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Historical cost versus current cost basis of accounting in preparing financial statements

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Abstract
Historical cost basis indicates that asset, liability or equity is recorded at its original acquisition cost where current cost basis indicates that assets and liabilities be measured at the current value at which they could be sold or settled as of the current date. This paper has shown the basic differences between historical cost basis and current cost basis of accounting. Five (05) manufacturing company has randomly selected to show the effect of each of these bases in preparing financial statements. Author has tried to focus the impact of two bases on various components of financial statements of selected manufacturing company. Statistical tools like mean, median and standard deviation have been used to focus the effects. Finally some recommendation has been made for better presentation of financial statements.

Keywords: historical, current, cost, impact, financial statement

1. Introduction
Historical cost accounting indicates that assets and liabilities are recorded at their historical costs, which are not updated for changes in the items' values. Costs also recorded in the income statement are based on the historical cost of items sold or used, rather than their replacement costs. Current cost is the cost that is required to replace an asset in the current period. This derivation includes the cost of manufacturing a product with the work methods, materials, and specifications currently in use. The fair value and the historical cost are not mutually exclusive. Quite on the contrary, the two concepts are complementary, as each has both strengths and weaknesses. (Deaconu, 2004) [9]. Amongst all the values that are submitted to accounting valuation, the most utilized one is historical cost. This component can be verified, as it is recorded in the document that proves the property right over a certain asset, such as a promissory note or a debt. The accounting system based on historical cost is widely accepted by accountants due to its objective nature, as it is supported by transactions that have already been completed, and it‘s generally easily understandable to its users. (Ristea, 2003). The main objectives of this paper are as follows:

- To focus the features of historical and current cost basis of accounting
- To show the differences between historical and current cost basis of accounting
- To show the effect of two bases in financial reporting,

2. Literature Review
Peter Kekung and Effiong (2012) [24] expressed into their article that both historical cost and fair-value accounting have significant effect on reported profit. Based on the findings of their study, they concluded that the amount calculated as depreciation, charged as taxes and paid as dividends greatly influence the operating profit of the company. The study recommended that companies should prepare their financial report using both historical cost and fair-value methods simultaneously. This will allow the companies to know the true financial position of their companies before declaring dividend and other benefits.
Jaijairam (2013) [20] conducted a research and stated that fair value accounting method relative to historical cost accounting. Author stated that both methods are widely used by entities in computing income and financial positions, there is controversy over superiority. Researcher also expressed that while both methods of accounting affect financial statements, the impact of fair value accounting on the balance sheet and income statement is extreme due

to the potential volatility of the method. Fair value accounting is deemed superior when compared to historical cost accounting because it reflects the current situation in the market whereas the later is based on the past.

Strouhal (2015) [27] discussed that the issues of currently used valuation models in financial reporting systems. The analytical part of this paper addresses the impact of studied valuation models on selected financial ratios with the purpose of identifying the most and the less sensitive ones on various valuation models.

In the non-financial sector such as manufacturing, wholesale and retail industries, the balance sheet values are less important compared to financial sector but they still have a real impact. Investors and creditors rely on the value of assets in determining the credit worth of an entity - lenders consider the value of assets as collateral while investors consider the value of asset as the indication of the entity's operation status now and probably in future (Zyla, 2010) [29].

Argilés, Blandon and Monllau (2010) [4] stated that no significant differences between both valuation methods to assess future cash flows. However, their most tests reveal more predictive power of future earnings under fair valuation of biological assets, which is not explained by differences in volatility of earnings and profitability. The study also evidences the existence of flawed HC accounting practices for biological assets in agriculture, which suggests scarce information content of this valuation method in the predominant small business units existing in the agricultural sector in advanced Western countries.

According to Meigs (1984) [23], using historical cost method, profit is determined by comparing sales revenue with the historical cost of the asset sold. Thus in income determination, accountants assumed that a business is well off when it has recovered its original money investment and that it is better off whenever it recovers more than the original sum of money invested in any given asset. The fact that historical cost accounting is based on historical cost,

Fair Value Option (FVO) election choice may have a substantial effect on income statement and earnings. Whilst certain changes in values are only reflected on the balance sheet, OTTI (Other-Than-Temporary Impairment) changes that flow through income statement have a direct impact on net income; for instance, the value of available for sale securities. FAS 115, states categorically that trading assets are held with an aim of disposing them in the near future Laux & Leuz, (2010) [21, 22].

Solomon (1997) [26] argued that accounting practice of which reporting of profit is fundamental is motivated by and responds to development that enhances the power of accounting to represent neutrally, a given economic reality. This is the basis for the evaluation of the impact of inflation on reported profit. Inflation distorts financial report into which profit is included such that they do not seem to neutrally and accurately represent financial information that is needed for appropriate decision making, policy formulations among many others.

Taplin, Yuan and Brown (2014) [28] examines the use of fair value accounting for investment properties by 96 randomly selected Chinese listed companies' year-ending 2008 annual reports. Half the sampled companies use fair value while half use historical cost, both methods being allowable under International Financial Reporting Standards (IFRS) and Chinese Accounting Standards (CAS).

3. Methodology of the Study

Creswell (2003) [8] portrays methodology as a coherent group of methods that harmonize one another and that have the capability to fit to deliver data and findings that will reflect the research question and suits the researcher's purpose.

3.1 Sources of Data

Data have collected from both primary and secondary sources. Questionnaire method ahs been used to collect primary data. Published financial statements are the main sources of secondary data.

3.2 Sample Size

Three (03) manufacturing business firms named Olympic Industries Limited, Berger Paints Bangladesh Limited and Aamra Technologies Limited are selected randomly to collect data.

3.3 Data Analysis

Collected data have been analyzed by showing the changing effect of both bases. Various hypotheses also tested to show the effect of historical as well as current cost basis.

3.4 Hypotheses of the Study

The following hypotheses are selected for the study:

H_0:1 There is no significant difference between reported depreciation using both historical and current cost accounting.

H_0:2 There is no significant difference between reported profit using both historical and current cost accounting.

H_0:3 There is no significant difference between reported tax using both historical and current cost accounting.

4. Theoretical Framework

4.1 Features of Historical Cost Basis

Some important features of historical cost basis are listed below:

i. The historical cost basis states that businesses must record and account for most assets and liabilities at their purchase or acquisition price.
ii. The historical cost principle is a tradeoff between reliability and usefulness.
iii. The historical cost basis to record an asset is completely reliable
iv. When bonds or other debts are issued, they are recorded on the balance sheet at the original acquisition price.
v. Historical cost is the original price.

4.2 Features of Current Cost Basis

i. Fixed assets are to be shown in the balance sheet at their current value not at their depreciated original cost.
ii. Depreciation for the year is to be calculated on the current value of the relevant fixed assets.
iii. The cost of stock consumed during the year is to be calculated on the current or replacement value at the date of consumption and not at the date of purchase.
iv. The effects of the loss or gain from loans will be computed and set off against interest.

4.3 Differences between Historical Cost and Current Cost Basis

Differences between Historical Cost and Current Cost Basis

Historical Cost Basis	Current Cost Basis
The transaction price or the acquisition price at which the asset was acquired, or transaction was done.	The market price that an asset can obtain from the counterparty.
Depreciation is always calculated on the historical cost.	Impairment is always calculated on a current value basis.
Historical cost derivation is easy and majorly readily available.	Fair value or current value calculation is highly complex and requires technical and niche skills.
Calculation of historical cost does not require any assumptions.	Calculation of current value is dependent on the various assumptions and various methods of calculation.
Since historical cost is the transaction price so the layman can easily identify the historical cost.	Since current cost is not the transaction price so the professionals/actuaries are needed to calculate current value.

4.4 Requirements of Various Accounting Institutions

FASB Statement 33 provides that an enterprise need not present information on a current cost basis if there would be no material difference between that information and information on a historical cost/constant dollar basis. Therefore, an enterprise needs to present information on a current cost basis only if it has significant holdings of inventory, property, plant, and equipment apart from income-producing real estate. The debate and academic research is usually concerned with financial instruments, but the IAS 41 requirement of fair valuation for biological assets brings it into the agricultural domain.

IAS 40 requires firms to choose between the cost and fair value models and apply the chosen policy to all of their investment property.7Under the cost model, firms apply the requirements of IAS 16 – Property, Plant and Equipment (IAS 40.56) pertaining to this method, according to which investment property is carried at its cost less any accumulated depreciation and any accumulated impairment losses (IAS 16.30).8 Notably, however, fair value must be disclosed in the footnotes, except where, under exceptional circumstances, fair value cannot be determined reliably (IAS 40.79 (e)). Under the fair value model, investment property is carried on the balance sheet at fair value (IAS 40.33), with all changes in fair value reported in the income statement (IAS 40.35). The fair value of investment property is the price at which the property could be exchanged between knowledgeable, willing parties in an arm's length transaction (IAS 40.5). It is determined under a fair value hierarchy described in IAS 40.45-47, where the best evidence of fair value is given by current prices in an active market for similar property in the same location and condition and subject to similar lease and other contracts. Firms are encouraged, but not required, to enlist independent valuers (i.e., appraisers) with relevant qualification and experience when determining fair value (IAS 40.32).

5. Analysis and Findings

Table 1: Impact of historical cost and current cost basis in reporting depreciation during 2018-2019: (in Thousand Taka)

Company	Actual Depreciation (Reported on Historical Cost Basis) (a)	Estimated Depreciation (Basis on Current Cost Basis) (b)	Excess (Deficit) Depreciation on Current Cost Basis (c=a-b)	Increase (Decrease) in Profit (Reported) (d=c)	Increase (Decrease) in Tax (25%) (Reported) (e=d*25%)
Olympic Industries Limited	333348	360876	(27528)	27528	6882
Berger Paints Bangladesh Limited	296025	302383	(6358)	6358	1590
Aamra Technologies Limited	31255	31804	(549)	549	137

Source: Annual Report

Table 01 has shown that Olympic Industries Limited has recorded their depreciation during the financial year 2018-2019 on the basis of historical cost of fixed assets. If they were record their depreciation on the basis of current cost then total depreciation would have increased by Tk.27528 thousand. As a result their profit has increased by Tk.27528 thousand and they had to pay excess tax by Tk.6882 thousand. Berger Paints Bangladesh Limited has recorded their depreciation on the basis of historical cost of fixed assets. If they were record their depreciation on the basis of current cost then total depreciation would have increased by Tk.6358 thousand. As a result their profit has increased by Tk.6358 thousand and they had to pay excess tax by Tk.1590 thousand. Aamra Technologies Limited has also recorded their depreciation on the basis of historical cost of fixed assets. If they were record their depreciation on the basis of current cost then total depreciation would have increased by Tk.549 thousand. As a result their profit has increased by Tk.549 thousand and they had to pay excess tax by Tk.549 thousand.

Table 2: Impact of historical cost and current cost basis in reporting Property, Plant and Equipment during 2018-2019: (in Thousand Taka)

Company	Historical Cost (Reported) (a)	Estimated Fair Value (Basis on Current Cost) (b)	Gain (Loss) on Current Cost Basis (c= b-c)	Increase (Decrease) in Profit (Reported) (d=c)	Increase (Decrease) in Tax (25%) (Reported) (e=d*25%)
Olympic Industries Limited	2754849	2982351	227502	(227502)	(56876)
Berger Paints Bangladesh Limited	3781328	3862548	81220	(81220)	(20305)
Aamra Technologies Limited	46761	47532	771	(771)	(193)

Source: Annual Report

Table 02 has shown that Olympic Industries Limited has recorded their property, plant and equipment during the financial year 2018-2019 on the basis of historical cost. If they were record their property, plant and equipment on the basis of current cost then total amount would have increased by Tk.227502 thousand. As a result their profit has decreased by Tk.227502 thousand and they had paid less tax by Tk.56876 thousand. Berger Paints Bangladesh Limited has recorded their property, plant and equipment on the basis of historical cost. If they were record their property, plant and equipment on the basis of current cost then total amount would have increased by Tk.81220 thousand. As a result their profit has decreased by Tk.81220 thousand and they had paid less tax by Tk.20305 thousand. Aamra Technologies Limited has recorded their property, plant and equipment on the basis of historical cost. If they were record their property, plant and equipment on the basis of current cost then total amount would have increased by Tk.771 thousand. As a result their profit has decreased by Tk.771 thousand and they had paid less tax by Tk.193 thousand.

5.1 Testing of Hypotheses

H_0: 1 There is no significant difference between reported depreciation using both historical and current cost accounting

Table 3: Anova There is no significant difference between reported depreciation using both historical and current cost accounting]

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	1.809	1	1.809	8.950	.006
Residual	5.658	28	0.202		
Total	7.467	29			

Table 03 focuses the calculated value of F (8.950) is greater than the critical value F (4.200) with (1,28) degree of freedom at 5 percent level of significance. So, the null hypothesis is rejected. If we also compare the sig. value then we can see that the significance value is less than alpha i.e. .05. So, null hypothesis is rejected. It indicates that there is a significant difference between reported depreciation using both historical and current cost accounting.

H_0:2 There is no significant difference between reported profit using both historical and current cost accounting.

Table 4: Anova [There is no significant difference between reported profit using both historical and current cost accounting.]

Model	Sum of Squares	Df	Mean Square	F	Sig.
Regression	1.186	1	1.186	5.288	.029
Residual	6.281	28	.224		
Total	7.467	29			

Table 04 focuses the calculated value of F (5.288) is greater than the critical value F (4.200) with (1,28) degree of freedom at 5 percent level of significance. So, the null hypothesis is rejected. If we also compare the sig. value then we can see that the significance value is less than alpha i.e. .05. So, null hypothesis is rejected. It indicates there is a significant difference between reported profit using both historical and current cost accounting.

H_0:3 There is no significant difference between reported tax using both historical and current cost accounting.

Table 5: Anova [There is no significant difference between reported tax using both historical and current cost accounting.]

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	1.056	1	1.056	4.611	.041
Residual	6.411	28	.229		
Total	7.467	29			

Table 05 focuses the calculated value of F (4.611) is greater than the critical value F (4.200) with (1,28) degree of freedom at 5 percent level of significance. So, the null hypothesis is rejected. If we also compare the sig. value then we can see that the significance value is less than alpha i.e. .05. So, null hypothesis is rejected. It indicates there is a significant difference between reported tax using both historical and current cost accounting.

6. Recommendation and Conclusion

The finding of the study has reflected the realistic conditions under which historical cost accounting is performed. Based on the findings of the study, it is concluded that the amount calculated as depreciation and profit greatly influence the tax of the company. Since inflation has been increasing in the economy of Bangladesh so historical cost basis of accounting to be inadequate, transactions and accounts should be made inflation compliant to ensure that profits reported from such transactions are not misleading. The historical financial statements of the company should be published together with current cost financial statements. The historical cost basis overstates the reported profit of the company regarding depreciation, it is hereby recommended that during the period of changing prices, the assets of the company should be revalued to reflect the price level changes before depreciation is calculated and charged to the accounts. This will give a high depreciation charge and high depreciation charge means low profit and vice versa. Companies should prepare their financial report using both historical cost and current cost basis simultaneously.

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