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Department: Accounting

Level: 400

Course: Acc406 (International Accounting)

ASSIGNMENT

ACCOUNTING FOR CHANGING PRICES

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. 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. Not all goods and services increase in price by 10 percent when the average rate of inflation is 10 percent. The price of a new machine might increase by 15 percent, the price of component parts might increase by 12 percent, the price of janitorial services might increase by 5 percent, and the price of raw materials might actually decrease by 4 percent. These are measures of changes in specific prices. However, in our example, the changes in specific prices throughout the economy average out to an increase of 10 percent.

**Impact of Inflation on Financial Statements**

Ignoring changes in the prices of assets can lead to a number of problems such as:

i. Understated asset values could have a negative impact on a company’s ability to borrow, because the collateral is understated. Understated asset values also can invite a hostile takeover to the extent that the current market price of a company’s stock does not reflect the current value of assets.

ii. 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. Through the payment of taxes on inflated income and the payment of dividends out of inflated net income, both of which result in cash outflows, a company may find itself experiencing liquidity problems.

iii. To the extent that companies are exposed to different rates of inflation, the understatement of

assets and overstatement of income will differ across companies; this can distort comparisons across companies. For example, a company with older fixed assets will report a higher return on assets than a company with newer assets, because income is more overstated and assets are more understated than for the comparison company. Because inflation rates tend to vary across countries, comparisons made by a parent company across its subsidiaries located in different countries can be distorted.

**Purchasing Power Gains and Losses**

Holding cash and receivables during inflation results in a purchasing power loss, whereas holding payables during inflation result .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 in a purchasing power gain.

**Methods of Accounting for Changing Prices**

a .Historical Cost (HC) Accounting

b. General Purchasing Power (GPP) Accounting

c. Current Cost (CC) Accounting