

Historical Cost in Accounting

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Introduction

Historical cost measures an asset or liability using information derived from the original transaction, adjusted when required for depreciation, amortization, impairment, repayments, or other subsequent events. The original essay correctly identifies verifiability and comparability as strengths and reduced current relevance as a limitation. It incorrectly refers to a “Forensic Specialists Accreditation Board,” implies that the Financial Accounting Standards Board broadly abandoned historical cost, and concludes that the method should no longer be used. Modern U.S. GAAP and IFRS use mixed measurement models. Historical cost, amortized cost, fair value, value in use, and other current measurements are selected according to the economic characteristics of the item and the information needs of users (Financial Accounting Standards Board, *Conceptual Framework*; International Accounting Standards Board, *Conceptual Framework*).

What Historical Cost Means

At initial recognition, historical cost normally reflects the consideration paid to acquire an asset plus transaction costs necessary to prepare it for use. For a liability, it reflects the value received minus transaction costs, subject to the applicable standard. Subsequent historical-cost measurement is not simply the original invoice frozen forever. Property and equipment may be depreciated, receivables adjusted for expected credit loss, inventory reduced to net realizable value, and intangible assets tested for impairment. The resulting carrying amount remains transaction-based but changes as the asset is consumed or loses recoverability. Understanding these adjustments prevents the common misconception that historical cost ignores all later economic information (International Accounting Standards Board, IAS 16, IAS 2, IAS 36, and IFRS 9; Financial Accounting Standards Board, *Conceptual Framework*).

Verifiability and Documentary Support

A major advantage is that the original transaction usually leaves evidence such as contracts, invoices, payment records, and settlement documents. Independent accountants can examine this evidence and reproduce the starting measurement more easily than an estimate based on unobservable assumptions. Verifiability supports auditability and can restrain opportunistic revaluation. It does not make every historical-cost number perfectly objective. Management still estimates useful life, residual value, impairment, collectability, and allocation among components. The correct comparison is therefore not objective cost versus subjective fair value. Both models involve judgment, but the

location and magnitude of judgment differ. Historical cost often begins with a more directly observable event (Financial Accounting Standards Board, *Conceptual Framework*; Penman).

Stability and Stewardship

Historical cost can help users evaluate stewardship by showing the resources committed to an investment and the expenses recognized as those resources are consumed. Because carrying amounts do not change with every market fluctuation, reported performance may be less volatile and easier to connect with completed transactions. Managers can compare actual returns with the amount invested and assess whether assets generated sufficient income over time. Stability is particularly useful for assets held for operational use rather than immediate sale. However, stability should not be confused with economic constancy. A stable accounting number may conceal a large change in opportunity cost, replacement cost, or financial risk (Penman; Financial Accounting Standards Board, *Conceptual Framework*).

Comparability over Time

When the same accounting policy is applied consistently, historical cost supports comparison across periods within one entity. The acquisition price and depreciation schedule create a traceable series rather than a new valuation at every reporting date. This can make trends in margin, asset turnover, and capital expenditure easier to analyze. Comparability across different companies is more complicated. Two identical buildings acquired decades apart may carry very different amounts because prices changed, while companies may use different estimates of life and impairment. Consistency improves comparability only when users understand the underlying transactions. Notes and supplemental current-value information may be needed to explain why similar productive capacity appears at dissimilar carrying amounts (Financial Accounting Standards Board, *Conceptual Framework*; International Accounting Standards Board, *Conceptual Framework*).

The Problem of Changing Prices

Historical amounts can become less relevant during inflation or when a specific asset's market value changes substantially. An old property may be reported at a small fraction of current value, making the balance sheet an incomplete picture of economic resources. Depreciation based on old cost may also be lower than the amount required to replace productive capacity at current prices. Yet current market value is not always the relevant measure. A specialized factory intended for continued use may have limited sale value while generating significant cash flows within the business. The measurement question is not whether prices changed but which value best represents how the asset contributes to future cash flow (Penman; International Accounting Standards Board, *Conceptual Framework*).

Profit Measurement and Holding Gains

Under historical cost, revenue may be measured at current selling prices while some related expenses reflect older acquisition costs. During inflation, this can increase reported profit even though part of the apparent gain is needed to replace inventory or equipment. The original essay correctly notices that operating results and holding gains can become difficult to separate. Analysts may adjust for replacement cost, inventory method, or current price information to understand sustainable performance. However, current-value accounting also creates gains and losses before realization, and those changes may be volatile or difficult to measure. Every model must explain whether performance arises from operations, market movement, or changes in estimates (Penman).

Fair Value

Fair value is a current-value measurement based on the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. FASB's fair-value framework, now incorporated in Accounting Standards Codification Topic 820, provides a common definition and a hierarchy of inputs. Level 1 uses quoted prices in active markets, while Levels 2 and 3 rely increasingly on observable adjustments or entity-developed assumptions. Fair value can be highly relevant for traded securities and derivatives because current market exposure is central to their economics. It is less straightforward when markets are inactive, assets are unique, or forced-sale prices do not represent orderly transactions (Financial Accounting Standards Board, ASC Topic 820; Benston).

Measurement Uncertainty

A current estimate can be relevant yet uncertain. Level 3 valuations may depend on projected cash flows, discount rates, growth, volatility, default assumptions, or comparable transactions. Small changes can produce large differences, and users may struggle to distinguish economic change from model revision. Historical cost can reduce this measurement uncertainty but may sacrifice current relevance. The IFRS Conceptual Framework does not prescribe one default basis for all items; it describes historical cost and current value and asks standard setters to consider relevance, faithful representation, and the characteristics of the asset, liability, income, and expense. Measurement is therefore a choice among trade-offs rather than a contest with one universally superior winner (International Accounting Standards Board, *Conceptual Framework*; Benston).

Mixed Measurement under U.S. GAAP

U.S. GAAP combines measurement bases. Many items of property, plant, equipment, inventory, and internally used intangible assets remain primarily cost-based, subject to depreciation, amortization, or

impairment. Certain financial instruments and derivatives are measured at fair value, while loans and receivables may use amortized cost adjusted for expected credit loss. Pension obligations and stock compensation require present-value or fair-value inputs. FASB Statement 157 did not create fair-value measurement for every asset; it established a consistent framework when another standard requires or permits fair value. The original essay's claim that FASB moved away from cost in general should therefore be replaced by a description of this mixed model (Financial Accounting Standards Board, ASC Topic 820; Financial Accounting Standards Board, *Conceptual Framework*).

Mixed Measurement under IFRS

IFRS also uses multiple bases. IAS 16 permits a cost model and, when conditions are met, a revaluation model for property, plant, and equipment. IAS 2 generally measures inventory at the lower of cost and net realizable value. IFRS 9 classifies financial assets according to contractual cash-flow characteristics and business model, producing amortized-cost, fair-value-through-other-comprehensive-income, or fair-value-through-profit-or-loss outcomes. Biological assets and investment property can involve current values under relevant standards. The combination reflects different ways assets generate cash. A machine used in production is economically different from a security held for trading, even if both meet the conceptual definition of an asset (International Accounting Standards Board, IAS 16, IAS 2, IAS 36, and IFRS 9).

Historical Cost and Impairment

Impairment rules respond to one of historical cost's most serious weaknesses by reducing carrying amounts when expected recovery falls below the recorded amount. The specific test differs across standards and jurisdictions. Some models compare carrying amount with recoverable amount, while others use undiscounted and discounted cash-flow steps or expected credit-loss approaches. Impairment introduces current expectations into a cost-based system but often recognizes downward change without equivalent upward revaluation. This asymmetry can reflect prudence and concerns about unverifiable gains, yet it also means carrying amounts are not complete measures of current value. Users should read the impairment policy and assumptions rather than infer that cost-based numbers are untouched by estimates (International Accounting Standards Board, IAS 36; Financial Accounting Standards Board, *Conceptual Framework*).

Intangible Assets and Internally Generated Value

Historical-cost accounting struggles with internally generated intangible value. Spending on research, brands, customer relationships, workforce capability, data, and organizational knowledge is often expensed or recognized only under restrictive conditions. An acquired business may therefore record identifiable intangibles and goodwill that a similar internally grown company does not. The imbalance

affects comparisons in technology and service industries. Measuring internally generated value at fair value would not solve the problem easily because control, separability, useful life, and future benefit may be uncertain. Better disclosure of expenditure, strategy, and nonfinancial indicators can supplement the financial statements without pretending that every valuable capability can be measured reliably as an asset (Penman; International Accounting Standards Board, *Conceptual Framework*).

Decision Usefulness for Different Users

Lenders may value conservative, verifiable amounts and cash-flow coverage, while equity investors may seek current information about growth opportunities and market exposure. Managers need cost records for budgeting and asset control, and regulators may prioritize solvency or market risk. The same measurement can therefore serve one decision better than another. General-purpose financial reporting cannot optimize every use, so standards balance relevance and faithful representation for a broad audience. Users also combine accounting data with market prices, appraisals, operating statistics, and forecasts. A historical-cost balance sheet is not intended to state the entire market value of a company, particularly because many internally generated resources are not recognized (Financial Accounting Standards Board, *Conceptual Framework*; International Accounting Standards Board, *Conceptual Framework*).

Advantages and Disadvantages in Practice

Historical cost is advantageous when transactions are observable, assets are held for use, markets are thin, and current estimates would be costly or unstable. It supports audit trails, stewardship, and disciplined recognition. Its disadvantages grow when old prices become disconnected from current economic conditions, when replacement cost matters, or when financial instruments expose the entity to rapidly changing market risk. Fair value improves timeliness and comparability for some items but introduces volatility and model uncertainty for others. The practical question should be stated item by item. Asking whether a measurement basis portrays how an asset or liability affects cash flow is more useful than declaring one model modern and the other obsolete (Benston; Penman).

Conclusion

Historical cost remains a central measurement basis because it is transaction-grounded, verifiable, understandable, and useful for stewardship. It is not adequate for every asset or liability, and its relevance can decline when prices, risk, or business conditions change. Fair value and other current measures can portray present exposure more directly, but they may depend on uncertain assumptions and inactive markets. FASB and the IASB have not simply replaced historical cost; their standards use mixed measurement according to economic characteristics and reporting objectives.

The best financial statements combine appropriate measurement, impairment, consistent policy, and transparent disclosure. Measurement quality depends less on choosing one universal basis than on explaining why the selected basis faithfully represents the item (Financial Accounting Standards Board, *Conceptual Framework*; Financial Accounting Standards Board, ASC Topic 820; International Accounting Standards Board, *Conceptual Framework*; Penman).

References

1. Financial Accounting Standards Board. *Conceptual Framework for Financial Reporting*.
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4. International Accounting Standards Board. IAS 16, IAS 2, IAS 36, and IFRS 9.
5. Benston, George J. "Fair-Value Accounting: A Cautionary Tale from Enron." *Journal of Accounting and Public Policy*, vol. 25, no. 4, 2006, pp. 465–484.
6. Penman, Stephen H. *Financial Statement Analysis and Security Valuation*. 5th ed., McGraw-Hill, 2013.