ACCOUNTING FOR CHANGING PRICE (INFLATION ACCOUNTING)

When the price of goods and services in an economy increases in general, it can be said that inflation has occurred. Economist often measure inflation by determining the current price of goods and services and then compare the current price for the same goods and services at an earlier time.

Implication on Inflation on Financial Statements

During inflation, assets reported on the Statement of Financial Position are understated in terms of their current value. Ignoring changes in the prices of assets can lead to the following problems such as:

1. Understated asset value could have a negative impact on a company’s ability to borrow. Understated assets can invite a hostile takeover to the extent that the current market price of a company’s stock does not reflect the current value of assets.
2. Overstated income results in more taxes being paid to the government than would otherwise be paid and could lead to shareholders demanding a higher level of dividend than would be otherwise expected. Payment of taxes on inflated income and the payments of dividends out of inflated net income, both of which would result in cash outflows and a company might find itself experiencing liquidity problems.
3. Companies are exposed to different rates of inflation, understatement of assets and overstatements of income will differ across companies and this can distort comparisons between companies. Inflation rates tends to vary across countries, comparisons made by a parent’s company across its subsidiaries located in different countries can be distorted.

Purchasing Power Gains and Losses

Holding cash and receivables during inflation results in a purchasing power loss, whereas holding payables during inflations 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 accounting caused in a period of changing in price. The first solution is to account for changes in general price level. In this approach it makes adjustment to the historical costs of assets to update for changes 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. The other solution is to account for specific price changes by updating the value of assets from historical cost to the cost to replace those assets. This is known as current replacement cost (CRC) or, simply current cost(CC)accounting. In addition, GPP accounting also requires that purchasing power gains and losses be included in the determination of net income.

Net Income and Capital Maintenance

The 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.

General Purchasing Power(GPP) Accounting

Under GPP accounting, nonmonetary assets and liabilities, stockholder’s equity, and all income statements items are restated from the GPI at the transaction date of the GPI at the end of the current period. Non-current assets and intangible assets and the related depreciation and amortization would be restated for changes in general purchasing power.

Current Cost (CC)Accounting

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.

Under CC accounting, historical costs of nonmonetary assets are replaced with current replacement costs and expenses are based on these current costs.

If HC accounting is used as the basis for taxation and dividend distribution, there is a good chance that the company will not be as well off at the end of the year in terms of either purchasing power or productive capacity at it was at the beginning of the year.