

Confidence Accounting Consultation Responses

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ACCA
29 Lincoln's Inn Fields
London WC2A 3EE
United Kingdom

www.accaglobal.com

&

Long Finance
Z/Yen Group
90 Basinghall Street
London EC2V 5AY
United Kingdom

www.longfinance.net

Background

Confidence Accounting is a proposal to use distributions, rather than discrete values, where appropriate in auditing and accounting. In a world of Confidence Accounting, the end results of audits would be presentations of distributions for major entries in the profit & loss, balance sheet and cashflow statements. The proposed benefits of Confidence Accounting include a fairer representation of financial results, reduced footnotes, more measurable audit quality and a mitigation of mark-to-market perturbations. The free-to-download report was published on 5 July 2012 ([press release](#)):



[Confidence Accounting: A Proposal](#) by Ian Harris, Michael Mainelli and Jan-Peter Onstwedder of Z/Yen Group published by Association of Chartered Certified Accountants (ACCA), Long Finance and the Chartered Institute for Securities & Investment (CISI) July 2012, 63 pages

Andy Haldane, Executive Director for Financial Stability at the Bank of England welcomed the proposal and wrote in the foreword, **“My hope is that this proposal moves our thinking a step closer towards a set of accounting standards for major entities that put systemic stability centre stage. In the light of the crisis, anything less than a radical re-think would be negligent.”**

For a quick introduction to Confidence Accounting, particularly its application to banking, in 2011 the CISI published [“Accounting for Confidence”](#) which provides a short overview. Confidence Accounting was introduced for the non-professional in [“The Price of Fish: A New Approach to Wicked Economics and Better Decisions”](#), winner of the 2012 Independent Publisher Book Awards Finance, Investment & Economics Gold Prize.

Consultation Period

During the consultation period there were three public events:


- a roundtable at Z/Yen on 12 September with over 20 people in attendance;
- a seminar on 30 October, hosted by CISI, in conjunction with Standard & Poor's with 80 attendees;
- a seminar on 6 December, hosted by ICAS with 60 attendees and chaired by Sir David Tweedie.

Private events included a seminar with a number of pension funds and two seminars with a large financial regulator.

The consultation prompted a blog in Financial Director by Eric Tracey -

<http://www.financialdirector.co.uk/financial-director/opinion/2219142/fd-guest-column-confident-accounting>.

The ICAS published an article applying Confidence Accounting to natural resources:

[Buried Treasure Naturally Confident – Accounting For Resources](#) 

Michael
Mainelli and
Jan-Peter
Onstwedder

2012

The CA, ICAS –
Institute of Chartered
Accountants of
Scotland (December
2012), pages 84-85.

Two universities set a small quiz for accounting students on Confidence Accounting during the consultation.

Summary Of Responses

In the July 2012 publication there was an invitation to readers to comment on the contents, with a deadline of 31 December 2012. Several pension funds asked for more time for a joint response and the deadline was extended to 31 January 2013. Questionnaires were left on seats at events with the same questionnaire available online.

Comments were received by e-mail from 39 people. 17 (44%) were for the idea, and 5 (12%) were against. The remainder (44%) are considered neutral. In this context, 'neutral' includes someone who supports the idea but also expresses some reservations, or someone who is neither for or against the idea, but may well form an opinion once further work has been done or the concept has been discussed further.

Positive respondents supported the idea of change, particularly away from the current reliance on single values and 'pass or fail' audit opinions. Supporters of the idea see it as an opportunity to apply and express judgement in areas such as going concern and valuations.

Respondents who were against the idea expressed doubts that Confidence Accounting would solve current problems, such as the perceived lack of prudence reflected in corporate reporting, or doubted its value to key stakeholders, as opposed to just analysts.

A comparable question asked by Z/Yen, of attendees at events held on the issue of confidence accounting up to February 2013 is as follows:

'Do you think that Confidence Accounting will be an improvement on traditional accounting?'

A small number of attendees (26 out of a total of 143) replied to this question. 8 (31%) replied 'yes', whilst 2 (8%) disagreed. The remainder (16 – 61%) believe that there will be a partial improvement. It might be inferred from this that the people who took the opportunity to e-mail detailed comments tended to be more supportive.

The majority of those who e-mailed comments expressed an interest in discussing the idea further. Five respondents were not, two of whom definitely do not support Confidence Accounting, with the remainder not giving a view on the idea (for example, one respondent mainly outlined how his own approach compares to Confidence Accounting).

On pages 5-9, relevant extracts are given from the submitted comments, grouped by theme. These illustrate the questions, support and concerns raised in the detailed responses sent by e-mail, and could be used as a basis for further discussions.

Some respondents against Confidence Accounting are prepared to debate the idea further, and are consequently not dismissing it entirely at this stage. Together with the respondents who have made positive and neutral comments, it has been possible to identify potential candidates who can contribute to taking the Confidence Accounting debate further, during a future Roundtable at ACCA.

Specific Comments - Grouped By Theme**1. Whether change is needed**

‘... analysts and investors may not have thought much that a problem exists, but if educated they would find interest.’

‘... we welcome your initiative to explore new forms of reporting financial performance, and especially the effort to address - and make explicit – the uncertainty embedded within accounts.’

‘The implications for management behaviour are very important. This topic should encompass not only straightforward misjudgements, but deplorable practices such as massaging accounts.’

‘Currently, auditors and accountants are unaccountable, and this situation should be improved under the new system.’

2. The advantages of Confidence Accounting

‘This topic is of close interest to the fund management community, and investment analysts in particular, whose work is likely to be made that much easier.’

‘If ranges or bands start to become attached to accounts, then less sophisticated investors will be awakened to the issues of leverage and the possible precariousness of their investments.’

‘One of the most powerful plugs for the new system arises from the references to the dot-com era. If the use of ranges had been in force then, it might have made many investors pause, muting both the run-up to the bubble and the subsequent crash.’

‘The ranges proposed by confidence accounting could provide a basis for the more detailed and critical work that many feel is now needed from the external auditor and audit committee.’

‘In turn this set me thinking ... that certain industrial sectors will be more confidence accounting centred than others - close to cash versus distance from cash simplistically.

‘And I guess pensions accounting might become more sane...’

‘I can see lots of potential applications in the Public Sector... It feels as if this should be an essential component of Risk Management.’

'I believe (Confidence Accounting) should become a valuable "best practice" ethos for those firms brave enough to initiate it as wildly (often inaccurate) valuations are the bane of all our existence.'

3. The effect on the true and fair view, and the drive to re-assert prudence

'I do not take particular issue with the concept of confidence accounting, however, I do challenge the tying of the concept of confidence accounting with "true and fair view". There is a misconception that true and fair view is a subjective test to which various things can be attached by implication of its subjectivity. However, in law it is not a subjective test. The term first appears in 1947 in the Companies Act..., and then accounting rules, such as prudence, and accruals were put beneath it, to assist in delivering it by exemplifying it. Confidence accounting, could well create material uncertainty, and is not a true and fair view.'

'We feel that the Confidence Accounting proposal gives inadequate attention to the framework of corporate governance and company law in which accounting has evolved over the years... we are specifically calling for a return to prudence in our accounting framework.'

4. Organisational and cultural barriers

'Although change is generally resisted in any setting, we believe dramatic changes to the format of financial statement presentation will receive especially strong resistance due in part to the pure logistical challenges that would be required upon changing formats (e.g., company's financial reporting systems, basic financial statement analysis, frequently used ratios, etc.).

'However, this Proposal and our paper present alternatives to the current format and by so doing will hopefully generate open discussions - a crucial first step to considering improvements that will require revised reporting format.'

'I conclude that range accounting reflects the uncertainty of the outcomes of management decisions, yes, but the ills of the current system are rooted in the behavioural idleness of the analysts and rating agencies. As ever, power resides with the dominance of those who use publicity to demand that their life is made easy. Good luck!'

5. Theoretical and practical difficulties

'Not knowing whether the range is any more reliable than the single estimate it is designed to give context to, then we fail to see how the production of a range without guidance improves things. Complexity might increase. The eye is naturally drawn to the midpoint of a range.'

‘As you concede in your proposal, CA will never replace instances of requiring single numbers in accounts. One of the main purposes of accounts is to share the spoils of capitalist enterprise. The shareholders and taxman will want a definite proportion of a fixed number, not a share in a probability?’

‘Tax authorities require a figure on which to levy tax. Shareholders expect that they will be paid a dividend out of known profits. Regulators place limits on capital adequacy. It is difficult to see how these things can be squared with accounts being presented as ranges, unless we take a particular standardised point of the range, (presumably the mean, though it need not be) to use in tax computations, and so on. However that merely seems to bring us back to where we started, placing emphasis once again on a single point.’

‘One cannot state the confidence interval that another, independent, audit would get a result within.’

‘... we are looking partly at measurements and partly at predications. In either case a mathematical model is needed in order to define the relationships between the influence quantities and the result. This can be particularly difficult with predications, where the system may exhibit chaotic behaviour in some cases and not in others, even if the underlying conditions appear similar.’

‘I think it is fair to say that considerable training, if not a significant culture shift, will be needed for proper implementation of these proposals.’

‘... we feel that there would be many practical barriers to implementation ...In our view these barriers are so significant that it is difficult to see how they could be overcome even in the medium term.’

‘I am not sure, however, how well references to kurtosis in the draft annual report will go down with the general reader of the accounts.’

‘A question was posed as to whether ‘Aunt Agatha’ would understand the new system. The answer was that she would not understand many of the existing footnotes either.’

6. Involvement by external auditors and audit committees

‘You are correct to suggest that the audit committee – audit company interface is an area we see as rather weak and that might be strengthened by the transparency that showing and justifying ranges could bring.’

‘Overall, we feel there is a long way to travel before a standard setter would pick up the concept of ranges within the financial statements and start to produce the guidance we believe is necessary for a trusted and credible representation of ranges. We see greater potential for the use of ranges within the external auditor - audit committee relationship.’

‘For various reasons, not all of them to do with accounting standards, auditors already seem much too reluctant to qualify their report or to apply pressure to management to change accounts before publication. Expressing financial statements in terms of ranges is likely to amplify these problems, as it will become even harder to attach labels such as “right” and “wrong” to particular accounting estimates. Of course accounts already contain estimates, and so such difficulties are already present to some extent, but if management’s view is expressed as a range it might be even more difficult for auditors to challenge.’

‘Of course accountants (*i.e.*, *auditors*) are already assessed by their historical decisions in an ad hoc word of mouth way, or even in extreme cases by legal action, but CA proposals suggest a means of formalising their everyday performance. For example company A made only half the profits predicted by the accountant, but the accountant attached a broad band to this section of their accounts so they will be penalised less. But with Company B the profits also halved, but in this case the accountant awarded the company a narrow band, which the accountant must be penalised more for.

‘Give the accountants the wiggle room to go beyond the dry numbers and nail their colours to the mast. As long as they are strongly tied to the need to maintain their long-term reputation by being deemed vindicated by history and to have had integrity, the system can only gain.’

7. Confidence Accounting adopted as a communication add-on

‘There is a lot of work to do and experimentation required before this idea is anywhere near ready for the attention of the standards setters. For me, the most fruitful areas for taking the idea further are the audit committee and the audit itself... The single point numbers in the financial statements might not change but the audit committee might want different words around those numbers where the confidence distributions were wider or especially skewed from situations where the distributions are more normal and not especially wide.’

‘Another option, or a complementary action, could be that the issuing organization puts “some words around” how they have come to a specific number, including the related uncertainties.’

‘... accounts must comply with Company Law. Namely, they must provide a prudent assessment of the capital position for the company, such that directors do not distribute out of capital. It might also be useful to know the ranges around point estimates, perhaps in a note, but anything that removes vital capital protection would concern us.’

‘Maybe the best way of presenting such scientific methods is ensuring that the top report (integrated report so you would like) clearly notes that the figures inherently contain uncertainties and then link to more detailed scientific methods of presentation for those interested.’

8. Progressing the idea

'We also have concerns about the reliability of valuation ranges, given that they are necessarily backward-looking ... Notwithstanding these concerns ... publication of valuation ranges alongside financial statements would facilitate understanding of the final value chosen for the accounts... ACCA and CISI should explore how information on valuation ranges could be used as a basis for Audit Committees to frame discussions with external auditors, and to communicate decisions around valuations to shareholders.'

'We recommend that ACCA and CISI take forward the position with standard setters that the presentation and discussion of ranges will deepen knowledge and enhance the work that external auditors and audit committees carry out together.

'Linked to this, we believe that ACCA and CISI should carry forward the momentum from this consultation by encouraging audit committees to take an active interest in ranges.'

'(I fully agree that) further research on the psychology and comprehension of distributions, as well as their graphical presentation, would be very helpful. '

'There would be winners and losers if such a system change were to go through. Or at least there should be! ... I think it would therefore be of interest to have clear benefit statements for/from the various protagonists (*i.e., stakeholder groups*). Accounts and accounting are, in many ways, public goods. Yet, at the heart of the systems in "Anglo Saxon" countries, accounting information is treated as being by and for private enterprise organizations that are owned by individuals or shareholders.'

Authors' Response

“Se vogliamo che tutto rimanga come è, bisogna che tutto cambi.” – “If you want things to stay as they are, things will have to change”. Giuseppe Tomasi di Lampedusa [1896-1957], *Il Gattopardo*, Feltrinelli (1959).

We thank all of the people who took time to comment on our report. We enjoyed the vibrant discussions. People seemed to divide into three camps - supporters, change-is-too-hard and antis. Virtually everyone agreed that audit and accountancy need to improve. The antis were few, but perhaps the most interesting for us. To them we say, we would welcome an opportunity to discuss your suggestions for reform. For the change-is-too-hard camp, we can only say that we don't believe in futility, man-made problems in accountancy are not so huge that nothing can be done about them. For supporters, great, but what can you do to help advance the debate? Nobody said change was going to be easy.

We found that there was sincere interest in applications to insurance and natural resource companies as next steps. There was a desire to explore a simple 'how to' or 'primer'. We could see that tax and pensions were areas that need much more consideration. There was a desire to coordinate Confidence Accounting approaches with more real-time information provision.

And we have changed our minds a bit too. First, we think that the use of distributions could probably best start with the balance sheet alone, leaving the other financial statements to change later. Second, while regulatory, institute, legislation and audit standards might be useful change agents, Confidence Accounting can begin immediately in the dialogues between audit committees and their auditors. And one such tender is now underway.

Again, many thanks to all who contributed.

Professor Michael Mainelli FCCA FCSI FBCS

Ian Harris FCA

Jan-Peter Onstwedder MBA

ACCA

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LONG FINANCE

Established in 2007 by Z/Yen Group in conjunction with Gresham College, the Long Finance initiative began with a conundrum: 'when would we know our financial system is working?' Long Finance aims to 'improve society's understanding and use of finance over the long term', in contrast to the short-termism that defines today's financial and economic views. Long Finance is a community which can be explored and joined.

www.longfinance.net

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