Historical cost accounting is the worst possible accounting convention, until one considers the alternatives.' Discuss.

Introduction

Accountants use **historical cost** in preparing accounts. This is a simple concept that means that the data you see on say a balance sheet is recorded at the historical cost. The historical cost is therefore the cost at the time the company or entity completed the transaction. Historical cost accounting is therefore the opposite of current cost accounting. Current cost accounting would record account transactions at the current (the cost at the time the financials were prepared) cost.

There are two categories into which methods of valuing assets may put: historical cost accounting and current cost. The historical cost system uses valuation that rest upon recordable facts about précis paid for assets in the past or amounts agreed to be owing to, or owed by a business. There are some problems in defining when assets have been bought or sold or when they can be agreed to have risen in value, but these are usually resolved by relying on the evidence of actual external transactions. This way of adding up the assets has been used with variation over the past centuries, because it is usually simple, objective and prudent.

Current value accounting is a more recent idea and more complicated, however, it addresses many of the problems associated with historical cost accounting, particularly in times of inflation. The main assets valuation based used within current valuation bases used within current valuation accounting are replacement cost, net realisable value and economic value. Depending on the circumstances, a choice must be made concerning which base to use for valuing particular assets at its current value.
A useful method of doing this to consider what the deprival value of the assets is. The value to the business of any assets may reasonably said to be the maximum amount that the business would lose if it lost the assets – in other words the deprival value of the assets. The prices meaning given to deprival value and the ways in which the three bases of valuation are used will depend on which system of current value accounting is chosen. It can easily be seen that, although involve much more subjectivity than historical cost valuations. In practise, as well shall see, it is possible to introduce some convention to narrow the range of choice.

Over time, criticisms of historical cost accounting have been raised by a number of notable scholars, particularly in relation to its ability to provide useful information in times of raising prices. For example, criticism has been raised by Sweeny, McNeal, Canning and Paton in the 1920s and 1930s. From the 1950s the level of criticism increased, with notable academics prescribing different models of accounting that they considered provided more useful information than was available under conventional historical cost accounting. Historical cost accounting assumes that money holds a constant purchasing power.

Some of the 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 makes this assumption less valid than it was at the time the model was developed. One component is specific price-level changes, occasioned by such things as technological advances and shifts in consumer preference; 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.

However there were also many who supported historical cost accounting. As we would appreciate, 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. The very fact that historical cost accounting has continued to be applied by business entities has been used by a number of academics to support its continued use.

According to Chambers, 1996 it has been argued that historical cost accounting information suffers from problems of relevance in times of rising prices. That is, it is questioned whether it is useful to be informed that something cost a particular amount many years ago when its current value might be considerably different. At issue is whether it is logical to add together assets acquired in different periods when those assets where acquired with dollars of different purchasing power.
In number of other countries, organisations are permitted to revalue their non-current assets. However, is that different assets are revalued in different periods, yet the revalued assets might all be added together, along with assets that have continued to be valued at cost, for the purposes of balance sheet disclosure.

Historical cost accounting do not take account of changing prices, such accounts can tend to overstate profits in times of rising prices, and that distribution of historical cost profit can actually lead to an erosion of operating capacity. It has also been argued that historical cost accounting distorts the current years operating results by including in the current years income holding gains that actually accrued in previous years. For example, some assets may have been acquired at a very low cost in a previous period, yet under historical cost accounting, the gains attributable to such actions will only recognised in the subsequent periods when the assets are ultimately sold.

There is a generally accepted view that dividends should only be paid from income. However, one central issue relates to how we measure income. Income can be variously defined. One famous definition was provided by Hicks, that is, that income is the maximum amount that can be consumed during a period while still expecting to be as well off at the end of the period. Any consideration of "well offness" relies upon a notion of capital maintenance. Different notion will provide different perspective of income. There are a number of perspectives of capital maintenance. One of the versions of capital maintenance is based on maintaining financial capital intact, and this is the position taken in historical cost accounting. Another perspective of capital maintenance is one that aims at maintaining purchasing power intact. Under this perspective, historical cost accounts are adjusted for changes in the purchasing power of the dollar which, in times of rising prices, will lead to a reduction in income relative to income calculations under historical cost accounting the historical cost of

an Item is adjusted by multiplying it by the chosen price index at the time the assets was acquired.
Current value accounting is made under another approach to accounting which seeks to provide a measure of profit which, if distributed, maintains physical operating capital intact. This approach of accounting relies upon the use of current values, which could be based on present values, entry prices, or exit prices.

Current purchasing power accounting (or 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) and has been favoured by a number of other researchers. Current purchase power accounting (CPPA) has also, at various times, been supported by professional accounting bodies throughout the world (but more in the form of supplementary disclosure to accompany financial statements prepared consistent with historical cost accounting principles.)

CPPA was developed on the basis of a view that in times of rising prices, if an entity where to be disturbed unadjusted profits based on historical cost, the results could be a reduction in the real value of an entity-that is, in real terms the entity could otherwise distribute part of its capital. In considering the development of accounting for changing prices, the majority of research initially related to restating historical cost to account for changing prices by using historical cost accounts as the basis, but restating the accounts by use of particular price indices. The literature then tends to move towards current cost accounting which changed the basis of measurement to current values as opposed to restate historical values. Consistent with this trend, the accounting profession initially tended to favour price-level adjusted accounts, but tend to switch to current cost accounting which required entity to find the current values of the individual assets held by the reporting entity.

Current purchasing power accounting with its reliance on the use of indices is generally accepted as being easier and less costly to apply than methods that rely upon current valuation of particular assets. It was initially considered by some people that it would be too costly and perhaps unnecessary to attempt to find current value for all the individual assets. Rather than considering the price changes of specific goods and services, it was suggested on practical grounds that price indices be used.
When applying general price level accounting, a price index must be applied. Price index is a weighted average of prices in prior period, often referred to as a base period.

When applying CPPA, all adjustments are done at the end of the period, with the adjustment being applied to accounts prepared under the historical cost convention. When considering the changes in the value of assets as a result of changes in the purchasing power of money it is necessary to consider assets are those monetary assets and non-monetary assets separately. Monetary assets are those assets that remain fixed in terms of monetary value. These assets will not change their monetary value as a result of inflation. Non-monetary assets can be defined as those assets whose monetary equivalent will change over time as a result of inflation, and would include such things as plant and equipment and inventory.

One of the main strength of CPPA is its ease of application. The methods relies on data that would already be available under historical cost accounting and does not

require the reporting entity to incur the cost or effort involved in collecting data about the current values of the various non-monetary assets. CPI data will also be readily available. However, and as indicated previously, movements in the prices of goods and services included in a general price index might not be reflective of price movements involved in the goods and services involved in different industries. That is different industries may be impacted differently by inflation.

Some of the limitations are that the information generated under CPPA might actually be confusing to users. They might consider that the adjusted amount reflect the specific value of specific assets. However, as the same index is used for all assets, this will rarely be the case.

Current cost accounting:

Current cost accounting is one of the various alternatives to historical cost accounting that has tended to gain the most acceptances. Unlike historical cost accounting, CCA differentiates between profits from trading and those gains those results from holding assets.

Holding gains can be considered as realised or unrealised. If the financial capital maintenance perspective is adopted with respect to the recognition of income, then holding gains or losses can be treated as income. Alternatively they can be treated as capital adjustment if a physical capital maintenance approach is adopted. Some version of CCA, such as that proposed by Edward and bell, adopt a physical capital maintenance approach to income recognition. In this approach which determines the valuation on the basis of replacement cost, operating income represent realised revenues, less the replacement cost of the assets in question. It is considered that this generates a measure of income that represents the maximum amount that can be distributed, while maintaining operating capacity intact.

In under taking current cost accounting, adjustments are usually made at year end using the historical cost accounts as the basis of adjustments. If we adopt Edwards and Bells approach to profit calculation, operating profit is derived after ensuring the operating capacity of the organisation is maintained intact. Edwards and Bell believe operating profit is best calculated by using replacement cost. In calculating operating profit, gains that accrue from holding assets are excluded and made available for dividends although when they are included when calculating what is referred to as business profit. In relation to non-current assets, for the purposes of determining current cost operating profit, depreciation is based on the replacement cost of the assets.

Unlike historical cost accounting, there is no need for inventory cost flow assumptions. Business profit shows how the entity has gained in financial terms form the increase in cost of its resources which was ignored in historical costing.

The current cost operating from holding gains and loses, and the realised holding gains are both tied to the notion of realisation, and hence the sum of the two equate to the historical cost profit. Differentiating operating profit from holding gains and loses

has been claimed to enhance the usefulness of the information being provided. Holding gains are deemed to be different to trading income as they are due to market wide movements, most of which are beyond the control of management.

According to Edwards and Bell, these two kinds of gains are often the results of quite different decisions. The business firm usually has considerable freedom in deciding what quantities of assets to hold over time any or all stages of production process and what quantity of assets to commit to the production itself. The difference between the forces motivating the business firm to make profit by one means rather than another and the difference between the events on which the methods of making profits depend require that the two kind of gain be separated if the two types of decisions involved are to be meaningfully evaluated.

The current purchasing power accounting and current cost accounting have a number of strength and weaknesses. Some of the criticism relates to its reliance on replacement values. The CCA model uses replacement values, if the market is prepared to pay the replacement cost, a dif we assume rationality, then the amount paid must be a reflection of the returns it is expected to generate.

Current cost accounting is that it is often difficult to determine replacement costs. This approach also suffers from the criticism that allocating replacement cost via depreciation is still arbitrary, just as it is with under historical cost accounting.

An advantage of current cost accounting is better comparability of various entities performance, as one entities profit are not higher simply because they bought assets years earlier and therefore would have generated lower depreciation under historical cost accounting.

Current cost accounting is a system designed to adjust accounting for changes in prices that affects a company's assets. However, the more usual convention is historical cost accounting.

Statement of financial Accounting Standards No. 33 "Financial Reporting and Changing Prices" Disclose both historical cost and current cost-constant purchasing power disclosures. These disclosures were to supplement rather than replace historical cost-as the basic measurement framework for primary financial statements.

The big advantages of Historical cost accounting are that it leads to absolute certainty and it fits in perfectly with the cash flow statement. HCA tells us exactly what has been paid and what has been received and therefore there is no doubt about balance sheet amount the alternatives where accountant attempts to take inflation in accounting, can lead to many problems.

The disadvantages of Historical cost accounting include the fact that HCA values can relate to transactions that could be a year old, 10 years old as much as 100 year old. It is true some business have old equipments and old stocks that are still working well but that were bought a long time ago. The problem is that the acquisition value may be out of date and so the balance sheet is showing out of date value. Taxation problem

come with inflation accounting. In time of high levels of inflation, profits are inflated and therefore the tax bill tends to increase; and this is one of the reason inflation accounting was developed in U.K and in other countries.

Conclusion:

The more usual convention is Historical cost accounting, companies end up using historical cost accounting because it leads to absolute certainty and it fits in perfectly with the cash flow statement. The alternatives to historical cost accounting such as, Current cost accounting, Purchasing power accounting and so on have not survived, the reason the alternatives have not survived, and IAS 15 on inflation accounting is about to be replaced, if it has not been already, is that no one can agree on the best way to represent account values. Historical cost accounting provides definite values, and the other methods don't. Thus companies ends up using historical cost accounting than its alternatives.

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