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**Question**
Summarise, in not more than 2 pages, the note on **Accounting for Changing Prices.**

SUMMARY

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 i.e. historical cost provide inaccurate information when price changes. Inflation is the general increase in the prices of goods and services over a period of time. Economist measure inflation by comparing the current price and prices at an earlier time. The general inflation rate also reflects the decrease in the purchasing power of the currency. Financial statement that are reported at historical cost are understated in terms of their current market value which impact the financial statements. It include:

1. Understated asset values which can have a negative impact on a company’s ability to borrow.
2. Overstated income, which results in more taxes being paid.
3. Distortion of comparisons among companies.

Inflation impacts purchasing power gains and losses. Holding cash and receivables during inflation results in a purchasing power loss, also holding monetary liability such as payables results in a purchasing power gain.

There are two methods for accounting for changing prices, they include:

1. General purchasing power accounting (GPP): this approach makes adjustment to historical costs of assets to update for change in the purchasing power of the currency.
2. Current cost accounting: this is also known as current replacement cost. This method account for specific price changes by updating the values of assets from historical cost to the current cost to replace those assets. In addition to adjusting asset values for changes in the general price level and determining expenses from GPLAHC amounts, GPP accounting also requires that purchasing power gains and losses be included in the determination of net income.

Net income and capital maintenance

There is a variation in net income as a result of applying the three methods of asset valuation; historical cost, general purchasing power and current cost method. 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.