A debate has been ongoing in the accounting literature for the past several decades regarding the relative merits of historical cost versus current cost information for financial reporting. Historical cost reporting involves recording assets and liabilities at their acquisition cost. Under this system, revenues and expenses are generally recognized only on the basis of transactions with outsiders. This means that changes in the value of assets and liabilities are not recognized, or recorded in the books, until sold. Presently, generally accepted accounting principles, which serve as the basis for preparation of external financial statements, are based on historical cost methods.

Current cost reporting involves preparation of financial statements that recognize changes in the value of assets and liabilities at the time they occur. This means that the income reported for a firm includes both realized gains and losses (stemming from external transactions) and unrealized gains and losses (recognizing changes in market values). Present accounting regulations encourage, but do not require, supplementary disclosures of the current value of inventory and plant and equipment. However, the Financial Accounting Standards Board is still debating issues related to the usefulness of current value disclosures.

This study provides empirical evidence regarding the quality of decisions made under alternative reporting systems. The study uses an experimental approach to determine whether current value disclosures were associated with improved investment disclosures and whether current value income is more useful if it dichotomized into trading (realized) and holding (unrealized) components.

1. Previous Research

Prior research in the area of current value disclosures falls into three general categories. The first category consists of normative papers, which

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1. There are a few exceptions. Marketable securities are carried at the lower of cost or market on a portfolio basis, for example.
use analytical and theoretical arguments to assess the relative desirability of historical cost versus current value financial statements. These studies generally support current value statements, although recognizing that implementation problems may exist.

The second category of research involves an examination of the impact of current value disclosures on returns to equity holders. These studies have sought to determine the impact of supplementary current value disclosures on stock prices of firms. The results of this line of research are mixed. Most studies reported that current value disclosures provide little or no information to the market above historical cost financial statements. However, there is limited evidence that current value disclosures are used by capital market participants to assess growth rates in productive activity.

The third category of prior research involves surveys of analysts, bankers, and other users of financial statements. The results of these studies generally indicate that users would like to have current value information for decisions. In summary, the results of prior research generally indicate that although there is some support from the financial community for current-value-based disclosures, the empirical support regarding their usefulness is limited.

2. Research Design and Hypotheses

This study involved the use of investment professionals. The subjects were 105 professionals representing public accounting, internal auditing, bank officers, financial managers, and investment brokers. Subjects were presented with a set of financial statements and asked to rank four firms on the basis of their desirability as an investment. The subjects were divided into three groups. Group 1 received financial statements prepared on a traditional historical cost basis (HC). Group 2 received financial statements prepared using current cost figures but without separation of holding gains and losses and trading gains and losses (TCC). Group 3 received financial statements prepared using current cost figures, which separated out trading and holding gains and losses (CCC). The financial statements were based on hypothetical companies that engaged in the commodities futures business. The firms traded an identical commodity portfolio consisting of cattle, hogs, wheat, and soybeans. Trading decisions for each commodity were made monthly. Hence for each commodity there were 144 trading decisions over a four-year interval. The only difference between the four firms was in their percentage of correct buy, sell, and hold decisions. A correct decision was one leading to the highest return on a particular contract. Prices of the contracts were obtained from the Chicago Mercantile Exchange and the Wall
The research question addressed was, Does presentation of financial statements in current cost format improve users' ability to rank firms as potential investments? It was expected that if the research question was answered in the affirmative, then rankings of current cost statements (TCC and CCC) would be more accurate than rankings of historical costs (HC). In addition, if components of current cost (CCC) provided additional information beyond total current costs (TCC), then rankings on this basis should be more accurate than total current cost. Thus it was hypothesized that the accuracy of rankings would be CCC > TCC > HC.

3. Results

The results are supportive of the hypothesis that current cost financial statements allow users to rank companies as investment prospects more accurately than do historical cost basis statements. The accuracy of rankings was greatest for CCC statements, in the middle for TCC, and the smallest for HC statements. Statistically, only the difference between CCC and HC was significant. This suggests that current cost information leads to improved investment decisions over historical cost when the realized and unrealized components are separately disclosed.

In summary, this study used a unique experimental approach to test the question of whether current cost disclosures make a difference in users' ability to rank the relative attractiveness of firms as an investment prospect. The results of the study suggest that they do when given current cost data dichotomized between realized and unrealized holding gains and losses as contrasted with historical cost data. This suggests that the demand for current value information in at least some decision contexts is valid and such information can prove useful to decision makers.