ACCA

Should accounts be trying to predict the future?

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Founded in 1904, ACCA has consistently held unique core values: opportunity, diversity, innovation, integrity and accountability. We believe that accountants bring value to economies in all stages of development. We aim to develop capacity in the profession and encourage the adoption of consistent global standards. Our values are aligned to the needs of employers in all sectors and we ensure that, through our qualifications, we prepare accountants for business. We work to open up the profession to people of all backgrounds and remove artificial barriers to entry, ensuring that our qualifications and their delivery meet the diverse needs of trainee professionals and their employers.

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Financial reporting does not provide predictions of the future. It does, however, aim to provide recent historical financial information in a way that is most helpful to allow others to make their own predictions.

In this paper ACCA's Global Forum for Corporate Reporting examines the past and future perspectives of financial reporting.

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The fundamentals of accountancy, like other functions, come into the spotlight when things go wrong. So when companies go bust, when there are major losses or more systemic financial crises, people often ask: what were the accountants doing? Or they ask the related question: where were the auditors?

From one angle these questions make no sense. Accounts are self-evidently a record of the past and were produced before the bust. Typically, management presents full financial statements for the year ended 20XX a few months after year end, depending on how long the company takes to prepare them. So while the profit and loss account is clearly the past, the balance sheet represents a snapshot in time, like the present but the present a short while ago. Of course there may be shorter interim accounts every half year or quarter but, whatever the period, financial statements are historical and not a forecast for the year ahead.

While accounts may be historical records, this is not to say that the work of accountants is always backward-looking. A major part of their contribution to businesses is to develop forecasts and budgets to help underpin corporate strategy, and to plan and control operations. Reporting actual outcomes is done not only to inform external stakeholders, but also to monitor and refine the forward plans and budgets.

In fact, in the IFRS conceptual framework the stated objective for historical reporting is to provide financial information to help existing and potential investors, lenders and other creditors assess the prospects for future net cash inflows to an entity to help in making decisions about providing resources.

Reconciling these past and future perspectives of financial statements is fundamental. The development of conceptual frameworks for the accounting standards has helped clarify thinking on this, but it leads into other questions about accounting. Some commentators have emphasised the role of financial statements in providing the true and fair view of the record of the past and believe that stressing the predictive element of decision making places burdens of expectation that will be hard to fulfil. Some make links, therefore, between the past-orientation and predominance of historical cost, prudence, and an aim of reporting to existing shareholders on management's stewardship of the business on their behalf. Equally, the predictive role is linked to the accounts as a report to the market more generally, and to fair values, more complex accounting and extensive disclosures of assumptions and judgements. This paper examines the past and future perspectives of financial reporting, without straying too far into these wider implications.

NOT INCLUDING THE FUTURE

As noted above, financial statements are a record of the past and so they should in principle restrict themselves to that. Nonetheless, in practice the dividing line between the past and the future can be tricky to determine in some cases.

In revenue recognition, for example, there is clearly a process from the initial enquiry of a customer through order, delivery and payment. Accounting must decide when that sale can be recognised as part of the past/present and not anticipate sales even where they are likely. The principles are prudent here – there must be a contract and control of the item must have passed to the customer.

Restricting accounts to past events may not always appear prudent. Many found the strict definitions of liabilities or provisions in IFRS that there must be an obligation at the balance sheet date, went against traditional 'prudent' practice. Building up provisions in advance for repairs is not permitted even when these would be highly likely to be spent.

How much does information arising subsequently clarify the present (the snapshot of the balance sheet date) or how much do they constitute future events? The general principles in IAS10 state that events after the balance sheet date but before the accounts are approved for issue should be categorised as either adjusting (those that clarify conditions existing at the balance sheet date) or non-adjusting. Non-adjusting events while not changing the accounting numbers may be disclosed as notes if they are material to an understanding of the business. So for items stated using current values – for example, a currency exchange rate or quoted market prices – major price changes are subsequently deemed non-adjusting and are accounted for in the future. In other cases it can, however, be harder to separate revisions to estimates from later changes, for example when current values are not based on prices in active markets. So impairments of trade receivables and inventory take many subsequent events as clarification of the position at the balance sheet date and therefore adjust the values in the financial statements.

REFLECTING THE FUTURE

It is not really possible to have an entirely historical record and in many cases accounting does have to consider the future.

It is an underlying concept that accounts are prepared on the basis that the business will remain a going concern for the foreseeable future. Under IFRS management is required, in assessing the validity of that assumption, to take into account all information about the future for at least 12 months after the balance sheet date. This going concern assumption should be a carefully considered expectation that the

business will not go bust in that period, but not perhaps a guarantee. Other jurisdictions or the auditors may require a longer 'look forward' period, say 12 months after the approval of the accounts. If a business is not a going concern new liabilities might need to be recognised and the values of others might need to be adjusted. Even the depreciation of amortised cost of plant and equipment depends on the forecast of a future expected economic life.

The example of the impairment of receivables and other current assets has been noted and the extent of the future being reflected is likely to increase as the financial instrument accounting moves from incurred loss impairment in IAS39 to expected losses in IFRS9. For other sorts of asset there is impairment based on value in use or on net realisable value, which is a present value of predicted future cash flows.

Many liabilities have no fixed amount and so there has always been the need to estimate future cash flows to value provisions for pension promises, insurance claims or the outcome of legal cases.

In most cases the difference between reflecting the future, or not, lies in recognition and measurement. If the event giving rise to the asset or liability is in the past then it can be recognised, but a consideration of likely future events may be needed to measure (value) it properly. This looking forward involves considerable judgement and so is the source of much disclosure complexity in order to explain the material assumptions, sensitivities and judgements.

PROVIDING RELEVANT INFORMATION

So accounts are a past record that has to reflect the future to some extent, but that definition does not yet reconcile with the objective of helping with the estimation of future cash flows.

The key is that accounts do not (yet) include forecasts, but the past record is provided as a source of information (although not the only one) to allow users to predict the future cash flows for themselves. The objective of the accounting standards is to be as helpful as possible to users in the selection of historical information that is given to them and in the way it is presented.

Timeliness of reporting is a key attribute in assisting prediction by ensuring that historical reporting is as up to date as possible. The trend for faster reporting seems likely to continue. Market pressures, rather than regulation, have meant that interim reports (whether half yearly or quarterly) already include more of the information that was previously only available once a year.

As regards future cash flows, accounts include a cash flow statement and an accruals-based income statement, which in combination allow users to estimate the connectivity between profits and net cash inflows.

The income statement is presented in a way that is likely to help in estimating future profits – for example, in providing comparative figures and the separate presentation of additional items that might be expected to occur infrequently and of discontinued operations. Segmental performance is presented to allow analysts to apply different growth and risk factors to income from different lines of business or from different economies.

One of the key forthcoming debates in the IASB's work is that on the rationale for including items of income or of expense either as part of profit, or as other comprehensive income (OCI). One possible discriminator for OCI items is their non-recurrence or volatility, meaning that they do not assist in the prediction of future profits or cash flows.

As noted above, a predictive role for accounts has been linked to an increased use of fair value as opposed to historical cost. It is harder to see this direct connection because fair value is intended to capture not a past value nor a future value but a present value (at the balance sheet date). For short-life assets, for example, cost may represent a past fair value and it is not inevitable that a current fair value will be more predictive of the future realisation value than a past value. For longer-life assets, such as property, historical costs may get significantly out of date. It is a probably reasonable to presume that current fair values represent a better prediction of future cash flows than older ones. Nonetheless, fair values introduce market changes, over which management may have limited short-term control, as 'noise' in the predictive models, and this obscures the longer-term performance of the management of the company in earning returns.

The financial statements themselves may be one source of information to help estimate future cash flows, but other elements of corporate reports are increasingly providing additional information to help. In relation to financial risks, the notes to the financial statements have to discuss the risks that a business faces and the strategy that has been adopted to address those risks. A management report is increasingly recommended or required to supplement the financial statements – whether called a management commentary, strategic report, or management discussion and analysis. The IASB's Management Commentary practice statement would be typical in this regard in stating that such reports should specifically include forward-looking information, for example in:

- management objectives and strategies
- prospects, and
- critical performance measures.

Some studies have shown that in practice the quantity of forward-looking information disclosed tends to be less than expected. There is, of course, a natural reluctance to commit

to very precise forecasts in most circumstances, perhaps because of the problems when they are not met. Listed companies with an analyst following tend to leave the forecasts to the analysts.

Some other forms of reporting, such as integrated reporting (IR), aspire to remedy the perceived historical nature and limitations of existing financial reporting by also having a focus on forward-looking information. IR will try to explain how the business model creates value and how the strategy of the business relates to its ability to sustain its value creation in the short, medium and long term.

CONCLUSIONS

Financial reporting does not provide predictions of the future. It does, however, aim to provide recent historical financial information in a way that is most helpful to allow others to make their own predictions. In providing that historical information there are sometimes difficulties in determining the accounting period in which a transaction should be recognised. Having recognised those transactions, to value and measure them the accounts inevitably need to look forward and that is where much of the judgement inherent in accounting has to be applied. Outside the financial statements, businesses are encouraged to provide information in management reports to help users in estimates of future performance and cash flows, particularly information about strategies, risks or more specific forecasts.

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