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**ACCOUNTING FOR CHANGING PRICES (INFLATION ACCOUTING)**

Sometimes, the prices of assets fluctuate and 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 and economists measure the rate of inflation or the increase in general price level.

During inflation, assets reported on the Statement of Financial Position at historical cost are understated in terms of their current value. Having understated assets results in understated expenses (especially depreciation and cost of goods sold), which in turn results in overstated net income and overstated retained earnings. Inflation has some impacts on financial statements which are:

1. Understated asset values could have a negative impact on a company’s ability to borrow, because the collateral is understated. Understated asset values also 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 stockholders to demand a higher level of dividend than would otherwise be expected. This could eventually lead to liquidity.
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.

**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. They are general purchasing power (GPP) and current cost (CC). 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. While under CC accounting, historical costs of nonmonetary assets are replaced with current replacement costs and expenses are based on these current costs.

Current cost accounting is applied to determine the amount of income that can be distributed to owners while maintaining the company’s productive capacity or physical capital. This arises as a result of the fact that 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.