Corporate Financial Reporting of Marketable Securities in Nigeria

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Abstract

This study was conducted to investigate Corporate Financial Reporting of Marketable Securities (MS) in Nigeria with a view to determine the impact of the reporting system on the financial performance of banks. To achieve the above objective research questions were raised, hypotheses were formulated, and a review of related literature was made. In order to generate the necessary data for this study, a survey method of research design were employed and the 25 recapitalized banks in Nigeria formed the population of the study. The data for this study were sourced from the financial statements of banks and the Central Bank of Nigeria (CBN) statistical bulletin for a period of 15 years, i.e. 1995 – 2009. The data generated for this study were analyzed using frequencies, percentages and bar chats while the stated hypotheses were tested with multiple regression analysis. Our findings indicated that the reporting system of MS influences the financial performance of banks. This will help them make a rational choice of

reporting and accounting system that will enhance the market value of the bank. Based on the above findings, it was recommended that Marketable Securities should be reported at market value by Nigerian banks; marketable debt securities should be classified as temporary investments while marketable equity securities should be classified as long-term investment and emphasis on the reliability of accounting information should be shifted to the relevance and timely of accounting information to enable market value have prominence over the cost rule in reporting marketable securities.

Key words: Corporate financial reporting, marketable securities, market value, GAAP, IFRS

Introduction

According to Cheng (2008), Marketable Securities (MS) are financial instruments whose prices are currently available on the national security exchange or in the over-the-counter market quotation. The reporting of such securities is applicable in three different situations – purchase; sales; and valuation. According to Walter (1999), when marketable securities are acquired, a market price which includes cost of security and commission to stock brokers is paid. The total cost of the security therefore, is debited to marketable securities and credited to cash book. The sale of marketable securities may result in a realized gain or loss. When the sales value of the security is greater than cost, a gain is realized but when cost of the security is greater than the sales value, a loss is incurred. The accounting treatment is to debit cash book by the sales value, credit realized gain by the difference of sales and cost, and credit marketable securities at carrying value, where sales value exceeds cost. Similarly, where the sales value is less than cost, the accounting treatment is to debit cash book by the sales value, debit realized loss by the difference of sales and cost, and credit marketable securities at carrying value. At the time of valuation, marketable securities may result in unrealized gains or losses, which may be recognized in the net income or equity section of the balance sheet. If marketable securities are classified as current assets, the unrealized gains/losses will be reported in the net income, but as non-current assets, they will be reported in the equity section of the balance sheet.

While the Generally Accepted Accounting Practice (GAAP) recommends that marketable securities be reported at the lower of cost or market and realized / unrealized gains and losses be treated as extra-ordinary item,

market value has been an acceptable method for reporting marketable securities within certain industries that follow specialized accounting practices with respect to marketable securities. The question is why this controversy? In cognizance of this, Osisioma (2001) posited that immature development of accounting practice in developing nations is responsible for the poor financial reporting in those nations and Ofoegbu and Okoye (2006) claimed that financial reporting practices in Nigeria are generally deficit. Therefore, for banks in Nigeria to properly report its investments in marketable securities in order to present a true and fair view of its financial statements, this study becomes a "sine qua non". Specifically, the study is aimed at achieving the following-

(i)   To determine the effect of the cost rule method of reporting marketable securities on the financial performance of banks.

(ii) To identify the impact of the market value of reporting marketable securities on the financial performance of banks.

To achieve the above objectives, the following hypotheses were formulated-

(i)   The cost rule of reporting marketable securities has no negative significant effect on the financial performance of banks.

(ii) The market rule of reporting marketable securities has no positive significant impact on the financial performance of banks.

Theoretical Framework

Accounting researchers, regulatory authorities and professional bodies have investigated the financial reporting systems of marketable securities in developed and developing countries for a very long time. Each of these studies has been distinguished by differences in research settings, differences in definition of explanatory variables, differences in unit of analysis, and differences in statistical analysis. In all of these studies, there are mixed findings

Stickey and Wei (2010) examined the impact of cost principle of marketable securities on corporate performance of investment companies in Switzerland. A total of 202 companies were considered for the study and the chief accountants of the respective companies were considered as the unit of analysis. The researchers used the ordinary least square to analyse the data

generated from the study. Their result revealed a correlation co-efficient of -0.71 and a P-value of 0.028, which indicates that the cost principle of reporting marketable securities has a negative significant impact on corporate profitability.

Cheng (2008) investigated whether the lower of cost or market (LCM) seems appropriate in reporting trading securities in Thailand. He considered 83 professional accountants for the study and used simple percentages to analyse the data collected. The result shows that 65% of the respondents affirmed that LCM is an appropriate system of reporting trading securities while 35% disagreed with the assertion.

Hampton and Moody (2007) in their study "the reporting issues of marketable securities", observed that market value is the common system of reporting marketable securities among banks and non-banks financial institutions considered for the study in Philippines. They further reported that the primary reason for the choice of market value is that changes in market price of marketable securities are a source of economic benefit to the institution.

Ahmed (2006) examined the disclosure requirements of marketable securities in Jordan. He used a pilot survey of 97 reporting accountants for the study. In analyzing the data, the researcher used descriptive statistics of mean, variance, and standard deviation. His findings indicated that marketable securities are required to be reported at market value because of its potential benefits of improving the share price of the firm.

Lewis and Dupree (2003) conducted a comparative study of cost rule and market rule of reporting marketable securities by investment companies in Sweden. Accountants in the companies selected for the study were considered as the unit of analysis. The t-test statistical tool was used for data analysis for the study. The findings of the study indicated that while the cost rule negatively affect income statement and the balance sheet, the market rule positively influence both the income statement and the balance sheet.

Welkazi (2001) in his work entitled *The valuation system of marketable securities in Bangladesh* observed that historical cost takes prominence over any other system of valuation. The major reason accountable for this as revealed from the study is because the cost basis is consistent with income

tax procedures, recognizing neither gain nor loss until there is a sale or exchange of the security.

Valuation of marketable securities at cost finds support on the grounds that it is an extension of the cost principle; the asset is carried at cost until a sale or exchange provides an alternative asset and confirms a gain or loss. The cost method offers valuation on a consistent basis from period to period. It is the simplest method to apply and adheres to income tax requirement (Welkazi, 2001; Bodie et al, 1998). However, certain objections to cost can be raised. The use of cost means investments may be carried at amounts differing from values objectively determinable at the balance sheet date, and the integrity of both balance sheet and income statement measurements can be challenged. The use of cost also means identical securities may be reported at different values because of purchase at different prices. A further objection is that management, in controlling the sale of securities, can determine the periods in which gains and losses are to be recognized even though the changes in values may have accrued over a number of periods.

The use of market value is advocated on the basis that there is evidence of the net realized value of the marketable securities held at the balance sheet date and any changes from previous carrying values are recognized as gains or losses in the current period (Ahmed, 2005). Assuming marketable securities are defined as having a readily available sales price or bid and ask price from one of the national securities exchanges or over-the-counter markets, this method is that gains or losses may be recognized, i.e. prior to the actual sale of the securities. However, market values fluctuate, often significantly, which would require continual changing of the carrying value of marketable securities on the balance sheet. Market is also challenged as a departure from the cost principle and as lacking in conservatism. Furthermore, market is not acceptable for general accounting or income tax purposes.

The lower of cost or market method provides for recognizing market declines and serves to prevent potential mistakes arising in analyzing statements when these declines are not reported. Ahmed (2005) stated that the lower of cost or market is supported as a conservative concept consistently. Ball (2006) that if net realizable value of marketable securities is a desirable measurement concept, it uses should not depend on whether portfolio values are greater or less than original cost.

For those securities for which a change in market value is reflected in stockholder's equity the firm should determine as at the date of preparing the balance sheet whether a decline in market value below cost is other than temporary. According to Ukpai (2000), a decline in market value is considered other than temporary if there is no recovery in market value as at the balance sheet date. If the decline in market value is assessed to be other than temporary, then,

(i) Write down the marketable security to a new cost basis

(ii) Treat the write down value of the new cost as a realized loss

(iii) The new cost basis is not increased for later recoveries of market value.

A weakness in the position taken by the Financial Accounting Standard Boards (FASB) as identified by Ukpai (2000) is that some increases in the market value of securities owned are recognized in the Financial Statements while others are ignored. For this reason, many accountants and other professionals believe that investment in marketable securities should be valued in the balance sheet at current market price regardless of whether is above or below cost. Increases or decreases in market value would then be recognized as gains or losses as these changes occur.

Several strong arguments exist for valuing MS at market value. These include:

(i) Market value is a better indicator of the current debt paying ability represented by the securities than is their original cost.

(ii) Market value may be objectively determined from market price quotations.

(iii) The market price may be realized at any time without interfering with the normal operations of the business.

(iv) Changes in market price may constitute a major portion of the economic benefit resulting from investments in marketable securities. (Hampton and Moody, 2007; Lewis and Dupree, 2003; Ukpai, 2000).

At this point, it is important to stress that valuation of marketable securities at current market value, which exceeds cost is not in accordance with Generally Accepted Accounting Principles (GAAP), but it has been a regular practice among accountants and prepares of financial statements for informed decision making by investors and other stakeholders of the firm.

IFRS and Corporate Reporting of Marketable Securities

According to statement No. 115, investments in equity securities with readily determinable market values and all investments in debt securities must be classified into one of three categories: held-to-maturity, trading, and available-for-sale.

The following criteria classify debt and equity securities into these categories. All debt securities should be carried at amortized cost if an entity has both the positive intent and the ability to carry the securities to maturity. Securities may not be classified as held-to-maturity if an entity plans to hold the security for an indefinite period of time or it does not intend to sell or redeem the security by a specific date. Several severe restrictions prevent organizations from claiming a positive intent to hold a debt instrument to maturity in response to the following circumstances:

❖ Changes in market interest rates,

❖ Changes in the securities pre-payment risk,

❖ Changes in foreign currency risk,

❖ Changes in funding sources and terms,

❖ Changes in liquidity needs,

❖ Increases or decreases in loan demands,

❖ Changes in the availability or yield of alternative investments,

❖ Changes in funding sources or terms, (Devry, 2009; Gamba, 2004)

The Financial Accounting Standard Board (FASB) recently issued a new statement that requires all companies to change their methods of accounting for marketable securities. Rather than allowing organizations to use a historical cost approach in accounting for such financial instruments, the FASB statement No. 115 requires organization to adopt a market value

approach. The provisions of the statement will significantly affect the financial performance of firms positively or negatively (Becker, 2009).

Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities published recently by the Financial Accounting Standard Board (FASB), is important for banks particularly those that have large inventories of financial instruments in their investment portfolios. The statement not only requires them to recognize gains on investments, even if it has neither sold the financial instruments nor made plans to sell the instruments in the near future. Because the standard alters the method of reporting net income, assets, and retained earnings, it compares financial ratios from one period to the next. This incomparability of financial ratios could cause organizations to be in violation of loan covenants (Davry, 2009).

The issuance of statement No. 115 manifests the change in FASB's focus from the income statement to the balance sheet. The statement alters the method of reporting on financial instruments in both the income statement and the balance sheet, which results in different accounting for gains and losses in market values for certain securities and an increase in deferred incomes.

FASB Statements Nos. 12 and 115 have similar financial statement disclosure requirements. They require that the aggregate fair value, gross unrealized holding gains and losses, and amortized cost basis as of each balance sheet date should be reported in the balance sheets or in the notes to the Financial Statements for each of the three categories of investments (such as held-to-maturity, trading, and available-for-sale). All individual, trading, and available-for-sale securities should be classified as current and long-term, as appropriate. For example, the classification of held-to-maturity securities depends upon the date of maturity or the exercisable call date, whichever is more probable. The classification of available-for-sale securities hinges on such factors as the reasonableness of the intent of management to sell-based upon a review of the entity's prior classifications and the maturities of such financial instruments. However, marketable debt and equity securities classified as available-for-sale should be classified normally as current assets in the balance sheet, even though the organization currently has no plans to dispose of them. Because such assets usually represent a surplus of immediately available funds, they may be sold at the discretion of management.

Organizations should make additional disclosures for specific types of securities, including equity securities; debt securities issued by the Department of Treasury and other governmental agencies; debt securities issued by state governments and by political subdivisions of these governments; debt securities of foreign governments; corporate debt securities; and mortgage-backed securities

In addition, organizations should disclose the maturity dates of contractual maturities as of the most recent balance sheet date presented. Organizations should disclose the fair value and amortized cost-of-debt securities for at least the following major groupings. The effect of adopting the provisions of FASB Statement No. 115 should be reported in the footnotes to the Financial Statement as part of its footnote disclosures. However, Statement No. 115 does not permit organizations to present pro-forma disclosures of retroactively applied provisions of the standard. Increased by $2,000,000 (net of $1,200,000 in deferred income taxes) to reflect the net unrealized holding gains on securities classified as available-for-sale which were carried previously at amortized cost or under the lower of the cost or market approach. The amortized cost of these securities total $40,000,000. The period to maturity for the majority of these securities is deemed too long, which necessitates the transfer.

The International Financial Reporting Standards (IFRS) are designed to be a single set of high quality, understandable and enforceable global accounting standards that require transparent and comparable information in general purpose financial statements. The requirements of IFRS in the financial reporting of marketable securities are not significantly different from Statement of Financial Accounting Standards (SFAS) 115, Statement of Accounting Standards (SAS) 13 and International Accounting Standard (IAS) 32. IFRS requires that marketable securities should initially be recorded at acquisition cost (generally the cost to acquire the security). Subsequent accounting for marketable security depends on its classification. IFRS requires that:

(i)   Held-to-maturity securities are to be reported at amortized cost

(ii)   Trading securities are to be reported at fair value with unrealized gains and losses reported on the income statement.

(iii)   Available – for – sale securities are to be reported at fair value with unrealized gains and losses reported in equity section of the balance sheet.

The standard also requires that realized gains/losses and income (interests and dividends) are to be reported on the income statement for all marketable securities.

IFRS further requires that for all financial instruments including marketable securities, there must be disclosures of credit risk, liquidity risk, market risk, and risk management procedures and policies. This last requirement is the difference between SFAS, SAS and IFRS in reporting marketable securities.

A number of leading banks in Nigeria have started making voluntary decisions to improve the transparency and exposure level of their books by using IFRS for the presentation of their financial statements. Some of these banks are First Bank of Nigeria Plc, Guaranty Trust Bank Plc, Access Bank Plc, and EcoBank Transnational International (ETI). The Nigerian Stock Exchange (NSE) has urged quoted companies to comply with the International Financial Reporting Standards (IFRS) by 2011.

Research Methods

In order to collect the data needed for this study, the survey method of research design was employed involving the twenty-five (25) recapitalized banks as listed in the Nigerian Stock Exchange Fact Book of 2009.Considering the objectives of this study, the secondary method of data collection such as the companies' financial statements relating to the profitability, return on equity, age, and size of the selected banks and the Central Bank of Nigeria a (CBN) statistical bulletin on data for inflation rate and exchange rate were the main documents where the data for this study were generated.

In this study, financial reporting system was operationalised into cost rule and market rule, and financial performance was measured using Net profit before tax and return on equity of the banks. The value of marketable securities reported by the bank on the balance sheet date was used in measuring the cost rule while rate of inflation was added to the value of marketable securities on balance sheet date as proxy for market value. These

measures were considered for a time frame of fifteen years (from 1995 – 2009).

The data generated for this study were presented in a table and graph, the analysis was made using frequencies and percentages, while the stated hypotheses were tested with the multiple regression analysis. These were computed with the aid of the Econometric Views (E-views) version 3.1.

Model Specifications and Estimation

The following models in log-form are designed for this study.

Model 1:

The first objective of this study is captured in the model given below:

$$NPBT = f[\alpha_o Log + \beta_1 LogCOR + \beta_2 LogFIRA + \beta_3 LogINFRAT + ...\mu_i]$$

Model 2:

The second objective is captured in the model given below:

$$ROE = f[\alpha_o Log + \beta_1 LogMAR + \beta_2 LogFISIZ + \beta_3 LogEXCRAT + ...\mu_i]$$

Where;

NPBT	=	Net Profit Before Tax
ROE	=	Return On Equity
COR	=	Cost Rule
MAR	=	Market Rule
FIRA	=	Firm's Age
FISIZ	=	Firm's Size
INFRAT	=	Inflation Rate
EXCHRAT	=	Exchange Rate
CUA	=	Current Asset
NCA	=	Non-Current Asset
μi	=	Error Term
α_o	=	Regression constant
β	=	Regression co-efficient

Test of Hypotheses

This section of the study aimed at verifying the hypothetical statements earlier made in this study using the appropriate test statistics.

$H0_1$:   *The cost rule of reporting marketable securities has no negative significant effect on the financial performance of banks.*

In testing this hypothesis, the Net Profit before tax (NPBT) of the selected banks for a period of fifteen (15) years was regressed against the book value of marketable securities on balance Sheet date, firm age and inflation rate, as shown in the table below.

Table 1: Multiple Regression Analysis with NPBT against COR, FIRA and INFRAT

Statistical Variable	Co-efficient	Std.Error	T-statistic	P-value
Intercept ($\propto$)	1.76E+08	3.37e+08	-0.522399	0.0118
COR	-13796920	53872528	2.256103	0.0026
FIRA	-12333034	10875335	3.134037	0.009
INFRAT	-40845978	65451115	2.624068	0.043
R	-0.763			
R^2	0.581406			
Adjusted R^2	0.467244			

Source: E-Views Version 3.1 Window Output

The above table shows a multiple correlation co-efficient (R) value of -0.763, which is close to one from the negative side. This suggests that there is a strong negative relationship between the dependent variable (NPBT) and the independent variables (COR, FIRA and INFRAT).

i)   For 1% increase in cost of marketable securities, the banks' profitability decreases by13796920 units.

ii)   For 1% increase in firm's age, the banks' profitability decreases by 12333034 units

iii)   For 1% increase in inflation rate, the banks' profitability decreases by 40845978 units.

The multiple co-efficient of determination (R^2) of 0.581406 indicates that about 58.14% of the variation in NPBT is associated by changes in COR, FIRA and INFRAT. In other words, about 41.86% change in NPBT is due to other variables other than COR, FIRA and INFRAT, hence the model is a good fit. Since the P-Value associated with COR (0.0026) is less than 0.05, it indicates a significant implication. Therefore, the null hypothesis is rejected. This implies that the cost rule of reporting marketable securities has a negative significant implication on the financial performance of banks.

$H0_2$:   *Market rule of reporting marketable securities has no positive significant impact on the financial performance of banks.*

In testing this hypothesis, return on equity (ROE) of the selected banks for a period of fifteen (15) years was regressed against the market value of marketable securities, firm's size and exchange rate as shown in the table below.

Table 2: Multiple Regression Analysis with ROE against MAR, FISIZ and EXCHRAT

Statistical variable	Co-efficient	Std.Error	T-statistic	P-value
Intercept ($\propto$)	8.242827	2.731755	3.017410	0.0117
MAR	0.849394	0.378165	-2.246097	0.0462
FISIZ	0.294035	0.121951	2.411102	0.0345
EXCHRAT	0.014721	0.008960	-1.642998	0.01286
R	0.6076			
R^2	0.3691			
Adjusted R^2	0.197078			

Source; E-views Version 3.1 Window Output

The analysis presented above revealed a multiple correlation co-efficient (R) value of 0.6076 (which is close to one from the positive side. This suggests a strong positive impact of the independent variables (MAR, FISIZ and EXCHRAT) on the dependent variable (ROE).

(i)   For 1% increase in market value of marketable securities, the return on equity of the bank increases by 84.94%.

(ii)   For 1% increase in firm's size the return on equity of the bank increases by 29.40%.

(iii)   For 1% increase in exchange rate, the return on equity of the bank increase by1.47%.

The multiple co-efficient of determination (R^2) of 0.3691 indicates that about 36.91% of the variation in ROE is attributable to changes in MAR, FISIZ and EXCHRAT. In other words, about 63.09% change in ROE is due to other factors other than MAR, FISIZ and EXCHRAT, hence the model is a good fit. Since the P-Value associated with MAR (0.0462) is less than 0.05, it indicates a significant implication. Therefore the null hypothesis which states that the market rule of reporting marketable securities has no positive significant impact to the financial performance of banks was rejected.

Conclusion and Recommendations

The major objective of a business is to earn profit, which is the excess of revenue over cost. Since profit is the ultimate goal of any business, researchers, business executives, and other stakeholders always search for ways to improve corporate profitability. Earlier studies have demonstrated a fit between the cost rule system of reporting marketable securities and corporate profitability. Our finding in this study agrees with previous results. We observed that the cost rule system of reporting marketable securities has a negative significant implication on the profitability of banks. This finding agrees with Stickey and Weil (2010), which concluded in their study that the cost principle of reporting marketable securities has a negative significant impact on corporate profitability. Our result is equally in concordance with Lewis and Dupree (2003), which found that the cost rule of reporting marketable securities negatively affect the income statement and the balance sheet. More so, in his study, Welkazi (2001) observed that historical cost, which is the premise upon which the cost rule system of reporting marketable securities is based, takes prominence over any other system of valuation because it is consistent with income tax procedures.

Market value has become the most promising candidate of reporting marketable securities for the relevance and timely measure of the intrinsic value of marketable securities; and it has been reported by many scholars and researchers as a means of improving the company's share price. Hampton and Moody (2007) observed that market value is the common system of

reporting marketable securities among banks and non-banks financial institutions. They further explained that the primary reason for the choice of market value is that change in market price of marketable securities is a source of economic benefit to the institution. Ahmed (2006), indicated that marketable securities are required to be reported at market value because of its potential to improving the share price of the firm. More so, because of the inherent gains associated with market value, (i.e. profit maximization and shareholders' wealth maximization), FASB (1993), recommends that marketable securities should be reported at market value.

In this study, a strong positive relationship was found between the market rule system of reporting marketable securities and return on equity of banks. This lends support to previous studies such as Hampton and Moody (2007), Ahmed (2006), and FASB (1993).

In concluding our discussion, it may be necessary to point out that the presence of a negative significant implication of cost rule on the profitability of banks further demonstrates the principle of conservatism in corporate financial reporting.

This study has contributed to existing knowledge in the sense that it enables bank executives in Nigeria to gain a better understanding of the systems of corporate reporting of MS and their implications on financial statements. This will help them make a rational choice of reporting MS that will enhance share price of the bank.

In a nutshell, this study shows that the reporting system of marketable securities adopted by banks has different implications on their financial performance, and firms' fundamentals such as size and age and economic variables such as inflation rate and exchange rate moderate the influence of the relationship between the reporting systems of marketable securities and the financial performance of banks.

Based on the findings generated from this study and the conclusion drawn there from, the following recommendations were made;

i)   Marketable securities should be reported at market value by Nigerian banks.

ii)   In reporting marketable securities, the accounting profession should shift emphasis on reliability of accounting information which makes

the cost rule prominent to the relevance and timely of accounting information

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