

Difference Between Fair Value And Historical Cost Accounting

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Abstract:

Measurement adds the extra detail that turns line items into real-world documents — so accounting measurement is by nature critical to financial reporting. Historical cost accounting and fair value accounting are two accounts practices measurement approach which still have not been established. Historical cost accounting records the value of an asset or liability at the amount paid to acquire it and carries that original amount into subsequent periods (subject to revaluations such as depreciation or impairment). Fair value accounting, on the other hand, values a firm's assets and liabilities at their market value as carried out from the point of view of its economic climate in real time. The aim of this study is to find out the differences between both these accounting systems along with its advantages and disadvantages. There is a case for historical cost accounting this is perceived as more verifiable, because it's based on verifiable transactions and thus tend to be more trustworthy whereas Fair value accounting gives generally a relevant time-based figures. But fair value can introduce volatility into financial statements and may in some cases involve significant estimates when active market prices are not readily obtainable. The effects of both approaches on the quality of financial reports, transparency and decision making are also studied through the exploration of academic literature and international accounting standards in this research. The findings indicate that near-modern accounting systems can adopt both in a mix to ensure the balance between reliability and relevance. The distinction between these two approaches is what is learned in financial statements, which are used by investors, regulators and financial managers in assessing the performance of an economy.

Keywords:

Accounting, Finance, Historical Cost, Costing methods

Introduction: "The What & Why"

Financial statements are a fundamental tool that is used by investors, managers and regulators in evaluating the performance and position of an organization in terms of finances. Measurement of Assets and Liabilities Importance of assets and liabilities being measured and reported is a significant subject in accounting. The way in which some of the assets or liabilities are valued would greatly influence the financial ratios and figures that are recorded in the financial statements of the entities and is of interest to the decisions of the providers of capital and other interested parties.

Historically, the accounting systems have primarily tried to employ historical cost accounting whereby, one flat rate is allocated to each individual asset and liability based on the price paid at collection on which they were initially recorded. This method is not a new one because it is inclined on the transactions underlying it and can be attested through documentation. Therefore, historical cost accounting can be deemed accurate and objective. Critics have claimed this measure may not be a true measure of whether the economy is approaching a good state when the value of assets falls - or is stolen away - over generations because of inflation or because of a transformation in the market place.

In rebuttal, fair value based accounting has developed over the years as specific as regards current day reporting. This technique captures the assets and liabilities at the market value and thus will give a more useful and up to date image of the value of a company. Proponents affirm that fair value enhances transparency and makes investors make improved investments.

Despite these advantages the accounting method has been criticized as having the possibility of volatility in financial statements, which might arise because of the method, or as having a potential subjectivity in case there are no market prices where estimates can be made. One of the most debatable issues of contemporary accounting literature is the instability of historical cost and fair value accounting.

The paper quantifies the differences in two measurement processes and examines their impact on the quality of financial reporting and decision-making.

Literature Review: "The story so far "

Historical cost versus fair value accounting has a voluminous research on the research and theory of accounting and financial reporting. Historically, the accounting systems have been based on the historical cost principle - where assets are recorded at the price at which they were purchased. Historical cost is applicable to the traditional accounting theory since it is objective and verifiable. Researchers like Watts and Zimmerman (1986) consider history to be more temporal and entity comparative; historical cost accounting is more empirical in that the values of assets are captured based on verifiable transactions that result in reduced manipulation. The fact that it is stable gives the auditors and regulators an easier time in testing the financial statements. Critics, however, argue that historical cost tends to get outdated in the course of time and fails to depict the actual economic value of assets, and a correct, fair value is essential especially in today's environment (Beainy & Kamel, 2023).

This weakness of historical accounting prompted the emergence of fair value accounting as an alternative scheme of measurement. In other words, fair value refers to the price at which an asset is sold or a liability is transferred in a normal transaction with the market participants (International

Financial Reporting Standards, IFRS). Additionally, the accounting theory in which Barth (1994) believed that fair value accounting is more pertinent to the investors because it represents the market conditions.

Nevertheless, there are a number of researches that point out the difficulties related to fair value accounting as well. According to Laux and Leuz (2009), fair value may create too much financial statement and become subject to a lot of estimates when it is not possible to have active markets. This brings about uncertainty and lack of reliability.

Nonetheless, previous studies have revealed that the historical cost and fair value accounting methods have their advantages and disadvantages on financial statements transparency (Saber & Sassine, 2022). This is the reason why contemporary accounting standards are inclined toward the mixed measurement model that will combine the features of both of them.

Methodology: "The how we did it "

This paper which is qualitative in nature addresses the differences between historical cost accounting methods and fair value accounting. The paper is grounded on secondary data and the information found in accounting and academic journals, IFRS textbook and International accounting standards.

The articles on the topic of accounting measurement methods, quality of financial reporting and asset valuation were reviewed. Various scholarly researches and theoretical literature were searched to find out pros and cons of historical-cost accounting over fair value accounting.

The study also covers the accounting principles which stipulate the circumstances under which these measurement methods may be applied in the financial reporting. It particularly focuses on the IFRS 13: Fair Value Measurement which outlines the principles of fair value measurement in the financial statements. Business has also put into consideration basic accounting principles that focus on valuation at historic cost.

This discussion examines the two sides of the report provided by the accounting measurement in terms of reliability, relevance and transparency and their effect on the volatility of financial statements. In the accounting literature, these are (often) used as proxies of reporting quality.

This work attempts to compare historically cost and fair value accounting in a comprehensive way, at the time when interrelated literature-based research and current accounting epistemology never focused on a holistic comparison. My discussion thus focuses on the connection between such valuation techniques, and their impact on financial reporting practice and economic decision making.

Results: "The facts "

Distinctions between historical cost and fair value accounting using all possible literature and standards.

First, historical cost accounting is highly valid because the values of transactions in which the assets are recorded are founded on the actual values of transactions. These values can be verified/audited easily as they are values where it is possible to move paper (invoices, contracts etc.). It also generates more consistent financial reports since the value of an asset is not changed often.

Such a strategy lessens the misalignment between accounting and pricing, with reported asset values being more aligned with current market values. This will enable investors and financial analysts to be aware of the financial position of a company. To illustrate, whenever the market value of financial securities is usually relying on its quality at present, it permits timely data of choice making.

The findings also indicate that fair value accounting brings about a higher degree of volatility in the financial statements. Financial assets must be reported under market values and a fluctuating market can lead to variations in the same values between one reporting disclosure period to the other. The volatility would have an impact on reported earnings and financial ratios.

A factor in our discovery is that fair value measurement necessitates the use of estimations methods, unless there are active markets. According to valuation models, this type of price estimations is usually subjective and less credible.

The findings show that the historical cost has been more concerned with reliability and stability whilst the fair value seems to emphasize on relevance and up-to-date market data.

Discussion and conclusion: "The so what ? "

In this paper, the gap between fair value and historical cost accounting and its roles in enhancing the quality of financial reporting have been discussed. The results indicate that there are benefits of both measures along with some limitations.

Conclusion: Although financial information required is available, historical cost accounting remains. Reflections on the intent of displaying figures would resonate well in the disparities when determining their value/utility. It is less prone to fluctuations hence it helps in minimizing the adjustments in financial statements and in the help of ensuring that they can be even more easily verifiable. It would however keep some data out of date in case there is a significant movement of the value of assets over time.

Conversely, fair value accounting enhances relevance and transparency of financial reports as it is closer to current market prices and enables investors and financial analysts to make more effective decisions regarding the liquidity of a company. Yet the fair value measurement contributes to volatility (Beainy, 2026) and in certain situations necessitates subjective estimates in the absence of active markets.

These observations also imply that contemporary accounting systems enjoy the confluxing of the two types. The recent debate on International Accounting Standards that came to the limelight here is all about the measurement of assets at historical cost as opposed to measurement at fair value.

Future studies can be conducted to find out the relation between fair value accounting and financial stability during economic crisis, and/or how this model of measurement is being implemented in various industries. Education on benefits and costs to such accounting principles is an essential step in the enhancement of financial reporting that will eventually enhance the decision making process by economies.

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