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Editor's comments

Equity mutual funds are not just suffering in the US, but have also been experiencing outflows in Europe. Insurance companies and pension funds are under regulatory pressure to cut equity allocations. In the US, the cult of equity had been well established with a large proportion dabbling in stocks from a very young age and becoming lifelong adherents. This has been true in the UK as well, though to a much lesser extent, whereas in Europe the addiction to equities has been only of recent vintage and not firmly embedded in the psyche of the public.

While rigorous statistical data is not to hand, all the indications are that the distrust of equities has embraced the young, with every possibility that they might have a lifelong reluctance to play in stocks.

It is not surprising that the sales side is in difficulties. The malaise in equity markets extends to the entire spectrum in size, not just confined to small companies, though the latter are even worse off (see box).

Extracts from 'Raison d'être of the stock markets eroding', Investment Management Review, April 2012

If liquidity is restricted and IPOs are difficult for smaller companies, what does it add up to? The answer is that the stock market is decreasingly fit for purpose in terms of its intended functions. These are twofold, raising capital from investors and providing liquidity for the latter after purchase, in order to encourage them in the first function.

The giants of today's stock market were originally minnows, and the current difficulties for minnows endanger the future emergence of large companies. It is not a happy prospect.

The conundrum is why equity market levels are so high in spite of all this. A possible short-term explanation is that, under the pressure of quantitative easing, few are selling, but this is a programme that cannot be kept up by the central banks for ever, and all the evidence is that the real day of reckoning might come for equities in the not too distant future.

REVOLUTIONARY ACCOUNTING METHODOLOGY

'Confidence Accounting: a proposal', Ian Harris, Professor Michael Mainelli, Chartered FCSI and Jan-Peter Onstwedder, published jointly by Association of Chartered Certified Accountants (ACCA), Chartered Institute for Securities & Investment (CISI) and Long Finance, July 2012

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Introduction

A radical proposal for changing the face of accounting, published jointly by two top accountancy and investment bodies, together with a leading City think-tank, might, if implemented, be invaluable to fund managers, analysts and others, but heavy opposition and/or inertia might need to be overcome.

The concept behind this paper has been worked on by the authors, with distinguished careers in finance, and presented over many years. Two of them, Mainelli and Harris, used the term stochastic accounting in the 1990s and early 2000s. The actual idea goes as far back as 1977, when Professor Joshua Ronen of New York University's Stern School, wrote on the topic in a letter to the New York Times.

Confidence Accounting will not replace traditional accounts but will be presented alongside them, thus enhancing existing financial reporting.

"Confidence Accounting is a radical proposal for using (statistical) distributions rather than discrete values in auditing and accounting statements. In a world of Confidence Accounting, the end results of audits would be distributions for the profit and loss, balance sheet and cash flow statements of major entities. The proposed benefits of Confidence Accounting include a fairer representation of risks around financial results. That is an essential prerequisite for the effective pricing of risk by end-investors." These words are those of Andrew Haldane, the high profile Executive Director for Financial Stability, at the Bank of England, in his foreword to the document. They are accompanied by the hope that the proposed approach will represent a step forward towards accounting standards that will enhance systemic stability.

Key features and comments (as outlined in the paper and related documents)

- In the past two decades, there has been lots of criticism of accounting and auditing.
- Accountants should present uncertainties as ranges. For example, stating that the balance sheet of company 'x' is worth £'y', plus or minus £'z,' and there is 95% confidence that the figure will fall within the range, rather than presenting one determinate figure as is done in auditing now. This will move accounting and auditing towards measurement science, as carried out in laboratories.

In the dot-com era . . . accountants . . . had they shown probability distributions, might have served investors better and reduced unreasonable expectations.

- Users of accounts will be enabled over time to evaluate the quality of the audit by seeing how closely historic accounts fell within stated ranges.
- Clients can make decisions on the basis of historic evidence rather than relying on assertions of quality.
- The new approach will be applicable to banks and professional services firms, and probably most major firms in other industries. It will be a fairer representation of financial results.
- It will reduce the size and complexity of annual reports. For example, the 446 pages issued by the Royal Bank of Scotland in 2010 would have been reduced by between 29 and 99 pages.
- Confidence Accounting will not replace traditional accounts but will be presented alongside them, thus enhancing existing financial reporting. It will be, thus evolutionary, not revolutionary, according to the authors.
- In the dot-com era, some accountants subjected themselves to needless criticism by putting forward business plans based on deterministic numbers incapable of showing the all-too-frequent reality that involves a small chance of making lots of money and a large change of losing it. Had they shown probability distributions, they might have served investors better and reduced unreasonable expectations.
- In addition to figures and summary tables of key statistics arising from the distributions, standard representations of distribution histograms will have to be specified. Standards for distribution function measures will have to be specified as well, to ensure accurate presentation. Graphical disclosure is important for Confidence Accounting.
- By showing the four most relevant data elements (previous year's actual loss, current year's expected loss, current year's 90th percentile, and the worst loss over the previous ten years) most users will be able to make informed judgments about the degree of prudence used in the preparation of the accounts.
- Assumptions can be easily compared across a sector and with external views, eg, those of economic forecasters, rating agencies and equity analysts.
- There might be some difficulties in acquiring information for the determination of distributions, as many firms will have too few data sets. Hence, much can be done based on intra-firm comparisons, benchmark or auditor inputs derived from experience of other companies in the sector.
- Some organisations might publish an extremely wide range, but it is suggested that the market will punish those which do not invest in enough information.
- Confidence Accounting captures a range of valuation uncertainty at a particular point, the reporting date, but does not look at risk or uncertainty in the future. It is an accurate reflection of real-world phenomena and uncertainty.
- 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.

- Discussion is needed to clarify the implications for management behaviour. Much training is also required to move financial professionals on from additive and subtractive bookkeeping to more statistical approaches, and ranges rather than numbers will strain information systems.
- Everyone now concedes that non-professional users cannot use the information produced by financial services firms. John McFall MP, House of Commons Treasury Committee Chairman in 2008, asked Brendan Nelson of KPMG, a chief auditor, whether he understood HSBC's accounts and received a negative reply.

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- Accountants currently hide or throw away information, which the leads to investors and analysts wasting time in having to question management in order to recover the same information.
- The performance of accountants is not evaluated, neither is there indemnity for their mistakes.

Editor's comments

The authors describe Confidence Accounting as evolutionary, but are clearly referring to their suggested implementation approach, whereas the idea itself and the potential impact, if the proposals are adopted, are definitely revolutionary. One of the most powerful plugs for the new system arises from the reference 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. It might be difficult to find a better example of how Confidence Accounting could enhance financial stability, as desired by Haldane above.

The implications for management behaviour are very important. This topic should encompass not only straightforward misjudgments, but deplorable practices such as massaging accounts, which extends to 'creative' accounting and outright fraud in some cases.

There is an easy answer to the 'Aunt Agatha' question . In the fields of medicine, law and investment analysis, amateurs do not expect to understand fully all relevant documents, and need professional advice. This applies no less to accountancy. Currently, auditors and accountants are unaccountable, and this situation should be improved under the new system.

Training is a more complicated issue. Accountants are qualified to cover any company, and the vast majority of companies that they work with will fall outside the remit of this paper. This possibly argues for a special qualification for those who want to carry out work for the relevant companies. The question of how these companies are to be defined comes up. All quoted companies are a possibility. But then what about large private companies with debt? What is large? Some quoted companies might be quite straightforward, not requiring distributions.

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. It should also receive support from those who value high quality corporate governance. The key to the deserved adoption of these proposals is in the hands of the potential users, not just in the fund management community. If they do not push for it, not many others are likely to.

This principle of distributions is of wider applicability than to accounting and auditing, to which the authors naturally confine themselves. It will also benefit the activities of business and investment analysis, where distributions rather than point forecasts would in general be more sensible and enlightening, introducing a new dimension to the measure of risk, but that is for the future.

For this paper to become a practical proposition, as it deserves, the logic of the proposal is not enough. Intensive and ongoing lobbying is likely to be needed. New ideas can take decades to become widely recognised and accepted.