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ASSIGNMENT: SUMMARIZE THE NOTE ON ACCOUNTING FOR CHANGING PRICES

The prices of most assets fluctuate, they can increase or decrease. 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. Price increase and fluctuations can be caused by inflation.

Inflation generally refers to when prices of goods and services in an economy increase. Economists usually measure inflation by comparing the current price of a good or service with the price for that same good or service in previous years. For example, if a basket of goods and services costs N100 at the end of Year 1 and the same basket costs N120 at the end of Year 2, then inflation in Year 2 was 20 percent ([N120− N100]/N100).

When there is an increase in inflation rate, it shows a decrease in the purchasing power of the currency. For example, it takes N 120 at the end of Year 2 to purchase as much as N100 could purchase at the end of Year 1. The naira has lost 20 percent of its purchasing power during Year 2.

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, which in turn results in overstated net income and overstated retained earnings. Ignoring changes in the prices of assets can lead to a number of problems such as:

* Understated assets can negatively affect a company’s ability to borrow as collateral is understated.
* Overstated income leads to more taxes being paid to the government than what would have been paid and the shareholders may also demand for higher dividend than what is expected. This may cause the company to experience liquidity problems.
* It can also distort comparisons across companies.

PURCHASING POWER GAINS AND LOSS.

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 inflation. 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

In order to deal with the distortions caused by historical cost (HC) accounting in a period of changing prices, two solutions have been fostered;

The first is to account for changes in the general price level by making adjustments to the historical costs of assets to update for changes in the purchasing power of the currency and therefore is referred to as general price-level-adjusted historical cost (GPLAHC) accounting simply put, General Purchasing Power (GPP) accounting.

The second is to account for specific price changes by updating the values of assets from historical cost to the current cost to replace those assets. This is known as current replacement cost (CRC) or, simply, Current Cost (CC) accounting.

Application of each of the three methods of asset valuation (HC, GPP, and CC) results in a different amount of net income.