**NAME:** YELLOWE GOODNESS NWOBIANDU

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**ASSIGNMENT TITLE:** SUMMARY OFACCOUNTING FOR CHANGING PRICES(INFLATION ACCOUNTING)

**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.

When the prices of goods and services in an economy increase in general, we say that inflation has occurred. Inflation rate also reflects the decrease in the ***purchasing power*** of the currency.

**Impact of Inflation on Financial Statements:** During inflation, assets reported on the Statement of Financial Position at historical cost are understated in terms of their current value. Having understated assets results in understated expense 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 asset values could have a negative impact on a company’s ability to borrow because the collateral is understated.

**Purchasing Power Gains and Losses**: In 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 and liabilities 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 Prices:** Two solutions have been developed to deal with the distortions caused by historical cost (HC)accounting in a period of changing prices. Firstly is to ***account for changes in the general price level***. This approach is referred to as ***general price-level-adjusted*** ***historical cost (GPLAHC)*** accounting or ***general purchasing power (GPP)*** 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 assets. This is known as ***current replacement cost*** ***(CRC)*** or ***current cost (CC)*** accounting. 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:** 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.

**General Purchasing Power (GPP) Accounting:** Under GPP accounting, nonmonetary assets and liabilities, stockholders’ equity, and all incomestatement items are restated from the GPI at the transaction date to the GPI at the end of the current period.

**Current Cost (CC) Accounting:** Maintaining the purchasing power of equity does not ensure that the company is able to continue to operate at its existing level of capacity, because the prices of specific goods and services purchased by an individual company do not increase at the rate of average inflation. 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.