**Ahmed Al-Amin Taiwo**

**17/SMS02/065**

**ACC 406**

**Accounting for Changing Prices**

Conventional accounting involves different items being reported at different instances in their life due to price changes and this makes historical costing in the statement of financial position irrelevant.

Inflation is the persistent rise in prices of goods and services and is often measured using the current price and historical price. This measures current price level or rate of inflation which reflects change in purchasing power of a currency. The rate of inflation doesn’t affect all goods equally and these differences reflect changes in specific prices.

During inflation, recording items at historical cost in the statement of financial position and ignoring price changes often leads to problems such as; Understated asset values, lower credit rating, wrong reflection of stock, overstated income, higher taxes, demand for higher dividend by stockholders, liquidity problems, distorted comparisons across companies, etc.

Historical cost accounting ignores the fact that holding monetary assets results in a purchasing power loss and vice versa for monetary liabilities.

Two solutions have been developed to deal with the problems of historical cost accounting and these are; accounting for changes in the general price level which adjusts historical cost of assets as changes occur in the purchasing power of the currency and this is referred to as General Price-Level-Adjusted Historical Cost (GPLAHC) or General Purchasing Power (GPP) accounting for short. The other solution is to account for changes in specific prices by updating the values of historical cost to current cost, this is known as Current Replacement Cost (CRC) or Current Cost (CC) accounting. GPP accounting also requires that purchasing power gains and losses be included in the determination of net income.

Application of the three methods of asset valuation results in a different amount of net income and each relates to a specific concept of capital maintenance. Debates around the issue of the appropriate method of asset valuation relates to the importance of capital maintenance.

Under historical cost accounting, income is the amount that can be distributed to owners while maintaining the “nominal” amount of contributed capital at the beginning of the year but this ignores changes in purchasing power. GPP accounting income refers to the amount that can be distributed to owners while maintaining the purchasing power of capital at the beginning of the year while taking change in purchasing power into account. CC accounting determines the amount of income that can be distributed to owners while maintaining the company’s productive capacity or physical capital as maintaining the purchasing power of equity doesn’t necessarily mean that the company is able to operate at its existing level of capacity as prices of specific goods and services purchased by an individual company do not necessarily increase at the rate of average inflation.