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Accounting for changing prices (Inflation accounting)

The prices of most assets are not fixed and could increase due to inflation, therefore reporting assets on the SOFP at their historical cost during a period of inflation could render the SOFP information irrelevant. An inflation rate depicts a decrease in the purchasing power of the currency e.g., If the price of goods and services in the current year has increased by 10% from the previous year, then the naira has also lost 10% of its purchasing power.

During Inflation, assets reported at historical cost are understated in their current value which results in understated expenses and further leads to overstated net income and retained earnings. The effects of ignoring price change of assets are:

i) Understated asset values could negatively impact the company’s borrowing ability since the collateral is understated. It also invites a hostile takeover.

ii) Overstatement income could cause a company to experience liquidity problems, this arises when government demands more tax and shareholders demand more dividend as a result of the false income reflected in the SOFP.

iii) Since companies are exposed to different rates of inflation, understatement and overstatement of assets and income will be different across various companies and this could lead to a distortion in comparison across companies.

Purchasing Power Gains and Losses

Historical accounting not only ignores changes in the value of assets, but also ignores changes in the purchasing power gains and losses that arise from holding cash, receivables and payables during inflation. Holding cash and receivables during inflation leads to purchasing power loss, while holding payables lead to gain. Borrowing of money also leads to a gain in purchasing power. A net purchasing power gain occurs when an entity maintains monetary liabilities in excess of monetary assets during inflation while a net purchasing power loss occurs when the situation is reverse.

Methods of Accounting for Changing Prices

1. Account for changes in the general price level. This method adjusts the historical costs of assets to changes in purchasing power of currency. It is referred to as ‘general price level adjusted historical cost’ (GPLAHC) or ‘general purchasing power’ (GPP) accounting. GPP also requires that purchasing power gains and losses be included in net income determination.

Historical cost income is the amount that can be distributed to owners while maintaining the nominal amount of contributed capital at the beginning of the year. GPP income is the amount that can be distributed to owners while maintaining the purchasing power capital at the beginning of the year.

2. Account for specific price changes. This method updates the values of assets from historical cost to current cost to replace the assets. It is known as ‘current replacement cost’ (CRC) or current cost’ (CC) accounting.

The application of each of these methods result in different amount of net income, each relating to a specific concept of capital maintenance and a comparison of their results will show the problems that could arise if changes in prices due to inflation are ignored.