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**Summary of accounting for changing prices (inflation accounting)**

The conventional accounting model, with some exceptions like marketable securities and financial instruments, reports assets and related expenses at historical cost. Inventories and fixed assets appear at acquisition cost on the balance sheet, and some allocated portion of this acquisition cost appears on the income statement when firms sell or use the assets. The conventional accounting model also uses dollar or other currency to measure historical cost amounts over time on the presumption that the currency reflects a common measuring unit—that is, one dollar spent yesterday and one dollar spent today reflect equal sacrifices of purchasing power. Changes in supply and demand resulting from new technologies, demo- graphic shifts, consumer tastes and other factors causes market values to change. Even relatively small annual changes in prices can cumulate over time, resulting in serious distortions in the financial statements.

**Impact of Inflation on Financial Statements**

Understated asset values could have a negative impact on a company’s ability to borrow, because the collateral is understated.

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.

the understatement of assets and overstatement of income will differ across companies; this can distort comparisons across companies.

**Purchasing Power Gains and Losses**

Historical cost accounting ignores the purchasing power gains and losses that arise from holding monetary assets (cash and receivables) and monetary liabilities (payables) during the 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. 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**

1. **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. The conventional HC model of accounting ignores the loss in purchasing power of the beginning of year amount of capital.
2. **General Purchasing Power (GPP) Accounting:** Under GPP accounting, non-monetary 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. GPP income represents the amount that can be distributed to owners while maintaining the purchasing power of capital at the beginning of the year.
3. **Current Cost (CC) Accounting**: Under CC accounting, historical costs of non-monetary assets are replaced with current replacement costs and expenses are based on these current costs.