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**16/sms02/039**

**Acc 406**

**Accounting for changing prices (Inflation Accounting)**

Conventional accounting results in a mix of attributes being reflected in the asset section of the Statement of Financial Position. 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. Prices of most assets fluctuate, often increasing. 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

Historical Cost (HC) income is the amount that can be distributed to owners while maintaining the “nominal” amount of contributed capital at the beginning of the year.

**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.

**Purchasing Power Gains and Losses**

In addition to ignoring changes in the values of nonmonetary assets, historical cost accounting also ignores the purchasing power gains and losses that arise from holding monetary assets (cash and receivables) and monetary liabilities (payables) during a period of inflation. Holding cash and receivables during inflation results in a purchasing power loss, whereas holding payables during inflation results in a purchasing power gain.

**Methods of Accounting for Changing Price**

**General Purchasing Power (GPP) Accounting**

The first solution is to 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. 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. Non-current assets and intangible assets and the related depreciation and amortization would also be restated for changes in general purchasing power.

**Current Cost (CC) Accounting**

The alternative solution is to account for specific price changes by updating the values of assets from historical cost to the current cost to replace those assets. To determine the amount of income that can be distributed to owners while maintaining the company’s productive capacity or physical capital, current cost (CC) accounting must be applied.

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