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ACC 406

**ACCOUNTING FOR CHANGING PRICES**

This has to do with inflation accounting. During inflation, 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. The effect of inflation is on the purchasing power of the currency. The currency will lose the value of its purchasing power by the percent of inflation.

Inflation has some impacts on the financial statements, some of these impacts are:

1. Overstated income also leads to a high amount of tax paid
2. This may have a negative impact on the company in terms of borrowing. The assets being understated reduce the collateral of the business.
3. 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.

**Purchasing power gain and losses**

Having cash-in-hand and receivables during the inflation period leads to purchasing power loss while having payables during the inflation period leads to purchasing power gain. This is so because during inflation the value for money drops. For example, if a person borrows 3000 thousand naira when the 3000 thousand naira could buy a football and he is paying back when a football is 4000 thousand naira, he has made a purchasing power gain.

**Methods of accounting for changing prices**

There are methods for changing prices which are: historical cost accounting, general purchasing power accounting, and current cost accounting method.

1. Historical cost accounting: 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. The conventional HC model of accounting ignores the loss in purchasing power of the beginning of year amount of capital.
2. General purchasing power accounting: This explicitly takes the change in purchasing power of the currency into account.
3. Current cost accounting method: Under current cost accounting, historical costs of non-

monetary assets are replaced with current replacement costs and expenses are based on these current costs.