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ACC 406

INTERNATIONAL ACCOUNTING

ACCOUNTING FOR CHANGING PRICES (INFLATION ACCOUNING)

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. 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.

Inflation is the general increase in the price level of goods. Economist measure inflation by determining the current price of a pack of goods in a period and compare it to the pack of good in the present period. For instance the price of a carton of indomitable was NGN1500 in 2019. In 2020 it became NGN2000. The rate of inflation is 33.3% (2000-1500/ 1500 \* 100).

The effect of inflation is on the purchasing power of the naira. The naira will lose the value of its purchasing power by the percent of inflation. That is, the naira will lose its value by 33.3%. The inflation rate is an average rate and it doesn't necessarily mean that the prices of all goods and services will be increased by 33.3%.

**Impact of Inflation on Financial Statements**

During the period of inflation, the assets which in the statement of financial position are recorded at historical cost are understated. Having understated value results expenses which results in overstated net income and overstated retained earnings. Therefore, ignoring the changes in the prices of the assets can lead to a number of problems such as:

1. This may have a negative impact on the company in terms of borrowing. The assets being understated reduces the collateral of the business.
2. Overstated income also leads to a higher amount of tax paid.
3. 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.

**Purchasing power gain and losses**

Having cash-in-hand and receivables during the inflation period leads to purchasing power loss while having payables during the inflation period leads to purchasing power gain. This is so because during inflation the value for money drops. So if I borrowed NGN1500 when 1500 could buy a carton of indomietables and I'm paying back when a carton is 2000, I have made a purchasing power gain.

**Methods of accounting for changing prices**

It is important to note that the 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.

1. Historical cost accounting: 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 accounting: This explicitly takes the change in purchasing power of the currency into account.
3. Current cost accounting method: Under current cost accounting, historical costs of nonmonetary assets are replaced with current replacement costs and expenses are based on these current costs.