Advantages and disadvantages of historical cost accounting, alternatives to historical cost accounting

2.1 Introduction

Conventions and accounting concepts as applied in accountancy are the rules and regulations by which the accountant lives. The historical cost accounting convention 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.

The historical cost accounting is the situation in which accountants record revenue, expenditure and asset acquisition and disposal at historical cost: that is, the actual amounts of money, or money's worth, received or paid to complete the transaction.

Historical costs

Historical cost is a generally accepted accounting principle requiring all financial statement items be based upon original cost. Historical cost means what it cost the company for the item. It is not fair market value. This means that if a company purchased a building, it is recorded on the balance sheet at its historical cost. It is not recorded at fair market value, which would be what the company could sell the building for in the open market.

Criticisms of the historical costs method

Historical cost method, over a period of time has been subject to many criticisms, especially as it considers the acquisition cost of an asset and does not recognise the current market value. Historical costs are only interested in cost allocations and not in the value of an asset. While it tells the user the acquisition cost of an asset and its depreciation in the following years, it ignores the possibility that the current market value of that asset may be higher or lower than it suggests.

Another main criticism of historical accounting method is its obvious flaws in times of inflation. The validity of historic accounting rests on the assumption that the currency in which transactions are recorded remains stable, i.e. its purchasing power remains the same over a period of time. Another main point with regards to inflation is rise in prices for an asset. An asset purchased at a point in time may be expensive in future. The traditional accounting principles record all assets at an original cost and continue to use these historic figures throughout the asset’s life, while economists make a more intelligible assumption that money has a time-value attached to it. The economist’s approach...
is broadly embraced in the corporate finance model whose objective is centred on value creation for the shareholders.

In addition effects of inflation may not be the same for all the companies in the market and historical cost accounts become almost unhelpful when comparing corporate performance.

Alternatives to historical cost accounting

Over the years accounting bodies have introduced a number of alternative accounting methods to historical cost accounting. Opportunity costs are commonly used in economics and do not have much relevance here, however accounting bodies and academic commentators have forwarded new methods of accounting using the current asset value, as opposed to the conventional acquisition cost.

Replacement costs could be used as a possible alternative to historical cost method. In crude terms replacement costs may be defined as the estimated amount that would have to be paid in order to replace the asset as the date of valuation. An advantage of replacement cost is that it focuses on the services the asset will provide rather than the precise physical asset.

However, there is an immediate flaw noted in its definition, where the costs have to be estimated. Estimation has to be carried out after reviewing the asset, the market and if an identical asset is still being traded in the market. While there are problems in simply achieving a precise replacement cost, this method also does not provide the various choices and features that historical cost accounting has to offer.

More accounting systems such as current cost accounting, exit price method, etc. are possible alternatives to historical cost accounting but these are also subject to manipulation to set a norm for measuring corporate performance.

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 resources 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. The alternative measures for measuring and reporting assets provide management with considerable discretion and opportunities to influence the value of assets reported. Critics admit that the possibility of manipulation exists, but the profession can formulate rules on how current values are to be ascertained. 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 dependent 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.

2.3 Conclusion

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 fool proof 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.