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**SUMMARY OF ACCOUNTING FOR CHANGING PRICES**

**(INFLATION ACCOUNTING) NOTE**

**ACCOUNTING FOR CHANGING PRICES (INFLATION ACCOUNTING)**

Conventional accounting leads to a combination of characteristics 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 alter, 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 immaterial. When there is general increase in the price of goods and services in an economy, we say that inflation has occurred. Economists often measure inflation by determining the current price for a stock of goods and services and then compare the current price with the price for the same stock of goods and services at an earlier time.

During a period of 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 expenses (especially depreciation and cost of goods sold), 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

1. Understated assets having a negative impact on the company’s ability to borrow and invitation of forceful takeovers.
2. 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 creating liquidity problems.
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.

Two solutions have been developed to deal with the distortions caused by historical cost (HC)

accounting in a period of changing prices. The first solution is to **account for changes in the general price level**. This approach makes adjustments to the historical costs of assets to update for changes in the purchasing power of the currency and therefore is referred to as general price-level-adjusted historical cost (GPLAHC) accounting or, more simply, general purchasing power (GPP) accounting. The second solution will be to **account for specific price changes** by updating the values of assets from historical cost to the current cost to replace those assets. This is known as current replacement cost (CRC) or, simply, current cost (CC) accounting. Application of each of the three methods of asset valuation that is **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.

**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.

Under **General Purchasing Power** (**GPP)** accounting, nonmonetary 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.

Under **Current Cost (CC)** accounting, historical costs of nonmonetary assets are replaced with current replacement costs and expenses are based on these current costs. Maintaining the purchasing power of equity does not necessarily 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 necessarily 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.