**16/SMS02/030**

 **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. 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. For example, reporting land that was purchased in 1925 at its historical cost of N1, 000 is unlikely to provide financial statement readers with useful information in the 21st century. When the prices of goods and services in an economy increase in general, we say that inflation has occurred. 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**

During a period of inflation, assets reported on the Statement of Financial Position at historical cost are understated in terms of their current value. This results in understated expenses and overstated net income and retained earnings. Ignoring changes in the prices of assets can make understated asset values have a negative impact on a company’s ability to borrow due to understated collateral. Also, overstated income may result in more taxes being paid to the government. Companies may also experience liquidity problems.

**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 purchasing power gain.

**Methods of Accounting for Changing Prices**

Two solutions have been developed to deal with the problems caused by historical cost accounting in a period of changing prices. The first solution is to account for changes in the general price level, which in turn makes adjustment to the historical cost of assets to update for changes in the purchasing power of the currency. It is known as General Purchasing Power (GPP). 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 the asset. It is known as Current Cost Accounting (CCA). GPP also requires that purchasing power gains and losses should be included in the determination of net income.

Application of each of the three methods of asset valuation (HC, GPP, and 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. 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.

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