2011

Market Value vs Historical Cost Valuations of Fixed Assets in the Context of International Convergence

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SUBMITTED TO

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FOR

SENIOR THESIS

SPRING, 2011

4/25/2011

Acknowledgments

I want to thank my mother for raising me through thick and thin, my uncle for supporting me and guiding me in all the right directions, and my grandparents for teaching me how to live a happy life and be a good man. I also want to thank all of my professors for challenging me mentally, and pushing me to learn more than I would have dreamed, and for preparing me for the next stage of my life.

Positive Vibes…

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Abstract:

The purpose of this paper is to discuss the differences between accounting for fixed assets under IFRS and U.S. GAAP. Primarily the discussion will be driven by the question: which standard should the FASB lobby for in its joint effort with the IASB to converge U.S. GAAP with IFRS? The paper will start by establishing that financial reporting, as it has evolved in the United States, was developed primarily to assist in the accountability relationships between management and both credit and equity investors. From there the paper will look at which standard is better suited to fulfill this goal and enhance financial reporting. It will first discuss the differences of historical cost accounting versus market values in the income statement. Next, the paper will look at the differences created in the balance sheet by the two methods. Finally, the paper will consider additional implications of switching to a market value standard. This paper will attempt to prove that historical cost accounting is the more reliable method of the two, provides an equally if not more relevant income measure, and that market values do not enhance the financial statements in any clear way. Particularly in any fashion that

justifies the additional costs to the firm and to investors in debt and equity that market values would create.

IAS 16: A Brief Overview

IAS 16 allows for the revaluation of assets to market value. Such revaluations are to be made on a regular basis so that the carrying value of an asset is not materially different from its market value.

If one asset is revalued to market value than the whole class of assets must be revalued.

Once an asset is revalued it is depreciated under the same method as if the historical cost method was being used until the next revaluation.

“If a revaluation results in an increase in value, it should be credited to other comprehensive income and accumulated in equity under the heading “revaluation surplus” unless it represents the reversal of a revaluation decrease of the same asset previously recognized as an expense, in which case it should be recognized as income.”

"A decrease arising as a result of revaluation should be recognized as an expense to the extent that it exceeds any amount previously credited to the revaluation surplus relating to the same asset." (Summary of IAS 16)

The Primary Objective of Financial Reporting

Determining the purpose of financial reporting is key in deciding whether switching to a standard such as IAS 16 enhances the accounting information provided by financial statements. The FASB believes that "the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit." The FASB goes on to say that "decisions by existing and potential investors about buying selling, or holding equity and debt instruments depend on the returns that they expect from an investment in those instruments… Similarly, decisions by existing and potential lenders and other creditors about providing or settling loans and other forms of credit depend on the principal and interest payments or other returns that they expect.

Investors', lenders', and other creditors' expectations about returns depend on their assessment of the amount, timing, and uncertainty of (the prospects for) future net cash inflows to the entity. Consequently, existing and potential investors, lenders, and other creditors need information to help them assess the prospects for future net cash inflows to an entity. (FASB, Statement of Financial Accounting Concepts No. 8 OB2. – OB3.)" In sum, the FASB defines the main objective of financial reporting as providing useful information in making decisions, primarily by providing information that will assist the user in determining future cash flows to the entity.

This has not always been the view of what financial accounting's main purpose is. "(Charles E.) Sprague began his exposition (*The Philosophy of Accounts)* by noting that accounting "is a history of values."… He also noted the importance of uniform value in determining net wealth as follows:

"Annols or chronicles merely relate facts which have occurred; but true history groups together facts of the same tendency in order to discover if possible the cause of happiness and misery, prosperity and ruin; so true bookkeeping, being a history, should group together similar values in its equations to discover the causes and effects of Loss and Gain (Previts and Merino 109)*."*

Henry Rand Hatfield believed that "performance measurement could be taken as one of the discipline's primary objectives (Bell 6)." This view describes accounting as a tool for measuring and evaluation a firm's past performance, not the forecasting or estimation of future events.

The American Institute of Certified Public Accountants (AICPA) reflected this notion of accounting as a history in its Accounting Terminology Bulletin No. 1 issued in 1941:

"*Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof* (Ijiri 29)*."*

The AICPA acknowledged accounting as a means of recording historical events of the entity and by making this information available, allowed for users to interpret the results of a firm's past.

In the late 1960's is when we start to see a shift in what the perceived purpose of accounting information is. "In *A statement of Basic Accounting Theory,* accounting is defined as "the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information (Ijiri 29)." This is not quite the same as the current stance of the FASB, but the underlying shift towards accounting as a system for providing information for decision usefulness can clearly be seen.

In 1968, William H. Beaver, J.W. Kennelly and W.M. Voss took this changing perception of what accounting information's purpose is a step further, believing "that accounting must concern itself primarily with ex ante information which is useful for purposes of prediction (for example future cash flows). Only then can accounting serve decision-making needs, since decisions are inevitably based on estimates about the future (Bell 9-10)"

This belief is reverberated by the view of The Study Group on the Objectives of Financial Statements, which was established by the AICPA, in 1973:

"*Accounting is not an end in itself. As an information system, the justification of accounting can be found only in how well accounting information serves those who use it. Thus, the Study Group agrees with the conclusion drawn by many others that the basic objective of financial statements is to provide information useful for making decisions* (Ijiri 29-30)*."*

This statement released by The Study Group on the Objectives of Financial Statement foreshadowed the FASB's view of financial reporting as a system for providing useful information for decision making. The FASB also reflects the views of Beaver, Kennelly, and Voss in that useful information for decision-making is information that allows users to predict future events, particularly future cash flows to the reporting entity.

The view of what public accounting's primary objective is has clearly shifted over the years, moving towards a more user oriented, forward-looking information system. The point to be made here is that simply because views about financial reporting's primary objective have changed does not mean that the foundations on which the accounting system was created have changed, and we should not so lightly toss aside the views of earlier practitioners and academics. In Yuji Ijiri's *Theory of Accounting Measurement*, he states

"Though the fundamental principles of accounting have not changed we are now interpreting the same principles from a more user oriented viewpoint. Thus, what has

changed is our interpretation of accounting methods and not the fundamental substance of accounting (31)."

If this is true than what exactly is the so-called substance of accounting if it is not to provide users with useful information for making decisions and predicting future cash flows? Yuji Ijiri described accounting as

"… a system designed to facilitate the smooth functioning of accountability relationships among interested parties (ix)."

I am inclined to agree with Mr. Ijiri that, as will be shown, accountability is what lies at the core of what the public accounting system is in the United States. However, I must stress, in stating that accountability is the core objective on which financial reporting is based, I am in no ways suggesting that decision usefulness should not be a consideration when setting accounting standards, or that accountability and usefulness are divorced from each other. On the contrary, I believe that by providing information that is designed for upholding corporate accountability, users are supplied with very useful information. However, To suggest that financial reporting can and should provide information that will help investors forecast the next period's earnings, future cash flows, or subsequent stock prices ignores the limitations and the foundations of public accounting. It will never be able to provide all the information that users deem to be useful (news, intangibles such as self produced goodwill, managerial plans, etc.) and by pushing to include less reliable information such as estimated market values, supporters of a decision useful approach turn their back on the role public accountings was initially called upon to fill as a check against corporate abuses. When an accounting scandal is uncovered investors condemn management for their greed and their neglect of their

responsibilities. And yet, the finger is never pointed in the other direction. Users of financial statements must also accept their duty as owners of a business to know and demand to know how their business is performing, and how management is using the resources entrusted to them, instead of viewing the stock market as an easy way to make some extra cash. Quite simply put by "centenarian Frederick C. Crawford, chairman emeritus of the aerospace-defense contracting giant TRW… 'Wall Street has become a gambling joint (Previts and Merino, A history of Accounting in the United States 370).'" It is partly because of this expanding gap between ownership and management, and the dwindling concept of the shareholder as an owner that I believe has led to the view that accounting should serve the user in whatever financial endeavor he intends to take on. Accounting information is not meant to supply speculators with information that will help them make money, it is meant to protect small investors from suffering unfairly from corporate abuses, and this is where my major qualm with the FASB's analysis of financial reporting's primary objective lies. It neglects the foundations of public accounting as a system of accountability, and it makes a mediocre attempt to back up its claim that financial accounting is a system designed to provide useful information for economic decision making, primarily by assisting users in estimating and assessing "the amount, timing, and uncertainty of (the prospects for) future net cash inflows to the entity."

On the surface, the claim that financial reporting is designed to provide useful information, primarily in estimating future net cash flows, appears to be a very straightforward goal, and perhaps that is why the FASB provides no further guidance or discussion as to how financial information is to achieve this goal, or how users are able to

use accounting information to make such future cash flow predictions. However, if we pick apart the stated objective of accounting, it turns out that providing or using the information from financial reporting to assess "the amount, timing, and uncertainty of (the prospects for) future net cash inflows" is not such a simple task, if even a possible one. Information provided about assets and liabilities provide no information about the amount, timing, or uncertainty of future cash benefits to the firm. It may be assumed that assets such as inventories will be converted into cash relatively soon, but what about the certainty that they will all be sold, or that prices won't change, or that a new product introduced to the market will lengthen the period of time in which all inventories will be sold? What about provisions for bad debts, pensions, or tax liabilities, surely they reflect uncertainty. And yet they do not provide information about the timing of or the probabilities of making those uncertain payments (expenses with regards to bad debts). As financial reporting is now, (and perhaps even within the realms of what accounting could do), it is impossible to make a sound assessment of all three of the identified characteristics of future cash flows (timing, uncertainty, and amount). In order to estimate future cash flows to a firm with any kind of accuracy, you would need a wealth of additional information not provided by financial statements, such as economic forecasts, demand forecasts, future supply estimates, debt maturity schedules, management investment and growth strategies, etc. (Leuz, Pfaff, and Hopwood 67-68)

In addition to the above concerns, Philip Bell presents an additional issue with using financial statements to predict future cash flows:

"Predictions of future cash flows directly from actual accounting information on the present and past have proved woefully weak. Those of us who think of accounting as

lying in the realm of the social rather than the natural sciences tend not toe be surprised at that. It is one thing to fashion a model which will predict consistently events in nature (and even here the environment may change). It is quite another to fashion a model which will predict consistently economic or social events where tastes, resources, and technology are constantly changing… The link between accounting information, security prices, and future firm cash flows, on which all macro empirical accounting research involving capital markets is essentially based, is a tenuous link at best (Bell 19-20)*."*

Bell's observation does not explicitly mean that accounting is not designed to help users in determining future cash flows, but it does reinforce the inadequacy of financial reporting to meet such a goal, and that future firm cash flows may not even be significant indicator of future stock prices.

But perhaps I am misguided in my assessment that financial reporting's primary goal is not to assist users in determining future cash flows, so for now, let us assume that the FASB is correct in its interpretation of the objective of financial reporting. Assuming this is the case, the FASB itself goes on to acknowledge that financial reporting is an inadequate system for achieving this goal. It states:

"*General purpose financial reports DO NOT and CANNOT provide all of the information that existing and potential investors, lenders, and other creditors need. Those users need to consider pertinent information from other sources, for example, general economic conditions and expectations, political events and political climate, and industry and company outlooks* (FASB, Statement of Financial Accounting Concepts No. 8 OB6)."

Perhaps to say that financial reporting is inadequate is a bit harsh. May be it is simply that perfection, which in most all cases, cannot be reached by any information system, and that financial reporting is the best option. However, the reality that under even the most hypothetical of circumstances financial reporting cannot provide all of the information that users need is reason to question the validity of it as a system designed for providing useful information. It seems to me that the matter would be greatly simplified if the FASB were to say instead:

"*General purpose financial reporting provides users with an account of what management has done with the resources entrusted to it, the consequences of its actions and uses of those resources, and an account of the firms performance as a result. This information combined with other information such as general economic conditions and expectations, political events and political climate, and industry and company outlooks can assist users in making resource allocation decisions and in estimating future net cash flows to the entity."*

This seems to be much closer to the reality of what financial reporting actually is, and not what users or the FASB hope or wish it to be.

The adequacy of financial reporting in providing useful information is once again brought into question by the FASB's acknowledgement that:

"*Individual primary users have different, and possibly conflicting, information needs and desires. The Board, in developing financial reporting standards, will seek to provide the information set that will meet the needs of the maximum number of primary users* (FASB, Statement of Financial Accounting Concepts No. 8 OB8)."

Once more it appears to be that the FASB is trying to reconcile the fact that, although financial reporting's main objective is to provide useful information, it is unable to and can never provide information that is useful for the needs of all its users. There will even be times where information needs will be conflicting, leaving one group of users better off than another depending on the standard chosen to be used. Again, I must assert that the problem could be resolved if the FASB acknowledged accountability as the primary purpose of financial reporting. This would remove the gap between what particular users expect from the financial statements and the information that they actually can and do provide. Unfortunately, since the FASB has placed an emphasis on decision usefulness, the FASB will now and in the future, have to justify its emphasis on the disclosure of different pieces of information and its stance on different standards to users that feel alternative methods or information would be more useful for their particular needs. But perhaps I should not be so quick to judge the FASB, for I myself have provided no evidence suggesting that the primary objective of accounting is otherwise. In the next chapter I will defend my standpoint that accountability, not decision usefulness, is financial reporting's primary objective.

The Development of Public Accounting In the United States

Financial reporting is a product of society, and as such was designed to perform a particular function. This being the case, the foundations of public accounting are crucial in understanding what financial reporting as a system has been designed to do. We must first look at the development of financial reporting within the United States if we are to understand what the function of public accounting is.

We shall start the discussion in the late 1890's, long before accounting standards, accounting theory, and required financial reporting. Before this time accounting was primarily a tool of the sole proprietor. It helped him to determine his costs, his overall wealth, and provide information to the bank so he could obtain loans. During the late 1890's financial capitalism began its rise, and "it became clear that management would

become divorced from ownership and that a financier, such as J.P. Morgan, would yield enormous power (Previts and Merino, A History of Accounting in America 129)." The rise of financial capitalism led to a period where circumstances "encouraged the attitude that finance gimmickry rather than production was the easiest way to make money (Previts and Merino, A History of Accounting in America 129)." The President of the New York Stock Exchange at the time stated:

"*The financiers of course, were still interested in producing goods for sale, but they were likely to be equally if not more interested in profits to be made from issuing securities and powers to be gained in arranging mergers and acquisitions* (Previts and Merino, A History of Accounting in America 129)*."*

As a result of these pressures to engage in "financial gimmickry" it became apparent to many that protection of investors was needed. Economists "demanded publicity to protect investors' interests… Demands for corporate accountability to stockholders were being echoed in the political sector as progressive reformers advocated and sought public oversight of the activities of corporations (Previts and Merino, A History of Accounting in America 130)." Up to this point in American history accounting had been largely a tool of management, and it wasn't yet widely accepted that accountants could fill the role of protector that was being asked for, however, this view slowly started to shift with the rise of the progressive movement.

Political progressives demanded, "public officials be held accountable for their actions… New governmental accounting systems became mandatory under state laws and resulted in significant improvements in the conduct of public business. This kind of activity, which required and obtained the cooperation and participation of accountants,

was a major factor in bringing accountancy to public attention (Previts and Merino, A History of Accounting in America 132)." The above is key in understanding the financial reporting system as it is today. Public accounting finds its roots in demands for accountability and is brought to the public's attention because of its effectiveness in holding government officials accountable for their actions.

During the progressive movement, demands for corporate accountability continued and it became generally accepted that the best way to reign in corporate abuses was to make corporate accounts available to the public (i.e. financial reporting). In 1898 the Industrial Commission was created to "investigate and report on questions relating to immigration, labor, agriculture, manufacturing, and business… One of the conclusions reached in the commission's preliminary report, which appeared in 1900, was that an independent public accounting profession ought to be established if corporate abuses such as stockwatering and overcapitalization were to be curtailed effectively (Previts and Merino, A History of Accounting in America 133)." This is one of the first major acknowledgments of the use of public accounting as a means of protecting investors from corporate abuses and as a way of holding management accountable for its actions. The conclusions of the report highlighted the need for an organized group of public accountants to perform audits of public accountants, and after the release of the report, businessmen supported independent audits by public accountants out of fear of direct government intervention. During this period the accountant viewed himself as a foe pitted against the abuses and deceit of management. "As one practitioner stated: 'the professional accountant is an investigator, a looker for leaks, a dissector and a detective in the highest acceptation of the term… …He must interpret, rearrange and produce in

simple but distinct form self explanatory and free from mysteries of bookkeeping, the narrative of facts, the relation to each other in results. He is the foe of deceit and the champion of honesty (Previts and Merino, A History of Accounting in the United States 132)." The view that the accountant was an adversary to management is one that is important to understanding financial reporting. In its infancy, it was viewed as a system for curtailing management abuses and not only acknowledged managements' biases and alternative motives, but was the primary weapon used to fight against them.

Jumping forward to the 1920's in post World War 1 America, the role and view of the accountant and accounting information changed dramatically. "Government leaders, having adopted a paternalistic attitude toward business, suggested that there was no need for the accountant to police the business community – the integrity of management was not only assumed, it was eulogized… One of the primary responsibilities of the accounting profession was to ensure that business received a 'fair return' on its investment (Previts and Merino, A History of Accounting in America 218)." Additionally, the influence bankers had over corporate business had greatly diminished. In the post war era, corporations began to pay out set dividends each year as opposed to paying out earnings in their entirety. This had the effect of making dividends conceptually the same as receiving an interest payment and attracted small investors who had grown used to investing in Liberty Bonds. As a result, they flocked to equity markets, causing the number of bank loans to dive. Banks began investing their capital in equity markets as well, and "bankers, like all other sectors of the nation, had a vested interest in fostering the illusion of prosperity… Keeping the investor happy was as important to bankers as it was to business management, and nothing that would have

dampened investor expectations was likely to be countenanced (Previts and Merino, A History of Accounting in America 218)." With the growing presence of the individual investor, it seems that demands for corporate accountability would have increased, but there is little evidence to support this. On the contrary, "investors ignored warnings that pure speculation was a nonproductive function that was dangerous and potentially destructive (Previts and Merino, A History of Accounting in America 219)." Following the stock market crash in 1929, many critics of the accounting practices of the 1920's blamed the public accounting sector for failing to protect investors. However, public accountants of the period had neither the authority or the support of the government to curb management abuses, and with no major outcry for corporate accountability, there appeared to be no reason to make an effort to support the profession.

After the crash, The Securities Act of 1933, and The Securities Exchange Act of 1934 created the Securities Exchange Commission (SEC). Once again, disclosure of corporate accountants was viewed as the best way to protect investors and "independent public accountants were among the prime beneficiaries of reformers' demands for greater investor protection (Previts and Merino, A History of Accounting in America 244)." The SEC left the development of accounting principles in the hands of the private sector, and the public accountant and financial reporting continued to be charged with the protection of the investor and filled the role of government regulation.

At this time, financial reporting was designed to be a system that checked managements' greed and abuses, by holding management accountable through public disclosure of accounts. It was in no way intended to be a source of useful information for decision making. In fact, many believed, as is reflected by Roosevelt's personal belief,

that "investors would (not) benefit greatly by financial reports nor did he think that any legislation could prevent people from making errors in judgment about a firm's prospects. But legislation could force corporations to tell investors how their money was being used by disclosing managerial "bonuses and commissions" and by preventing presentation of "malicious misinformation" to stockholders (Previts and Merino, A History of Accountancy in the United States 274-275)." Once again the public accountant and financial reporting was the system that was used to protect investors and hold management accountable for their actions, it was no where suggested that the primary function of accounting information should be to provide useful information that assists the user in estimating future cash flows or even information that is useful for decision making. In Roosevelt's inaugural address he stated

"The rulers of the exchange of mankind's goods have failed through their own stubbornness and their own incompetence… they have resorted to exploitations.. [because] they know only the rule of a generation of self-seekers (Previts and Merino, A History of Accounting in America 257)*."*

This highlights the shift in the public view of American business after the crash, and highlights the development of financial reporting as a system to stand as an adversary to managements' abuses.

Taking one more leap forward to finish our historical discussion, we end up at the Sarbanes-Oxley Public Company Accounting Reform and Investor Protection Act of 2002 (SOX), which was a reaction to the events of Enron and the fall of Arthur Anderson. Once again, when there appears to be some form of corporate abuse an outcry for accountability and investor protection ensues. SOX called for upper management to

be held accountable for the information presented in the financial statements. In addition to holding management accountable, it also tightened regulation over the public accountants and imposed a greater amount of liability upon accounting firms. This is important because the belief that financial reporting is designed primarily as a source of information that is useful to users in making decisions only emphasizes the relationship of the accountant and the user, when in reality there are three parties. It is not sufficient for financial reporting to provide useful information about an entity to users, because from this view, the only concern is with the transaction of information from the accountant to the user. As a system, it must acknowledge that it is reporting information that is provided by management, checked by auditors, and then passed on to users. To neglect this fact or to neglect the biases or motivations of management compromises the integrity of the entire system. By recognizing that financial reporting is a system designed to facilitate the accountability relationship between management and investors and creditors, we acknowledge that managements own account of their actions and performance must be called into question, checked with a proper level of skepticism as to its correctness, and certified as either correct or incorrect. However, it is not enough to rely solely on the auditor to catch management misrepresentations, the underlying system itself must be strong enough to withstand management biases, otherwise the role of the auditor would be little more than an illusionist providing a false sense of investor and creditor protection.

After briefly looking at some key points in the development of financial reporting, it is clear that it was developed around the primary objective of providing a representation of an entity and its transactions, in order to hold management accountable

for their uses of investor funds, and protect the investor from corporate abuses. It was not designed to be a source of information tailored to meet the needs of its users or to first and foremost provide information that will help in estimating future cash flows. I feel that financial reporting will never be considered sufficient in achieving this goal, because management strategy, risk assessment, and unknown future events that effect the firm, its industry, and the economy as a whole, are not provided and cannot completely be provided by financial reports. It is scandals such as ZZZZ Best, Lincoln Savings and Loan, Enron, and WorldCom that make me believe that an emphasis on corporate accountability rather than decision usefulness is necessary, and it should retake its place as the objective of financial accounting that it should have never relinquished.

Decision Usefulness vs. Accountability

"I have been in business for almost forty years and I cannot recall a period in which greed and corruption appeared as prevalent as they are today. As a result of ongoing revelations of scandals, the securities industry will have to accept new legislation and regulation to curb speculative abuses of the past several years. This is long overdue,"

- Investment banker Felix Rohatyn (Previts and Merino, A History of Accounting in the United States 370)

By viewing accountability as the main objective of financial reporting, how does this change our interpretation of accounting and how does this view differ from the decision usefulness view? First off, by viewing financial reporting from a decision usefulness standpoint, the user is satisfied as long as an auditor assures the reliability of the information. Under the accountability view, we are concerned with the information as well as the underlying system that leads to that information. In particular, if financial reporting is viewed as a means for accountability, then financial reporting acknowledges

the pressures of managerial bias and management and investors' conflicting interests, and leads to an underlying system that is strong enough to withstand such pressures. "Not just unbiased information, but 'unbiasable' information, is what is ultimately aimed for in the accountability approach (Ijiri x)." Under the decision usefulness approach, the difference between an information set that provides useful information about management of a corporation and information about a storm system is not recognized. As a result "the decision approach tends to encourage subjective information assuming that it will be unbiased (Ijiri 10)."

The other main difference between the two schools of thought is that under the decision usefulness view the accountant is perceived as working on behalf of solely the decision user. "The accountant is expected to accept the decision maker's goal as his own and then to design an information system most useful in achieving the decision maker's goal (Ijiri 10)." This is a major issue with perceiving the main objective of financial reporting to be decision usefulness, because the fact is that financial reporting is a system that has developed slowly and over a long period of time, and for almost none of it was it developed with decision usefulness in mind. The system was designed as a private alternative for government regulation and control of the business sector, with its primary purpose being the protection of investors from corporate misconduct through the disclosure of corporate accounts. Users needs may and mostly likely will change over time, often times very rapidly or very dramatically. Although accounting itself has in a sense evolved overtime as well, it would be very hard to make the claim that its evolution has happened or will happen in any kind of sweeping or rapid fashion. As a result, it is very difficult to make the claim that financial reporting is able to constantly alter itself to

tailor fit the needs of users, or even that it has had enough time to evolve into an efficient system of meeting current user needs.

The accountability approach on the other hand does not make financial reporting a servant to the specific wants of its users, but provides information necessary to protect users from managerial manipulation. It also acknowledges that there are three parties present in the interaction. This is important when determining what information should and should not be reported with regards to the users need to know and the corporations right to privacy. Simply because information is useful to someone does not mean that a corporation should be forced to report it. The users' right to have that information needs to be investigated, and determining whether or not that information is part of the accountability function provides a useful basis for deciding whether that information should be disclosed or not (Ijiri 33).

To sum up the above, the view that accounting information's main goal is to provide users with information useful to their decision-making fails to adequately recognize that the managements' interests are tied to the information that is released, and that management of an entity is very keen to do what it can to make sure that information portrays it in the best light. Under the decision usefulness view the need for unbiased information is recognized, where the accountability view acknowledges that the information is influenced by bias, and attempts to reduce and eliminate that room for bias. Additionally, the accountability view takes into account the fact that useful information is not a natural right of the user, and simply because information is useful does not entitle the user to it.

Accountability, Performance Measurement, And The Income Statement

"Now, profit earning is in general a process that is continuous and often drawn out, and the attribution of profits to a particular short period of time, though a practical business necessity does violence to fact and must therefore be arbitrary… The determination of profits is, then, the result of method and opinion, not of logical definition, and the question arises how method and opinion are to be controlled – the ultimate purpose being, as already stated, to attribute to a particular day, month or year a profit which is the result of inter-related transactions extending over much longer periods of time. The answer is that principles have in fact been evolved which seem in general to work satisfactorily, and that such rules have acquired authority and to some extent the force of law (Baxter and Davidson 83-84)*."*

Embedded in accountability are the objectives to be achieved. Therefore, accountability requires a means of performance measurement with regards to those

objectives. One may argue that performance measurement is obviously useful information for making decisions, and as such fits perfectly well into the decision-making framework as well as the accountability one. This is true up until the point that you must acknowledge that implicit in performance measurement is the pressure on the individual or group that is being evaluated to manipulate or bias the information in their favor. As discussed earlier, anticipating and trying to combat managerial bias is best addressed from an accountability view (Ijiri 33-34).

Possibly the most important, or at least most widely used, economic performance measure is income measurement. If accountability is the main objective of financial reporting, and a major component of accountability is performance measurement, then it follows that depreciation expense is an important issue with regards to the objective of accounting. Even from a decision usefulness view, Philip Bell raises the question:

"If one thinks of the decision making process, for all those using accounting information inside and outside the firm, in terms of making forecasts about a firm's performance and analyzing feedback on those forecasts, is it really cash flows that should be the centerpiece of this exercise? Or is some measure of income still perhaps the most crucial element of information entering into the decision making process (20)*?"*

Under either view, income measurement is a very important part of financial reporting. Considering that "reported depreciation may comprise… as much as 40 percent or more of a manufacturing entity's total expenses. And [that] this percentage is steadily increasing for many entities as the world moves inexorably away from a labor-intensive economic structure toward a more capital-intensive economic structure (Bell 104)." Depreciation expense is a very important part of income measurement, and thus

the effects of switching to a standard such as IAS 16 must be considered with great scrutiny.

What exactly is depreciation expense? Establishing what depreciation expense intends to represent is paramount in determining which of the valuation methods is more appropriate. Depreciation expense stems from the introduction of accruals in accounting, which left accountants with the choice between whether to capitalize or expense an asset. As can be observed in accounting practice today, the former was chosen. The use of depreciation expense, however, was not a concept that was widely used or reported until the early 1900s. During this period practitioners and theorists agreed that there was a need for depreciation, but two schools of thought emerged as to why it was needed. The first school of thought consisted of those who held an operating view of depreciation. Henry Rand Hatfield stated that: "all machinery was on an 'irresistible march to the junk heap (Previts and Merino, A History of Accountancy in the United States 219)." Under this view, depreciation was seen as an allocation of costs, and stems from the idea of matching expenses and revenues. The other school of thought maintained that depreciation was "a means of maintaining capital in terms of physical capacity (Previts and Merino, A History of Accountancy in the United States 219)," and that it needed to be sufficient enough to ensure asset replacement. This view was met with great opposition, the main argument against it being that the idea that a "depreciation reserve" somehow supplied the firm with additional capital to ensure the replacement of existing assets was misleading and very much a fallacy. The Interstate Commerce Commission (ICC) supported the operating view of depreciation and it prevailed as the view to be held

by members of the accounting society in the United States. The concept of depreciation has changed little since that time; one current textbook describes depreciation as:

"*The process of recognizing, or spreading cost over multiple periods is termed cost allocation. For items of property, plant, and equipment, cost allocation is referred to as depreciation. As the asset is depreciated, the cost is said to expire – that is, it is expensed* (Schroeder, Clark, and Cathey 297)*.*"

It is quite clear that what depreciation expense was originally viewed as under the operating view and what it is viewed as today has changed very little.

Now that we have established that depreciation expense has been in is quite readily accepted as an allocation of costs, let us turn our attention to the different valuation methods. The historical cost method currently used clearly bases depreciation expense off of the original cost to the firm. Of the two valuation methods, historical cost exhibits the highest level of faithful representation (reliability), which is outlined by the FASB as a fundamental qualitative characteristic of useful financial information. It provides a neutral and fairly complete view of what it claims to report and is free from error.[1] In other words, depreciation expense reached by the historical cost method provides the most reliable information, since market values for fixed assets are not easily obtainable, and will involve either management judgment or the judgment of an appraiser, who, needless to say, would be employed by management. These estimates are

[1] It must be noted here that historical cost depreciation has its limitations, but these limitations are acknowledged. Depreciation under this method simply shows a reasonable allocation of costs spread out over different periods. Since it is impossible to now how much of the cost should be expensed in that period without knowing the exact life of the asset the best that can be done is estimate. Since depreciation is calculated via a select number of set approaches, neutrality is increased, granted at the expense of theoretical completeness.

thus more subjective than objective. In Philip W. Bell's discussion on representational faithfulness he states:

"If the notion of representational faithfulness is to be useful in evaluating an entity's performance in a given period in such a way as to compare it effectively with (1) projections of performance for that period, (2) actual performance of other, perhaps competitive entities in the same period, and (3) actual performance of the entity in question in other periods in the past, than the "existing economic reality" being portrayed must surely be an objective, not a subjective concept (xix)*."*

Bell has highlighted the importance of using an objective representation of depreciation, particularly for evaluating and comparing income measurements. Nobody can argue that numbers based on the historical cost method are the most reliable, therefore, the only justification for using market values in determining depreciation expense has to be that it provides a more relevant figure than historical cost, to the point that it outweighs the drawback of being less reliable. But is this really the case? "A number of studies document an association between accounting income numbers and stock returns. This evidence implies that historical cost – based accounting income, which employs cost allocation methods, has information content (Schroeder, Clark, and Cathey 298)." Even if historical cost based depreciation is irrelevant, which usually is the beginning of any argument against historical cost accounting, why should it be assumed that market values are any more relevant. The main argument to be had against historical cost depreciation is that it allocates costs arbitrarily, and yet using market values would be just as arbitrary if not more so. To fully understand why depreciation

expense seems to be simply an arbitrary allocation of costs, lets take a closer look at what a fixed asset and depreciation is.

An asset can be thought of as a purchased amount of services which are provided by the asset. A firm does not consume all of those services up in one period, so management must break up the cost and match the amount of expired services (expense) to the revenues earned as a result of the use of those services. In other words, depreciation is the consumption of services reflected by the tangible deterioration of the fixed asset. A change in the market price of a fixed asset is not depreciation as it has been defined in accounting. For a simple example that should highlight the point, let us say you enter into the business of land development in the state of Arizona in 2001, and you purchase a fleet of cranes, bulldozers, concrete trucks, etc. You have elected to revalue your assets every year on 12/31 so that you will not encounter the arbitrary cost allocation issues surrounding conventional depreciation methods, meaning that your depreciation expense exactly matches the change in market value of your equipment from the beginning of the year to the end of the year. Furthermore, let us assume that markets for these assets are highly active and extremely reliable values can be obtained for all of your equipment so there is no management or appraisal judgment required (a very generous assumption). You use your equipment heavily from 2001 to 2006 because there is a wealth of development jobs that you are contracted to work on. However, the market value of your equipment does not drop significantly because the demand for such construction equipment is high. As a result, your depreciation expense is much lower than it would be under historical cost methods. During this period things are wonderful, you are experiencing a wealthy revenue stream and expenses are low (at least

depreciation expense is lower than if you had elected historical cost methods) so your net income is high and you are able to attract healthy investment and keep current investors happy.

In 2006 the housing bubble bursts and you are unable to find work in 2007. Your equipment remains idle and you are able to obtain minimal work. To add to your problems the market value of your assets has dropped dramatically since other housing developers are also out of work and demand for the equipment you hold dives. In 2007 you are forced to record a very large depreciation expense and impairment charge regardless of the fact that your equipment has not experienced any physical deterioration. Work continues to be minimal through 2010, but things start to pick up in 2011 and 2012, and in 2013 the housing market picks up significantly. As a result, demand for equipment similar to yours increases. You revalue your assets in 2013 upwards and have no depreciation expense; in fact you record a capital gain that partly offsets your depreciation expense and impairment charge in 2007, which is recorded as income (and is what would occur under IAS 16). This means that you not only recorded no expense for the period, even though you used your equipment heavily, but you also were able to recognize additional income for doing nothing more than recognizing an excessive previous expense in a period which was already very bad. From 2013 until the disposal of your equipment, market value drops at a reasonably stable rate. You are pleased with this because it has allowed you to recognize a second time, expenses which you have already written off in previous years, reducing your tax liability.

The above example highlights the major problems with market valuation as a means of depreciation. Depreciation in an accounting sense is the physical deterioration of assets; the using up of previously paid for services. The FASB states:

"*Assets of an entity are changed by both its transactions and activities and by events that happen to it* (FASB, Statement of Financial Accounting Concepts No. 6 CON6-13)*.*"

The use of market values does not acknowledge the relationship of depreciation as an operating expense of the business, and makes assumptions about the asset that may or may not include "transactions and activities" or "events that happen to it" as well as include assumptions about external demand for the asset and economic, governmental, or social factors that may not be relevant to the particular asset while employed by an entity. Although depreciation under historical cost accounting may be an arbitrary allocation of costs, it at least attempts to reflect the expiration of services provided by an asset as they are used to help create revenues. The use of market values on the other hand reflects the compounded views and assumptions of the market as a whole, and has no direct connection to the actual consumption of the asset. Furthermore, when managerial judgment or the judgment of a professional appraiser is used to estimate market values a whole new layer is added. Now, not only are you assuming that market values of fixed assets appropriately reflects asset deterioration, but you are also assuming that the estimates of management (or hired appraiser) are correct for a valuation that may or may not reflect actual depreciation of individual assets. This reduces the verifiability of depreciation expense, which is considered by the FASB as an enhancing qualitative

characteristic of financial reporting information.[2] The above points call into question the entire argument brought against historical cost accounting, mainly that it does not provide relevant information. The relevance of historical cost depreciation may be determined to be low (although I do not believe this to be the case, but I must concede that straight line depreciation may at times be a very arbitrary allocation of costs) but it can hardly be said that market values provide a more relevant depreciation figure, if even an equally relevant one.

Bringing the use of market values for depreciation purposes further into question is the FASB's discussion of faithful representation and its relationship to relevance, it states:

"*If the level of uncertainty in… …an estimate is sufficiently large, that estimate will not be particularly useful. In other words, the relevance of the asset being faithfully represented is questionable* (FASB Statement of Financial Accounting Concepts No. 8 QC16.*"*

In most cases fixed assets are of a very specialized nature, and estimates of market value must be brought into question. If market values are too greatly dominated by estimates and opinion rather than fact, their relevance is diminished. Additionally, even if estimates of market values can be reliably estimated, it may not reflect the appropriate amount of use of the asset, in some cases completely contradicting the reality that an asset was used to generate revenue during a period.

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[2] Verifiability as defined by the FASB is the ability of different knowledgeable and independent observers to reach a consensus that a particular depiction is a faithful representation. See page 20, Statement of Financial Accounting Concepts No. 8

Since we have established that financial reporting should be viewed as a system of accountability, and implicit in accountability is performance measurement, income determination is of the upmost importance. Philip Bell stated:

"*Reliability, along with relevance, turn out… to be the essentials for accounting information to be useful in the decision making process in general, and in monitoring and assessing performance, which is a vital part of the decision making process, in particular* (345)*."*

Although he discusses it in terms of decision making, Bell acknowledges and emphasis the importance of accountability (monitoring and assessing performance), in particular, reliability and relevance. Since depreciation expense reached via historical cost accounting is more reliable and arguably more relevant than depreciation expense reached via market values, we should be highly critical of the notion of using market values for depreciation determination. It fails to attempt to match expenses and revenues, and if depreciation determined by market values does reflect the expiration of services provided by an asset, it does so as a result of correlation to the physical use of the asset by the firm, not because it aims to determine actual depreciation expense. Additionally, we must acknowledge the pressure from management to bias the information. Although under the historical cost method management is afforded the option between different depreciation methods, the options are few and the choice must be justified. It is much harder for an auditor to challenge the estimates made by management with regards to the market values of assets that are not frequently traded, and which the auditor has no special qualifications to value himself. This has the result of reducing verifiability and reliability of the depreciation expense figure.

To further complicate matters, under IAS 16, management is afforded the option of choosing which classes of assets to revalue and which classes of assets to keep at a historical cost basis. This allows managements bias to permeate the financial information even further and reduces the comparability of the financial reports issued by the entity.[3] This is the case because it means that one entity may report depreciation that is determined solely by historical cost accounting, while another may determine depreciation solely on the basis of market values, while a third may use any combination of historical cost and market values to determine depreciation. It is important to note that management will most often base their decisions on which assets to value at market and which to value at historical cost on the subsequent tax consequences of using one method over the other, not on whether or not the information will be more useful for users.

Even if accountability is not seen as the objective of financial reporting, and decision usefulness is the primary goal, it cannot be denied that income is a major part of investors' decision-making. This is highlighted by the fact that earnings per share is required to be reported in the financial statements, or the fact that the FASB has still not amended Concept Statement no 6, in which it states:

"Information about an entity's performance and status provided by accrual accounting is the primary focus of financial reporting (CON6-7)*."*

Additionally, the fact that modern accounting scandals have been executed through manipulations of the income statement reinforces the notion that users rely

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[3] Comparability is considered by the FASB to be enhancing qualitative characteristics of financial information. Comparability is defined as the qualitative characteristic that allows users to compare similar information about a reporting entity with other entities. See page 19, Statement of Financial Accounting Concepts No. 8

heavily on representations of income. For example, WorldCom was forced into bankruptcy because they inappropriately capitalized $3.9 billion of leasing costs instead of expensing them. "The rationalization for the capitalization of unused capacity cost under the leasing contracts was that the unused capacity was incurred in anticipation of (unverifiable) increased future business (Watts)." This also raises some serious questions about pushing for the inclusion of forward-looking information that may be useful for determining future cash flows. To sum up the point quite gracefully:

"*The term bottom line is a U.S. idiom, representing our discipline's signature on our culture. It is in origin an accounting term, not a medical term, not a legal term, not an engineering term. It has become a pervasive expression that compactly identifies our way of life, our competitive values and goals. The "bottom line" is as much a part of identifying the U.S. way of life as is baseball or blue jeans. As its usage becomes adapted to a global capital market order, the term will continue to signify that the role of accountants is one that is determining and results-oriented* (Previts and Merino, A History of Accountancy in the United States 425)."

The Balance Sheet, Relevance, And Economic Wealth

"The wise businessman will not believe his accountant although he takes what his accountant tells him as important evidence. The quality of that evidence, however, depends in considerable degree on the simplicity of the procedures and the awareness which we have of them. What the accountant tells us may not be true, but, if we know what he has done, we have a fair idea of what it means. For this reason, I am somewhat suspicious of many current efforts to reform accounting in the direction of making it more 'accurate' (Baxter and Davidson 55)*."*

Double entry bookkeeping in combination with accrual accounting has made the question of balance sheet versus income statement a heated debate over the years. Again, the argument levied at historical cost values is that they are irrelevant and users are not concerned with what a firm paid for their assets. Clearly market values are more relevant

because… I have yet to read one argument that convinced me that market values are more relevant to users to any kind of level that possibly justifies the additional costs in auditing fees, the possibility of managerial bias entering the estimates, or the decrease in "correctness" of the income statement. The cost benefit constraint of including market values will be crucial in determining whether or not switching to a standard such as IAS 16 would be beneficial.

Looking at the different users outlined by the FASB, let us start with investors. Investors are not going to concern themselves with market values of an asset (an assumption that will be challenged later). Investors will be indifferent if the market value of an asset is higher than the book value of an asset because that is a wealth increase that cannot be distributed to them unless it is sold, effectively replaced, and there is left over capital that can be distributed to them. Even if management intended to sell a piece of PPE, it is not fair to assume that the whole class of assets is going to be sold, making market values useless for estimating the possible cash distributions from the sale of a particular asset.

It can be argued that investors are concerned with the value of the assets to the firm and its operations, which I would agree that they are, but to say that market values represent value in use is simply incorrect. There is a substantial difference between the value in use and the value in exchange. Lawerence R. Dicksee explains the difference between the two and why users are not interested in these values:

"The justification for thus ignoring fluctuations in the value of capital assets is that these assets have been acquired, and are being retained, not with a view to their eventually being realized at a profit in the ordinary course of business, but with a view to

their being used for the purpose of enabling trading profits to be made in other ways. For example, there is no fixed connection between the realizable value of a ship and its earning capacity; and in the case of factory, its value to the undertaking depends merely upon the accommodation that it offers, and is entirely irrespective of any speculative rise or fall that may have taken place in the value of land or building materials. Similarly, the value of machinery to a business depends not upon the market price of iron or steel at that particular time. For practical purposes, therefore, these fluctuations may fairly be said to be of no account, and in any event it is quite an open question whether, pending a realization (which is not contemplated), any more reliable basis of value could be adopted than the actual cost in the first instance – subject, of course, to due provision for depreciation (Baxter and Davidson 93)*."*

If market values cannot provide a proper representation of value in use than perhaps they can provide an appropriate representation of opportunity costs of holding PPE. On the surface this seems reasonable enough, however, to understand the opportunity costs of holding an asset investors would also need to know the costs of selling the asset, the lost production as a result of not having the asset, the cost of replacing the asset, the cost of training employees to use the new asset, not to mention the amount of time it would take to sell the asset (since if it takes a long time to sell the asset, the estimated market values would not reflect the actual selling price of the asset). Additionally, "certain assets were purchased with a plan of operations in mind. That plan, those operations, indeed those people who developed that plan, must first be evaluated before alternatives about the future can be considered, and it is the accountant's task to provide the data for that evaluation. Once this is done, then one can compare the

cost of continuing to use the assets for the purposes for which they were originally acquired (Bell 151)." Evaluating performance brings us back to the income statement, and means that before we can truly determine whether opportunity costs are being inappropriately taken, we must first measure the performance of the assets in use. Since it has previously been established that historical cost based depreciation leads to a "better" income statement number, and there are many additional inputs other than market values in determining opportunity costs, market values of assets presented in the balance sheet turn out to be fairly inadequate for the purpose of estimating opportunity costs.

Now let us go back and challenge the assumption that investors are not interested in the value of assets in exchange. Perhaps they wish to know the value of the company if it goes bankrupt. This makes little sense since investors are at the bottom of the barrel in bankruptcy, and will almost never be distributed money from the liquidation of the firm, not to mention going through bankruptcy and liquidating all a firm's assets takes so long that market values of the entity's PPE would be irrelevant. It is highly unlikely that investors are interested in the value of a firm if it goes through bankruptcy, not to mention it is questionable at best if the firm would be able to receive market value for its assets.

I must concede, however, that investors would probably be interested in market values for two reasons. First, although market values give only the minimum value of an asset in use, they are correlated with discounted future cash flows. If the market value of assets increased or remained fairly high this would be an indication that the expected future cash flows from those assets were going to remain high, and if the market value of

assets decreased it would be an indication that the future cash flows from those assets were going to decrease. Secondly, Investors may wish to know market values of assets because it would allow them to better determine a firm's ability to obtain more debt financing. Although, it seems that as long as creditors are looking at the same aggregate value for fixed assets as investors are, using market values instead of historical cost values probably wouldn't change investors ability to determine a firm's ability to obtain additional debt financing by very much. When taking these two points into consideration, the important thing that has to be realized is that the balance sheet has been called to fill an impossible function. The number that represents fixed assets on the balance sheet is essentially a multi-dimensional figure, which is expected to sufficiently be condensed into a single-dimensional representation of fixed assets. The balance sheet number for fixed assets is being asked to represent unexpired costs and at the same time value of an asset in terms of discounted future cash flows to be contributed to the firm. The reality is that these are two separate concepts, and you cannot have one without partially sacrificing the other. By using market values, investors would gain a very subtle increase in the ability to predict future cash flows, since market values are only correlated with the future cash flows to be provided by fixed assets but don't actually represent the future cash flows to be provided (i.e. value in use). They may also gain a slightly better ability to determine an entity's ability to obtain additional debt financing, although it is unclear as to whether or not this is true. By doing this however, they subject themselves to an income measurement that is open to a good deal of management bias, which ignores accountings core function of holding an entity and its management accountable for its actions and performance. Also, if market values are actually useful, and investors start to

rely on market values as indicators of future cash flows, management will not be blind to this. Subsequently, management will make sure to use estimates for market values that result in a favorable outcome for them, not estimates that will provide the most useful information for users. As a result, the costs of switching to market values are too high to justify the benefits of a number that, if actually deemed to be useful, invites management to manipulate it for their own purposes.

Turning our attention to creditors, perhaps we can establish a justifiable reason for using market values. Accounting information is used in debt contracts in order to limit dividend distributions and insure a sufficient amount of net assets. These provisions give debt holders a certain level of security on bonds or outstanding debt and minimize the ability of managers to pay a liquidating dividend at the detriment of debt holders. Because debt covenants are contractual, verifiability of asset values is crucial to making the contracts enforceable. Since most fixed assets do not have easily obtainable market values, debt holders will be less inclined to rely on asset value estimates since it will be much harder to enforce a contract in a court of law if the estimates are not verifiable. As a result, historical cost based asset values are most likely more appealing to creditors. Additionally, debt holders have an "asymmetric payoff" with regards to net assets. If the firm's net assets are greater than the debt, debt holders do not receive any further payments. However, when net asset value is below the face value of debt at maturity, then debt holders will suffer the loss. For this reason debt holders will primarily be concerned with a more conservative, lower end view of earnings and net asset value. They want to know that the minimum value of net assets will be able to cover the outstanding debt, and creditors will be very weary of upwards estimates of net asset

value, especially when they are hard to verify. Consequently, creditors are content with historical cost accounting for both earnings and asset valuation, and most likely are not concerned with market values of assets unless they are lower than market value (Watts).

There is one more thing that we must consider and that is that users (primarily investors) wish to estimate the value of equity for a firm. Critics of this view contend that estimating the value of a firm is redundant, since the market has already valued the worth of the firm. If the securities market was a perfectly efficient market we might be able to assume this, but the reality is that nothing is perfect and this assumption turns a blind eye to the fact that M&A sales prices of firms usually are above their market capitalization "because there is a control premium or prices are paid for synergies. Using data published in Mergerstat Review 1994 – 2001, [Patrick] Gaughan shows that this premium averaged about 40 percent of market capitalization in the United States during the years 1982 – 2000… Since there is no good relation between market capitalization and transaction price, we cannot use market capitalization as a proxy for market price (Leuz, Pfaff, and Hopwood 61)." As a result, we cannot ignore the fact that users may want to determine on their own the value of a firm. Since there is an obvious gap between the book value of equity and the market capitalization of a firm, and an even further gap between book value and market price, the question at hand is: does using market values for fixed assets assist users in closing the gap between book-value and market-value and in estimating on their own the value of a firm?

Since the "economic approach to valuation is that the market value of the firm on a well-organized securities market is assumed to be the present value of expected future dividends to a decision horizon or to infinity (Leuz, Pfaff, and Hopwood 35)," (or some

form of discounted cash flow analysis) then incorporating market values for fixed assets would be useful in valuing a firm's future cash flows since the market value is supposed to be the "the market view of the future cash flows to be generated by assets (Leuz, Pfaff, and Hopwood 36)." If this is true then it would seem that market values for fixed assets would be very helpful in determining the value of a firm. However, before we can assume that market values would be helpful in this cause we must first look at some drawbacks of using market values as well as some issues created by the accounting system as a whole.

The first issue is that market values compound the views of many participants, and thus include assumptions about the future cash flows of an asset that may not be valid when the asset is used by a specific entity. This again brings up the difference between value in use versus value in exchange. Since a firm will only invest in an asset if it has a positive net present value, the market value of an asset will represent the minimum value (future cash flows it will contribute) to the firm. If what the user is concerned with is the future cash flows provided by an asset, a conservative estimate limits the usefulness of the balance sheet for estimating discounted future cash flows (net value of the company). Additionally, when you consider that to obtain market values for most fixed assets either the judgment of an appraiser (who is being paid by management) or management will be needed, the usefulness of market values is eroded even further. This also raises questions about what valuation techniques should be used, and what assumptions are tolerable in estimating market values. Therefore, not only are market values a conservative estimate of the future cash flows they are to provide, but they are not even a precise conservative estimate.

Lastly, assuming that market values can be easily and reliably obtained, simply by valuing each asset individually and adding up their values does not leave users with a faithful representation of the firms value because it ignores the fact that firms create competitive advantages by using all of their assets in combination with each other to create a product or provide a service. Ignoring these synergies further reduces the usefulness of market values in the balance sheet. When you take all of this in to account along with the fact that management will consider tax consequences rather than decision usefulness for financial statement users when choosing which classes of fixed assets to hold at market value, we are left with a fairly poor attempt at providing users with the discounted future cash flows produced by fixed assets (Leuz, Pfaff, and Hopwood 65-66).

Unfortunately the problems don't end with the valuation issues of fixed assets. The accounting system as it is now does not allow for essential items (for the purpose of determining firm value) to be represented by market values or represented at all on the balance sheet. These items include internally generated goodwill, human capital, internally created trademarks and patents, supplier synergies, customer loyalty, and other intangibles. Although there has been much discussion about how valuing and representing such intangibles in the financial reports (which I will not go in depth about) could be accomplished, there are still a great deal of questions and concerns that need to be addressed, and until these issues are resolved the use of market values for fixed assets (in most cases not even all of fixed assets) will not provide any substantial increases in balance sheet usefulness for determining firm value.

Additional Considerations

"*On April 5, 1934, Senator Hastings of Delaware rose in the United States Senate and declared: 'An audit is not a statement of facts, and an accountant should not be required to certify that the statements contained in a balance or profit-and-loss statement are true. Such a certificate is really misleading.' …The accounting profession is not dishonest. Its individual members probably possess as high a degree of personal integrity as the members of any calling in the world today. Yet upon the passage of a law which would make accountants responsible for material untruths, their profession, without a single important exception, felt impelled to change its form of certificate from one which states that its financial statements fairly present, in accordance with accepted principles of accounting, the position of a company. Apparently accounting principles and the truth do not make good bedfellows* (Baxter and Davidson 59)*."*

Before concluding, there are a few additional things we must take into consideration, mainly the fact that under current U.S. GAAP market values are allowed, but only for downward valuations. If it is reasonable to allow for the use of market values downwards, then why doesn't the current standard allow for valuations upward as

well? The main factor is that conservatism has been a pervasive concept in financial reporting since accounting's outset. But it seems now that both the FASB and many scholars are moving towards a concept of neutrality, and are condemning conservative practices. They seem to feel that unbiased information is what financial reporting should aim for, that the natural truth of things is what accounting should report. I would agree that in a perfect world accounting information should be completely unbiased, unfortunately the reality is that accounting information is inherently biased and to ignore this fact by abandoning conservative accounting would be a mistake. In this sense conservatism and accountability are very much intertwined with each other and in essence have sprouted from the same concern of combating managerial bias and incentive misalignment. The fact is that information is held by management, and is released by management through financial reports. As a result financial reporting in its nature is biased because it represents the views of management. When you take into consideration that most often times management and shareholder incentives are poorly aligned, it is hard to ignore that management has both the ability and the will to influence and manipulate accounting information. In recognizing this it is also important to understand that the consequences of overvaluing assets is much greater than the consequences of undervaluing them, and that most often management's incentives put pressure on them to overvalue assets, not undervalue assets. For example, as was discussed earlier, the costs to debt holders if assets are overvalued is much greater than if assets are undervalued. With regards to management compensation plans, because management most often has a short tenure and limited liability, they are inclined to value assets upwards in order to meet earnings benchmarks (by keeping depreciation expense low), and by the time the

true deterioration of the firms assets is realized, they will be gone. Thus, management may be able to receive their additional compensation, which is often times very substantial; by doing nothing more than shaping market value estimates upwards. Also, recognition of losses (impairment) acts as a signal to shareholders and the board of directors that they should look into management's use of firm assets and that management is possibly not performing up to par. As a result, management will only recognize an impairment charge when it is unavoidable. However, early recognition of gains does not convey any further information about management because they have incentives to report increases in the value of net assets. Therefore, it is useful for firm governance purposes to allow for downward valuations, but not upward valuations. To reinforce the point that the consequences of overstating earnings and net assets are much more extreme than understating them, "in securities litigation, buyers' lawsuits against auditors and firms outnumber sellers' lawsuits by a ratio of 13 to 1."[4] This shows how much more investors are angered by overvaluation of earnings and net assets than by undervaluation's, and perhaps without even realizing it have shown support for conservative accounting procedures. Conservative accounting, which has lead to only the recognition of "unrealized" losses on fixed assets but not gains, is a result of the fact that there are greater costs and consequences to be suffered when assets are overvalued rather than undervalued. As a result, it is not contradictory to allow for market valuations down and then turn around and say that market valuations upward are unacceptable. Requiring valuations downward serves the purpose of protecting investors and creditors, while at the same time not allowing management to estimate asset values upward also promotes

[4] pages 8-13, conservatism in accounting part 1

this goal of protecting investors and creditors. Thus, asymmetric holding loss and gain recognition does not make the argument against market values and the decision usefulness view irrelevant, but in fact runs perfectly in line with the concept of corporate accountability and protection of investors and creditors from corporate misconduct.

Conclusion

"There is much to be said for the simple untruth as against a complicated untruth, for if the untruth is simple, it seems to me that we have a fair chance of knowing what kind of an untruth it is. A known untruth is much better than a lie, and provided that the accounting rituals are well known and understood, accounting may be untrue but it is not lies; it does not deceive because we know that it does not tell the truth, and we are able to make our own adjustment in each individual case, using the results of the accountant as evidence rather than as definitive information (Baxter and Davidson 55)*."*

In concluding this paper I wish to again emphasis that accountability and decision usefulness are not and need not be divorced from each other, and I am in no way saying that accounting information should not be thought of as useful. What I am trying to emphasis is that the financial reporting system in the United States has developed overtime and to ignore the foundations laid down in the past will hinder progress in the future. Public accounting makes much more sense when viewed as a system to assist accountability relationships, and when it is viewed as a system designed primarily for providing users with information that is useful for decision-making, contradictions and expectation gaps arise. Financial reporting provides information that enhances the

judgment of users, but it is not designed to make decisions for them. "Our image of the future or of the various possible futures is always dependent on some kind of projection of our past experiences. These projections, however, are unreliable and they may be based on a very limited perception of the kind of dynamic system in which the enterprise operates. The basic difficulty here is that the future depends not only on the decision of one person, but on the decision of all the decision-makers of a society. A man can control his own decisions within limits, but he cannot control the decisions of others even though he may attempt to predict them (Baxter and Davidson 51)." In the end, every individual will interpret the information differently, and there will be winners and losers, the point of financial accounting is not and should not be to help users win, but to protect them from cheating and unfair losses that result.

With this in mind I do not believe that it would be beneficial to switch to a standard similar to IAS 16. Using market values to determine depreciation expense is not only less reliable than historical cost, but it does not even attempt to reflect the actual deterioration of a fixed asset, instead relying on the correlation between market values and the consumption of the asset. Additionally, the reliance on managements' opinion of the market value of assets allows for managerial biases to permeate the financial statements even further. Even if only one or two scandals arise as a result of market valuation misrepresentations, there is hardly much observable upside to justify the risk. I would also like to note that even if an independent appraiser is used to value fixed assets, they are still paid by management, and this creates a very similar situation to that of the credit rating agencies who were hired to rate the mortgage backed financial instruments. With regards to the balance sheet, I do not believe that investors or creditors are

particularly worried with market values of fixed assets, and even if they would find them useful in determining the intrinsic value of the firm, many more items, mostly intangibles, would have to be recorded on the balance sheet at market value for holding fixed assets at market values to make sense. As a result, it is very important to take the view of accountability, and not allow managerial biases to enter the financial statements via managerial estimates of market values, especially if it is in exchange for questionable increases in usefulness at best.

In conclusion, I do not believe that switching to a standard such as IAS 16 would be beneficial; in fact I think it would be detrimental to the income statement and it is extremely uncertain as to whether or not market values would increase the relevance and usefulness of the balance sheet. Even considering the fact that both historical cost and market values would be showed in the balance sheet, when the external factors of managerial influence on income measurement, additional appraisal fees, and the auditors inability to thoroughly check estimates is brought into the equation I find it extraordinarily hard to justify switching to a standard similar to IAS 16 (also, I am greatly concerned with the fact that depreciation is based on the market value method, not the historical cost method). Accounting has its limitations which must be recognized, and to move away from convention simply to try to more closely adhere to theory, especially when you know theory and reality will not and cannot be the same, would be one of the biggest mistakes standard setters could make. After the stock market crash in 1929 there were "references to the post-World War 1 period providing the 'hard historical evidence' that deviations from historical cost-based, conservative accounting led to the crash of 1929." George O. May had this to say:

"*In the 1920's accountants fell from grace and took to adjusting capital values on the books… to an extent never before attempted… In extenuation they might plead unsound laws, unpractical economics and a widespread if unfounded belief in a new order of things combined to recommend such a coarse, but… the wiser course is to admit the error and not be misled again* (Previts and Merino, A History of Accountancy in the United States 227)*."*

It is not that such a catastrophe will be repeated that is the point, but more that historical cost accounting has enjoyed a very long standing and successful career as one of accounting's corner stones, where as dealings with market values and revaluation have had a short and rocky history. The former comptroller general of the United States, Frank Bowsher said:

"*The history of accounting gimmickry in the 20th century has one unyielding lesson: It is impossible to repeal the facts of life. Ultimately illusions give way to reality* (Bell 79)*."*

There has yet to be a scandal that has uncovered itself in which historical cost accounting for fixed assets has been used. It is, however, very easy to see how a scandal could arise from the use or misuse, rather, of market values. The point being, that I am sure that there are many counter arguments to my paper, but the burden of proof is on the supporters' of market values to provide not just theoretical, but concrete and substantial evidence supporting a change away from historical cost accounting for fixed assets. I certainly do not envy those who have accepted such a challenge, for the burden is quite heavy indeed, and the strength of the historical cost system stems much deeper than the stubbornness of a practice to maintain an outdated and seemingly beloved convention.

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