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Acc 406

**Accounting For Changing Prices(Inflation Accounting)**

Inflation occurs when the prices of goods and services in an economy increase in general , economists usually measure inflation by comparing the current price of goods with the price of the same goods at an earlier time for example if a basket of garri cost 120 at the end of year 1 and the same basket of garri cost 132 at the end of year 2 , then inflation in year 2 was 10 percent .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. In our example, it takes N 132 at the end of Year 2 to purchase as much as N120 could purchase at the end of Year 1. The naira has lost 10 percent of its purchasing power during Year 2.

Not all goods and services increase in price by 10 percent when the average rate of inflation is 10 percent. The price of a new machine might increase by 15 percent, the price of component parts might increase by 12 percent, the price of janitorial services might increase by 5 percent, and the price of raw materials might actually decrease by 4 percent. These are measures of changes in specific prices. However, in our example, the changes in specific prices throughout the economy average out to an increase of 10 percent.

**Impact Of Inflation On Financial Statement**

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

ii.To the extent that companies are exposed to different rates of inflation, the understatement of assets and overstatement of income will differ across companies.

iii. A company may find itself experiencing liquidity problems.

**Purchasing power gains and losses**

when the general price level index is 120, N120 in cash can purchase one whole basket of goods and services. One year later, when the general price level index stands at 132 (10 percent inflation), the same N120 in cash can now purchase only 90.9 percent of a basket of goods and services. It now takes N132 to purchase the same amount of goods and services as at the beginning of the year.

**Methods Of Accounting For Changing Prices**

1. Accounting for changes in the general price level

2. Accounting for specific price changes