Courting confidence

The concept of confidence accounting is being developed using probability distributions to represent a range of outcomes, explains John Davies

John Davies FCIS is former head of technical at ACCA.

The dramatic changes in corporate value we saw during the financial crisis serve as a reminder that the accounting information currently contained in financial statements does not, and cannot aspire to, represent economic realities with absolute certainty.

Though figures are largely arrived at through standardised methodologies, they are also conditioned by the particular accounting policies adopted by preparers and are the product of various assumptions, estimates and forecasts. Judgments are made in the context of an understanding of business and market circumstances, which entails an element of subjectivity. It is also implicit in benchmarks such as 'true and fair' and 'fair presentation' that users of accounts can only expect an assurance that they comply with technical rules and incorporate reasonable judgments; International Financial Reporting Standards and other frameworks can only go so far.

It is to address this fundamental issue of uncertainty that the concept of confidence accounting is being developed. This identifies the degree of confidence that preparers have with the figures they are including. While companies may be perfectly justified, on technical grounds, in reporting certain figures, the absolute figures may be based on estimates shrouded with uncertainty. Even where fair values are adopted as a basis of measurement of assets and liabilities, this cannot be a guarantee that figures are entirely accurate. And as the financial crisis has shown, business circumstances can change so dramatically that assumptions thought reasonable can lead to figures becoming wholly misleading within a very short time.

DEGREE OF CERTAINTY

Confidence accounting is an approach to measuring the degree of certainty of values in financial statements. This was set out in a paper by Michael Mainelli FCCA and co-published by ACCA, the Chartered Institute for Securities & Investment and Long Finance. He suggested that attributing a single, precise number to assets and liabilities implied more accuracy than may be possible or justified, and proposed the use of probability distributions to represent a range of outcomes for specific items. The addition of probability distributions would serve to acknowledge the state of uncertainty and enhance readers' understanding by presenting an idea of the likelihood of reliability. The approach would serve the additional purpose of reflecting the entity's focus on risk by incorporating a direct association with management of risk.

Adrian Berendt FCCA

CHAIR, ACCA GLOBAL FORUM FOR GOVERNANCE, RISK AND PERFORMANCE

'The accountancy profession is moving toward a better understanding and handling of uncertainty. Accountants are increasingly expected to make judgments about potential conflicts between a single historic cost number and the "fair value" of an item in a forward-looking risk scenario. The problem is particularly acute for audit committees since they are now required to comment on whether financial statements are "fair, balanced and understandable". A possible solution to the financial reporting dilemma lies in recognising ranges. As well as providing a fair representation of financial results, ranges can mitigate mark-to-market effects, reduce the number of footnotes and aid audit-quality measurement.'

Professor Michael Mainelli FCCA

CO-FOUNDER Z/YEN AND MEMBER OF ACCA'S GLOBAL FORUM FOR GOVERNANCE, RISK AND PERFORMANCE

'Confidence accounting presents judgment calls as ranges – for example, revenue recognition, tax liabilities, goodwill and intangibles, asset valuations, share-based payments, or management and performance fees. There are complicated ways of expressing ranges, but one of the simplest ways is simply to state the bottom value, the expected value and the top value, with a judgment on the likelihood that the value is in that range – BET%. As a simple example, a value for freehold land assets might be expressed as B: £5m, E: £6m, T: £8m, with a 98% confidence the value is in that range.'

BETTER-EQUIPPED BOARDS

As well as enhancing the understanding of end users, confidence accounting may also serve to better equip boards of directors, and in particular audit committees, to fulfil their own responsibilities. Emphasis is increasingly being placed by regulators on the comprehensibility of reported information, a good example being the UK Corporate Governance Code's recent demand that the contents of annual reports must be 'fair, balanced and understandable'. Audit committees are expected to play a pivotal role in ensuring that this test of comprehensibility is satisfied.

This particular application of the concept of confidence accounting is the focus of a new paper shortly to be published by ACCA, written by Adrian Berendt, chair of ACCA's Global Forum for Governance, Risk and Performance. The paper discusses how a focus on confidence accounting could be adopted so as to enhance reporting quality and thereby help to meet the obligations of boards and their audit committees. It suggests that management could submit a narrative spelling out the range of uncertainty that it feels reasonable to attach to figures in draft accounts. These could vary depending on circumstances and the type of assets and liabilities involved.

For example, the degree of certainty attached to the figures for the company's holdings in cash and government bonds could be recorded as being very high, while cashflows from a high-risk investment might be given a much wider probability range. This could form a workable basis for the committee to review the reporting process and to satisfy itself as to whether the accounts and annual report provide a 'fair, balanced and understandable' picture.

Apart from the potential usefulness of the concept generally, there are a number of specific practical reasons why confidence accounting could prove useful to committee members. For example:

* Committee members will not typically be experts in accounting or auditing.
* The level of management confidence could be a driver of engagement.
* The inclusion of probability information would align the reporting process with the oversight of risk management arrangements.
* A discussion of probabilities may engender the adoption of more prudent judgments.

Confidence accounting does not purport to usurp or undermine the place of financial accounting information; instead, it seeks to add meaning to the figures. While it is still at an early stage, it appears to offer real potential for enhancing the credibility and understandability of accounts and reports, and thereby enhancing the position of users. Audit committees are just one of the stakeholder groups who can benefit from this new approach.

Confidence accounting: a proposal, is available at www.accaglobal.com/ab96