NAME: JOAN PATRICK ESSIET

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**ACCOUNTING FOR CHANGING PRICES (INFLATION ACCOUNTING)**

Accounts receivable are reported at the net amount expected to be received in the future; short-term investments are reported at either cost or current market value; inventory is carried at the lower of cost or market value; and property, plant, and equipment is reported at cost less accumulated depreciation.

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.

Inflation occurs when the prices of goods and services in an economy increase in general. Economists often measure inflation by determining the current price for a “basket” of goods and services and then compare the current price with the price for the same basket of goods and services at an earlier time.

**Impact of Inflation on Financial Statements**

1. Understated asset values could have a negative impact on a company’s ability to borrow, because the collateral is understated.
2. Overstated income results in more taxes being paid to the government than would otherwise be paid and could lead stockholders to demand a higher level of dividend than would otherwise be expected.
3. Different companies have different rate of inflation, the understatement of assets and overstatement of income will differ across companies and this can distort comparisons across companies.

**Purchasing Power Gains and Losses**

Holding cash and receivables during inflation results in a purchasing power loss, whereas holding payables during inflation results in a purchasing power gain. Borrowing money during a period of inflation results in a purchasing power gain. A net purchasing power gain will result when an entity maintains monetary liabilities in excess of monetary assets during inflation, and a net purchasing power loss will result when the opposite situation exists.

**Methods of Accounting for Changing Prices**

Two solutions have been developed to deal with the distortions caused by historical cost (HC) accounting in a period of changing prices which are; Account for changes in the general price level also called general price-level-adjusted historical cost (GPLAHC) accounting or, more simply, general purchasing power (GPP) accounting. The second method is known as Account for specific price changes also called current replacement cost (CRC) or, simply, current cost (CC) accounting.

**Net Income and Capital Maintenance**

The application of each of the three methods of asset valuation – historical cost, general purchasing power, and current cost results in a different amount of net income. The appropriate method for asset valuation relates to determining which concept of capital maintenance is most important.