ACCOUNTING & INFLATION AN EXAMINATION OF THE C.P.P. METHOD

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1. INTRODUCTION

The Australian Accounting bodies have now produced two exposure drafts which outline methods of accounting in a period of inflation. The first draft was a method of "Accounting for Changes in the Purchasing Power of Money" which is known as the C.P.P. Method. More recently a draft on a method of current value accounting has been published.

This article examines the C.P.P. method. It is intended to comment upon the current value method in another article.

Members of the Securities Institute are urged to study both proposals as adoption of either method could bring about substantial differences in the financial information presented in annual accounts.

When both proposals have been studied the S.I.A. should make the consensus of its members known to the accounting bodies. The membership of S.I.A. probably represents more users of financial statements than any other body and its view should be promulgated.

2. CONCLUSION

The authors of this article conclude that the method of financial reporting set out in the C.P.P. Draft does not satisfy the needs of users of financial statements.

We are delighted that the profession is searching for ways to deal with the serious shortcomings of accounts based on historic cost, but unfortunately the basis of the C.P.P. proposals is for historic cost accounts to be subjected to certain arbitrary arithmetic adjustments to reflect only some aspects of changes in the value of money.

The C.P.P. method does highlight the rather obvious effect of inflation on monetary balances. In times of inflation monetary assets will have declining purchasing power and monetary liabilities will be repaid in monetary units of a depreciating currency. The C.P.P. method discloses a loss where there is an excess of net monetary assets and a surplus where there is an excess of net monetary liabilities. Nowhere does it show the present position, in either realisable or replacement values, of the business.

C.P.P. accounts are difficult to interpret: They are misleading and will probably confuse many users.

If C.P.P. is adopted, we would be most concerned if this resulted in users believing that a means of accounting for inflation had been found and that the figures shown were in fact representing the actual situation.

It would be most unfortunate if adoption delayed the introduction of a more meaningful method of accounting.

The C.P.P. Draft asks for comment on three particular aspects:—

(a) Index to be used; while we do not support the C.P.P. method, if it is necessary to use an index, we would favour a single general index; the gross domestic product (G.D.P.) implicit deflator seems best for Australian conditions.
(b) Application of the index to paid—in capital; the suggestion that paid—in capital be regarded as a non—monetary item seems to be more consistent than the alternative. However, grave inconsistencies in philosophy and technique follow where the C.P.P. method excludes revaluation reserves, general reserves and unappropriated profits.
(c) Other methods of accounting for price changes; the Preliminary Exposure Draft on a method of current value accounting will be commented uponseparately.

3. NEEDS OF USERS (or Accounting Objectives)

In civilised community it is essential that in all commercial dealings there be certain basic information which is true, easily comprehensible, readily accessible and equally available to all.

Financial statements are the means of conveying information of financial results and position to those who contemplate making a decision: managers, potential investors, existing investors reviewing their portfolio, creditors and debtors, potential creditors and debtors, employees and those contemplating employment, governmental and other authorities.

To make an effective decision, a user of financial statements will require to know the present position of the enterprise, the means available to it and the outcome of past decisions.

The user will require financial statements to be prepared so as to record the reality they seek to represent: that is, assets and liabilities as shown are verifiable in law, in fact and in monetary values.

4. HISTORICAL COST ACCOUNTS

As financial statements prepared on the basis of historical cost accounting do not satisfy the real needs of most analysts and other users it is desirable that meaningful accounts be produced.

We consider such accounts should be substituted in place of the historic ones and that such historical data as is necessary to fulfill legal obligations ought to be given in supplementary notes.

5. OUTLINE OF C.P.P. METHOD

(Members should read the draft issued by the Institute of Chartered Accountants in Australia and the Australian Society of Accountants.)

Conventional historical accounts are retained and the C.P.P. accounts are presented as a supplement.

A suitable index is applied to the non–monetary historical items (except shareholders' funds) to restate them in units of uniform general purchasing power. Shareholders' funds are a residual item.

Monetary items are not adjusted as they are already in end of year dollar terms.

Balance sheet figures at the beginning of the period are converted into dollars of end period purchasing power. Non–monetary items are adjusted for changes in purchasing power since acquisition. Monetary items are adjusted for changes in purchasing power during the year. (That is, non–monetary items remain at the same adjusted level in C.P.P. accounts while opening balance monetary items are adjusted and end of year monetary items are unadjusted.) In effect, it is assumed that non–monetary items will not gain or lose purchasing power through inflation.

The C.P.P. profit and loss account will reflect (in a period of inflation):

- The loss of purchasing power through holding a monetary claim.
- The gain as a result of a monetary liability.
- Some elimination of inflationary stock profits.
- Additional depreciation.
- The net gain as a result of the index being applied to sales, purchases and all other costs for the period between the average date at which they occurred and end of year.

6. SOME SHORTCOMINGS OF C.P.P.

(a) In common with historical cost accounts, C.P.P. accounts may give a false impression of accuracy. There is too much emphasis on verification and not enough on realism and relevance. ("It is better to be vaguely right than precisely wrong" – attributed to J.M. Keynes.)

(b) Using a common general price index does not necessarily have any relevance to a particular company which may have experienced quite different changes in valuation.

(c) Including in earnings the gains and losses as a result of monetary items can give a misleading impression.

This could encourage some companies to maximise C.P.P. earnings by increasing their debt and thereby increasing the financial risk. Mainline and Cambridge Credit would no doubt have had very high C.P.P. results. Of more relevance to the user is the amount earned as a result of investing the proceeds of the debt raising.

(d) C.P.P. accounts derive from an arithmetic adjustment to historic accounts; such adjustments which lessen the degree of difference between historic figures and actual position are largely fortuitous. The method purports to show the effects of inflation on the financial position and results of the firm, but in fact deals only with what it claims to be the effects of inflation on the historical cost accounts.

It seems technically improper to apply price indices to figures which have been the subject of ad hoc adjustments in the previous year such as reduction to the lower of cost or net realisable value.

(e) Major difficulties exist in implementing C.P.P. and these highlight the imperfection that results and the unsoundness of the working rules. Readers should attempt a practical example.

Areas of concern include:

(1) Whether the components of shareholders funds should be treated as monetary or non–monetary items (or neither as at present).
(2) Foreign currency items can be treated in several ways as can the consolidation of foreign subsidiaries.
(3) Consolidated accounts appear to require considerable attention.

(f) It is thought unlikely that many managements will use C.P.P. accounts for their own decision making because of compilation delays and lack of relevance. If this is so, why should C.P.P. accounts assist investors?

(g) Most users will find it difficult to comprehend the C.P.P. results. There is little in the literature which attempts to explain the figures.

Confusion will occur when the historical cost and C.P.P. accounts show contradictory trends in key financial ratios. The retrospective adjustments of earlier balance sheet figures can be difficult to follow.

(h) The Draft itself recognises the implicit limitations in para 21: "In the conversion process, after increasing non–monetary items by the amount of inflation, it is necessary to apply the test of lower of cost (expressed in dollars of current purchasing power) and net realisable value to relevant current assets, e.g. stocks, and further to adjust the figures if necessary. Similarly, after restating fixed assets in terms of dollars of current purchasing power, the question of the value to the business needs to be reviewed in that context and provision for write–down made if necessary. Other matters that will need to be considered include the adequacy of the charge for depreciation on freehold and long leasehold properties and whether it may be necessary to include in the provision for deferred income tax in the supplementary statement, an amount for the income tax on any taxable gain which would arise on a sale of the assets at the date of the balance sheet at the amount shown in the supplementary statement". This indicates that even with C.P.P. accounting, companies will need to ascertain current values.

7. ACCOUNTING FOR INFLATION

The C.P.P. method is one way of illustrating some aspects of the possible effects of changes in purchasing power. As such it is a useful exercise to conduct from time to time. However, it should not be considered a desirable financial statement because of the reasons set out in 6 above.

In our opinion, the C.P.P. method is not the solution in inflationary times to enable companies to preserve their capital and remain viable. We do not see C.P.P. accounts as being useful in the determination of taxable income.