AF 301
Financial Accounting II
Historical Costing

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‘Historic cost accounting is the worst possible accounting convention, until one considers the alternatives.’

1. INTRODUCTION

The most commonly encountered accounting convention is the “historical cost accounting”. The creation of this accounting convention can be traced to the work of a Franciscan monk by the name of Pacioli in the year 1494.
Historical cost accounting sets prices on the basis of original costs, where the cost of assets is measured by their depreciated historic cost. Therefore, no account is taken of changing prices in the economy under historical cost accounting.
Over time, numerous other accounting theories have been developed by a number of well respected scholars and historical cost accounting has been criticised on the basis that it has too may shortcomings, with particular emphasis on its failing to provide useful information in times of rising prices. However, many of the proposed methods have been rejected by the accounting profession.
In the following section we mainly consider and assess the advantages and limitations of historical cost accounting with respect to some other prescriptive theories of accounting that have been advanced by various people. A final section concludes, summarise the findings and introduce some directions for future research.

2. THE LIMITATIONS OF HISTORICAL COST ACCOUNTING

As the traditional method of accounting, historical cost accounting has been used with variations over the past centuries. It uses valuations that rest upon recordable facts about prices paid for assets in the past or amounts agreed to be owing to, or owed by, a business. There are some problems in defining the time of the assets being bought or sold or when they can be agreed to have risen in value, but these can be solved by relying on the actual external transactions. This way of adding up the assets has been commonly used because it is simple, objective and prudent.
However, since 1920s, criticisms of historical cost accounting have been raised by some notable scholars such as Sweeney, MacNeal, Canning and Paton. From the 1950s the level of criticism increased by well-known academics such as Chambers, Sterling, Edwards and Bell. Different new models of accounting were developed and such work continued through to the early 1980s. Although it declined with the levels of inflation dropping throughout the world, the debate carries on.
It has been argued that historical cost accounting information suffers from problems of relevance in times of rising prices because it assumes that money holds a constant

purchasing power. As Elliot (1986) states:

An implicit and troublesome assumption in the historical cost model is that the monetary unit is fixed and constant over time. However, there are three components of the modern economy that make this assumption less valid than it was at the time that model was developed.

One component is specific price-level changes, occasioned by such things as technological advances and shifts in consumer preferences; the second component is general price-level changes (inflation); and the third component is the fluctuation in exchange rates for currencies. Thus, the book value of a company, as reported in its financial statements, only coincidentally reflects the current value of assets.

This quote outlines the main focus of the debate. Historical cost accounting information suffers from problems of relevance in times of rising prices. The current cost of asset could be considerably different from the amount many years ago. The logic behind the additivity has also been questioned. In other words, is it logical to add together assets acquired in different periods when those assets were acquired with different purchasing power?

3. THE ALTERNATIVES UNDER CONSIDERATION

3.1 CURRENT PURCHASING POWER ACCOUNTING

Current purchasing power accounting (or as it is also called, general purchasing power accounting; general price level accounting; or constant dollar accounting) can be traced to the early works of such authors as Sweeny (1936). It was developed on the basis of a view that in times of rising prices, using historical cost accounting distribute unadjusted profits could result in a reduction in the real value of an entity. Current purchasing power accounting (CPPA) solves this problem by using historical cost accounts as a basis, but restating the changing prices by use of particular price indices. This approach has been favoured by a number of researches and also supported by professional accounting bodies throughout the world from 1960s to mid-1970s. For example, the Accounting Principles Board supported the practice in Statement No. 3. The advocates of this method have claimed that it is easier and less costly to apply than other accounting methods that rely upon current valuations of assets.

According to CPPA, it is necessary to deal with monetary assets and non-monetary assets separately in times of changing in the purchasing power of money due to inflation. Monetary assets are defined as assets that remain fixed in terms of their monetary value such as cash and accounts receivable. Whereas non-monetary assets are assets whose monetary equivalents will change over time as a result of inflation, and they include such things as plant, equipment and inventory. In times of inflation, monetary assets holders tend to lose in real terms, as the assets will have less purchasing power compared with that in the beginning of accounting period. On the other hand, holders of monetary liabilities will gain as the amount they have to pay at the end of the period will be worth less compared to what it was at the beginning of the period. It is stressed that under current purchasing power accounting, no change in

the purchasing power of the entity is assumed to arise as a result of holding non-monetary assets. As stated in Provisional Statement of Standard Accounting Practice 7 (PSSAP7), issued in the United Kingdom in 1974:
Holders of non-monetary assets are assumed neither to gain nor to lose purchasing power by reason only of inflation as changes in the prices of these assets will tend to compensate for any changes in the purchasing power of the pound.
Generally, gains or losses on monetary items are advised to be included in income under current purchasing power accounting. And all the adjustments should be applied to accounts prepared under the historical cost accounting at the end of the accounting period.
One main strength of CPPA is its ease of application. The method relies upon data that would already be available under historical cost accounting, thus it saves the cost and effort to revaluate the current value of the various non-monetary assets. It is mainly accepted by people who find it too costly and perhaps unnecessary to attempt to find current values for all the individual assets.
However, limitations of CPPA are obvious.
First, price movements involved in the goods and services of specific industries may not be appropriately reflected by the price index chosen. Not everybody has the same consumption patterns as is assumed when constructing a particular index and further, different industries may be affected differently by inflation. Therefore, the choice of an index can be highly subjective.
Second, the information generated under CPPA might be misleading to users. It is possible that they consider the adjusted amounts as the reflection of specific value of specific assets. However, because the general price index is applied to all assets, this will rarely be the case.
Third, various studies have failed to generate support to prove that information gathered under CPPA is relevant for decision making.

3.2 CURRENT COST ACCOUNTING

Following the initial acceptance of current purchasing power accounting in 1970s, the accounting profession tended to favour current cost accounting, which is a more recent idea and is more complicated compared with historical cost accounting. It addresses many of the problems associated with historical cost accounting, particularly in times of inflation. Notable advocates of this approach have included Paton, Edwards and Bell. In 1980 the Accounting Standards Committee issued SSAP 16 which required supplementary disclosure of current cost data (SSAP was withdrawn in 1985).
The main asset valuation bases used within current cost accounting are replacement cost, net realisable value (i.e. the net present value of the particular asset) and economic value. Depending on the circumstances, a choice have to be made concerning which base to use for valuing a particular asset at its current value.

3.2-1

The replacement cost (RC) model is proposed by Edwards and Bell. They adopt a

physical capital maintenance approach to income recognition and assess income and value by reference to entry costs or current replacement costs of materials and other assets utilised within the business entity. In short, it treats holding gains or losses as operating income, which represents the difference of realized revenue and the replacement cost of the asset in question. This approach is considered to be generating a measure of income that represents the maximum amount that can be distributed, while maintaining operating capacity intact.

In undertaking Edwards and Bell approach of current cost accounting, adjustments are normally made at year ending using the historical cost accounts a the basis of adjustments. When using this method, operating profit is derived after ensuring that the operating capacity of the business is maintained intact. Holding gains are excluded from the calculation of operating profit and are not made available for dividends. This is because holding gains are deemed to be different trading income as they are due to market-wide movements, most of which are beyond the control of management.

As with current purchasing power accounting, the replacement cost model described above has been identified as having a number of strengths and weaknesses. It is claimed that differentiating operating profit from holding gains and losses can enhance the usefulness of the information being provided. Separation of holding gains and losses from other results can provide a better insight into management performance as such gains and losses are due to impacts generated outside the organisation.

On the other hand, however, it is argued that acquiring assets in advance of price movements might be part of efficient operations. The rationale for replacement cost is also being questioned. Another potential limitation is that it is usually difficult to determine replacement cost.

Chambers, a scholar who supports current cost accounting based on exit values has criticised upon the replacement cost accounting by stating that:

In the context of judgement of the past and decision making fo r the future, the products of current value accounting of the Edwards and Bell variety are irrelevant and misleading.

He and some others prescribed an alternative accounting model under current cost accounting — exit price accounting.

EXIT PRICE ACCOUNTING

The exit price accounting model is based on the economists' concept of opportunity cost. It is a model that has had strong academic support, most notably in Australia from Professor Ray Chambers who referred to this approach as Continuously Contemporary Accounting (CoCoA). According to Chamber, the accounting method on valuing assets should be based on their net selling prices (exit prices) at balance date and on the basis of orderly sales. He used the term current cash equivalent to refer to the cash that an entity would expect to receive through the orderly sale of an asset, and he had the view that information about current cash equivalents was fundamental to effective decision making. Consistent with this view, Chamber states:

Excluding all past prices, there are two prices which could be used to measure the

monetary equivalent of any non-monetary good in possession: the buying price and the selling price. But the buying price, or replace price, does not indicate capacity,…whereas the selling price does. We propose, there fore, that the single financial property which is uniformly relevant at a point of time for all possible future actions in markets is the market selling price or realisable price of any goods held. …What men wish to know, for the purpose of adaptation, is the numerosity of the money tokens which could be substituted for particular objects and for collections of objects if money is required beyond the amount which one already holds.

Thus Chambers has made a judgement about what people need in terms of information. He focuses on new opportunities — the ability or capacity of the entity to adapt to changing circumstances and the most important item of information to evaluate future decisions is, according to Chambers, current cash equivalents. He also makes an assumption that the objective of accounting is to guide future actions. Capacity to adapt is the key and the capacity to adapt to changing circumstances is dependent upon the current cash equivalents of the assets on hand. The higher the current market value of the assets on hand is, the greater is the ability of the organisation to adapt to changing circumstances.

Unlike that in the replacement cost accounting, profit is directly tied to the increase or decrease in the current net prices of the entity's assets in exit price accounting. No differentiation is made between realised and unrealised gains but all gains are treated as part of profit.

A number of strengths and weaknesses have been associated with exit price accounting. Advocates of exit price accounting have argued that by using one method of valuation for all assets the resulting numbers can logically be added together. And there is also no need for arbitrary cost allocations for depreciation as depreciation will be based on movements in exit price.

However, exit price accounting has never gained widespread acceptance. If it is implemented it would lead to a fundamental and major shift in financial accounting and this could result in many unacceptable social and environmental consequences.

The relevance of exit prices has also been called into question. Particularly when the selling of assets is not expected.

CURRENT TRENDS

In the late 1970s and early 1980s many accounting professions issued recommendations that favoured disclosure based upon a mixture of current purchasing power accounting and current cost accounting. Despite of this, there were also many who supported historical cost accounting. Following the falling inflation since mid-1980, accounting standard-setters throughout the world have switched away from issues associated with accounting in times of rising prices. This phenomenon can be explained by considering the advantages of historical cost accounting and the limitations of its alternatives.

Many organization opposed introduction of alternative methods to historical cost accounting because of self-interest. Under historical cost accounting, management has a mechanism available to manage its reported profitability. Holding gains might not

be recognized for income purposes until such time as the assts are sold. If alternatives were introduced, this ability of manipulate reported results could be lost.

Alternative models of accounting might not be favoured by analysts either. The accounting profession, like some researchers, questioned the relevance of the accounting information adjusted to take account of changing prices particularly in times of lower inflation. As mentioned earlier in this essay, there is some evidence that information might not be relevant to the decision making processes of those parties involved in the capital market.

Besides, accounting standard setters are concerned that a dramatic change in the accounting conventions might cause widespread disruption and confusion in the capital market and therefore might not be in the public interest.

It has also been speculated that the adoption of a new method of accounting could have consequences for the amount of taxation that the government ultimately collects from businesses.

CONCLUTION

The purpose of this essay was to assess the historical cost accounting and its alternatives. As we have seen, historical cost accounting has a number of drawbacks particularly in times of rising prices. Its two most widely accepted alternatives, current purchasing power accounting and current cost accounting, set out to solve the problem. Current purchasing power accounting uses historical cost accounting as basis along with the price index. Its main attraction lies in its ease to implement and less costly. Under current cost accounting there are two types of accounting methods: replacement cost accounting and exit price accounting. Replacement cost accounting differentiates operating profit from holding gains and losses and uses the business profit to show how the entity has gained in financial terms from increase in cost of its resources. Exit price accounting The method of accounting predominantly used today is based on historical cost accounting. Hence the accounting profession and reporting entities have tended to maintain the support for this approach.

WORD COUNT

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