THE EFFECT OF COST APPROACH AND CORPORATE PROFITABILITY OF LISTED CEMENT FIRMS IN NIGERIA

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ABSTRACT
This study empirically investigates the effect of the cost approach to fair value measurement on the corporate profitability of listed cement firms in Nigeria, measured by Return on Capital Employed (ROCE) and Return on Equity (ROE). Grounded in Agency Theory, the research employs an ex-post facto design, analysing secondary data from the annual reports of Dangote Cement Plc, BUA Cement Plc, and Lafarge Africa Plc over a five-year period. The findings reveal a statistically significant positive relationship, with the cost approach explaining 24.0% and 25.1% of the variances in ROCE and ROE, respectively. The results indicate that in this asset-intensive sector operating within a volatile economic context, the cost approach, by providing a conservative, replacement-cost-based valuation, enhances the reliability of financial statements and leads to more meaningful assessments of capital efficiency and shareholder returns. The study concludes that the cost approach is a critical valuation technique for aligning reported asset values with contemporary economic realities in emerging markets, thereby offering valuable insights for standard-setters, regulators, and firm management.
Keywords: Cost Approach, Fair Value Measurement, Corporate Profitability, Return on Capital Employed (ROCE), Return on Equity (ROE).

Introduction

Fair value measurement under International Financial Reporting Standards (IFRS) encompasses several valuation techniques, with the cost approach representing a fundamental method based on current replacement cost. This approach values an asset by reference to the amount required to replace its service capacity, adjusted for obsolescence (IASB, 2011). In asset-intensive industries like cement manufacturing, where property, plant, and equipment constitute the core of operational capacity, the choice of valuation method directly impacts the book value of assets and, consequently, key profitability metrics. The cost approach offers a conservative yet market-informed estimate that can provide stability in financial reporting, contrasting with the more discretionary income approach or the market-driven market approach.

Corporate profitability, measured through indicators such as Return on Capital Employed (ROCE) and Return on Equity (ROE), is a primary gauge of financial health and operational efficiency (Pandey, 2015). For Nigerian cement firms, operating in an environment of inflation, currency volatility, and fluctuating input costs, the reliability of asset valuation is paramount. The cost approach, by focusing on the current cost to replace productive assets, may offer a realistic picture of the capital invested and its earning potential. However, its effect on reported profitability remains an empirical question, particularly given the potential for this approach to understate asset values relative to their income-generating potential or current market prices.

While extant literature has explored the market and income approaches extensively, the specific impact of the cost approach on profitability in emerging market contexts is under-researched. This study therefore seeks to fill this gap by investigating the effect of the cost approach on ROCE and ROE of listed cement firms in Nigeria. By doing so, it contributes to a more nuanced understanding of how different fair value measurement techniques influence financial performance assessment in a critical sector of the Nigerian economy.

Statement of the Problem

Accurate assessment of corporate profitability remains a critical concern for stakeholders in Nigeria's capital-intensive cement industry, where significant investments in property, plant, and equipment are central to operations. Key metrics such as Return on Capital Employed (ROCE) and Return on Equity (ROE) are essential for evaluating financial health and operational efficiency. However, the valuation methodology applied to these substantial assets directly influences the reliability of these profitability indicators. The cost approach to fair value measurement, which estimates an asset's current replacement cost adjusted for depreciation, is a prescribed method under IFRS 13, yet its specific impact on reported profitability in the volatile Nigerian economic context is poorly understood. This approach, while potentially offering a stable and prudent valuation benchmark, relies on managerial estimates for replacement costs and obsolescence, introducing subjectivity into financial statements (IASB, 2011; Barth, 2021). The cement sector faces persistent challenges from inflation, foreign exchange volatility, and rising energy costs, which can drastically alter replacement values and obsolescence calculations (Adegboye, 2018). Consequently, the empirical question of whether the application of the cost approach enhance the reliability of ROCE and ROE by providing a conservative, reality-based asset value, or whether the managerial discretion it permits lead to distortions that misrepresent true profitability remains unresolved The absence of clear evidence on this relationship creates uncertainty for investors, regulators, and management in assessing performance, thereby forming the core problem this study seeks to address.

Purpose of the Study

The primary aim of this study is to examine the effect of cost approach and corporate profitability of listed cement firms in Nigeria. In more specific terms the study intends to:

1. Ascertain the effect of cost approach on return on capital employed of listed cement firms in Nigeria.
2. Examine the effect of cost approach on return on equity of listed cement firms in Nigeria.

Research Questions

The following research questions guided the study.

1. What is the effect of cost approach on return on capital employed of listed cement firms in Nigeria?
2. What is the effect of cost approach on return on equity of listed cement firms in Nigeria?

Hypotheses

The following hypotheses were tested at 0.05 level of significance.

H$_{o1}$: Cost approach does not have significant effect on return on capital employed of listed cement firms in Nigeria.

H$_{o2}$: Cost approach does not have significant effect on return on equity of listed cement firms in Nigeria.

Literature Review

Cost Approach

The cost approach represents one of the three fundamental valuation techniques prescribed under International Financial Reporting Standard (IFRS) 13 for fair value measurement. It is defined as being "based on an estimate of the cost of replacing the 'service capacity' of the asset under consideration" (IFRS 13, Paragraph 62). In accounting theory, this is understood as the current replacement cost, calculated not for a new asset, but for an asset that would provide a comparable benefit, taking into account the obsolescence of the current asset (Zijl and Whittington, 2005). The core mechanism of this approach involves estimating the amount that would be required currently to acquire or construct a substitute asset of equivalent utility, adjusted for all forms of depreciation such as physical deterioration, functional obsolescence, and economic obsolescence. This positions it as a fundamentally different methodology from the market approach (which uses prices from active markets) and the income approach (which discounts future cash flows), offering a prudent and reality-based estimate of the economic sacrifice needed to maintain productive capacity.

The reliability and objectivity of any fair value measurement, including the cost approach, are governed by the Fair Value Hierarchy established by IFRS 13, which categorizes inputs used in valuation techniques into three levels to prioritize market-based evidence. Level 1 inputs are quoted prices in active markets for identical assets. Level 2 inputs are other observable market data, such as quoted prices for similar assets or inputs derived from observable data. Level 3 inputs are unobservable, entity-specific assumptions (IASB, 2011). The application of the cost approach typically engages Level 2 and Level 3 inputs. Observable data, such as current market prices for new equipment or contractor quotations for reconstruction, serve as Level 2 inputs. However, the critical adjustments for an asset's obsolescence such as judgments about its remaining useful life, technological adequacy, and economic viability, often rely on unobservable, internal management estimates, placing these elements within Level 3 of the hierarchy (Glautier, et al., 2021).

This placement within the hierarchy is crucial as it directly links to the potential for managerial discretion and information asymmetry as explained by Agency Theory. While the cost approach may appear more objective than the highly speculative income approach, it is not immune to subjective judgment. Management must estimate the current cost to replace service capacity and assess the extent of obsolescence, decisions that can significantly influence the final asset valuation (Baxter, 2003). The discretion inherent in these Level 3 assessments creates a venue where agents (managers) could potentially influence reported asset values to manage key financial metrics, such as capital employed and depreciation expense, thereby affecting profitability ratios like Return on Capital Employed (ROCE) and Return on Equity (ROE). Consequently, understanding the cost approach requires an analysis of both its methodological grounding in replacement cost and its operational reliance on a mix of observable and unobservable inputs within the IFRS 13 framework, which together determine its reliability and impact on financial statement quality.

Nigerian Cement Industry Context

The Nigerian cement industry is fundamentally an asset intensive sector, characterized by massive capital investments in long lived, specialized property, plant, and equipment (PPE) such as quarries, kilns, grinding mills, and related logistical infrastructure (Adegboye, 2018). The valuation of these tangible assets is not merely an accounting exercise but a critical determinant of both the balance sheet strength and the perceived efficiency of capital utilization. In this context, the cost approach to fair value measurement gains particular relevance. Unlike historical cost accounting, which records assets at a potentially outdated purchase price, the cost approach provides an estimate of the current economic sacrifice required to replace the productive capacity of these vital assets. This is especially crucial in an economic environment like Nigeria's, which is marked by persistent inflation, currency volatility, and fluctuating costs for imported machinery and spare parts. Under such conditions, historical cost can quickly become a poor representation of the capital actually employed in the business, distorting profitability metrics like Return on Capital Employed (ROCE) (Diewert, 2005).

Furthermore, the specialized nature of cement manufacturing assets often means there is no active resale market for identical used equipment, limiting the applicability of the pure market approach. Similarly, the income approach, which depends on forecasting long term cash flows from specific assets, can be highly speculative in a sector exposed to volatile input costs, energy prices, and government policy shifts (Laux & Leuz, 2009). The cost approach, by focusing on the current replacement cost adjusted for the asset's age and condition, offers a more stable and verifiable benchmark. It answers a pragmatic question: what would it cost the firm today to regain the operational utility provided by this asset? This provides a realistic and conservative basis for valuation that aligns with the prudent stewardship of capital in a heavy industry. For stakeholders including investors, lenders, and regulators, the use of the cost approach can enhance the transparency and reliability of financial statements by ensuring that the reported value of capital intensive assets reflect contemporary economic realities, thereby leading to more meaningful assessments of corporate profitability and financial health (Christensen & Nikolaev, 2013).

Cost Approach and Profitability

Profitability, measured by metrics like Return on Capital Employed (ROCE) and Return on Equity (ROE), is the primary indicator of a firm's financial health and operational efficiency, serving as a critical signal to both investors and managers (Penman, 2007). In capital-intensive industries like cement manufacturing, profitability is heavily influenced by asset valuation methods, market conditions, and input cost management. The choice of accounting measurement directly impacts reported profitability; the fair value framework, particularly the market approach which uses observable market prices (IASB, 2011), can introduce volatility into earnings by recognizing unrealized gains and losses (Kieso et al., 2021). This shift from historical cost to fair value aims to provide more relevant information by reflecting current market values, thereby enhancing transparency for investor decision-making (Abiahu et al., 2020). However, this relationship between measurement choice and reported profit also introduces complexity, as market-based valuations depend on managerial assumptions and observable inputs, affecting the reliability and comparability of profitability metrics (Christensen & Nikolaev, 2009; Thesing & Velte, 2021).

The application of the cost approach for asset valuation establishes a direct and mechanistic link to corporate profitability metrics, specifically Return on Capital Employed (ROCE) and Return on Equity (ROE). ROCE, calculated as profit before interest and tax divided by capital employed (total assets less current liabilities), is a primary measure of how efficiently a company generates returns from its capital base. The cost approach directly influences both components of this ratio. An upward revaluation of property, plant, and equipment (PPE) under this approach increases the denominator, capital employed, by raising the book value of net assets. Concurrently, the numerator, profit, is affected through the subsequent depreciation charge. A higher asset value leads to a larger annual depreciation expense, which reduces reported profit (Penman, 2007; Diewert, 2005). Therefore, the net effect on ROCE is contingent on whether the revaluation (reflecting increased asset utility or replacement cost) translates into proportionally higher earnings. If not, ROCE can decline, presenting a more conservative picture of capital efficiency.

Similarly, Return on Equity (ROE), defined as profit after tax attributable to shareholders' equity, is sensitive to cost approach valuations through multiple channels. A revaluation surplus is typically recorded directly in equity under other comprehensive income, thereby increasing the equity base (denominator) without immediately passing through the income statement (Kieso et al., 2021). However, the higher depreciation expense flowing from the revalued amount reduces net income (the numerator). This dual impact makes the effect on ROE nuanced and dependent on the magnitude of the revaluation and the remaining useful life of the asset. From an agency perspective, management's discretion in estimating replacement costs and obsolescence under the cost approach can be used strategically to smooth earnings or manage leverage ratios, thereby influencing investor perceptions of profitability and stewardship (Barlev & Haddad, 2003). Consequently, the choice to employ the cost approach is not a neutral accounting decision but a significant determinant that shapes the reported outcomes of ROCE and ROE, reflecting both the economic reality of asset replacement and the potential for managerial influence over profitability assessment.

Agency Theory

This study is grounded in Agency Theory, which explains the potential conflicts of interest and information imbalances between managers (agents) and shareholders (principals) (Jensen & Meckling, 1976). In financial reporting, managers who are responsible for overseeing company resources typically have greater knowledge about the firm's assets and operational status than the shareholders. This informational advantage may result in a misalignment between managerial objectives such as managing earnings, securing their positions, or maximizing performance based rewards and the principals' interest in obtaining accurate and value relevant financial information (Watts & Zimmerman, 1986).

The application of the cost approach to fair value measurement introduces a distinct dimension to this agency dynamic. While this approach often utilizes more observable data (Level 2 inputs) than the highly discretionary income approach, it remains heavily reliant on significant managerial judgment and estimation. Key decisions required under the cost approach such as determining the current replacement cost of specialized assets, assessing the extent of physical and functional obsolescence, and estimating remaining useful life, are based on internal data and unobservable assumptions (IASB, 2011; Glautier et al., 2021). This

discretion creates a fertile ground for information asymmetry, as managers can influence the reported valuation of property, plant, and equipment (PPE) to serve their own interests.

Within the Nigerian cement industry, characterized by high capital intensity, the valuation of PPE is material to the balance sheet. Agency Theory predicts that managers may utilize the discretion inherent in cost approach estimations to strategically influence key profitability metrics such as Return on Capital Employed (ROCE) and Return on Equity (ROE). For instance, by employing conservative estimates of replacement cost or aggressive assessments of obsolescence, managers can depress asset values and associated depreciation charges, thereby managing reported earnings and equity. Conversely, more optimistic valuations can strengthen the balance sheet. These valuation choices directly alter the capital base in ROCE and affect both net income and equity in ROE. Therefore, Agency Theory provides the critical lens to examine not merely the statistical relationship between the cost approach and profitability, but to interrogate the underlying principal-agent incentives and governance mechanisms that shape the application and financial outcome of this valuation technique in an emerging market context like Nigeria (Ramanna, 2008; Thesing & Velte, 2021).

Methodology

This study adopted an ex post facto research design. The population consisted of three cement manufacturing firms listed on the Nigerian Stock Exchange: Dangote Cement Plc (DANGCEM), BUA Cement Plc, and Lafarge Africa Plc (WAPCO). These firms were selected because they were among the first to adopt International Financial Reporting Standards (IFRS) and comply with Roadmap Committee recommendations for IFRS-compliant financial statements. Secondary data were collected from the firms' published annual reports covering 2009–2014, allowing comparison of reported profits before and after fair value measurement adoption. Data were sourced from the NSE website, capturing five-year periods for each company. The dependent variable was profitability (reported profit), while independent variables were fair value measurement methods Market Approach, Income Approach, and Cost Approach, considered alongside Fair Value Hierarchy levels (Level 1, 2, and 3 inputs). Data analysis employed t-tests to examine differences among the independent variables, comparing reported profits under fair value and historical cost methods. Regression analysis was further applied to assess the relationship between fair value approaches and profitability. This approach ensured a systematic, quantitative evaluation of the impact of fair value measurement on reported profits in Nigerian cement manufacturing firms.

Results and Discussion
Testing of Hypotheses

Ho_1: Cost approach does not have significant effect on return on capital employed of listed cement firms in Nigeria

Table 1: Model Summary of Cost Approach and Return on Capital Employed
Part A: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.490[a]	.240	.237	1.985

a. Predictors: (Constant), Cost approach

From table 1 above, the **R**: 0.490 indicates a moderate positive correlation between the cost approach and the return on capital employed. **R Square**: 0.240 suggests that 24% of the variance in ROCE is explained by the cost approach. While this indicates a relationship, it also means that 76% of the variance is explained by other factors not included in the model. **Adjusted R Square**: 0.237 is close to R Square, implying that the model's ability to explain variance is not overestimated by including unnecessary variables. **Standard Error of the Estimate**: 1.985 indicates the average distance between the actual ROCE values and the predicted values. Lower values are better, but this number depends on the scale of ROCE.

Part B: ANOVA[a]

Model		Sum of Squares	Df	Mean Square	F	Sig.
	Regression	355.112	1	355.112	90.169	.000[b]
1	Residual	1126.357	286	3.938		
	Total	1481.469	287			

a. Dependent Variable: Return on capital employed
b. Predictors: (Constant), Cost approach

The **F-statistic**: 90.169 with a **p-value** of 0.000 indicates that the overall regression model is statistically significant. This means that the cost approach significantly predicts the return on capital employed. Since the p-value is well below the 0.05 threshold, the null hypothesis (H05) can be rejected.

Part C: Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	8.287	.690		12.017	.000
	Cost approach	.428	.045	.490	9.496	.000

a. Dependent Variable: Return on capital employed

Intercept (Constant): The value of 8.287 represents the predicted ROCE when the cost approach is zero, implying that even without the cost approach, the firms have a baseline ROCE of 8.287. **Cost Approach Coefficient**: The unstandardized coefficient of 0.428 indicates that for every 1-unit increase in the cost approach, the return on capital employed increases by 0.428 units. The p-value of 0.000 indicates that this effect is highly significant.

The **Beta** value of 0.490 shows the strength of the standardized effect of the cost approach on ROCE, confirming the moderate positive influence.

Ho$_2$: Cost approach does not have significant effect on return on equity of listed cement firms in Nigeria.

Table 2: Model Summary of Cost approach and Return on Equity of listed Cement Firms in Nigeria

Part A: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.501[a]	.251	.248	1.970

a. Predictors: (Constant), cost approach

R = 0.501: This indicates a moderate positive impact between the cost approach and the return on equity (ROE). A higher cost approach is associated with a moderate increase in ROE. **R Square = 0.251**: This means that 25.1% of the variation in return on equity is explained by the cost approach. While this shows a notable impact, the remaining 74.9% is attributed to other factors not included in the model. **Adjusted R Square = 0.248**: The adjusted R Square is slightly lower than R Square, indicating that the model's explanatory power holds even when adjusted for the number of predictors. **Standard Error of the Estimate = 1.970**: This reflects the average distance between the observed and predicted ROE values. A lower value indicates better model accuracy, but the size of the error depends on the scale of the data.

Part B: ANOVA[a]

Model		Sum of Squares	Df	Mean Square	F	Sig.
	Regression	371.914	1	371.914	95.865	.000[b]
1	Residual	1109.555	286	3.880		
	Total	1481.469	287			

a. Dependent Variable: return on equity
b. Predictors: (Constant), cost approach

F-statistic = 95.865: This represents the overall significance of the model. The **p-value (Sig.) = 0.000**, which is well below the conventional threshold of 0.05, indicates that the model is statistically significant. The high F-statistic confirms that the cost approach significantly affects the return on equity.

Part C: Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	8.124	.686		11.849	.000
	cost approach	.438	.045	.501	9.791	.000

a. Dependent Variable: return on equity

Intercept (Constant) = 8.124: This is the predicted ROE when the cost approach is zero. It suggests that even without the influence of the cost approach, firms have a baseline return on equity of 8.124. **Cost Approach Coefficient (B) = 0.438**: This means that for every 1-unit increase in the cost approach, the return on equity increases by 0.438 units. The **p-value = 0.000**, which is highly significant, indicates that this relationship is not due to chance. **Beta (Standardized Coefficient) = 0.501**: This shows the strength of the cost approach's impact on ROE in standardized terms. The moderate positive effect (Beta = 0.501) suggests that the cost approach is a key predictor of ROE.

Discussion of Findings

The analysis of Hypothesis 1 in table 1, shows that the cost approach significantly affects ROCE with a moderate impact (R = 0.490). The regression model indicated that 24% of the variance in ROCE is explained by the cost approach. This implies that firms using the cost approach to value their assets may experience a notable increase in their capital returns. This

finding aligns with previous research emphasizing the importance of asset valuation in profitability measures. According to Christensen and Nikolaev (2013), the cost approach, which estimates the replacement cost of assets, is particularly useful for industries like cement manufacturing, where asset-heavy operations are the norm. By reflecting a realistic value of the assets, firms can better plan for capital investments and resource allocation, thereby enhancing their operational efficiency and profitability. Empirical studies like that of Adeyemi and Kargi (2022) also support this result, finding that adopting appropriate fair value hierarchies, including cost-based valuation, can reduce earnings management and enhance financial transparency. This increase in transparency and the reflection of more realistic asset values can, in turn, lead to improved ROCE, as companies can make better-informed investment decisions.

Similarly, the analysis of Hypothesis 2 from table 2 demonstrates a statistically significant positive relationship between the cost approach and ROE (R = 0.501), with 25.1% of the variance in ROE being explained by the cost approach. This indicates that firms adopting the cost approach experience an improvement in equity returns, highlighting the approach's effectiveness in optimizing shareholder value. As indicated by empirical literature, the cost approach tends to offer a stable and conservative measure of asset valuation, which resonates well with investors who seek predictability in returns. Christensen and Nikolaev (2009) argue that cost-based valuation methods are particularly relevant in sectors with fluctuating market conditions, as it offers a benchmark that mitigates extreme valuation volatility. This stability can help safeguard shareholder equity and improve investors' confidence, contributing to increased ROE. Oyewo (2020) found that the cost approach was widely applied in the valuation of tangible assets, which aligns with the findings of this study on cement firms, an asset-intensive sector. By focusing on replacement costs, firms can more accurately assess their investment requirements and control costs, leading to higher profitability and returns on equity.

Conclusion

This study investigated the effect of the cost approach to fair value measurement on the corporate profitability of listed cement firms in Nigeria, as measured by Return on Capital Employed (ROCE) and Return on Equity (ROE). The findings reveal a statistically significant positive effect of the cost approach on both ROCE and ROE. The regression models demonstrated moderate positive correlations, with the cost approach explaining 24.0% of the variance in ROCE and 25.1% of the variance in ROE. The significant coefficients confirm that an increase in the application of the cost approach is associated with an increase in these key profitability metrics. This suggests that for Nigerian cement firms, employing a valuation method grounded in the current replacement cost of assets, adjusted for obsolescence contributes to a more realistic reflection of the capital base and, consequently, to improved indicators of capital efficiency and shareholder return. The results align with the theoretical expectation that in an asset-intensive industry operating within a volatile economic environment marked by inflation and currency fluctuations, the cost approach offers a prudent and stable valuation benchmark. By moving away from potentially outdated historical costs, it provides a more accurate picture of the economic resources employed and the investment required to maintain productive capacity. This enhances the relevance and reliability of financial statements for stakeholders. Furthermore, the study, framed within Agency Theory, acknowledges that while the cost approach involves managerial judgment (particularly with

Level 3 inputs), its application in this context appears to support, rather than distort, the meaningful assessment of profitability. In conclusion, this research contributes to the extant literature by affirming the significant and positive role of the cost approach in the profitability assessment of listed cement firms in Nigeria. It underscores the importance of selecting a valuation technique that aligns with the industry's economic realities, where specialized assets lack active markets and long-term cash flows are uncertain.

Recommendations

Based on the findings, the following recommendations were made:

1. Regulators and standard-setting bodies should explicitly recognize and reinforce the applicability of the cost approach within the IFRS 13 framework for asset-intensive industries in volatile economies, as its prudent and reality-based valuations demonstrably enhance the relevance of key profitability metrics.
2. The management of the listed cement firms should strategically integrate and transparently disclose the use of the cost approach in their asset valuation processes, as its systematic application contributes to more reliable assessments of capital efficiency and shareholder value.

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