Historical Cost in Islamic Accounting Perspective

M. Dawud Arif Khan[1] and Moch. Buchori Muslim[2]
[1]*Institut Ilmu Al Quran (IIQ) Jakarta*
[2]*Universitas Islam Negeri (UIN) Syarif Hidayatullah Jakarta*

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Abstract: The research is to search for the meaning of the events of social and culture that is based on the perspective and experience of researcher, in this case related to the concept of historical cost, evaluated from the sharia's perspective.This study uses a qualitative-interpretive approach, The main source of this research is the Conceptual Framework of the Preparation and Presentation of Sharia Financial Statements, Accounting and Auditing Standards for Islamic Financial Institutions, the books of classical Islamic jurisptudence and conventional accounting books with GAAP and IFRS approach. *Other sources are taken from the literatures those discuss the concept of valuation of assets in accounting. This study supports the formulation of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and Institute of Indonesia Chartered Accountants (IAI) which states that the basis of measurement that is commonly used by Islamic entities in the preparation of financial statements is historical cost. This study concludes that the historical cost accounting concept in accounting is not contradictory to sharia principles and commonly used by sharia entities in the preparation of financial statements, combined with other measurement basis, as long as the use of other valuation concepts produces relevant and reliable information in financial reporting.*

1 INTRODUCTION

Valuation is always related to *measurement* term, which involves assigning monetary amount at which the elements of the financial statements are to be recognized and reported (Keith Alfredson att., 2007). In accounting theory, the main problem related to the question about measurement is how should the assets and liabilities of a company be measured? On the basis of its historical acquisition price, at the selling price, is it updated first with the current price, or uses the present value of the future cash flows that can be generated? (J. Godfrey attt., 2010).

Kieso said, "GAAP requires that companies account for and report most asset and liabilities on the basic of acquisition price. This is often reffered to as the historical-cost principle. Cost has an important advantage over other valuation: it is reliable" (Donald E. Kieso and Jerry J. Weygandt, 1995). Pyle and Larson stated that accounting principle called the cost principle should be borne in mind when reading financial statements. Under this principle, all goods and services purchased are recorded at cost and appeare on the statements at cost. For example, if a business pays \$50,000 for land to be used for carrying on its operations, the purchase should be recorded at \$50,000. It makes no difference if the owner and several competent outside appraisers thought the land "worth" at least \$60,000. It cost \$50,000 and should appear on the balance sheet at that amount. Furthermore, if five years later, due to booming real estate prices, the land's market value has doubled, this makes no difference either. The land cost \$50,000 and should continue to appear on the balance sheet at \$50,000 even though is estimated market value is twice that (William W. Pyle and Kermit D. Larson, 1984).

Kieso stated that the implementation of the historical cost principle still requires careful consideration of which acquisition value is used. However, the question "what is the acquisition price?" Is not always easy to answer Donald E. Kieso and Jerry J. Weygandt, 1995). *Accounting Principles Board* (APB) (Richard Vangermeersch; Michael Chatfield and Richard Vangermeersch, 1996) gives opinion that in applying the cost principle, cost

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are measured on a cash or cash equivalent basis. If the consideration given for an asset or service in cash, the acquisition price is measured at the entire cash outlay to secure the asset or service. If it is something other than cash, the acquisition price is measured at the cash equivalent value of the asset given or the cash-equivalent value of the asset received, whichever is more clearly evident (APB, 1973).

The history of historical cost cannot be separated from the beginning of the development of accounting theory. In the early 20th century (1900s), the management of companies played a major role in the formulation of accounting principles and as a result many different companies might use different accounting techniques for the same problem (Ahmed Riahi Belkaoui, 1993). That is, the use of the historical cost principle has not been standardized and its application can also vary among companies that existed at the time. The period before the formulation of the historical cost principle by Godfrey et al. referred to as pre-theory period (J. Godfrey att.), Belakoui called is as the development of double-entry bookkeeping (Ahmed Riahi Belkaoui, 1993), and Chasteen et al called is as pre-formal theory era (Lanny G. Chasteen att., 1992).

Godfrey et al, Belkaoui, and Chasteen agreed that the 1930s was one of the important periods in the development of accounting theory, especially with regard to the application of historical cost principle in the measurement and valuation of assets. They also agreed that the economic crisis that hit the world in this period had a significant influence on the perspective of accounting and financial reporting issues (J. Godfrey att.; Ahmed Riahi Belkaoui; L. G. Chasteen, R. E. Flaherty; M. O'Connor).

The economic crisis in the 1930s period raised a big question about the role of accounting in financial reporting and the ability to provide reliable information for decision making. Stephen Zeff reports that Healy and Kripke, two prominent practitioners, strongly criticized the practice of write-up accounting that were prevalent in the United States in the 1920s. They saw a lot of practices in recording the value of company assets that were "elevated in value" during that period (J. Godfrey).

The problems that arise regarding accounting in this period are the magnitude of the influence and role of management in the formulation of accounting principles. Diffusion of share ownership gives management a full control over the format and contents of accounting disclosures. The results of this dependence are (Ahmed Riahi Belkaoui):

1.1. The accounting technique adopted is not supported by theoretical aspects.
1.2. The focus is on determining taxable income and how to minimize income tax.
1.3. The techniques adopted are more motivated by income smoothing.
1.4. Complex problems are avoided and solutions with policies are more adopted.
1.5. Different companies may use different accounting techniques for the same problem.

This situation caused a lot of dissatisfaction among users of financial statements in the 1920s. William Z. Ripley and J.M.B. Hoxley, specifically voiced the debate over the issue of improving the quality of financial reporting standards, so that it would be more useful for economic decision-making. Adolph A. Berle and Gardiner C. Means also pointed to company wealth and industrial company strength, and called for protection for investors (Ahmed Riahi Belkaoui).

The SEC's former chief accountant, Lynn Turner, told the New York Times that many accounting frauds, such as Funding Equity, occurred during the 1920s, and helped cause the recession disaster in 1929 and encouraged the formation of the Stock and Exchange Commission (SEC). The SEC was created to administer various securities acts. Under powers provided by congress, the SEC was given the authority to prescribe accounting principles and reporting practices (Richard G. Schroeder and Myrtle W. Clark, 1995). This explains why Belkaoui called this period an Institutional Contribution Phase.

The significance of the 1920-1930 period was also signed by the beginning of the standardization of the application of the historical cost principle in the world of accounting. Godfrey et al. states that prior to the 1930s, the main focus of accounting was on the use of transactions based on historical cost which were actually a consequence of the application of the conservatism principle. However, although known as an empirical period in the development of accounting, there is a logical debate about the level of benefit of measurement procedures. This is related to the world economic crisis which began in 1929 (J. Godfrey). Godfrey et al mentions that after the Wall Street crash of 1929, the traditional historical cost system was implemented, although it was not systematically codified as a basis for capital valuation, and for economic recording and reporting and related company activities, until the end of the 1930s (J. Godfrey).

The experts' view shows the importance of establishing the historical cost principle as the initial milestone in the establishment of modern accounting theory. This was also supported bt Chasteen et al. which states that prior to the 1930s accounting measurements were still based on individual accountants' considerations (corporate accountants and their auditors), so the bias level of comparability of financial statements was very high (Lanny G. Chasteen att.).

After the 1930s, professional associations and standard-setting institutions emerged and grew, so that accounting standards became relatively standardized, and measurement refers more to the objectives of financial reporting. The establishment of the SEC and its encouragement to professional institutions to standardize accounting standards is one of the starting points for the development of accounting standards, including measurement and assessment standards, which are better (Richard G. Schroeder and Myrtle W. Clark). Paton and Littleton stated that company reports should based on the assumption that management reports to investors who do not adequately understand the situation faced by management. The value presented by management must be relatively objective and verifiable. Such value measurement can only be realized using the historical cost system (W. Patton and A.C. Littleton, 1940).

2 ADVANTAGES AND DISADVANTAGES OF THE HISTORICAL COST PRINCIPLE

The extensive use of historical cost principles in accounting and financial reporting shows that the principle is considered good and has substantial benefits. Some of the advantages of this principle include:

2.1. Objective and reliable

Historical cost is objective, because the value used is a value that can be easily traced to transaction documents. Pyle and Larson stated that the objectivity principle supports the idea that transactions are recorded at their cost (William W. Pyle and Kermit D. Larson). Kieso stated that cost has an important advantage: it is reliable (Donald E. Kieso and Jerry J. Weygandt).

2.2. Provides comparable information

The historical cost principle provides information that can be compared from period to period, because assets are recorded at historical prices.

2.3. Does not present a holding gain (loss)

Pyle and Larson stated that since the assets are for use in the business and are not for sale, their current market value are not particularly relevant and need not be shown (William W. Pyle and Kermit D. Larson).

2.4. Relevant in making economic decision

Jiri (1975) proposed three reasons why historical costs are relevant for decision making (Nur Barizah and Julia Mohd. Said, 2007):

2.4.1. It is difficult to be manipulated, because based on actual transaction,

2.4.2. It is useful for control purposes. The income statement provides a basis for determining how management has fulfilled its responsibilities. Past transaction records are needed for accountability.

2.4.3. It has been proven reliably so far. Until now, this concept is still considered relevant, especially for small and medium enterprises.

Godfrey et al. also has presented the arguments of the supporters of the historical cost principle, including that the relevant for decision making, based on actual transactions, has been proven reliably so far, and the profit report generated is realistic. In addition, accountants must avoid modifying internal data. One means to avoid this is the application of the historical cost principle (J. Godfrey).

However, historical costs are also not spared from criticism because of the disadvantages inherent in this principle. The disadvantages that can be identified are: (1) understatement of expenses, (2) the statement of financial position of the company is unrealistic, (3) historical costs are not relevant for decision making, (4) historical cost accounting can mislead readers of financial statements (Nur Barizah and Julia Mohd. Said).

Historical cost principle also received criticism from Muslim scholars. Husain Syahatah for example, stated that the determination of the value of the asset should be based on the prevailing market value (Husein Syahatah, 2001). Gambling and Karim (1991) as quoted by Iwan Triyuwono (2006) states that related to the determination of the amount of zakat, the measurement of the value of the entity's assets by using the current cost accounting becomes more appropriate compared to the historical cost accounting (Iwan Triyuwono, 2000).

Conceptual framework prepared by AAOIFI stated that measurement attributes refer to the attributes of assets and labilites that should be measured for financial accounting purposes. For example, asset attribute that may be selected for measurement in financial accounting may include the acquisition cost of the asset, the net realizable or cash equaivalent value of the asset as of a given date, the asset's replacement cost as of a given date or any other attribute whose measurement would result in relevant information. The choice of the attribute(s) that should be measured for financial accounting purposes should be guided by the relevance, reliability, understandability and comparability of the resulting information provided to users of financial statements (Accounting and Auditing Organization for Islamic Financial Institutions, 2002).

In Indonesia, the Sharia Accounting Standards Board of Institute of Indonesia Chartered Accountants (IAI) has also released a Conceptual Framework of the Preparation and Presentation of Sharia Financial Statements. It states that measurement is the process of determining the amount of money to recognize and include every element of the financial statements in the balance sheet and income statement. This process involves choosing a particular measurement basis (Sharia Accounting Standards Board of IAI, 2015). A various measurement bases are used in different degrees and combinations of financial statements, they are: historical cost, current cost, and realizable/settlement value (Sharia Accounting Standards Board of IAI).

Although many Muslim scholars expressed the idea that the measurement and valuation of assets should use fair value rather than hisotrical cost, as mentioned above, the Islamic accounting standards published by AAOIFI from Bahrain and IAI from Indonesia, still adopt the historical cost. In fact, the IAI Sharia Accounting Standards Board clearly states that the measurement basis normally used by sharia entities in the preparation of financial statements is historical cost. This is usually combined with another measurement basis.

3 STUDY OF THE HISTORICAL COST CONCEPT ACCORDING TO THE ISLAMIC SCHOLARS (ULAMA)

The valuation of assets in fiqh literature is more related to the purpose of calculating zakat and the distribution of inheritance and fai asset (Abu Ubaid Al-Qasim, 2008). However, the values of the views of the ulama should also include the idea of assets in general, because they are not substantially different from the past with the present.

The basis for estimating the value of an asset is a history of Abū 'Amr bin Ḥamās who told that his father said: "Umar ordered me, 'Pay zakat on your property!'. I answered, 'I have no property except arrows and animal skin.' Then Umar said, "Estimate their value, and then pay the zakat!'." The order from Umar is the basis for the process to do estimate the value of asset. This Abū 'Amr's story can also be found in al-Umm by Imam al-Shāfi'ī (Muhammad bin Idrīs Al-Shāfi'ī, 1987).

The discussion of asset valuation has been recorded in the fiqh literature, in the section concerning the calculation of merchandise related to zakat. Yūsuf Qarḍawī stated that in the opinion of jumhur (ulama), goods at maturity (zakat) are valued at the market price of that time (Yusuf Qarḍawī, 1993). This is in line with the current value or fair value concept. Wahbah al-Zuhaili mentioned that traders estimate the value of their merchandise at the end of each year according to the price at the time of issuing zakat, not the price at the time of purchase. Merchandise is combined at the time of valuation, although different in type (Wahbah Al-Zuhaili, 1997).

How about historical cost concept, is there reference(s) in classical fiqh literature? The idea of historical cost in classical literature fiqh can be found in the books of the Shāfi'iya who proposed that the merchandise is determined in value by what is used by the merchant to buy. Shāfi'iya said that merchandise was valued in accorandce with the purchase price, because the niṣāb was based on the purchase price (Wahbah Al-Zuhaili).

al-Shāfi'ī mentioned that merchandise is an item purchased or acquired intended for commerce. When it has been one year (haul) since it was owned, the merchant must value the merchandise with a currency that is more widely used in his country, dinar or dirham. If the merchandise is purchased with nuqūd (gold or silver), which is obligatory for zakat, or with goods that are obligatory on the value of zakat, then the remain property is calculated based on the day he bought the items (Muhammad bin Idrīs Al-Shāfi'ī). This concept is in line with the conservative idea which is the basis of historical cost concept, which is using the basis of the asset value at the time of acquisition (J. Godfrey att.).

al-Nawāwī explained that the merchandise was estimated at the end of ḥaul (year), because it was related to *al-qīmah* (valuation). Assessing merchandise at any time is not easy, then the estimation for the valuation is carried out at the time of the occurrence of the obligation, namely at the end of *ḥaul* (year). The *ḥaul* is calculated since the possession of merchandise at *niṣāb*. This is the opinion of al-Shāfi'ī. If there are merchandise being sold to obtain other merchandise, then it does not break the count of *ḥaul*, because the zakat of merchandise is related to its value, and the value of the second item and the value of the first item is one (Abū Zakariyā Muhyī al-Dīn al-Nawāwī, nd).

From the description, it is known that the acquisition value (purchase price) is the basis for calculating niṣāb and is used to determine the amount of zakat that will be issued. This concept is in line with the historical cost principle in asset valuation.

Al-Khaṭīb Al-Sharbinī also said that the merchandise was estimated to be of value at the end of each ulaul to what he bought. This is if merchandise is purchased using money. If not, then it is estimated to use the value closest to the money used in the merchant's territory or country (Muḥammad Al-Sharbinī al-Khaṭīb). This confirms the basic use of measurement that is closer to the purchase price.

al-Malibarī stated that the *niṣāb* of merchandise determined at the end of *ḥaul* (year), even though ownership (at first) is less than one *niṣāb*. The profit generated in the current year is added to the initial capital, if it is not in the form of gold / silver (money). If is in the form of money, it is not added to the initial capital. The capital is paid for zakat according to the calculation of the year, and the profit is also paid for zakat based on profit's year (Zain al-Dīn al-Malibarī, 1980).

Following the description in Fatḥ al-Mu'īn above, the benefits that have been realized (in the form of money) must be separated from the *ḥaul* calculation for its zakat. This shows the tendency of al-Shāfi'īs to choose the concept of realization in the matter of muamalah, so that it does not recognize the concept of unrealized profit. Profit is the amount that has actually been received in cash, so the unrealized amount has not been recognized as profit.

The discussion in some of the fiqh literature above, besides limited to the valuation of merchandise inventory, also relates to the problem of calculating the zakat of merchandise. Even though, the concept of valuation can be adopted for the purposes of Islamic financial reporting.

The accounting concept for merchandise inventories valuation adopted today is closer to the opinion of the Shafi'iyyah, which are tend to the acquisition value, although there are differences regarding the concept. Inventories are usually stated at the lowest of the historical cost or net realizable value (LCNRV) (Sharia Accounting Standards Board of IAI). The application of this concept can be found in the accounting standard for the salam agreement, which states that at the end of the financial reporting period, inventories acquired through salam transactions are measured at the lower of cost or net realizable value (Sharia Accounting Standards Board of IAI).

4 CONCLUSION

Islamic accounting standards developed by AAOIFI in Bahrain and another by the Indonesian Institute of Accountants (IAI) in Indonesia use the reconstruction approach, that is, following the objectives, principles, and conventional accounting concepts that already exist, then testing them from the Sharia point of view. Parts that are in line with the Sharia will be accepted and used, while parts that are not in accordance with the Shariah will be rejected.

Following this approach, sharia accounting standards adopt the qualitative characteristics that are not in conflict with sharia, including that financial statements must present relevant and reliable information. Jiri and Godfrey et al. support the opinion that historical costs are relevant for decision making. When referring to reliable qualitative characteristics, Kieso and Weygandt state that historical cost has an important advantage, that is reliable. Pyle and Larson stated that the objectivity principle supports the idea that transactions are recorded at their cost. Within the framework of sharia accounting, there is a paradigm of responsibility for trust, and fulfillment of social responsibility. If the concept is accountability, then the historical cost becomes more relevant than the current value.

From the study of the books of the Ulama, we have the results that the idea of historical cost can be found in the books of the Shafi'iyyah who porposed that the merchandise is estimated in value with what is used to buy, in accordance with the purchase price, because the niṣāb of merchandise is based on the purchase price. In relation to the calculation of zakat and niṣāb, the author prefers the approach of the Shafī'iyyah. The purchase price is certain and has occurred, while the estimated current value is approximate and there is a possibility of not being realized. Benston mentioned that fair values other than level 1 (quotation prices in active markets) enable for manipulation and are not easy to verify. Zakat should be based on a more certain basic value. In addition, matching between business practices and markets cannot always be done, because some types of businesses are not market-based, so it is not easy to get an estimate of the current value.

Based on the discussion on the issue of the relevance and reliability of financial reporting above, there is enough evidence that the use of historical costs is still relevant and can be accepted in the sharia perspective. Following the concept promoted by the Shafī'iya, the measurement of assets should be based on historical value. This is considered more beneficial, especially if it is associated with the calculation of zakat.

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