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**MATRIC NO: 16/SMS02/033**

**COURSE CODE: ACC406**

**COURSE TITLE: INTERNATIONAL ACCOUNTING**

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

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. When the prices of goods and services in an economy increase in general, we say that inflation has occurred. Economists often measure inflation by determining the current price for a “basket” of goods and services and then compare the current price with the price for the same basket of goods and services at an earlier time. In this case we have measured the increase in the general price level, or the rate of inflation. The general inflation rate also reflects the decrease in the purchasing power of the currency.

**Impact of inflation on financial Statement**

During inflation period, asset reported on the statement of financial position at historical cost are understated in terms of their current value. Understated assets results in understated expenses, 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 asset values could have a negative impact on a company’s ability to

borrow, because the collateral is understated.

1. Overstated income results in payment of more taxes on inflated income and the

payment of dividends out of inflated net income, both of which result in cash outflows, a company may find itself experiencing liquidity problems.

1. 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. The fact that inflation rates tend to vary across countries, comparisons made by a parent company across its subsidiaries located in different countries can be distorted

**Purchasing power Gains and Losses**

Historical cost accounting also ignores the purchasing power gains and losses that arise from holding monetary assets known to be “cash and receivables” and monetary liabilities “payables” during a period of inflation. Cash and receivable held during inflation results in a purchasing power loss, whereas payables held 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,

**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.

Under 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. Non-current assets and intangible assets and the related depreciation and amortization would also be restated for changes in general purchasing power.

**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.

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.