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

tel: +44(0)20 7562-9562

International Auditing and Assurance Standards Board (IAASB)
529 5th Avenue, 6th Floor
New York City, New York 10017
USA

17 February 2013

Dear Sir or Madam,

A FRAMEWORK FOR AUDIT QUALITY – CONSULTATION RESPONSE

We, Z/Yen Group, www.zyen.com, and Long Finance, www.longfinance.net, in conjunction with the ACCA and the Chartered Institute for Securities & Investment have suggested a fundamental reform of auditing and accounting that would allow external validation of audit quality. The approach is termed ‘Confidence Accounting’, where uncertainties (ranges) are presented to investors and managers, rather than discrete numbers.

Our primary publication was:

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.

free download: http://www.accaglobal.com/content/dam/acca/global/PDF-technical/corporate-governance/tech-af-cap.pdf

continuing discussion: http://www.longfinance.net/publications/confidence-accounting.html

Background

Your January 2013 document, “A Framework For Audit Quality” requested consultation responses by 15 May 2013. We welcome your paper as part of the debate on audit quality and are replying in order to connect your thinking with ours on Confidence Accounting. By way of background, we would note:

- the audit market for large firms listed on exchanges is overly concentrated on four firms, and this concentration seems to coincide with lower competition and lack of diversity in approach;
- lower competition appears to have resulted in higher prices and poorer service over time and low, if any, productivity improvements;
- lack of diversity appears to have resulted in little innovation and, in the case of large financial services clients, increased herd behaviour;
- given that auditors have, over time, acquired a preferential economic role (i.e. their use is mandatory for large companies) that allow them to extract economic rents it is right to consider how to ensure a vibrant, competitive market, albeit perhaps less vibrant or competitive than other sectors – as well as what social benefit is given in exchange for a preferential role;
- structural changes seeking to increase competition and transparency in the audit market are desirable. Elements of such changes we would consider might include:
  - enforcing competition policy clearly, which in other markets might lead to capping the market share of the largest firms, or breaking them up, or requiring compulsory audit retendering;
  - making it easier to take legal action against audit firms for poor opinions;
  - treating auditing standards under the same regime as ISO standards, i.e. open processes, a single accreditation body (auditor of the auditors) backing certification (company audits) within a competitive market;
- structural changes seeking to increase competition and transparency in the audit market we would particularly recommend for closer examination include:
  - providing ways to ascertain the quality of auditors' performances over time, Confidence Accounting;
  - requiring audit firms to provide an "indemnity" of some form for their opinions.

Your Paper

"A Framework For Audit Quality" fails to set out how audit quality would be measured. There are 11 mentions of measurement in your document:

how *not* to measure:

> *Given the objective of an audit, the existence of material misstatements in the financial statements that were not detected by the audit may be an indicator of audit failure. However, the absence of material misstatements in the financial statements cannot, of itself, be the only measure of audit quality because there may have been no material misstatements to detect. [page 13]*

a recognition that uncertainty is part of auditing, thus requiring estimation and judgement:

> *Few items included in the financial statements can be measured with certainty, and many involve estimation and therefore judgment. [page 23]*

a recognition that measurement is necessary for firms to improve:

> *Although it is difficult to measure, audit quality is likely to be improved if it is specifically addressed in the appraisals for both partners and staff. [page 33]*

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fax: +44 (020) 7 628-5751
www.zyen.com

tax as an example of measurement uncertainty:

> *In some environments, management may seek to minimize tax liabilities through such measures as deferring issuing invoices even when performance obligations have been met. In other environments; more than one set of accounting records may be retained—one showing the "economic" position and one the "tax" position—which may create some confusion. Such circumstances are likely to create complexity and necessitate reserving for a contingent tax liability, which is usually subject to considerable measurement uncertainty. [page 54]*

recognition that users desire disclosures which increase measurement uncertainty issues:

> *In recent years, developments in financial reporting have focused increasingly on meeting users' needs for financial information that is more "relevant," even if such information may be more subjective and less "reliable." This has led in particular to a trend towards greater use of fair value measurements and other estimates, which may have significant measurement uncertainty. Disclosures regarding the underlying assumptions made and measurement uncertainty (e.g., sensitivity analyses) are an integral part of faithful representation of such financial statement amounts. But some of those disclosures are qualitative in nature, such as hedging and risk management strategies. As a result, some question the "auditability" of such financial information as it is less objectively verifiable as financial statements items such as cash. [page 55]*

judgment can be complex:

> *Gathering necessary information and making appropriate judgments when recognition, measurement and disclosure decisions may rely to a considerable extent on the exercise of judgment by management in applying the relevant financial reporting requirements, particularly when they involve assumptions, probabilities, forward-looking expectations, or the use of complex models. [page 55]*
>
> *Verifying the fair values of financial instruments when there is not an active market and measurements are based on unobservable inputs. In such circumstances fair value calculations can involve complex models and highly judgmental assumptions, often requiring specialized expertise. [page 55]*

uncertainty estimates vary by industry and general economic environment:

> *The degree to which accounting estimates involving significant measurement uncertainty are required is likely to vary depending on the industry in which the entity operates and the general economic environment...[page55]*

We would contend that you don't manage what you don't measure. Until you define your measures of quality, this framework remains weak. We would argue that the paradigm of accounting needs to be modernised, to take account of uncertainty and its measurement in line with other metrological professions and sciences.

90 Basinghall Street
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United Kingdom

Risk/Reward Managers
tel: +44 (020) 7562-9562
fax: +44 (020) 7 628-5751
www.zyen.com

Confidence Accounting

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.

Confidence Accounting would help auditing move towards 'measurement science', cf. with the way most laboratories report measurements. A single number for accounting terms such as profit or balance sheet value is clear and simple, but wrong. Confidence accounting would be the presentation of audited accounts in a probabilistic manner. If an audit firm's estimates move too far outside the stated confidence ranges, their clients would be able to make their own decisions about audit quality.

Andy Haldane, Executive Director for Financial Stability at the Bank of England welcomed our 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.

Some older materials:

- Michael Mainelli, "Confidence Accounting: Putting Essential Uncertainty Back Into Auditing And Accounting", Journal of Risk Finance, Volume 10, Number 3, Emerald Group Publishing Limited (June 2009).
- original formal attempt to start debate - http://www.zyen.com/index.php?option=com_content&view=article&id=170 - Michael Mainelli and Ian Harris, "Balancing the Odds: Stochastic Accounting", Balance Sheet, Volume 10, Number 2, pages 22-27, MCB University Press (2002).

The consultation period for our July 2012 publication closed at the beginning of 2013. ACCA intend to publish the results shortly. The basic responses from a variety of pension funds, accountants, analysts and regulators were positive. The Institute of Chartered Accountants of Scotland have also been very supportive, including publishing an article applying Confidence Accounting to natural resource company issues. One audit committee chairman has opened tender discussions using Confidence Accounting. Two universities have included discussion of Confidence Accounting in their accounting syllabi. That said, there was concern about change and complexity, and a desire to focus the approach on the balance sheet rather than the profit and loss statement, and to start using it as a tool for better communication between auditor and audit committee before moving to standards or regulation.

Please do feel free to contact us with any queries or suggestions. May we thank you for your time and consideration. We wish you every success in your inquiry.

On behalf of Z/Yen Group Limited:

Professor Michael Mainelli FCCA FCSI FBCS
Executive Chairman

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