NAME: Ibeneme Philip u.

MATRIC NO: 15/sms02/035

COURSE CODE: Acc406

**Summary of Accounting for Changing Prices.**

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.

**Impact of Inflation on Financial Statements**

During a period of inflation, assets reported on the Statement of Financial Position at historical cost are understated in terms of their current value

* Understated asset values could have a negative impact on a company’s ability to borrow, because the collateral is understated.
* 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.
* 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 Gains and Losses**

In addition to ignoring changes in the values of non-monetary assets, historical cost accounting also ignores the purchasing power gains and losses that arise from holding monetary assets (cash and receivables) and monetary liabilities (payables) 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. 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 alternative solution is 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. 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, non-monetary 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. Because inventory was acquired on January 1, 2011, when the GPI was 100, and the GPI at December 31, 2011, is 120, the cost of sales (inventory) is restated using the ratio 120/100. Non-current assets and intangible assets and the related depreciation and amortization would also be restated for changes in general purchasing power.

**Current Cost (CC) Accounting**

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.