

Accounting Issues: An Essay Series

Part VI—Investments In Securities

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ABSTRACT

The sixth in a series of theory-based essays, this article presents accounting for investments in debt and equity securities along with some related conceptual and measurement issues. Additional coverage is devoted to potential ethical dilemmas and both theoretical and empirical literature related to this asset.

Key words: Accounting theory, marketable securities

INTRODUCTION

This series is designed to restore to the introductory accounting course the theoretical structure now missing from most principles texts. Laux 2007(a) offers the justification, and thus far the series has addressed the other major assets—cash, accounts receivable, inventory, property, and intangible assets. "The Conceptual Framework at a Glance" section of the 2007 work uses the hierarchy of accounting characteristics (displayed on the following page) along with a mountain-hiking analogy to describe some of the daily accounting dilemmas encountered at the base of the mountain, potential measurement and classification issues associated with the adjusting process in the foothills of the journey, and the goal to be reached at the mountain top—reflecting economic reality, thereby making the information useful for decision makers. To that end, the current article briefly reviews the fundamental accounting rules for investments in marketable securities, followed by a section outlining the conceptual framework connections and measurement issues. Finally, the last section introduces some real-world examples of companies that have struggled with securities-related reporting. The section also looks at some of the literature devoted to investments, both conceptual and empirical.

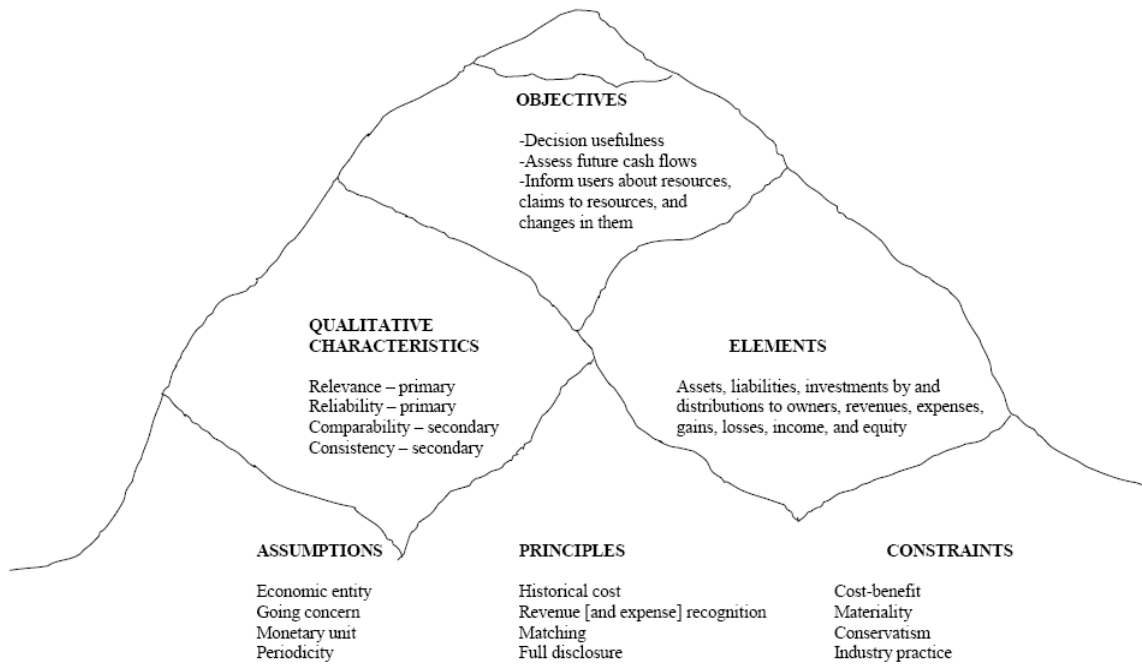
ACCOUNTING FOR INVESTMENTS IN DEBT AND EQUITY SECURITIES

As the principles course indicates, accounting for investments in the debt and equity securities of other companies requires management to categorize the securities based on the intent for holding the investment. For debt securities (the bonds of other companies), this means answering the question: Do we have both the intention and the ability to hold the bonds to maturity? If the answer is yes, then these are classified as "held to maturity," interest revenue is recognized as earned, and if the bonds were bought at below par value (at a discount), the annual reported value will grow each year until it reaches face value at maturity through an adjusting process that reports interest income that is higher than the amount actually received in cash; the corresponding carrying value is referred to as "amortized cost." If the answer to the question of intent is "no," the securities must be classified further as either "trading" (likely to be sold in the near future) or "available for sale" (with no intent to hold to maturity but undecided about short-term trading). These two classifications (for both debt and equity securities) require different accounting treatment, as described in the following paragraphs.¹

Available for sale (AFS) securities (both debt and equity) are reported on the balance sheet at their market value at that date (referred to as "mark-to-market" accounting). Unlike investments in property, plant, and

¹ This section relies heavily on "Accounting for Certain Investments in Debt and Equity Securities," *Statement of Financial Accounting Standards No. 115* (Norwalk, Conn.: FASB, 1993) as well as the excellent textbook coverage provided in both Spiceland [2007] and Kieso [2003].

equipment, there is some likelihood that securities will be sold (are not necessary for a "going concern" to stay in business), and therefore this approach is deemed more relevant than historical cost accounting. As Spiceland [2007, p. 562] describes this point: "...changes in market values, and thus market returns, provide an indication of management's success in deciding when to acquire the investment, when to sell it, whether to invest in fixed-rate or variable-rate securities, and whether to invest in long-term or short-term securities." The changes in value associated with AFS securities require recognition of "unrealized holding gains and losses," which appear in the stockholders' equity section of the balance sheet. Note that they are NOT reported on the income statement. The associated conceptual concerns are discussed in the following section. Next we turn to the treatment of trading securities.



When securities are held to profit from short-term market price fluctuations, they are classified as trading securities, and not only are market values reported on the balance sheet through year-end adjustments, but gains and losses are recognized on the income statement as part of earnings *even though the securities have not been sold and those gains and losses actually realized*. For most firms (other than financial institutions), very few securities are classified as trading.

For long-term holdings in equity securities (the stocks of other corporations), firms are required to use the equity method when the investor is able to influence the operations (including dividend declaration) of the investee (the company whose stock is owned). Under this method, income is recognized when the investee earns an income with a corresponding increase in the balance sheet valuation on the books of the investor. When the investee pays dividends, the investor recognizes the cash received and a decrease in the balance sheet value of the investment. Note that, for all three classifications, realized gains and losses are recognized on the income statement when sold; the major differences arise from how *unrealized* (holding) gains and losses are treated. The following section links these various accounting approaches to the conceptual framework.

CONNECTIONS TO THE CONCEPTUAL FRAMEWORK

Recall from previous articles in this series that the overriding concern is that accounting information be useful to investors and creditors in assessing both the potential future cash flows of the business and the financial status of the firm. **Relevance** and **reliability** constitute the primary qualities that render this utility. How does the accounting for investments in securities measure up in these areas?

A ready market exists for both trading securities and most available for sale securities, so liquidity (closeness to cash) is high, even if management chooses not to sell the securities. Thus, most investors and creditors would find the market value **relevant** to the assessment of both cash flow and financial status. For held-to-maturity (HTM) debt and stock investments subject to equity method accounting, the balance sheet valuation is less helpful. For debt securities, amortized cost might bear very little relationship to the current market value of the bonds, but since the intent is to hold the bonds for their income-generating (interest-earning) ability, this cash flow (interest revenue) is the truly **relevant** aspect in judging future cash receipts. For long-term equity holdings, past proportional earnings of the subsidiary offer some feedback and predictive value; though shares owned times the current per share market value might be more **relevant** in assessing true value, the securities are unlikely to be sold, so current market value is not really **relevant**, except to assess current financial position. The history of dividend receipts (not recognized in earnings, you will recall) would be helpful in judging cash flow prospects.

The **reliability** of market values is generally high, but because the reported changes in value vary based on management's classification of the securities, objectivity suffers. Likewise, **comparability** and **consistency** depend on managerial honesty about the intent to hold or sell the securities. More will be shared about the ethical aspects of this reality in the following section. The **periodicity** and **matching** principles require the analyst to consider the accounting treatments behind the various categories of the investments, as discussed in the following paragraph.

With *trading* securities, in addition to valuation on the balance sheet at market value, the likelihood of realizing gains and losses is high, so they are shown on the income statement when market value changes even if NOT realized through actual sales. This "matches" the value change with other revenues and expenses in the period in which the value changes occur. If the securities are categorized as *available for sale* securities, the balance sheet treatment is the same (at market value), but changes in value are NOT recognized on the income statement. Instead, they appear in the stockholders' equity section of the balance sheet (separate from Retained Earnings). When these changes in value are actually realized (through sale of the securities—an actual arms-length transaction), gains and losses go to the income statement. The reasoning is that these gains and losses are less likely to be realized in the current period. The question arises, how much less likely? Many argue that this treatment hurts understandability, **consistency**, and **comparability**, an argument that appears in the conceptual literature addressed in the next section. For *long-term* holdings (held-to-maturity debt instruments and equity interests meant to be influential), changes in value are not recognized, because it is assumed they are unlikely to be realized. Thus, on the whole, both balance sheet and income statement reporting varies for investments in securities depending on management's classification, which must be **fully disclosed** in financial statement footnotes. Finally, asset impairment (permanent declines in value of securities) must be recognized as losses in the period incurred and the asset permanently written down to the lower market value, thus adhering to both the **matching** principle and **conservatism**. This is the same one-way street (declines in value recognized but recoveries ignored) that we discussed in previous articles in this series (inventories and property, plant, and equipment). The following section looks at some real-world reporting problems and other literature devoted to investments in debt and equity securities.

"INVESTMENTS" IN THE NEWS AND LITERATURE

The biggest "headliner" associated with mark-to-market accounting featured Enron and the fair value methods it used for energy contracts. In an attempt to buoy up the market price and show exceptional earnings increases quarter after quarter, Enron accountants used unreasonable assumptions to book paper gains on these energy contracts. Other companies in the energy industry subject to investor scrutiny include Dynegy and Williams Companies. [See Cummins, 2002, as cited in Kieso et al., p. 641, for a good summary.] Other companies noted for the propensity to manage earnings through accounting choice include General Electric and W.R. Grace, though the

classification of securities investments and timing of securities sales were not among the most egregious techniques employed. Another issue that has often made the popular press is the fact that accounting for equity investments differs internationally, hurting comparability [See especially, "Apples to Apples..." 1999, as cited in Kieso et al., p. 633.] Finally, Enron's abuse of "Special Purpose Entities" (alleged "separate entities" to which Enron "sold" assets—at a gain, of course—with associated stock-based pledges that actually resulted in Enron's selling to itself) represented accounting magic at its worst!

Conceptual literature related to investments in securities abounds. No doubt, this is due in part to the fact that the accounting is somewhat confusing, but the primary argument revolves around the subjectivity associated with classification of investments. In addition, the use of fair value in accounting provides fodder for a fair amount of debate (See Barlev and Haddad, 2004.) Also earning some press among scholars and accounting professionals is the issue of "gains trading"—selling off "winners" to recognize gains in income, a form of income manipulation. (This makes the list of methods of earnings management in Jackson and Pitman 2001, for example; Hunton, Libby, and Mazza, 2006, discuss the relationship between transparency and earnings management as it pertains to accounting for available-for-sale securities.) For a good, brief discussion of these issues, see Kieso et al. [2003, pp. 657-58]. In addition, showing some value changes on the income statement and others in the stockholders' equity section of the balance sheet leads Beresford et al. [1996] to ask, "Is a Second Income Statement Needed?" The accounting profession has wrestled with a concept called "comprehensive income," and a number of good conceptual discussions are devoted to this topic, including Foran and Foran [1987] and Beresford et al. [1996]. Finally, Parks [1993] and Kieso et al. [2003] find fault with the fact that liabilities are not treated similarly to investments in securities, even though they are also financial instruments with market values. DePree and Grant [1999] look at the ethical implications of managing earnings in the context of accounting for investments in marketable securities. Of course, for a real introduction to the various conceptual arguments, there is no better starting point than the discussion in Appendix A (entitled "Background Information and Basis for Conclusions") of Statement 115 itself.

On the empirical front, four recent articles investigate reporting for investments in securities. Kinney and Trezevant [1997] look at the use of special items to smooth income and influence investor perceptions. Although the authors lump gains and losses from the sale of marketable securities in with those associated with sales of other assets, this represents a favorite method of managing earnings. The focus of Maines and McDaniel [2000] is "whether and how alternative presentation formats affect nonprofessional investors' processing of comprehensive-income information, specifically, information disclosing the volatility of unrealized gains on available-for-sale marketable securities" (p. 179). They find that these analysts weigh unrealized gains heavily when they appear on the statement of comprehensive income but not when disclosed in the statement of stockholders' equity. Thus the relevance of these unrealized gains and losses depends on where they are disclosed in the financial statements. "The Sale of Assets to Manage Earnings in Japan" [Herrmann, Inoue, and Thomas, 2003] finds that Japanese managers use income from the sale of fixed assets and marketable securities to meet earnings forecasts. Similarly, Jaggi and Leung [2003] report that Hong Kong managers who are "beating" the estimates bury unrealized gains in the stockholders equity section, holding them as "Cookie Jar" reserves for potential use in future periods. If losses exist, they are taken to the income statement to the extent that earnings per share are not reduced below that of the previous year, consistent with income smoothing.

THIS SERIES CONTINUES

This sixth installment described the accounting for investments in securities and connected the theoretical constructs of the conceptual framework with this accounting element. It featured a few headline stories and reviewed some of the literature addressing issues related to investments. The next installment in the series will look at a few of the major liabilities and their conceptual challenges.

AUTHOR INFORMATION

Judy Laux has been a professor in the Economics and Business Department at Colorado College in Colorado Springs for 29 years, teaching accounting, finance, and senior thesis. Her research interests include accounting

theory and pedagogy as well as market efficiency. Her senior thesis students have co-authored a number of published works, presenting at national and international conferences.

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