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**17/SMS02/066**

**ACC 406**

**ASSIGNMENT TITLE : ACCOUNTING FOR CHANGING PRICES**

**Summary of the note**

Reporting assets on the Statement of Financial Position at their historical cost during a period of price changes can make the Statement of Financial Position information irrelevant. When the prices of goods and services in an economy increase in general, we say that inflation has occurred and also the general inflation rate affects the purchasing power of the currency.

Inflation has several impacts on the financial statement because during the period of inflation assets reported on the statement of financial position are understated in terms of their current value. Understated assets brings about understated expenses and in return results to overstated net income and overstated retain earnings .

**The following are some problems that ignoring changes in the prices of asset can bring about;**

* Understated value of assets can have negative effect on the company’s ability to borrow because the collateral is understated
* Overstated income means there will be more taxes paid to the government and that can make stakeholders demand more dividend that should be paid

historical cost accounting also ignores the purchasing power gains and losses that arise from holding monetary assets . This means holding cash and receivables during inflation period brings about loss in purchasing power but holding payables during inflation brings about purchasing power gains

**There are two methods of accounting for changes in prices ;**

* Account for changes in the general price level : This approach makes adjustments to the historical costs of assets to update for changes in the purchasing power of the currency. It is referred to as general price level adjusted historical cost ( GPLAHC)
* Account for specific prices changes : This is known as current replacement cost (CRC) or, simply, current cost (CC) accounting. In addition to adjusting asset values for changes in the general price level and determining expenses from GPLAHC amounts

**Net income and capital maintenance**

Application of each of the three methods of asset valuation—Historical Cost (HC) General purchasing power(GPP) , and Current cost (CC)— results in a different amount of net income. Each measure of net income relates to a specific concept of capital maintenance. Much of the debate surrounding the appropriate method for asset valuation relates to determining which concept of capital maintenance is most important.

**General purchasing power ( GPP )**

Under GPP accounting, nonmonetary assets and liabilities, stockholders’ equity, and all income statement items are restated from the GPI at the transaction date to the GPI at the end of the current period.

**Current cost accounting (CC)**

Under CC accounting, historical costs of nonmonetary assets are replaced with current replacement costs and expenses are based on these current costs.