Fair value vs. historical cost accounting essay sample

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In order to make the most profitable and rational decisions entity's stakeholders have to evaluate organisation's financial statements. Today's world of rapidly changing prices has made it difficult to estimate what something is actually worth. Thus leading to debates at what price – historical costing price or market value – assets and liabilities should be reported. Therefore, before making any evaluations about reported transactions it is important to understand the difference between historical cost and fair value accounting. Penman (2007, p. 34) in his research same as Laux and Leuz (2009, p. 827) in their article referred to fair value either as defined in IFRS or in FAS 157 – both similarly identifying it as a price at which an asset could be sold or a liability could be paid to an independent, unrelated and well-informed stakeholder at the current date. Whereas historical cost accounting, as mentioned by Marshall, McManus and Viele (2011, p. 48), responds to cost principle and indicates assets and liabilities at their original acquisition price not taking into account increases or decreases in their market value.

Regarding only conceptual side of fair value and historical costing price Penman (2007, p. 36) indicated that when using fair value accounting shareholder receives the most necessary data through balance sheet and determines equity's value viewing the book value. In contrast, historical cost application shows the information through income statement, where earnings report value-added through arbitrage made by buying products from suppliers and selling them to customers at different price. Additionally Penman's interpretation represented that in historical cost accounting current income is used to predict future income – at fair value predictions are

not necessary since balance sheet provides the valuation. However, fair value income statement indicates the change in value during the period and reports management performance. Besides, unexpected earnings in fair value income statement identify value at risk. After all, Penman made a point saying that in historical cost accounting revenues and costs have to be matched, but in fair value accounting balance is not required. In comparison with historical cost, which is determined by simply recording the original cost taking into account depreciation, determination of fair value is more complex.

In their article Laux and Leuz (2009, p. 827) noted that IFRS as well as FAS 157 regard estimation of fair value for an asset or liability depending on market inputs. It is said that prices in active markets with identical assets and liabilities are taken as a measurement for fair value. But if such prices are not available one has to either look for a relevant observable market data or use model assumption and apply valuation techniques and significant adjustments in order to obtain fair value. Complexity of fair value’s assessment and simplicity of historical cost’s determination leads to differences in quality of these accounting methods. As it has been said in Krumwiede’s (2008, pp. 35-38) article, data received from regarding historical cost are reliable and self-evident, since historical cost reporting does not necessarily involve neither estimations nor judgments. In contrast, the author mentioned questionable reliability and verification difficulties related to information received from fair value reporting because of prices often determined by using model assumptions and valuation techniques

such as present value technique, which requires management's predictions about the future and judgments when indicating risks. Moreover, the author noted that when using fair value it is easy for management to manipulate with earnings, overstate or understate values as for their own good.

Furthermore, Marshall et al. (2011, p. 201) referred to historical cost as being not only more reliable but also more consistent and conservative than fair value. Still, Laux and Leuz (2009, pp. 827-828) have mentioned some important advantages that fair value has over historical cost. Authors noted that because of the timely information provided by fair value it stimulates frequent corrections and increases transparency. These advantages lead to relevancy of fair value accounting, whereas lack of transparency and not up to date information makes historical cost accounting less relevant. However, authors stated that relevancy can be applied to fair value only when regarding liquid assets, otherwise fair value accounting can generate misleading information. Besides they have also noted that, while historical costs remain stable during all times fair value prices can be deformed by inefficient markets, liquidity problems or investors irrationality increasing volatility in financial statements.

What is more, Laux and Leuz (2009, p. 832) presented that unlike fair value accounting historical cost accounting permits to realize gains at the most suitable timing and results in more flexible and discrete impairment testings. Nevertheless, in the article it is said that fair value not only provides more reliable and timely information for investors, but it also can be used to compare different entities more accurately then using historical cost

accounting data. Referring to Krumwiede’s (2008, pp. 35-39) article, usage of historical cost instead of fair value reporting is mostly associated with subjectivity and weak reliability of fair value when it comes to addressing assets whose observations in active markets are rarely available. Generally these are intangible and long-term assets which are reported at historical cost rather than fair value. However, in this article it is said that SFAS propose using fair value for impaired assets and their write-downs. Furthermore, results from author’s mentioned surveys and reviews from analyst reports indicated that when reliable inputs for fair value determination are available stakeholders prefer using fair value instead of historical costs, for example, when reporting liquid assets.

Additionally, in Laux’s and Leuz’s (2009, p. 827) article it is identified when one has to use fair value accounting. The authors noticed that in FAS 115 it is said to report trading securities and available-for-sale-securities at fair value, as well as use fair values for disclosures in the notes of financial statements (FAS 107). Considering all the information mentioned above, differences between historical cost and fair value accounting can be found in their definitions – regarding prices at the current date vs original cost; in concept – focusing on changes in market value vs looking at earnings from realized sales; in measurement – application of judgments and model assumptions vs identifying depreciation; in quality – relevance vs reliability; in implementation – liquid assets, impairments and disclosures vs long-term and intangible assets. Since these differences also refer to strengths and weaknesses of historical cost and fair value accounting, after regarding them

one should be able to make more accurate evaluation of financial statements reported at either historical cost or fair value.

Bibliography

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