Ometie oritsegbubemi Olivia

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**ACCOUNTING FOR CHANGING PRICE**

Inflation can be defined as when the prices of goods and services in an economy increase in general. 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. For example, if a basket of goods and services costs N120 at the end of Year 1 and the same basket costs N132 at the end of Year 2, then inflation in Year 2 was 10 percent ([N132 − N120]/N120).

In this case we have measured the increase in the general price level, or the rate of inflation.

# **Impact of Inflation on Financial Statements**

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

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.

# **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.