Historical cost vs current cost accounting method

Método contábil de custo histórico versus custo atual

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ABSTRACT

Historical cost accounting indicates that assets, liabilities, and equity are recorded at the value of the transactions issued to acquire them. In contrast, current cost accounting (CCA), also known as present value accounting, reflects the cost required to replace an asset in the current period. This replacement cost encompasses the expenses incurred in producing a product using the current methods, materials, and specifications. Data collection was performed using qualitative research literature review. This study will illustrate the fundamental differences between historical cost accounting and the current cost accounting basis. Despite the shortcomings of historical cost accounting, there are still greater benefits obtained through it. Based on the literature review, this research finds that historical cost accounting remains relevant in decision-making.

Keywords: historical cost accounting, current cost accounting, impact, financial statement.
RESUMO
A contabilidade de custos históricos indica que os ativos, passivos e patrimônio líquido são registrados pelo valor das transações emitidas para adquiri-los. Por outro lado, a contabilidade de custos atuais (CCA), também conhecida como contabilidade de valor presente, reflete o custo necessário para substituir um ativo no período atual. Esse custo de substituição engloba as despesas incorridas na produção de um produto usando os métodos, materiais e especificações atuais. A coleta de dados foi realizada por meio de uma revisão da literatura de pesquisa qualitativa. Este estudo ilustrará as diferenças fundamentais entre a contabilidade de custos históricos e a base contábil de custos atuais. Apesar das deficiências da contabilidade de custos históricos, ainda há maiores benefícios obtidos por meio dela. Com base na revisão da literatura, esta pesquisa conclui que a contabilidade de custos históricos continua sendo relevante para a tomada de decisões.

Palavras-chave: contabilidade de custos históricos, contabilidade de custos atuais, impacto, demonstrações financeiras.

1 INTRODUCTION

The emergence and growth of multinational-level companies, the expansion of international markets, and various changes in investor behavior are among the factors driving the internationalization process of economic activities, leading to the need to standardize international accounting standards (Prima, 2022). Accounting standards are crucial because without them, users of financial statements would have to study the accounting principles of each company before making comparisons with the financial statements of other companies.

Financial statements are prepared based on accounting standards applicable in a country. Financial statements prepared based on different accounting standards across countries complicate investors’ ability to compare the financial performance of companies globally (Sahputra et al., 2022). Especially in the current era of globalization with capital flows that know no national boundaries, the need for international accounting standards that can be compared has increased. This need is addressed by the implementation of the International Financial Reporting Standard (IFRS) as the international accounting standard.

IFRS was introduced to enhance the comparability of international financial statements. After the introduction of this new accounting regime, numerous studies have been conducted on the regulation of different accounting standards, testing the impact of IFRS on the quality of accounting information to ensure the relevance of accounting information for various purposes. These studies generally examine the impact of changes on the relevance of accounting information and report diverse findings.
The purpose of financial reporting is to provide accountability and decision-usefulness of financial statements conducted through both accrual and cash basis approaches. There are several accounting models for financial reporting, including Historical Cost Accounting (HCA) and Current Cost Accounting (CCA). For over a decade, accountants have systematically used historical cost accounting methods as a fundamental basis for measuring, recording, and reporting economic activities and related company activities (Rahmawati, 2006).

Historical cost accounting shows that assets and liabilities are recorded based on historical costs, not updated for price increases, considering that the value of a commodity will be affected by inflation. Costs are also recorded in the income statement based on the historical costs of goods sold or used, not replacement costs. Current costs are the costs needed to replace an asset in the current period. This includes the cost of producing a product with the methods, materials, and specifications currently used. Fair value and historical cost are not mutually exclusive; instead, these two concepts complement each other because each concept complements both strengths and weaknesses. Among all accounting values, the one most commonly utilized by companies is the historical cost accounting method (Daulay, 2020). This component can be proven true, as recorded in deeds proving ownership rights to a specific asset, such as deeds or debts. The historical cost-based accounting system is widely accepted by accountants because of its objective nature, supported by past transactions, and is generally easier to understand and accept by users (Biwas, 2019).

As the nature of financial statements is relevant and reliable, the application of historical cost accounting still receives criticism to this day because many elements in financial statements applying the historical cost principle do not directly reflect economic values, thus, the application of historical cost has its problems with the basic characteristics of financial statements.

Due to the limitations of historical cost, fair value emerges as a solution to overcome these limitations. However, whether fair value can meet the expectations of information users is a question. Tim Krumwiede, raised criticism against fair value; first, even well-intentioned management's fair value estimates will be wrong to some extent due to various predictions. Second, dishonest and opportunistic management can take advantage of valuations and estimates used in the manipulation process and sort those numbers to generate income in line with their desires (Krumwiede, 2008).
Current value accounting is considered superior to historical cost accounting because it provides a more up-to-date picture of market conditions, while historical cost accounting is assessed based on historical data (Biwas, 2019).

2 METHODOLOGY OF STUDY

This research employs a qualitative method known as literature review, which is a study conducted by collecting data or scholarly works through the examination and analysis of literature materials relevant to the core issues.

The steps in data collection include efforts to narrow down the research, gather information through both structured and unstructured observations, documentation, visual materials, as well as designing protocols to record information (John, 2017). The research process is carried out through the following stages: (1) selecting a general topic, (2) envisioning problem-solving, (3) brainstorming on the topic, (4) developing a research plan or strategy, (5) matching reference tools and searching for databases, (6) identifying and obtaining sources, (7) evaluating sources by research questions, (8) gaining insight based on reflection, and (9) formulating statements based on insights (George, 2008).

3 LITERATURE REVIEW

3.1 DEFINITION OF HISTORICAL COST

Historical cost is defined as an agreement within the accounting system. The principle of historical cost requires the use of acquisition prices in recording assets, liabilities, equity, and costs. Acquisition price is the price or exchange value agreed upon by the parties involved in the transaction (Suwardjono & Wantah, 2010).

According to Rouf Biswas, historical cost indicates that assets, liabilities, or equity are recorded at their initial acquisition value, whereas the current cost basis indicates that assets and liabilities are measured at their current value, where they can be sold or settled at the current date (Biwas, 2019).

3.2 DEFINITION OF CURRENT VALUE

Based on Financial Accounting Standard Board Concept Statement No. 7, it can be concluded that present value or fair value is the price that would be received in the sale of assets or the payment to transfer liabilities in an organized transaction between market participants at the measurement date. Present value is a market-based measurement. For some assets and liabilities, market transactions or observable market information may
provide market value. For other assets and liabilities, market value may not be available (Safira, 2020). However, the objective of fair value measurement in both cases is the same to estimate the price at which a regular transaction to sell assets or transfer liabilities occurs between market participants at the measurement date in the current market conditions, from the perspective of market participants who own the assets or liabilities.

3.3 CONCEPT OF CURRENT VALUE ACCOUNTING METHOD

Addressing the measurement issue, present value accounting provides information about the value of wealth and management by stating all assets and liabilities on the balance sheet as values to shareholders (Penman, 2007).

1. The balance sheet, or financial statement, serves as the primary medium for conveying information to shareholders.
2. Assets and liabilities are recorded on the balance sheet using present value, the book value of equity reports the equity value.
3. The income statement reports "economic income" as it represents changes in value over a period between previous periods.
4. Following the principle of economics that changes in value cannot predict future changes, current earnings cannot forecast future earnings. However, this does not apply to valuation, as the balance sheet provides the assessment.
5. Unexpected earnings, being a surprise to value, report on the risk of equity investment. Volatility and fluctuations in income provide informative value on risk.
6. The P/E ratio is Price/Shock-to-value, a realization of value on risk (with a very different interpretation for this compared to historical cost).
7. Income reports management's value addition for shareholders. In short, the balance sheet fulfills valuation purposes, and the income statement provides information on risk and management performance.

3.4 CONCEPT OF HISTORICAL COST ACCOUNTING METHOD

Historical cost accounting is often misinterpreted in the debates on the development of accounting methods today, with criticism that historical cost reports the balance sheet in an outdated manner. The background of historical cost accounting can be explained as follows (Penman, 2007):
1. The income statement is the primary means of conveying information about value to shareholders, not the balance sheet.

2. The income statement indicates how well a company has executed in price arbitraging, i.e., acquiring assets or liabilities in the input market and transferring or selling them in the output market. This concept involves historical cost earnings that report the value added from purchasing inputs, transforming them according to a business model, and selling them at a different price with the output price higher than the input price.

3. In contrast to fair value accounting, the historical cost accounting method can forecast future income where an assessment can be made.

4. The P/B ratio is generally not equal to 1.0, and the P/E ratio takes the existing current earnings as a basis and multiplies them by the forecasted future earnings.

5. Earnings do not report surprises for prices; surprises occur when there is an exchange in input and output market activities.

6. Earnings measure management's effectiveness in arbitraging input and output markets, adding value to the market.

Historical cost accounting views the value generated in business as purchasing inputs (from suppliers), transforming them according to a business plan, and selling products that, as a result (to customers), exceed the costs; in short, value is added by arbitraging (entry and exit) prices in the input and output markets for goods and services according to the business plan (Tiosanna, 2020). Historical cost accounting does not report the expected value from business planning but rather focuses on reporting the progress made in implementing the plan, recognizing the value added (earning) from actual transactions in the input and output markets being arbitrated.

3.5 MEASUREMENT OF CURRENT VALUE METHOD

FASB recently issued a draft on the measurement of fair value to develop consistency, reliability, and comparability with financial and non-financial assets and liabilities reported. It describes fair value as the "price at which assets and liabilities can be exchanged in an orderly transaction between knowledgeable, unrelated parties" (FASB 2004, para. 4). Because the goal of fair value measurement is to estimate the exchange price in the absence of an actual transaction, FASB grapples with the reliability of fair value measurement. The
reliability of these measurements is compared to the reliability of other measurements based on judgments and estimates, causing unreliable measurements. According to Suwardjono (Suwardjono & Wantah, 2010), fair value becomes the target of measurement with present value because fair value measurement fully captures all five elements (SFAC no.7, prg.23):

1. An estimate of future cash flows or, in some complex cases, a series of future cash flows arriving at different times.
2. Expectations about variations that might occur in the amount and timing of these cash flows.
3. The time value of money is indicated by the risk-free interest rate.
4. The price or value of risk-bearing or uncertainty inherent in an asset or liability.
5. Other factors including liquidity and market imperfections.

The reliability of fair value depends on the inputs in the measurement process. SFAS No. 157 provides a hierarchy of inputs for measuring fair value with three levels: level 1, level 2, and level 3 (Donleavy, 2016).

1. Level 1 involves observations from active markets, such as stock exchanges, for similar assets or liabilities. To broaden the measurement of fair value based on Level 1 market observations, most individuals would agree that reliable and readily available market media for observation is essential.
2. Level 2 inputs, which FASB prefers over Level 3 inputs, include all observable inputs other than Level 1 inputs. An example of a Level 2 input for an asset would be observed sales prices for a similar asset with quoted prices. Level 2 is situated in less active markets with less frequent trading than Level 1 markets.
3. Level 3 inputs are assets or liabilities that cannot be observed through the market due to little or no market activity. In many cases, Level 2 and Level 3 inputs are used to assess assets like long-term and intangible assets since Level 1 inputs may not be available for those markets. When Level 2 and Level 3 inputs are necessary, the reliability of fair value measurements is questioned. (Krumwiede, 2008).

Using forecasts, the reliability of this valuation technique is subject to criticism. Studies have found that Discounted Cash Flow (DCF) is the most commonly used valuation technique for goodwill. Additionally, in SFAS No. 144, FASB acknowledges a technique typically used to measure the present value of long-term assets. Let’s now focus
3.6 WEAKNESSES OF HISTORICAL COST

The weaknesses of using historical values according to Muljono include:

1. **Low Cost Burdening**: Specific events, like asset purchases, can result in a low cost burden, as the costs are based on a value set several periods ago during the recording of the expense.

2. **Inflation Impact**: Inflation may lower the recorded value of assets in the balance sheet compared to the recent purchasing power of money. Additionally, rapid changes in exchange rates for assets and liabilities in foreign currency exchanges controlled by the company can complicate accurate exchange rate differentials.

3. **Depreciation Allocation**: The allocation of costs for depreciation and amortization might be too low due to asset value growth, leading to an overestimation of profits.

4. **Profit/Loss Calculation Based on Stable Monetary Unit**: Profit and loss calculations, based on the assumption of a stable monetary unit, may not reflect the current economic state of the company when measured against the ongoing purchasing power developments.

5. **Failure to Show Real Capital**: The company may not reveal its real capital, and there is a tendency for cannibalism of capital related to corporate tax payments and the distribution of profits larger than necessary.

on DCF because of its widespread use in valuing the present value of long-term and intangible assets. In the April 2011 edition of the Young Accountant Bulletin, it is stated that there are three hierarchies in estimating fair value: using market value, comparing it with the market price of comparable items, and using estimates. Although the present value can be measured using the current market value, it does not necessarily mean that the present value is entirely the current market value. For certain items in financial statements that come from routine transactions (arm’s length transactions) and whose prices can easily be measured by market prices, the present value can be measured using the current market value. This type of fair value measurement is also called mark-to-market. However, for items whose market prices are not available, the present value is measured using a valuation model based on certain calculations and estimates. This type of fair value measurement is also called mark-to-model. Thus, the use of fair value can have subjective implications, especially concerning assessments.
6. Management Decision-Making Challenges: Management may face difficulties in making decisions based on financial statements if these decisions rely on accounting reports prepared with the assumption of a stable monetary unit (Muljono, 1999).

3.7 WEAKNESSES OF CURRENT VALUE

Although present value aims to overcome historical cost weaknesses, there are drawbacks to present value. According to Tim Krumwiede, there are some critical criticisms of present value:

1. Management's Estimates: Management’s estimates of present value can be wrong due to a wide range of predictions and assumptions that might be inaccurate in measuring present value.

2. Opportunistic Behavior: There is a risk of opportunistic behavior and dishonesty from management, taking advantage of assessments and estimates used in the manipulation process and sorting financial figures to achieve desired income figures (Krumwiede, 2008).

3.8 ADVANTAGES OF HISTORICAL COST

Advocates of historical cost in conventional accounting methods present several arguments:

1. Relevance in Economic Decision-Making: Historical cost is relevant in making economic decisions.

2. Based on Actual Transactions: Historical cost is based on actual transactions, not possibilities.

3. Usefulness Over Time: Historical cost-based financial statements have been useful throughout history.

4. Best Understanding of Profit Concept: The best understanding of the profit concept is the excess of the selling price over the historical cost.

5. Integrity Preservation: Accountants must preserve the integrity of data from internal modifications.

6. Usefulness Depends on Fair Value or Exit Price: The usefulness of financial statements depends on fair value or exit price.

7. Market Price Changes as Additional Data: Changes in market prices can be expressed as additional data.
8. Insufficiency of Data to Justify Historical Cost Rejection: There is an insufficiency of data to justify the rejection of historical cost accounting.

3.9 ADVANTAGES OF CURRENT VALUE

Penman argues for the advantages of present value:

1. Investors Focus on Value, Not Cost: Investors are concerned with value, not cost, so reporting present value is essential.
2. Relevance Over Time: Historical prices become irrelevant over time in assessing the financial position of an entity. The market provides up-to-date prices for a company's assets.
4. Reporting Economic Income: Widely accepted definitions, like the Hicksian definition of income as a change in wealth, support the reporting of economic income. Changes in the present value of net assets on the balance sheet result in income. Present value accounting offers a solution to accountants' problems in measuring income and is preferable to the hundreds of regulations underlying historical cost income (Penman).
5. Present value is a market-based measurement unaffected by specific factors for a particular entity; equivalently, it signifies an unbiased and consistent measurement from period to period and across entities (Penman, 2007).

4 CONCLUSION AND RECOMMENDATIONS

Financial reporting aims to provide accountability and decision-usefulness through accrual basis and cash basis financial reporting. Several accounting models exist for financial reporting, including Historical Cost Accounting (HCA), Current Cost Accounting (CCA), and the Exit-Price model. The historical cost measurement basis is straightforward to apply as it can be validated and offers benefits because values are based on acquisition. The application of historical cost accounting is still permitted by current national and international financial accounting standards. However, its continued application receives criticism due to the elements in financial statements applying historical cost principles that do not directly reflect economic value.

Historical cost accounting does not report the expected value of business planning outcomes but focuses on reporting progress made in plan execution, recognizing added
value (earnings) from actual transactions in input and output markets as a trading strategy to profit from price differences across multiple markets.

Present value becomes a measurement target because it captures the full essence of the five elements. There are three hierarchies in estimating present value: using market value, comparing with market prices of comparable items, and using estimates. The use of present value can have subjective implications, especially concerning assessments. Criticisms of present value include potential errors in management estimates due to wide-ranging predictions and incorrect assumptions. Additionally, opportunistic and dishonest management may take advantage of assessments and estimates in manipulating financial figures to achieve desired income figures.

Future researchers may consider using samples from various business sectors, such as industry and banking, to compare the application of historical cost accounting and present value in financial statement preparation. Furthermore, researchers are encouraged to explore alternative methods to enrich the literature on historical cost accounting and present value in financial statement preparation.
REFERENCES


