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FASB Proposal to Change Accounting for Investments in Funds

By Gregory Smith

The Financial Accounting Standards Board (FASB) [recently released](#) a proposal that will change how corporate investors in funds report changes in the fair value of their investments in earnings.

The proposal may cause unrealized changes in the fair value of investments in funds to be included in net income—increasing volatility in earnings per share. In a [comment letter](#), ICI has made recommendations to help avoid this outcome.

How the Rules Work Now

Under current Generally Accepted Accounting Principles (GAAP), corporate investors classify their investment securities in three ways:

- **Held to maturity:** Investments in debt securities classified as *held to maturity* are valued at amortized cost. Changes in fair value are not reflected in earnings (absent impairment).
- **Available-for-sale:** Investments classified as *available-for-sale* are valued at fair value. Investors report the change in fair value over the reporting period under *other comprehensive income* (a supplemental presentation of earnings gains and losses that is separate from net income from continuing operations and earnings per share). Changes in value of available-for-sale investments are reflected in net income and earnings per share only when the investment is sold and the gain or loss is realized.
- **Trading:** Investments classified as *trading* are valued at fair value. Investors report the change in fair value over the reporting period in net income and earnings per share.

Corporate investors in funds may classify their investments as *available-for-sale*, meaning unrealized changes in value are not reflected in net income.

The FASB Proposal: A New Framework

According to the FASB, the proposal would improve financial reporting for investments by developing a consistent, comprehensive framework for classifying and measuring investments. Investments would be classified into one of three categories based on the asset's cash flow characteristics and the investor's business model for managing the investment. Based on this assessment, investments would be classified into one of three categories:

- **Amortized cost:** investments with solely payments of principal and interest that are held for collection of contractual cash flows
- **Fair value through other comprehensive income:** investments with solely payments of principal and interest that are both held for the collection of cash flows and for sale
- **Fair value through net income:** investments that do not qualify for either category above

Under the proposal, all equity investments would be classified as *fair value through net income*, which is similar to the *trading* classification described above. Investments in funds are considered equity investments, even where the fund invests in fixed-income securities. The *fair value through other comprehensive income* category would not be available for equity investments. As a result, unrealized changes in the fair value of investments in fund shares would be included in net income and earnings per share.

Concerns with the FASB Proposal

Investors often hold bond funds to generate income or for liquidity management—not for trading or realization of gains or losses.

These investors have expressed concern that the proposal's requirement to reflect changes in fair value in net income will obfuscate their operating performance. In particular, these changes in fair value will introduce “noise” into their reported earnings per share. In turn, corporate treasurers might be inclined to avoid mutual funds and invest directly in securities that qualify for *amortized cost* or *fair value through other comprehensive income*.

ICI Recommendations

ICI recommends that the FASB provide investors with an irrevocable election, made at the time of investment, to classify equity investments as *fair value through other comprehensive income*. We believe such classification better reflects the purposes of investments in the fixed-income funds.

[International Financial Report Standards](#) (IFRS 9) already contain such an irrevocable election. Thus, our recommendation also would promote convergence between GAAP and IFRS.

Learn more about fund accounting and financial reporting issues at the [Operations section](#) of ICI's website.

Gregory Smith was senior director of operations, compliance, and fund accounting for ICI.