
**FAIR VALUE ACCOUNTING VS. HISTORICAL COST ACCOUNTING:
IMPACT ON FINANCIAL STATEMENT ACCURACY DURING**

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ABSTRACT

The controversy between fair value accounting and historical cost accounting has become more heated since the financial crisis in 2008, especially in regard to which accounting standard is more useful in providing reliable financial reports in times of turmoil in economies. The following review aims at synthesizing existing bodies of knowledge in research studies focusing on these two models, outlining in depth their theoretical bases, applications, and conditions under which they would be more useful for specific stakeholders. Fair value accounting is relevant and up-to-date but can be subject to speculation and turbulence in markets, and historical cost is stable but may not reflect actual economic data in times of turmoil. Based on eighteen research studies and theoretical frameworks, this paper will explore the application and functionality of these two models in diverse economic conditions, especially in times of turbulence and uncertainty. The conclusion of this paper is showing that neither of these models can provide a general solution and that context-dependent applications and combinations may provide a solution for increasing and specific needs in financial accounting in these new technological and highly unstable economic times.

KEYWORDS: fair value accounting, historical cost accounting, reliability of financial statements, economic volatility, uncertainty of measurement, quality of financial reporting.

INTRODUCTION

Financial reporting finds itself at a strange crossroads. On the one hand, we call for financial reports that match today's world—no sense in information that explains yesterday's world in a way that informs today's decisions! But then we also want consistency, a way that allows us to compare data without a headache from changes every which way. This dilemma finds itself at the epicenter of a long-running question in accounting circles: How should assets and liabilities be recorded—fair value vs. historic cost?

This is not a novel question to ask, but economic downturns have a peculiar ability to make this one pressing as well. When the market went down with a crash in 2008, people accused fair value accounting of causing this disaster to snowball through penalties for banks to account for their monumental losses that precipitated more chaos than necessary. Another set of people argued that at least on an old cost basis, these problems would have remained under wraps.

Why this debate is so fascinating and infuriating is because both sides have a very convincing argument. Fair value advocates are absolutely right about relevance and transparency. Reliability and comparability are also legitimate concerns voiced by defenders of the historical cost model. Maybe what we need to see is not a battle of winners and losers but better utilize the applicability of each.

Theoretical Foundations and Conceptual Frameworks

The origins of historical cost accounting rest on a beautifully simple idea: match what you paid for it. The reason it appears so simple, so sensible, is that it's so verifiable—it's a matter of physically showing up and handing over cash (Mehta, A., Tax Revenue Composition: A Relative Assessment).

The simplicity and elegance of this kind of accounting are what gave rise to a system so valuable and so reliable, so verifiable, that it was considered the most conservative form of accounting available—and hence, the safest method to use when it comes to financial auditing (Mehta, A., Tax Revenue Composition: The thought process behind fair value accounting is different. According to it, historic purchase values become less and less relevant with time. A property bought for \$1 million two decades ago may currently be worth \$5 million—or perhaps \$500,000. Does it not make more sense to know its current value rather than its purchase price two decades ago? This view is in tune with the hypothesis that

financial reports ought to be used to forecast future cash flows rather than simply report history.

The International Accounting Standards Board and the Financial Accounting Standards Board have been increasingly leaning towards the use of fair values in recent decades despite some controversy. The justification of this approach lies in the idea of decision usefulness, such that investors will make better-informed decisions based on current information instead of historical values. The only problem that arises in implementing this concept lies in some uncomfortable realities.

Fair Value Accounting: Promises and Pitfalls

Fair value accounting works well in a normal market situation and provides a lot of advantages. The market prices that result from active market processes can create objective benchmarks based on market wisdom. Banks holding securities, for example, could display balance sheet information that portrays true economic positions instead of reporting an asset with possibly outdated prices.

This method is most excellent where financial assets are involved. For instance, where derivatives are involved, they are barely on the balance sheet at historical cost because the only value they have is the increase that comes from the market movements. Such items are practically reported at their fair value because historical cost does not enable the capturing of economic substance as is the case here. Similarly, the investment portfolio that is reported at its current market value will reflect what an institution could actually get if it wanted to liquidate (DR. MOHAMMED ABID & HARSHA LOHAR, 2025).

However, here is the point where the system hit the rails. Fair value accounting works flawlessly in stable markets. But when the market is not stable, the system has serious flaws. During the 2008 financial crisis, the fall of asset values sparked large write-offs that may well have sped up the crisis. There was also the need for banks to dispose of their assets in markets that were trending downward. In this case, the markets continued to fall.

However, this is not an easy task, especially in dysfunctional markets and markets with low liquidity. And what exactly is the "fair value" of an asset in situations wherein nobody's buying? Financial institutions find themselves having to base their calculations on assumptions and models, resulting in their becoming subject to manipulation, since

management discretion gets opened once again with their use, thereby clouding the promised transparency again.

Historical Cost: Blinders on Stability?

Historical cost accounting is something of a rarity in today's world of finance, and that is its stability. This is because assets are carried at their historical cost, or at cost less accumulated depreciation. This shields finance from market fluctuations in moods. During times when markets are volatile, things like this can be extremely welcome. Businesses will not be exposed to the shockwaves associated with wildly fluctuating balance sheets.

The conclusiveness that comes with reliability cannot be overlooked. The basis of accounting for historical costs is measurable history, which consists of specific transactions that actually took place at certain dates in the past. Historically, these accounts could easily be verified through documentation, which makes manipulation or mistake difficult tasks related to financial statements.

The gold standard in accounting conservatism, reliability, and financial statement presentation is determined by the ability of financial statements to provide a clear picture of a company's financial position at a certain point in time. However, there exist a number of issues with the historical cost approach, and these become apparent during times of economic instability. As a result of significant changes in the value of the company's assets, either when their value increases or when it depreciates, there become even stronger deviations between the historical cost accounts and the economic situation. There could be a situation where a company has healthy finances but has materially impaired assets. The appreciated assets will be recorded at a lower value, and a healthy company can appear less healthy than it actually is.

The relevance gap increases over time. For instance, take a plant that was acquired as a purchase investment thirty years ago. Historically, its cost could have depreciated but may not even relate to the current value or cost of a new asset. People making financial statements or investment judgments may find themselves dealing with data that is accurate but is more or less useless (Choudhary, P. D., & Madhwani, R., 2013).

Economic Volatility: The Stress Test

Economic downturns bring to light the gaps in both approaches. The global economic crisis of 2008 illustrated both the potential of fair value accounting to increase instability—it is true that banks took huge write-downs of their equity as their assets' value drastically declined—and to hinder banks' ability to extend new loans during an economic downturn, which further aggravated the situation.

Some scholars found evidence to support their findings that fair value estimates themselves added to procyclicality instead of reducing market cycles.

However, the case made by the fair value supporters about the potentially damaging consequences of an opposing approach—letting banks veil their worsening situations by pointing to their inherent values—is hard to argue against. Would it have revived market confidence by trying to cover losses in the market? Or would it simply have postponed the day of reckoning? The answer is an unknown variable in an unknowable equation.

The tourism and hospitality industry during different recessions provides a number of interesting examples. As pointed out by Choudhary and Madhwani (2013), recessions impact this area dramatically; accounting accruals assume a crucial role in shaping these effects. Historical cost reporting could provide a completely different picture when the financial performance deteriorates because the value of the asset could remain unchanged despite the financial meltdown.

The Role of Strategic Management and Organizational Context

Unfortunately, most organizations in the Accounting management does not occur under a void—strategic issues intersect. Organizations differ based on factors like the size of the business that affect accounting management concerning financial reports (Chaplot, 2018). There are varying demands and needs for accounting management depending on the nature of the business. A global corporation that issues public securities differs from a regional concern that is privately owned. These factors somehow affect accounting management measurements but uniform accounting principles are followed.

Medium-scale businesses tend to focus on consistency and equivalence, in contrast to market-to-market sensitivity, especially in the case of small towns (Mehta, A., & Hiran, D., 2023). For such businesses, the historical cost approach has helped in creating consistency that

allows better planning and management of relations with financial institutions. Variations in fair values could create inconsistencies in operations and would instead make it complex to make decisions.

The management perspective assumes importance in this regard. To arrive at appropriate strategic management, it is necessary to comprehend present positions as well as their performance patterns. However, if accounting practices become sources of considerable fluctuations, these may deviate instead of spotlighting the necessary information for management (Chaplot, 2018). Of particular importance is how these standards are adequate for different scenarios in an organization.

Technological Disruption and Future Directions

Technology is revolutionizing the field of accounting at an increasingly rapid pace with consequences for this discussion. Artificial intelligence and machine learning make it possible to carry out complex valuation calculations and real-time reporting, which were not feasible before (DR. Mohammed Abid, & Ramswaroop Bhambi, 2025). Such developments could eventually resolve the inconsistencies between the fair value and historical cost methods by allowing for continuous and reliable measurements on the fair value basis.

Machine learning models can process a huge amount of data in an attempt to provide fair values with more accuracy compared to the conventional approaches. AI models can potentially reveal more information that human auditors may not have noticed before. The technology can also improve the processes of audits so that the checking of fair values becomes more reliable (DR. MOHAMMED ABID & HARSHA LOHAR, 2025).

there are new risks posed by technology.

The valuations may be "black box" calculations, so lack clarity as to how a particular estimate is arrived at. However, model risk still exists. Advanced models may perform poorly when conditions differ from past observations. The "smartest guys in the room," as shown by the 2008 financial crash, created "expert systems" to determine asset values, which produced incredibly inaccurate valuations despite their mathematical correctness.

Finding Balance

Hybrid Approaches and Contextual Application

Perhaps the most fruitful way ahead lies in recognizing that a fair value alone or a historical cost alone may not be the best basis for all purposes. Various assets or various situations or

various ends may require a different basis altogether. It seems that existing attribute models which use fair value attributions for certain items and historical cost attributions for others reflect a certain balancing act, albeit accompanied by complexity and potential for inconsistency.

Others are of the view that there is a need for more disclosure than being required to make a choice between measurement bases. Since sophisticated users are required to have information on both historic cost and fair values, they are capable of reaching their own determination of relevance and credibility of that information.

Economic instability could itself offer a hint on measurement alternatives. During calm periods, the FAIR accounting principle is useful for providing up-to-date information without creating unnecessary precise noise. Then again, during periods of crises and uncertainty, the return to historical cost accounting or more prominent disclosures about measurement uncertainty could offer more towards ensuring reliability goals.

CONCLUSION

The debate between fair value and historical costs ultimately always presents underlying contradictions in financial reporting itself. There are concurrent demands for information to be relevant and reliable; it should be current and comparable; and it should be responsive and stable.

In a volatile economy, the need to strike a better balance between the two has become paramount.

In connection with financial instruments recognition in the financial report's statements and disclosures within the financial report itself, management Neither of the two recognition principles is entirely satisfactory. As long as the market is in good working order, the concept of fair value offers the advantages of relevance and transparency. However, in times of turmoil, the corresponding concept of historical cost is preferable since it achieves the aim of stability of measurement.

Going forward, the accounting profession could benefit stakeholders better by applying contextual thinking instead of seeking context-independent solutions. ME measures fit different situations better than others, depending on the assets in question. Mixed methods,

greater focus on disclosures, or tailored accounting standards that vary based on economic realities could offer better insights than extreme alternatives.

With advancing technology and periodic disruptures in the markets, these questions are bound to remain pertinent in the future as well. The aim should not be to score a point in a philosophical argument but to devise a strategy so that the stakeholders are able to take well-informed decisions irrespective of the economic conditions prevailing at any point in time.

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