

Example of critical thinking on historical cost accounting system

[Business](#), [Company](#)



Abstract

Historical cost accounting refers to the accounting method in which only the original costs of assets, liabilities, revenues or expenses are recognised. This means the method is silent as to the effects of depreciation, inflation, time value of money among other things. Much of the arguments for and against the historical cost accounting method can be divided into two, academic and practical reasons. The academic arguments resonate around issues of integrity and rationality while practical argument consider the fact that decision making uses accounting information and the overall need for accuracy in decision making. Its pros include the fact that it is applied universally and hence compatibility of statements, it is simple to understand hence can be given to lay men for consumption and lastly it is stable and non -susceptible to errors or malpractices. However, critics have argued that it fails to score on accuracy as it omits essential matters such as time value of money, the effect of inflation and the need to capture the replacement costs of assets rather than the initial cost. It is this paper position that historical costs must be used together with other methods for purposes of accuracy and sound decision making.

The historical cost accounting system refers to the principle in which the costs of assets and liabilities are recognised by their original costs rather their current value. In addition, revenue and expenditure items are as well recorded and recognised in their original values. Historical costs thus employ the initial cost as operative cost. This is as opposed to current cost, replacement cost, market value, fair value or weighted costs which are modifications for the historical cost accounting. It should be noted that most

accounting departments in the business field employ the use of historical costs. This paper canvasses the arguments in support and against the application of the historical costs accounting system. It would evaluate the benefits and demerits of the historical cost accounting approach.

One main argument for the application of historical cost method often is the need to allocate costs consistently. Through historical costing, a simplistic approach of allocation of costs is achieved. This is because the cost accountant simply recognises the cost of purchase or sale of the item in question. In the end, the records show a consistent inflow and outflow without introducing any discrepancies as to the values of recognition. In addition, the consistent application enables the use of the data and information gathered from any statements to be applied in making economic decisions. The economic decisions would mostly be based on whether the overall effect on cost versus income resulted in a loss or a gain. Such decisions do not require the application of the complicated costing methods which could distort the decision making process. The spirit in economic cost decisions often is to obtain whether the action was resultant of a positive or negative flow of finances.

Historical costing has been credited for its stability and impossibility of distortion. It is reported that other methods open channels for creative accounting and mal-practises. Creative accounting refers to processes in which accountants come up with fraudulent figures and accounts for the purpose of defrauding the institutions or firms involved. Historical application is clear on the costs to be recognised and is not subject to calculations and adjustments that end up allowing the accountants to mess with the figures.

To this extent, historical application can be said to be both stable and credible. In the world where white collar crime is persistent, firms need to stick with historical costing so as to avoid loopholes that facilitate committing of the crimes through avenues like creative accounting and malpractices.

The stability of historical costing can also be observed in the fact that over time immemorial, firms have applied the historical costing and have posted successful returns both in terms of performance and decision making. This stability works in unison with consistency to enable firms make informed decisions. In making forecasts, consistency, stability and accuracy is only guaranteed in the application of historical costing. The forecasts would be accurate since unaffected and unmodified data is used in the analysis. This is as opposed to instances where the data was adjusted say through current costing methods and are, therefore, subjected to inflation rates. The stability could also be demonstrated in the fact that the historical costs applied are the consequent of the actual flows at that time and do not use rates of conversion which are themselves not static hence introducing fluctuations which go against the need for stability.

One function of auditors is to ascertain the true and value of statements of accounts. Indeed, this they carry out through analysis of the statements in relation to other accompanying documentation and evidence such as vouchers, receipt books, among other things. One loophole historical costing avoids is the possibility to forge values through the use of non-historical costing. This then enables the protection of the integrity of the information. Internal audits cannot collude with the workforce to manipulate the data to

force reconciliation. This advantage derives from the fact that historical costing is rigid in approach. The records in the accompanying documentation say vouchers must and should tally with the records in the statements. Other non-historical accounting approach may dispense with the need for tallying and correspondence of values.

Historical cost accounting is also supported on the ground that it is less susceptible to errors and omissions. It is agreed that accounting statements should be prepared for the consumption of both accounting experts and ordinary lay men. Historical cost accounting ensures no errors or omissions are allowed in the system. This is because even in the application of other methods of accounting, the initially used method is the historical method. Take for instance the application of current costing. The accountants have to convert the records from historical to the current cost figures. This process is laborious and susceptible to errors and omissions. The fluctuating inflation rate also means the process would be tedious and require some competence. This process if mishandled could expose the information or data being processed to a number of errors and omissions. One then needs to weight the opportunity costs of applying the historical costing methods as compared to the current or any other methods that ideally would require adjustments. In the same breadth, the fact that accounting information is intended for the consumption of ordinary citizens without indebt knowledge of accounting necessitates the application of the simplest accounting method. Applications like current costing, market values or fair values need additional knowledge of accounting. The objective of information would be defeated in applying these methods to the disadvantage of the target group.

It is argued that non-historical methods of accounting are subjective and depend on the accountants' interpretation of accounting standards and principles. Usually, accountants take the opportunity to deliberately misinterpret and employ concepts of creative accounting to portray the accounting information in the taste of the management. This could easily sway the stakeholders who depend on these accounts to assess the stewardship status of managers. Situation where managers collude with the accountants would be rampant if the non-historical methods were allowed as the presentation method of accounting statements.

Finally, historical cost accounting method is preferred for purposes of compatibility and comparison across the industry. It should be appreciated that financial statements are not consumed in a vacuum. The practice in firms often is to run comparisons between the firm's performance to that of other organizations as well as the industrial performance. While the historical cost accounting is acceptable and applicable across the board, the firms are yet to have a general consensus of other applicable costing techniques.

While a section may prefer current cost, others prefer fair value yet others prefer the use of replacement estimates costing methods. With the disparities and lack of consensus, it is essential to retain the historical costing method for purposes of comparison and analysis in a way that is devoid of any errors or discrepancies. Closely related to the comparison aspect is the need for computation of taxes which could apply two ways. Firstly, the computation of taxes in the local jurisdiction should be based on a uniform accounting method. The historical cost accounting is the most

stable and most applicable and hence should carry the day. Secondly, it facilitates taxation of foreign subsidiaries which could be accounted for in foreign currencies. The need to apply a uniform cost accounting method also remains essential.

Even with the reasons mentioned in support of historical cost accounting, scholars and firm managers alike have come up with contrary arguments that indicate weaknesses of the technique and called for the re-examination of system with the intention of settling on other methods of accounting. Indeed, these critics have shown both practically and theoretically that the historical cost accounting method is flawed and needs urgent adjustments. Among the proposed methods as earlier mentioned include current cost accounting, fair value, market value and the replacement cost estimates method. The remainder of this paper will explore the arguments against the historical cost accounting method application.

The strongest argument put forth against historical cost accounting is the failure to account for inflation. The historical cost accounting in allocating costs, revenues and expenses assumes that the values have not changed in any way. However, inflation which occurs throughout has an effect of substantially changing the real values. Managerial accountants in an effort to accommodate inflation use adjustments methods to the historical data and figures. This enables them make more valuable analysis of values since the effect of inflation has been factored. Generally, inflation has the effect of depreciating the original costs and the historical accountant fails to appreciate and take into account that fact. Inflation as an economic effect usually has the final impact of reducing the actual values as compared to the

original values. An adjustment hence is necessary and important so as to conform to the prudence concept of accounting. According to the concept of prudence it is always essential for accountants to recognise the lower value of the asset and the higher value of the liability. An inflation adjusted set of data and values would effectively reflect that.

Another argument against the application of historical cost accounting method is the need to take into consideration market values rather the original costs. This argument is hedged on the fact that for liquidity purposes, the firm would rely on the market value of the assets. When and if the need for liquidation of assets arises, the market value would prevail. Ordinarily, accountants prefer to apply the historical cost accounting approach until the going concern is put on doubt. Upon the declaration of lack of going concern, the accounting procedures in application are adjusted and market values applied. Often, the consequence is that the realisation account has a deficit that is attributable to the decline due to the reliance in historical costs rather than the market values. Often firms do not necessarily experience this deficit problem because liquidation is not an everyday affair. However, the deficit could explain the reason why bankruptcy and insolvency is prevalent upon liquidation. To avoid this quagmire, it is suggested that historical accounting be forgone immediately and market or current values be applied. This has been witnessed in industries where the risks are so high such as the banking industries. Usually, these industries prepare two sets of accounts. One account meant for lay men would apply historical costing method while the other set has its values adjusted to the current cost accounting method.

Another important argument against the historical approach of cost accounting is that it is generally misleading. This could be explained in different ways. Firstly, it misleads the consumers in respect of the value of assets and liabilities. Usually, the real value of assets and liabilities is different mainly due to inflation and the general depreciation. It is, therefore, prudent to be in the know of the actual value rather than rely on the balance sheet values based on the historical cost accounting method. Secondly, historical cost accounting method could be misleading as it fails to capture the replacement costs of assets. This inconvenience would weigh heavy on the firm if and when it becomes necessary to replace an asset. Usually, the amount of depreciation accumulated is less as compared to the replacements value. This is because the accumulated depreciation is computed using original costs which are exclusive and merely historical. Another misleading fact occurs as to the owed liabilities. The amount captured in the balance sheet reflects the original cost of the liabilities or financial instrument. For example the loan value reflects the original value of the loan and does not capture the fact that banks adjust their interest values as per the prevailing rate.

Lastly, the historical cost accounting method fails to take into consideration the time value of money. To the typical financial accountant, one dollar yesterday is the same as one dollar today. This, however, is not the position. Financial management informs us that the value of money changes in accordance with time. The value of money weakens with the passage of time. Historical cost accounting fails to reflect the change aspect to its consumers. This change, however, is not negligible and ought to be factored

in during decision making concerning the future of the firm. This hence suggest that decisions would be more informed with the use of adjusted figures that have factored in the inflation rate, the time value of money using the discounting rates and the fair values of financial instruments.

In conclusion, it should be appreciated that historical cost accounting has been used over time across the globe. Despite its successful application, where risks are high and accuracy is necessary, it is preferable to complement the historical data with adjusted data taking into account the current costing method. However, for successful results, precise and definite accounting standards and principles should be laid out to guide the application. This will address the issue of subjectivity and susceptibility to creative accounting and other mal-practises. In the long run, it will be appreciated that the purpose of accounting is to show the true and fair position of the firm. Nothing should work to negate that spirit.

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