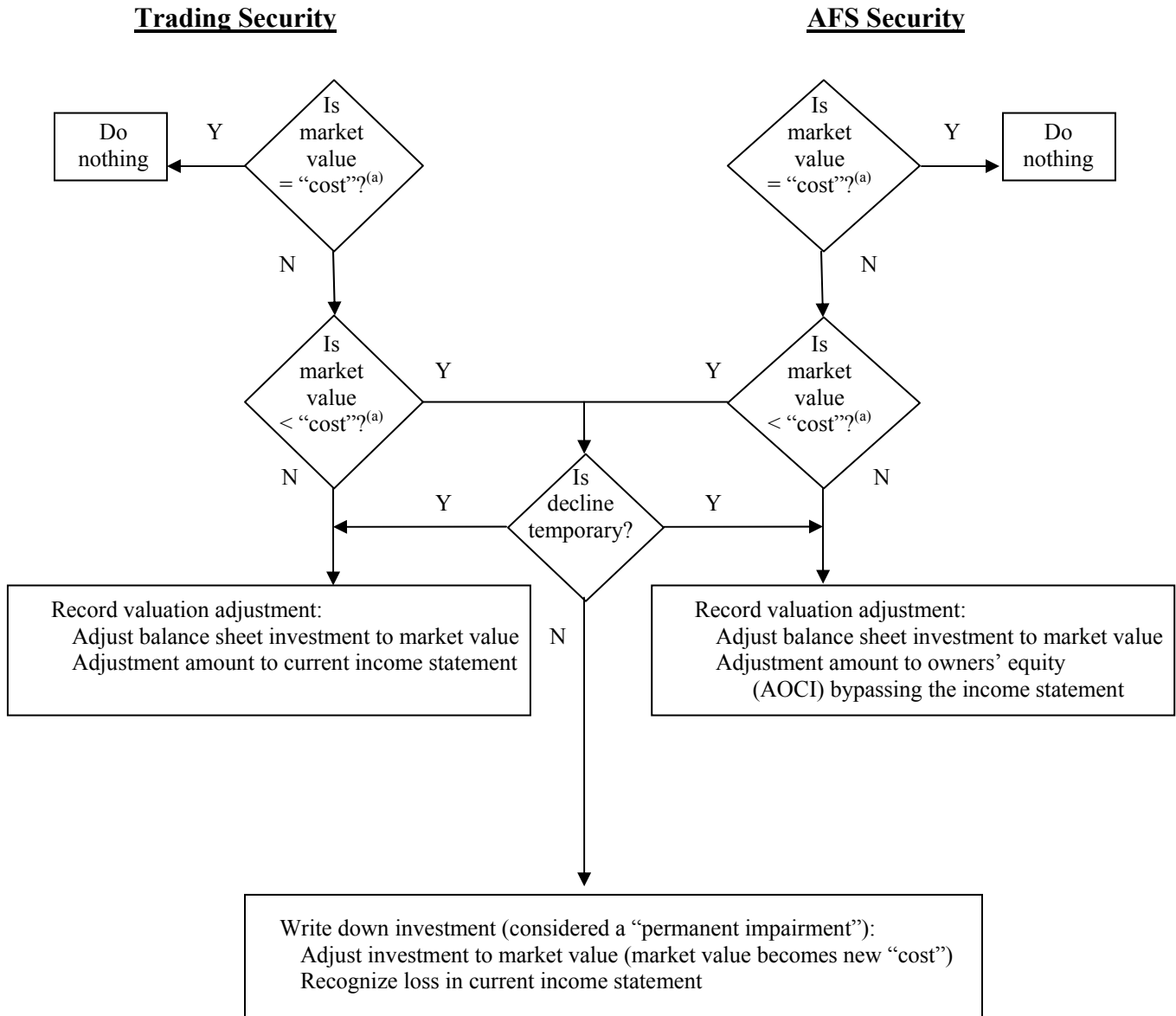
Investments in marketable debt securities (i.e., bonds) also must be classified according to management's intent with respect to those investments. As with marketable equity securities, this classification affects the accounting for those securities.

Marketable debt securities must be classified as either: (1) hold-to-maturity securities, if management's intent is to hold those securities until they mature; (2) trading securities, defined as with equity securities; or (3) available-for-sale securities, also defined as with equity securities. If debt securities are classified as hold-to-maturity securities, they are accounted for at amortized cost. If they are classified as either trading securities or available-for-sale securities, they are accounted for by using the market value method in a manner similar to that previously described for equity securities.

Exhibit 1

**ACCOUNTING FOR MARKETABLE SECURITIES**

Flowchart



<sup>(a)</sup> Original cost or "cost" resulting from a previous permanent impairment.