

Historical cost essay sample

[Finance](#), [Financial Analysis](#)



The historical cost accounting is an accounting technique that values an asset for balance sheet purposes at the price paid for the asset at the time of its acquisition. It is usually used in combination with other measurement bases. For example, inventories are usually carried at the lower of cost and net realizable value, on the other hand marketable securities are usually carried at market value, and entities prefer to carry pension liabilities at their present value. The main advantage of using historical cost accounting model is its simplicity and certainty. Most entities know what they have paid for the assets when they purchased them. Similarly they also know what proceeds they received in exchange for their obligations.

Historical cost method is a very objective method because usually subjective estimates are not involved. The drawback of historical cost accounting model is that it cannot deal with the effects of changing prices of non-monetary assets. Therefore some entities prefer to use current cost basis instead of historical cost accounting model. The most prominent disadvantage of this method is that book values may be based on badly out of date costs. This becomes more of a problem during periods of high inflation. Therefore, historical cost does not generally reflect current market valuation or fair value of an asset or liability. Historical-cost financial statements do not provide information that is relevant to investors.

Fair value is defined as the amount at which the asset could be bought or sold in a current transaction between willing parties. Fair value is a reliable estimate if the parties involved in the transaction are “ knowledgeable” where they are aware of the relevant risks and rewards, utility of the asset, supply and demand of asset, market conditions, and other factors. The

transaction should be an arm's length transaction. Arm's length transaction means that the parties to the transaction are acting in their own interest. A transaction can be arm's length transaction if the parties act independently and have no relationship to each other. intangible assets that had never been recognized now had to be separately identified and reported in a business combination. The statement also notes that " judgment is required in estimating the period and amount of expected cash flows," and that these judgments should be consistent with the objective of measuring fair value. it may be necessary to use the present value of discounted cash flows technique presented in SFAC 7 when a market value cannot be used to establish a reasonable value.

The inflation issues and current market valuation are ignored in this method. Thus, it might ' not provide useful and relevant information for decision making' Current cost accounting attempts to provide more realistic book values by valuing assets at current replacement cost, rather than the amount actually paid for them. This contrasts with the usual historical cost approach. It is usually calculated by adjusting the historical cost for inflation, in addition to the usual adjustments such as depreciation. The drawback of current cost accounting is it is more complex than historical cost accounting, and attempts to implement it tend to create controversy over what adjustments are appropriate. The problems that current cost accounting attempt to solve are obviously linked to inflation. Interest in inflation accounting tends to be greatest when inflation is high, and low when inflation is low. Current costs are claimed to have several advantages over the historical cost concept.

The current cost represents the amount the firm would have to pay currently to obtain the asset or its services; therefore, it represents the best measure of the value of the inputs being matched against current revenues for predictive purposes. It permits the identification of holding gains and losses, thus reflecting the results of asset management decisions and the impact of the environment on the firm not reflected in transactions. The current cost represents the value of the asset to the firm if the firm is continuing to acquire such assets and if value has not been added to the asset by the enterprise. The summation of assets expressed in current terms is more meaningful than the addition of historical costs incurred at different time periods. It permits the reporting of current operating profit, which may be used to predict future cash flows.

One of the disadvantages of the current cost concept is that some objectivity has been lost; unless the assets currently sold in the market are identical in all respects to the assets held, some subjectivity must be applied in transferring current exchange prices to the owned assets. Also, current costs might not represent the current value to the enterprise. If the firm were required to pay the current costs, it might be economically advantageous to acquire other asset forms instead. The present value of the benefits to be provided by the asset may not be equal to the current or replacement cost of the asset. This is particularly true when technological changes have occurred in the demand for the product.

For example, if the demand for a product has declined significantly, the specialized equipment required for its production will have declined in

service value to the firm; the depreciated cost of acquiring similar equipment is not a good measure for the service value to the firm. Reporting current cost in accounting are recommended rather than historical cost as it is the fair value reported in the current year would be beneficial to the firm and the shareholders of the company. Current costing accounting (CCA) approach recognizes the changes in the price of individual due to the change in general price level. This is the method which includes the process of preparing and interpreting financial statement in such a way that relevant change in the price is considered significantly. In CCA method, the assets are valued in current cost basis. It does not consider the retail price index. This method considers the replacement value of the assets for its real accounting records. The value of assets at which it is to be replaced in future is called the replacement value. Sometimes it is known as replacement cost accounting approach also. Under this method, each financial statement is to be restated in terms of the current value of such items.

Features Of Current Cost Accounting(CCA)

1. The fixed assets are recorded at replacement cost value in the balance sheet.
2. Inventories are shown at market value rather than market or cost price whichever less as in the historical system is.
3. Revaluation surplus are transferred to current cost accounting reserve but not distributed as dividend to shareholders.
4. Depreciation of fixed assets is to be calculated at replacement value.
5. Two types of profit i. e. profit from operation and profit from revaluation are calculated.
6. Liabilities are recorded in their original value because there is no any change in monetary unit.

Objectives Of Current Cost Accounting(CCA) Approach

1. To provide correct and reliable financial information based on the current replacement cost. 2. To calculate the profit without changing the historical profit. 3. To protect the business in the event of normal inflationary situation. 4. To keep level of capital in very balance position by making valuation of assets in proper value based on replacement value. 5. To provide realistic information to the management, investors, creditors, government and to other interested parties. 6. To prepare the financial statement at the end of the year on the basis of current value of such items.

FASB issued an exposure draft on fair-value measurements. This proposal provides guidance for valuing assets and liabilities that are required to be measured at fair value under other pronouncements. The ultimate goal of the fair-value project is to improve comparability, consistency, and reliability of fair-value measurements by creating a model that can be broadly applied to financial and nonfinancial assets and liabilities.

The framework would also remove policies that disagree with SEC guidelines for investment funds, and clarify the use of fair-value measurements in other authoritative pronouncements. The exposure draft would not replace, but instead would expand upon, current disclosures relating to the use of fair-value measurements for assets and liabilities. Disclosures would include information about fair-value amounts, how they are determined, and the effect of any remeasurement on earnings, including unrealized gains and losses (see Joseph V. Carcello and Jan R. Williams, “ Fair Value Measurement,” in Miller GAAP 2004).

These new disclosures would apply to securities that are perpetually measured at fair value and to assets that are periodically measured for impairment. Carcello and Williams note that this standard would have broad implications, affecting or amending more than 30 accounting standards. In summary, this exposure draft does not expand the assets or liabilities to be measured at fair value. Instead, it provides a consistent framework for measuring these assets and liabilities and for disclosing information about their valuation. Although the standard does not increase the assets and liabilities currently measured at fair value, it provides a format that FASB could use in the future to measure additional assets and liabilities at fair value. How is historical accounting better than alternatives?

Quite clearly the several limitations and flaws of the traditional historical costs method have been highlighted and picked upon from time to time. Still historical costs are the standard form of accounting due to its unique features and conventions that make it better than most available alternatives. One of the main reasons why historic accounting even though flawed forms the basis of our traditional accounting model is because accountants are reluctant to price the assets at current market value. Over the years number of cases relating to accounting malpractice and creative accounting have been exposed that have made accounting bodies reluctant from using current values which directly affect the share prices. Accountants have to guard the integrity of their data against internal modifications. The use of current cost or exit price opens the door to manipulation of these numbers. Under historical cost accounting there is no room for manipulation and the data is supported by evidence such as invoices, receipts, etc.

Any other basis for recording transactions would be subjective, i. e. the amount in which the transaction will be recorded would be dependant on individual point of view and is bound to differ with different people. The historical cost system provides managers with a significant range of alternatives in recognising, reporting and measuring economic information. One of the advantages of using historical costs it helps the managers to forecast future operational costs based on past data. The basic function of historical accounting is to tell a user “ the cost of a thing”. Without knowing the original costs future projections are almost hampered. Historical costs play an important role here providing this necessary information. Historical cost is based on recording actual transactions. Not only is there a record of actual transactions, but also the figures are reliable.

For current cost or exit price accounting, changes in prices are recorded but these are not based on actual transactions. Financial statements based on historical cost have been found to be useful. Empirical evidence indicates that people find the conventional statements useful. No other method of accounting can provide exact information at a glance on the change in trends in the company’s working like the historical costs method. Accounting bodies have not abolished the flawed historical cost method as they recognise the fact that other methods are flawed as well and there is not better replacement. Also they cannot ignore the fact that despite its several limitations historical cost accounting, it has several advantages and it has now been widely recognised and accepted by corporations across the globe.

Even if accounting bodies develop a new accounting method or simply pick an existing method to form the standard of accounting, will it be better than historical cost accounting? People are familiar working with the historical costs and that makes it even more difficult for the accounting bodies to replace it. A consistent effort is needed from the accounting bodies to develop a foolproof method, which can effectively take over the traditional historical method. Until then historical cost accounting will remain one of the oldest and controversially dominant method for measurement of corporate performance.

There are many issues involved with fair value accounting. Some argue that fair value is beneficial to investors when they are trying to evaluate risk, return and valuation of a business. If a company marks to market, does it not give an investor a better understanding of that company's current value? Some may say that this method can help the company in times of economic trouble and credit problems, and others feel that it is merely a band-aid on a wound that needs stitches. To some people, it is a problem to have to decipher financial statements to understand what is listed at fair value and what is listed at historical cost. Switching to one method would mean that there would be no more implementing both methods for different assets. Would that more truthfully represent a company? Would this valuation system be beneficial to banks lending money to these companies?

In the event that a company has credit problems in a troubled economy, the use of fair value accounting may benefit them. At the same time if the economy is volatile and the value of everything significantly decreases, this

would be another problem. The use of fair value could drastically help a company get approved for loans, however, if the company is doing horribly and needs a loan to survive, inflating the value of their assets may help them acquire the financial aid they need but it may not help the business turn a profit. In that case, the company may have been better off not taking out a loan, but instead realizing that they can not survive. In a volatile market with unstable price fluctuations, fair value may not be such a good idea. Suppose this company were to value their assets at current market value and receives a loan because of it. What happens when the company defaults on their loan and at the same time the market crashes causing all of the company's assets to drop in value? Would this not be a problem for the banks?

When a company's value is comprised of assets that are valued at their current market value instead of what they paid for them, it is obvious that the difference is material. Fair value can help just as much as it can hurt. It really depends on the type of asset being valued and whether or not people know how to use it. The FASB should probably hold off on making new rules until they can come up with some sort of guidelines so people understand when and where to use it.

When valuing assets at historical cost, depreciation seems to be a simple concept. If companies start valuing all of their assets at fair value, this will most likely create problems with depreciation as well as appreciation of assets. Just as companies want to capitalize on the loss of value of an asset, would they want to pay tax on gains of some appreciating asset that they

normally would not have had to do if reporting under the historical cost principle?

Historical cost and fair value have both been around for a long time. Whether or not to make a permanent switch to fair value is an important decision for the FASB to make. All the angles need to be covered when considering this switch. Does the good outweigh the bad? The historical cost principle has worked fine all this time, why mess with something that has proven its reliability?