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Accounting in Historical Costs – since when and until when?

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Abstract

The financial accounting has been thoroughly developed, the accounting methods and instruments applied internationally having been slowly appropriated, to the point that nowadays they have been taken over and successfully implemented by the vast majority of Romanian economic entities. We can say today, that, as a result of a thorough analysis of the economic environment in our country for the last twenty years, it is perceptible a change in the attitude and mentality of the people in general and of the accounting specialists in particular. These changes constitute a cause and a challenge at the same time, for any researcher passionate about the financial field of accountancy - of bringing some added value in an area as contradictory as the asset evaluation.

Key words: historical cost, evaluation, accounting information, accounting reporting
J.E.L. Classification: G3; G32; G34

1. Introduction

The accounting is a technique or in its contemporary dynamics, a techno-science that has continuously evolved. The double entry method, a basic method of the accounting technique has its origins in the Middle Ages. In the accounting theory and practice there have been proposed several bases of assessment, including: historical cost, current cost, achievable value, present value, fair value. The question is which of these evaluation bases will be chosen taking into consideration the advantages and disadvantages of each. Finally, the accounting standard setters have concluded that in the measurement and disclosure of the accounting information, the most appropriate would be the historical cost, because of the advantage given by its reliability, by the clarity of definition, by the verifiability.

Thus, the accounting in historical costs was developed in the nineteenth century as a result of the industrial revolution, but it has its origins in the XV th century, when it was first used in the textile factories. Gradually, the precautionary principle begins to be introduced in accounting, such that, currently, we can not talk of historic costs in accounting without bringing it into discussion. Savary is among the first authors to introduce in accounting aspects related to the principle of prudence.

Therefore, *the historical cost* is the cost of origin – assessed, measured and recorded at the entry of the assets in the entity and at the creation of debt, being the consequence of two fundamental principles: monetary nominalism principle and the precautionary principle.

The principle of monetary nominalism ignores the fluctuations in value of the monetary unit and requests the evaluation of the assets acquired, for consideration, at acquisition cost - of the assets obtained from own production, at production cost, of debt and liabilities at face value. Once determined, the historical cost remains fixed as long as the property is held by the entity.

The precautionary principle requires the accounting of potential value minuses and prohibits the accounting of the dormant positive differences related to assets. Thus, the assets remain recorded at the historical cost if they increase in value, otherwise the assets are valued at the amount of inventory according to Romanian regulations or to its recoverable amount or to the net achievable value in compliance with IFRS standards.

While the first action is simply a "cosmetic" change, the second one is real and costly and it can be in contrast with the interests of the shareholders who want to avoid the existence of hidden reserves. However, there are users of accounting information, such as credit institutions, that agree with the historic costs accounting, partly due to these hidden reserves. The historical cost continues to be for accountants, the basic agreement when it comes to choosing between different accounting treatments. In order to be able to rely on the information provided by manufacturers, both external and internal users must ensure that the information is verifiable and objective. And just the use of the historical cost as basis of measurement allows the manufacturers to provide financial statements, verifiable and objective information.

The historical cost is oriented towards the past, but, unlike the other bases of assessment, it presents a great advantage: it is clearly defined and ascertainable; once established it remains fixed as long as the property is in possession of the entity. Given these advantages, it seemed that nothing could happen to the historical cost. Then which is the great disadvantage that makes obsolete the historical cost value? The answer is: *the inflation*. The determination of the basis of measurement, used for finding various patrimonial elements in the synthesis documents represented one of the most difficult problems of accounting.

In the accounting theory and practice there were accredited more measurement bases: *the replacement cost, the net achievement value, the economic value and the historical cost (diminished by amortization and provisions, if any).* The question is which of these bases should be used by an accountant? The producers and users of background papers estimated that more useful would be *"the historical cost"*. This cost has a great advantage over all the other bases, advantage given by *"its reliability"*.

In conclusion, the historical cost is a consequence of the assessment of the various assets and liabilities at the date of their entry in the patrimony. They are valued as follows: goods entered for pecuniary interest (for payment), **at acquisition cost**; goods produced by the enterprise, **at production cost**; incoming goods free of charge, **at utility value**; assets and liabilities **at their nominal value** (stipulated in the contract, order, invoice or any other document).

2. Pros and cons of historical cost

The ability to achieve a proper assessment is in fact the key to success in financial services, since in order to "buy" or "sell" a financial instrument, it is imperative to know its value. Also, after the purchase of a financial asset or the contracting of a financial liability, the evaluation represents "the success in the risk management involved by this element, but also in the reporting of the value created, for the shareholders of an economic entity ". The global economic crisis "revealed" a big problem regarding the evaluation of financial reporting. The problem consists in the lack of provision of necessary information known by investors, lack that would have stopped even the best evaluation technique, to generate a significant level of accuracy.

The transition from an accounting based on historic costs to one based on fair value was classified as a conceptual revolution in accounting. We are increasingly witnessing, nowadays, a restatement of the accounting model over the value, from the specialists in this field, in terms of reconsidering the fundamental principles of evaluation. We notice in the daily practice, the aspect according to which accounting tends to evolve from the system of istorical cost to that of current value, that constitutes in fact the cause of frequent scientific disputes between specialists with opposing opinions regarding the means of evaluating the assets of an economic entity, in the current context.

Thus, the supporters of fair value measurement are against applying further evaluation to the historical cost, arguing this point of view by the fact that, the evaluation at historical costs provides a distorted picture of reality, respectively the balance sheet items are undervalued and the expenses, with the stocks and the amortization, in the income and loss account, are also undervalued, while the fair value evaluation aims to improve the quality of the financial statements and attempts to provide reliable and relevant information to all the users. In the first case, the result is overvalued and its distribution leads to distributions of capital.

We must highlight some issues regarding the fair value measurement, consisting of the situation when there is an absence of adequate information on the financial statements, in the explanatory notes, this can be more dangerous than the evaluation at historical cost, leading to a high volatility of the financial result of the economic entity which applies it, unaware of the risks that may arise, due to the inclusion in the result, of some "virtual" elements, generated by market developments, which are potential gains or losses.

Following the impossibility to agree on one or the other, the specialists have reached a consensus regarding the application in the future of both measurement bases, as:

1. The historical cost - which is a fair amount to the initial value (input);
2. The fair value - that is a basis for further evaluation, in relation to its initial one (for financial reporting purposes).

And one of the main features of accounting, implicitly of the balance sheet / the financial situation position is "to express everything by monetary standard, namely to ensure the generalization of data by bringing certain heterogeneous elements, to a common denominator, through currency ".

In fact, a proper evaluation is particularly important for accuracy, honesty and timeliness of the information contained in the balance sheet, regardless of whether it is used to reflect the situation (wealth) of the company or to determine the outcome of the exercise. Under current conditions, the issue of the evaluation is even more important as the financial statements become an information element of first degree. The extension and intertwining of the relationships between companies - most often on the international market imposes an accuracy and correctness of the informational data included in the financial statements because, based on this information, it is assessed the economic and financial situation, and the efficiency of the economic activity of these units, and according to them are defined the relations between economic entities.

The advantages of the fair value, which was favored by the development of capital markets and by the improvement of the methods of processing information, are against the historical cost. Thus, the fair value as measurement basis has the most supporters, especially in the countries with economies focused on the capital market, under which it has the following advantages:

• allows obtaining more reliable financial statements

In the context of the characteristics of the accounting information, the fair value is relevant and reliable, in the sense that it represents the measurement instrument for which there can be obtained very reliable information, for example, "the fair value allows a reliable accounting treatment for the currency hedging operations ".

• provides greater objectivity and accounting neutrality

The fair value does not allow the excess of creative accounting, from the management, while the historical cost is based on subjective estimates, subject to the entity's manager regarding the corrections to be made to the records, regarding the adjustment of the depreciation related to assets.

• allows a better comparability of the fungible assets, especially of the financial instruments

Regardless of the original date of their registration into accounts, the fungible assets are converted into actual values.

• it allows a "more economical" vision on the assets and the capital attracted by the entity

Their fair value is oriented towards forecasting, facilitating an assessment of entity and reflecting *the opinion of the markets, better translates the present value of future cash flows* which helps in the decision making process.

With all the advantages of fair value presented, however it presents some **disadvantages** among which the most representative are:

• it does not always provide reliable information

If we take the example of the present value, it is necessary to estimate the lifetime of the asset, its residual value, the cash flows it will generate in time, respectively the discount rate. The estimates are, by nature, subjective. To this, it can be added the deliberate distortion of some parameters. Thus, the valuation model induces an inherent risk, and another one related to the deliberate manipulation of information. Of course, in order to mitigate this criticism of the models for determining the fair value, there can be remembered the ways of diminishing the risk of the model, that would be effective, namely the establishment of some provisions for this type of risk.

• it does not allow the reflection of the value of intangible assets

In this case, some of the assets of this type have not been the subject of accounting records, but they have contributed significantly to the overall value of the business. Examples in this case are: *the qualification and motivation of the staff, the competence of the managers, the quality of good payer of the entity.*

However, it is difficult for the accounting standards and the standard setters to succeed to comply the interests of all users. Although it declares its openness towards all user groups, even IASB favors the investors, in relation to whose requirements, they considered these norms. The same applies to FASB, ot the two normalization bodies are, in fact the promoters of the fair value, the proponents of shareholder value and of the importance of the capital markets that are formed and of the reported value. Europeans are more skeptical about the usefulness of the fair value for other categories of users of the accounting information.

Following the arguments against it, it is unlikely for the fair value to be applied within an accounting system in its own right, especially in terms of losing confidence in the capital markets, observed in recent years, exacerbated by the global economic crisis. This is because the fair value is an emanation of the capital market. Even taking in consideration the advantages offered by the fair value system, that are weighed with the disadvantages, it can not be stated with certainty that this is superior to the historical cost system. The latter has an undeniable advantage - that of being known and therefore mastered. The content of the current accounting rules confirms this by providing a combination of fair value and historical cost as evaluation methods: the historical cost and the prudence to calculate the distributable result, and the fair value to calculate the overall result that reflects the creation of wealth for shareholders.

3. The fair value in the current economic climate

To measure an asset at fair value means to assign, as value, the amount for which it could be exchanged freely between the parties previously informed, in a transaction with the objectively determined price. The fair value is most often a market value determined according to the recorded data of the market, through an evaluation, usually by professionally qualified appraisers.

If there is no data available on the market concerning the fair value, because of the specialized nature of the assets and of the low frequency of transactions, the fair value can be determined by other methods, typically used by professionals in the evaluation. The estimated fair value is required for:

- the evaluation of the assets received free of charge or ascertained as plus in the inventory;
- the assessment, in order to report in the balance sheet the tangible assets if the entity uses the fair value model;
- the assessment, in order to report in the balance sheet, the short-term financial investments if they are listed on the regulated markets (the order requires the fair value model in this case);
- determining the inventory value of some categories of assets (Tangible and intangible assets valued at cost, financial assets and short-term investments valued at cost, stocks).

To measure an asset at fair value means to assign as value the amount for which it could be exchanged freely between the parties previously informed, in a transaction with objectively determined price.

Estimating the fair value is required for: *the evaluation of the assets received free of charge or ascertained plus in the inventory; the assessment, in order to submit, in the balance sheet, the tangible assets if the entity uses the fair value model; the assessment, in order to report in the balance sheet the short-term financial investments if these are listed on regulated markets (the order requires the fair value model in this case); establishing the inventory value of some categories of assets (tangible and intangible assets valued at cost, financial assets and short-term investments valued at cost, stocks).*

4. Fair value and creating value

In recent years an idea has become increasingly topical: to account certain elements (especially property) at the estimated value of future cash flows that these can bring to the company, and not at historical cost (evaluation to be done at least at some point, after acquiring the respective elements).

In order to represent as value an asset it is more likely to to account future revenues than past expenditures. The strongest incidents of such assessments will be included in the annual reports released by the company.

The investors need information about performance. They must have access to forward-looking information. In recent years, the cash-flow information became useful in order to analyze the performance of a company. This is because the cash flow is an undeniable reality, while the profit is a construction more or less based on this reality.

The development of the role of creating shareholder value makes urgent the review of the accounting model of the value. With the significant increase in the value creation models, there is observed an evolution of the international accounting normalization which seems to evolve in the same direction.

There should however be considered a clarification of the objectives of the accounting model in order to integrate explicitly the need to provide useful information to shareholders using different measurement principles that allow us to respond to two distinctive objectives: the historical cost and the prudence to calculate the distributable result and the fair value to calculate the overall result. This model can not express entirely, however, the wealth created because it is unable to assess the intangible assets that are a primary source of performance.

The accounting should not be limited to only provide historical information about the financial position and performances of the company, but also allow the formulation of predictions about the enterprise itself.

The model of classical accounting refers to a vision of the company that acts in a stable environment and with a higher degree of certainty. Even the specific methods of the financial management of the enterprise, build on the assumption of an efficient market, from where the uniformity of the evolution of some key indicators such as the production cost and the turnover.

The artificial division of the life of the enterprise in annual financial exercises is unable to take into account the complex reality that a large number of organizations are facing today: *environmental turbulences, the extremely wide demand, the strong uncertainty in terms of technology.*

5. Conclusions

The criticism brought to the fair value addresses really problematic situations, but the solution proposed to restrict its usage remains unconvincing from at least three reasons.

They do not bring any viable alternative, ignore the negative impact that would result from the loss of some information that is currently provided in the financial statements and affects the distinction between accounting and the prudential concerns, having in fact different objectives and that should be separated with greater attention.

The opponents of the fair value lose this dispute from the start, because they fail to accompany their arguments with tangible solutions, in other words with a counter offer. If it is easy to identify and highlight the shortcomings of the fair value accounting not quite as easy it is to find an alternative method to better meet the characteristics of relevance, reliability, comparability and understandability that a broad consensus and a series of principles assign to the current standards.

The specialty literature occasionally mentions some alternatives, but the arguments are not convincing enough. The historical cost would provide a significantly lower degree of comparability and relevance of information, being clearly rejected by the users of this information, particularly by the financial investors.

The support that we give to the concept of fair value is not even close to being considered perfect, aware that there will be a number of amendments to the current standards, to be achieved in the future, as the IASB president himself recently suggested.

However, the purpose assigned to fair value and the market-based assessments, does not appear exaggerated if we integrate it in the picture presenting the characteristics of the financial markets in a world in full development, picture which also reflects the lessons learned from past crises. A restriction of the fair value not only would not heal the wounds of the current financial crisis, but, on the contrary, would be likely to worsen them, reducing the level of trust that investors, and others, have in the financial institutions. But other changes are necessary to deal with, the necessary changes following the crisis, changes that should overcome shortcomings disclosed at various levels.

The transition, from a historical cost based accounting, to one based on fair value, was classified as being a conceptual revolution in accounting and not more than that.

The objective of accounting based on fair value is to reflect the market values in the financial statements and its changes in the consolidated statement of the results obtained by the entity.

This role already raises many practical problems because the estimated fair value remains a subjective process, especially if this should be done without the existence of a market, which involves many professional judgments and the possibility of being handled by the one that estimates it.

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