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Do Historical Cost Financial Statements Comply With the Objectives of SFAC 1?

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Michelle L. Bogner

DeKalb, Illinois

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Student name: Michelle L. Bogner

Approved by: Patrick R. Delaney

Department of: Accountancy

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ABSTRACT (100-200 WORDS):

The Financial Accounting Standards Board has issued Statements of Financial Accounting Concepts to provide the objectives which financial reporting should comply with. As the economic environment and markets have changed, there has been some controversy over whether historical cost information complies with these objectives. This paper reviews the objectives and comes to the conclusion that historical cost is satisfactory for the present, but a change will probably be needed in the future. Several alternatives are discussed and a gradual change to a valuation basis is recommended. User and preparer opinions are discussed and the recommendations take into account their opposition to change. The main conclusion of the paper is that SFAC 1 basically says that financial reporting should provide users with the information they need and want. Historical cost information seems to be satisfactory now, but a move to supplemental information is also considered positive. Any change occurring in financial reporting will have to be implemented slowly and build on what users already understand.

INTRODUCTION

When you walk through a parking lot and see a penny do you always stop to pick it up? I don't. A penny seems too insignificant for me to bend over and waste the time to grab it. That was not always true. My parents are always telling me stories about how it was a big deal to get a penny or a nickel in their childhood. They would go to the candy store and get something for it. Now it costs about fifty cents for a pack of gum that would have probably cost them a nickel. This change in prices is caused by inflation. We live in a changing environment where even the value of our monetary unit is not fixed. This change has had quite an effect on the field of accounting. There has been some question as to whether the historical figures we put on financial statements are a good representation of a company's position.

To help in analyzing problems such as this, the FASB created a conceptual framework for financial accounting and reporting. Part of the framework project involved issuing five Statements of Financial Accounting Concepts. These statements are not equivalent to Statements of Financial Accounting Standards, which are the rules of financial reporting, but instead lay the foundation and provide a background on which standards may be based. The concept statements are intended to set the objectives and qualitative characteristics for the recognition and measurement of economic events and how they are communicated in financial reporting. The first of these statements, and the one

the rest of this paper will be concerned with, is entitled "Objectives of Financial Reporting by Business Enterprises." I will perform an analysis of the statement in order to answer the question--Do historical cost financial statements comply with the objectives of SFAC 1?

SFAC OBJECTIVES

Before an analysis can begin, the objectives of SFAC 1 must be identified. The first objective states that "Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions." Those people with a reasonable understanding of business and economic activities should be able to comprehend the information after studying it with reasonable diligence. Users include nonprofessionals as well as professionals and the information provided by financial reporting should be useful to anyone who is willing to learn how to use it(16).

The second objective of SFAC 1 is that "Financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise." People invest money in and lend money to companies in order to make more money for themselves. They look to information to help them determine the risk of these activities and to help them choose the ones that will return the most cash above cost. Cash flow information of the relevant company is important because it affects the market

price of the securities and the company's ability to pay dividends(18).

The third objective in SFAC 1 is , "Financial reporting should provide information about the economic resources of an enterprise, the claims to those resources(obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events, and circumstances that change resources and claims to those resources." This information is helpful to investors and creditors as they identify strengths and weaknesses of the company and assess its liquidity and solvency. It may also be useful for those who want to estimate the value of a business, "But financial accounting is not designed to measure directly the value of an enterprise"(19).

HISTORICAL COST AS A BASIS

There are many different bases for measuring and reporting financial information. Under existing GAAP most assets and liabilities must be accounted for and reported based on acquisition price, or the historical cost. This basis has been the most easily obtainable value because it is simply the amount paid or owed at the time of acquisition. There is no guesswork involved because the transaction has already occurred.

Today's environment is changing drastically all the time. We see this in fluctuating interest rates, the purchasing power of the dollar, and globalized markets. With things changing so much, the usefulness of historical cost information must be

questioned. Creditors and investors use financial information to make predictions before they act. It is quite possible that historical cost does not provide the useful information prescribed by the objectives. The usefulness of historical cost data may depend on the type of resource it is measuring. A booklet put out by Arthur Andersen on financial statement objectives states, "For some economic resources, historical cost may remain the best concept of value to apply throughout part or all of the period they are held." They go on to say that this is particularly true if monetary values remain stable. However, as discussed previously, this is not the case in the current economy. They also agree that as time passes and monetary values change, historical cost information becomes inadequate(27).

The two main qualities that determine the usefulness of information are relevance and reliability. Historical cost does have an advantage over other valuations because it is reliable. The cost of the object is definite and verifiable and does not change over time. Since no judgement is involved in the determination, the information is also more objective(Kieso 42).

The main problem with historical cost lies with its relevance. The cause of the problem is inflation. According to an accounting theory book, "Under a historical cost based system of accounting, inflation leads to two basic problems." The first of these problems is that many of the numbers on the financial statements are not economically relevant because prices have changed since they were incurred. The numbers do not reflect

what the asset is worth today or even what it would be worth today if it were new. The second problem is that the numbers on the financial statements represent dollars spent at different times and hence different purchasing power. They are not additive because actually some of the dollars were worth more than others(Wolk 348). These two problems cause several aspects of relevance to be impaired. Predictive value is likely to be diminished by combining dollars of different purchasing power. The shortcomings of historical cost also make it very difficult to compare financial statements among differing firms(348). This is an important point because creditors and investors would probably find it useful to compare companies in order to choose the best investment. Arthur Andersen's book sums up by saying, "Historical cost is generally more verifiable and cost effective than any other measure. A lack of lasting pertinence is its only, but a very important, shortcoming as a clear measure of value"(25).

So, in answer to the question "Do historical cost financial statements comply with the objectives of SFAC 1?, I would have to say yes. They provide information that is useful to investors and creditors, help to predict future cash inflows, and provide information on the resources, obligations, and changes to them as prescribed by SFAC 1. However, historical cost may not be the best basis for providing this information. Changing price levels should not be ignored completely. This paper will now be focusing on the alternatives to historical cost and trying to

determine the best basis for the information in satisfaction of the objectives.

CONSTANT DOLLAR ACCOUNTING

One alternative to historical cost is constant dollar accounting. This approach restates financial statement items into dollars with equal purchasing power. Constant dollar accounting is still cost based, it just restates the information into a common unit of measurement. The restatement uses the price index for the current year in relation to the index of a base year. Under constant dollar accounting, purchasing power gains or losses from holding monetary assets and liabilities can be identified. In the case of cash, for example, a purchasing power loss would be experienced in a time of inflation, because the same dollar would be able to buy less. These gains and losses allow the effect of inflation to be seen(Kieso 1,423).

There are several advantages to constant dollar accounting. The first is that it allows the impact of inflation to be quantified. By requiring each company to follow the same procedure and use the same index, the financial statements of differing firms become more comparable. Also, the financial statements of the same firm are more comparable from year to year since the impact of inflation is eliminated. Probably the biggest advantage of constant dollar accounting is that it allows inflation to be considered without changing the whole accounting structure. It simply builds on the historical cost principle that everyone already understands(Kieso 1,428).

Constant dollar accounting also has some disadvantages. Preparing constant dollar statements costs more than using historical cost, and the benefit of more relevant information may not offset these costs. Users are not familiar with constant dollar statements and may be confused by them. Another disadvantage of constant dollar accounting is that it restates the value of assets after considering price level changes, but these restated values may not be any more meaningful than historical cost. The amounts still do not reflect what the assets are worth in today's market(Kieso 1,429). The only difference between historical cost and constant dollar is that constant dollar accounting identifies the effect of inflation.

CURRENT COST ACCOUNTING

Another alternative to historical cost is current cost accounting. This method not only takes into account the effect inflation has on an item, but also the change caused by market forces. The price of an item changes due to changes in the market for the item as well as inflation. Specific prices may change much more than the general price level. Current cost measures the value of items as "the cost of replacing the identical asset owned." This cost is determined either by current catalog prices or by multiplying the book value by a specific index. This approach is much different because it changes the measurement basis from historical cost to current value(Kieso 1,429).

Under current cost, monetary items do not need to be

restated. These amounts are already stated at current cost under historical cost because the dollar is considered the same in each period. Therefore, no purchasing power gains or losses are incurred, but holding gains or losses from nonmonetary items do result. These gains or losses are the increases or decreases of an item's value during the time a company possesses it(Kieso 1,429).

Like every other measure of value, current cost has its own advantages and disadvantages. One advantage is that it takes the change in prices to a very specific level. This approach is more effective because the price of certain items may decrease even though the overall price level is increasing. Current cost is also a better measure of efficiency. For example, the differences in depreciation on similar assets would be eliminated because depreciation would be based on current cost for both assets. The effect of higher or lower purchase prices would not be included in net income. The service potential of an asset is better estimated under current cost. The idea is that a holding gain occurs because the asset's service potential has increased. Another argument in favor of current cost is that it provides a basis for predicting future cash flows. Reported holding gains or losses can be expected to be realized when the asset is sold, so the amounts can be used to predict what will happen when the asset is disposed of(Kieso 1,433).

A major disadvantage of current cost is that the value may be subjective. If a market does not exist for an identical item,

it may be difficult to determine what value to assign to it. The current cost of an item may not be an accurate estimate of fair market value. If the asset is sold at a particular time, the amount someone is willing to pay for it may not equal the current cost estimate(Kieso 1,433). Even so, this method is one step closer to fair market value and seems to be more valuable than constant dollar accounting.

FAIR MARKET VALUE

Probably the best alternative to historical cost would be to use fair market value as a basis for measurement. A former partner of Arthur Andersen agreed by writing, "As an objective, we are convinced that fair market value is the most useful and, therefore, the appropriate basis for recording the economic resources and obligations of a business enterprise"(27). Even though fair market value seems to be the best solution, there are also downfalls to it. The value of items is always relevant. "Surely, nothing could be more relevant than knowing the present value of future cash flows related to a financial statement element"(Arthur Andersen 21). However, this information may be difficult to ascertain. For some items, the fair market value is not known until they are actually offered for sale and a price is agreed on. For other items, an amount can be found, but only through extensive market research. These shortcomings make fair market value accounting a costly alternative. Cost benefit analysis comes into play when considering the different methods of accounting. "No matter how relevant and reliable, no measure

of value is ultimately worthwhile if the cost of obtaining it outweighs its usefulness"(Arthur Andersen 24). This is the major argument against fair market value, even though it is the best measure of what the assets and liabilities of the company are worth today.

COMBINING MEASUREMENT BASES

The last alternative to pure historical cost information that I will discuss is a combination approach proposed by Michael H. Sutton and James A. Johnson. Their solution combines the traditional historical cost system with greater recognition of market values in financial statement. They offer their approach as a solution to the debate between current value proponents and supporters of historical cost. They believe the debate is ongoing because, "Today's complex economic and regulatory environments have tested the limits of the current accounting model." Sutton and Johnson believe that at some point the current value of the asset becomes more relevant than its historical cost. At this point they suggest switching from historical cost measurements to current values. The switch should occur "when current values most closely approximate the asset's ability to realize cash." Sometimes the assets convertibility to cash is not clear. In circumstances where this is true, this approach recommends using "current values when the next step is cash and the asset is readily marketable." A fourth statement is proposed to show the changes in value. This statement would be a "Statement of Changes in Provisional

Values." The balance sheet would show current values, the income statement would be the same as under historical cost, and the new statement would explain the differences in values with the bottom line shown as an increase or decrease in stockholders' equity(42).

This approach seems advantageous because it shows the effect of a changing economic environment without totally changing financial reporting methods. It allows current values to be used while still reporting earnings in the same manner that financial statement users know and understand. Once again, though, the additional information it provides would cost more to obtain. The benefit it provides may not outweigh the additional cost, especially if users are confused and choose to disregard it.

USEFULNESS OF NEW INFORMATION

A question that has to be considered when discussing a method change is whether the users of financial statements will continue to use the new information. It would not be worth it to create a new reporting model if users will not embrace it. FASB Standard 107 requires certain financial institutions to report the fair market value of financial instruments. KPMG Peat Marwick did a study of financial statement users for the Association of Reserve City Bankers as a result of the new requirement. The study revealed that ninety percent of financial statement users oppose fair market value accounting. They think of the debate about replacing historical cost as "the musings of theoreticians who are not directly involved in making investment

decisions." This opinion is coming directly from the users of the information, and they are the best judge of what kind of information they need. If they do not feel a switch is necessary, the new information will most likely not be used. User opposition may be explained by the fact that the information is new and different. It may make some users uncomfortable to have to use something they are unfamiliar with. These feelings may be combatted by providing the education needed to understand the information before a change is implemented. The study also revealed that ninety-five percent of the users surveyed would choose historical cost information with supplemental fair value information as an alternative format(US 13). While the results of the study indicate opposition by users to a complete change in measurement, extra information is regarded as a plus. Preparers of financial statements also show opposition to change. The study showed that, "Only 5% of financial statement preparers believed fair value reporting more accurately reflected an institution's financial position." Preparers are strongly affected by the cost of fair value information. They believe the high cost would affect the precision of the information. Overall, the study shows "that preparers and users are skeptical abut the reliability, comparability, and timeliness of fair market value accounting"(13). This study was aimed at a change to fair market value reporting, but any change in reporting methods will probably be met with opposition. People get used to doing things a certain way and it is difficult to introduce

change. Ultimately, the needs of the users is the major issue and they know what they need better than anyone else.

Ron Paterson of Ernst & Young argued the merits of historical cost accounting in his article "A Hidden Agenda in the Role of Valuation." Historical cost represents the past transactions of the company and the cash flows generated by them. He believes this is an advantage, "not just in terms of reliability, but also in terms of relevance." He thinks of "Transactions and cash flows as the underlying reality of business that accounts should provide information about." He believes that valuation information is not as relevant or reliable. This information does not relate to past transactions or transactions that will occur in the future. "Instead, it often concerns only opportunity costs and alternative courses of action that the company is not going to pursue"(3). His view proves that even within the field of accounting there is opposition to a change in measurement values. His is just one opinion, though, and I am sure there are many people with feelings as strong as his in favor of valuation information.

CURRENT FASB OPINION

The FASB, in the past, has experimented with requiring additional information. In 1979, large publicly owned companies were required to disclose some price-level adjusted information. The requirement included restated information using both constant dollar and current cost. A survey conducted by the FASB later found that not many people actually used the restated

information. As a result, in 1987 they ceased requiring the restated information, but continue to encourage companies to provide price level adjusted information and/or current value(Kieso 1,433). This example is just more evidence that users oppose change and seem to prefer to stick with the information they are familiar with.

CONCLUSIONS

So, now that I have discussed the alternatives and how users feel, I will draw my conclusions. First of all, I believe that historical cost does comply with the objectives of SFAC 1. I believe these objectives can be summarized by saying financial reporting should provide users with information they want and need to make informed decisions. As I have already discussed, users oppose changes in measurement and generally seem satisfied with historical cost information. Their opposition to change leads me to believe that they are already getting the information they need to make decision.

My next conclusion, though, is that since the environment in which we do business is changing, so too may the needs of financial statement users. While historical cost is satisfying users now, it may not in the future. If a company wants to provide the best information possible, supplemental disclosures of market values should be considered. This way the users get the information they are used to, along with restated information and they can choose what they want to form their decisions on.

My third conclusion is that a change in valuation is most

likely going to occur sometime in the future, and this change should be made with the users in mind. A complete change to a method that users are unfamiliar with would not comply with the reporting objectives because the users would not know how to analyze the information. The objective states that the information should be useful to those who are willing to learn how to use it and study it with due diligence. A sudden and complete change would require more than reasonable diligence to understand. I feel the change should be as gradual as possible. A start would be with supplemental disclosures that help users learn to read information measured differently. Then I believe an approach like Sutton and Johnson's would be best. The new information would be available in a combined format with earning information on a basis users are familiar with. An approach such as this would ease users into the change.

Many would probably argue that using market values for reporting is not necessary and not worth the cost of obtaining the information. SFAC 1 does say that the goal of financial reporting is not to reflect the current value of a business, but I believe this information will be necessary as the economy and markets continue to change. Eventually it will be worth the extra cost to have the information so that the companies can attract investors and creditors.

Change is inevitable in all facets of life, and the field of accounting is not excluded. The current methods appear to be working fine. However, the companies that predict change, accept

it, and react to it by providing more information to users are probably going to end up the most successful. As the saying goes, "The early bird gets the worm."

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