10. Trading Securities

From time to time a business may invest cash in stocks of other corporations. Or, a company may buy other types of corporate or government securities. Accounting rules for such investments depend on the "intent" of the investment. If these investments were acquired for long-term purposes, or perhaps to establish some form of control over another entity, the investments are classified as noncurrent assets. The accounting rules for those types of investments are covered in subsequent chapters. But, when the investments are acquired with the simple intent of generating profits by reselling the investment in the very near future, such investments are classified as current assets (following cash on the balance sheet). These investments are appropriately known as "trading securities."

Trading securities are initially recorded at cost (including brokerage fees). However, the value of these readily marketable items may fluctuate rapidly. Subsequent to initial acquisition, trading securities are to be reported at their fair value. The fluctuation in value is reported in the income statement as the value changes. This approach is often called "mark-to-market" or "fair value" accounting. Fair value is defined as the price that would be received from the sale of an asset in an orderly transaction between market participants.

10.1 An Illustration

Assume that Webster Company's management was seeing a pickup in their business activity, and believed that a similar uptick was occurring for its competitors as well. One of its competitors, Merriam Corporation, was a public company, and its stock was trading at $10 per share. Webster had excess cash earning very low rates of interest, and decided to invest in Merriam -- intending to sell the investment in the very near future for a quick profit. The following entry was needed on March 3, 20X6, the day Webster bought stock of Merriam:

3-3-X6	Trading Securities		50,000	
	Cash			50,000
	To record the purchase of 5,000 shares of Merriam stock at $10 per share			

Next, assume that financial statements were being prepared on March 31. Despite Webster's plans for a quick profit, the stock declined to $9 per share by March 31. Webster still believes in the future of this investment, and is holding all 5,000 shares. But, accounting rules require that the investment "be written down" to current value, with a corresponding charge against income. The charge against income is recorded in an account called Unrealized Loss on Investments:

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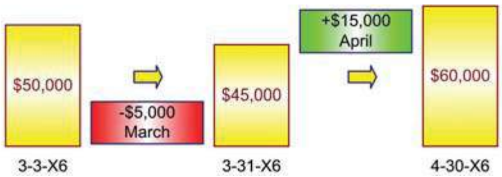
3-31-X6	Unrealized Loss on Investments	5,000	
	Trading Securities		5,000
	To record a $1 per share decrease in the value of 5,000 shares of Merriam stock		

Notice that the loss is characterized as “unrealized.” This term is used to describe an event that is being recorded (“recognized”) in the financial statements, even though the final cash consequence has not yet been determined. Hence, the term “unrealized.”

April had the intended effect, and the stock of Merriam bounced up $3 per share to $12. Still Webster decided to hang on for more. At the end of April, another entry is needed if financial statements are again being prepared:

4-30-X6	Trading Securities	15,000	
	Unrealized Gain on Investments		15,000
	To record a $3 per share increase in the value of 5,000 shares of Merriam stock		



Notice that the three journal entries now have the trading securities valued at $60,000 ($50,000 - $5,000 + $15,000). This is equal to their market value ($12 X 5,000 = $60,000). The income statement for March includes a loss of $5,000, but April shows a gain of $15,000. Cumulatively, the income statements show a total gain of $10,000 ($5,000 loss + $15,000 gain). This cumulative gain corresponds to the total increase in value of the original $50,000 investment. The preceding illustration assumed a single investment. However, the treatment would be the same even if the trading securities consisted of a portfolio of many investments. That is, each and every investment would be adjusted to fair value.

10.2 Rationale for Fair Value Accounting

The fair value approach is in stark contrast to the historical cost approach used for other assets like land, buildings, and equipment. The rationale is that the market value for trading securities is readily determinable, and the periodic fluctuations have a definite economic impact that should be reported. Given the intent to dispose of the investments in the near future, the belief is that the changes in value likely have a corresponding effect on the ultimate cash flows of the company. As a result, the accounting rules recognize those changes as they happen.

10.3 Alternative: A Valuation Adjustments Account

As an alternative to directly adjusting the Trading Securities account, some companies may maintain a separate Valuation Adjustments account that is added to or subtracted from the Trading

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Securities account. The results are the same; the reason for using the alternative approach is to provide additional information that may be needed for more complex accounting and tax purposes. One such purpose is to determine the “taxable gain or loss” on sale. Tax rules generally require comparing the sales price to the original cost (you may be surprised to learn that tax rules sometimes differ from accounting rules -- the mark-to-market approach used for accounting is normally not acceptable for tax purposes). There are also more involved accounting rules relating to measurement of the “realized” gains and losses when the securities are in fact sold. Those rules are ordinarily the subject of more advanced courses.

10.4 Dividend and Interest

Since trading securities are turned over rather quickly, the amount of interest and dividends received on those investments is probably not very significant. However, any dividends or interest received on trading securities is reported as income and included in the income statement:

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9-15-X5	Cash		75	
	Dividend Income			75
	To record receipt of dividend on trading security investment			

The presence or absence of dividends or interest on trading securities does not change the basic mark-to-market valuation for the Trading Securities account.

10.5 Derivatives

Beyond the rather straight-forward investments in trading securities are an endless array of more exotic investment options. Among these are commodity futures, interest rate swap agreements, options related agreements, and so on. These investments are generally referred to as derivatives, because their value is based upon or derived from something else (e.g., a cotton futures contract takes its value from cotton, etc.). The underlying accounting approach follows that for trading securities. That is, such instruments are initially measured at fair value, and changes in fair value are recorded in income as they happen.