



Profile: Michael McKersie

Governance, Accounting, and Auditing Critical to the Functioning of Organizations

How the Association of British Insurers (ABI), as representative of the largest single group of investors in the UK, keeps a close eye on the developments in corporate governance, accounting, and auditing

Intro

Being responsible for capital raising, company listings, and accounting issues for investors at the Association of British Insurers (ABI), which represents the largest single group of investors in the UK, Michael McKersie is specifically focused on the interface of investment market practice and regulation with corporate governance and the protection of the rights and interests of investors. Mr. McKersie views governance, accounting, and auditing as critical to the functioning of organizations. From his investor perspective, he provides his ideas and suggestions for further improvements in these areas.

Michael McKersie: A brief bio

Michael McKersie is assistant director, Capital Markets at the Association of British Insurers, having previously worked in both fund management and stockbroking. In this role, he is responsible for the following topic areas: capital raising, company listings, and accounting issues for investors. The public policy implications and the interface of investment market practice and regulation with corporate governance and the protection of the rights and interests of investors are the key dimensions of this work.

See also “About the Association of British Insurers” below.

About the Association of British Insurers

The Association of British Insurers (ABI) represents the collective interests of the UK’s insurance industry. The association speaks out on issues of common interest; helps to inform and participate in debates on public policy issues; and also acts as an advocate for high standards of customer service in the insurance industry. The association has over 300 companies in membership. Between them, they provide around 90% of domestic insurance services sold in the UK. ABI member companies account for almost 15% of investments in the London stock market.

See also www.abi.org.uk.

Governance critical to improve functioning of organizations

How important is good governance for your constituency, the British/UK insurance industry?

“Insurance companies are the largest single group of investors in the UK. Therefore, insurers—as well as ABI, as representative of the British insurance industry—are very sensitive to corporate governance developments in the UK and abroad. In addition to corporate governance, we also recognize the crucial role of accounting and auditing in the business reporting framework.

“We view governance as being critical to improving the functioning of organizations. It is about the way organizations work and should not be simply a compliance exercise. At ABI, we are against a checklist mentality. Instead, companies should make governance part of their mindset, and operate on behalf of their shareholders. On behalf of the shareholders, they should also focus on the long-term, sustainable performance of their organizations.

“Heavy, detailed corporate governance rules will not work in that respect. The UK corporate governance framework and principles, based on comply or explain, have worked well as evidenced through the review by the Financial Reporting Council of the operation of the UK Code and the modest changes that have been made. The areas that have perhaps proved more challenging have been the extent to which independent non-executives have been able to act as an effective check and balance in some parts of the financial sector and, more generally, how to achieve real high-quality engagement by shareholders with the boards of the companies they own. Therefore, we recommend continuing to develop the UK approach of principles rather than rules. We would like to see the underlying principles promoted and adopted in other jurisdictions as well.”

Bridge gap between internal control and governance

Before the financial crisis, many companies—especially those listed in the US—seem to have been preoccupied with a narrow interpretation of risk management and internal control. This preoccupation was influenced by the US Sarbanes-Oxley legislation, which focuses on internal control over financial reporting.

“There seems to be a sort of disconnect between the more narrow risk management and control systems focused on financial reporting or accounting and the broader question of how this fits within the overall concept of ensuring good corporate governance. We need to avoid those narrower requirements to ensure compliance with regulations do not squeeze out the role of directors taking responsibility for seeing the big picture and taking balanced decisions in the overall interests of the company.”

Cross fertilization: Boards should consist of directors with various backgrounds

The malfunctioning of boards, allegedly lacking knowledge and failing to provide oversight, is often mentioned as having contributed to the financial crisis. Do you have any corporate governance recommendations in relation to boards of directors?

“Relevant experience is crucial for a director, and also for a non-executive director. In addition, non-executive directors need to balance their time allocation and must make sure that their knowledge remains up to date. Despite claims to the contrary, we have seen no evidence of a shortage of good non-executive directors in the UK.

“On the other hand, we don’t believe in being more prescriptive with knowledge and qualifications for board or audit committee members. Instead, we want boards and audit committees to make use of the diverse skills and backgrounds of their members!

“Take care, however: very large boards will find it difficult to be effective as the benefits of increasing board size are outweighed by the costs.”

Base executive remuneration on a wider spectrum of performance measures

Another governance issue that has been in the center of debate in the financial crisis was executive remuneration: for example, rewarding excessive risk taking. What are your recommendations here?

“The ABI is alert to remuneration issues, and we advocate better alignment of executive remuneration with long-term sustainable performance of an organization and creation of real shareholder value. It is important to consider, therefore, what the right balance is in executive remuneration between base and variable pay and within performance-linked remuneration, how much should relate to financial results and how much should take account of other issues. It’s also vital to consider how much of total remuneration should be monetary, how much should be share based, and, in each case, how much should be subject to deferral or retention.”

Financial reporting recommendations

“Financial reporting is not a compliance issue but, instead, a vital tool for communicating with the owners of the company and the other stakeholders.”

Dual focus of financial reporting

How relevant is financial reporting to your constituency and what are your recommendations in this area?

“Shareholders are entitled to know information about the company they own. And it is only with that information that they can effectively engage with these companies. If they don’t have this information, they really are in the dark.

“We see the main purpose of financial reporting as twofold:

1. Providing investors with information that is useful to them in their decision making as market users to buy, sell, or hold; and also
2. Accountability/stewardship: for company boards and management to record performance and change in financial position of the company over the accounting period, so that shareholders are able to assess how the company’s assets have been managed, the quality of earnings achieved, and decisions taken on matters including payments of dividends. This relates to shareholders’ responsibilities collectively as the owners of the company and also the need to fairly protect creditors.

“It is not very surprising that what is called financial reporting now was called ‘accounting’ a few years ago! Indeed, we see the stewardship dimension as being the primary purpose.”

Are there any conflicts between these two objectives?

“Yes, there can be, and they often crop up when we are discussing proposed changes in accounting standards, and we see that they are promoted primarily from the decision-usefulness point of view. In practice, we see this most often when we are considering things like consolidation, where we are concerned that the accounts should fairly represent risks and rewards for shareholders, and we have problems in business combinations over accounting for goodwill. We also have difficulties in principle

with the way stewardship is addressed in the [Conceptual Framework](#) [of the International Accounting Standards Board (IASB)], for example, in the part dealing with the reporting entity, and the risk that this might be applied to future developments in accounting standards.

“However, most of the time, there will not be conflicts. We think it makes more sense to start from the stewardship perspective, because stewardship will yield financial reports that are inherently decision-useful.

“The presentation of company performance in financial statements is another issue. Some investors are concerned that standard setters focus too much on the balance sheet. Of course, it is important to get that right—after all, if you don’t get the static information right at balance sheet date, you won’t have the right information in the dynamic statements—but we see a greater need to focus on getting the presentation right in the performance statements, including addressing the relationship between the profit and loss (P&L) account and other comprehensive income, and including the role of recycling between these.”

Address financial reporting complexity

Isn't it another objective that financial reports should also be more understandable?

“The ABI supports the findings in the UK Financial Reporting Council (FRC) paper, [Louder than Words: Principles and actions for making corporate reports less complex and more relevant](#) (2009), which addresses complexity and improving the quality of financial reporting (see also ‘FRC report on reducing complexity of financial reports’).

FRC report on reducing complexity of financial reports

The FRC, the UK’s independent regulator responsible for promoting confidence in corporate reporting and governance, has published the discussion paper, [Louder than Words: Principles and actions for making corporate reports less complex and more relevant](#), arising from its project on reducing complexity in corporate reporting. The paper seeks to address growing concerns about the complexity of corporate reporting and recommends a commonsense approach to reducing complexity based on eight guiding principles—four for better communication in reports and four for improving the quality and effectiveness of regulations:

1. Regulations should focus on significant problems and be targeted:
 - a. To provide relevant information that meets important user needs; and
 - b. To reflect the reality of the business while minimizing unintended implementation consequences.
2. Regulators should limit constant change by intervening only when an area is high risk and change will bring obvious benefits. Intervention should be as cost effective as possible—for example, by using management information already produced for internal purposes.
3. Regulators should understand what other national and international regulators are doing in a particular area. Wherever possible, they should be consistent with one another and work together in a joined-up way.

4. Being clear means keeping regulations simple and user friendly. They need to be understood easily by those who will apply them and by those who will benefit from them. Regulations should emphasize:
 - a. A clear articulation of the desired outcome;
 - b. Principles and judgment where appropriate;
 - c. Plain language with well-defined terms;
 - d. Consistent terminology; and
 - e. An easy-to-follow structure.
5. Highlight important messages, transactions, and accounting policies and avoid distracting readers with immaterial clutter.
6. Provide a balanced explanation of the results—the good news and the bad.
7. Use plain language, only well-defined technical terms, consistent terminology, and an easy-to-follow structure.
8. Get the point across with a report that holds the reader’s attention.

The paper also recognizes that there is no easy solution and that change will only happen if all of those involved in corporate reporting make a concerted effort.

In its [response](#) to the discussion paper, the ABI endorses the principles for less complex regulation, as proposed by the FRC. In its response, the ABI states that the principles could help reduce complexity, although “they would be even better if they had identified that the interests of shareholders are of primary significance.” According to the ABI, “corporate reports are aimed currently at too many types of users and need to be refocused on their primary purpose: providing investors with information that is useful in their decision making and assessing management’s stewardship.”

See also www.frc.org.uk.

“However, it is often the preparers who say that accounting has become too bulky and complex. Users or investors don’t necessarily think bulkiness or complexity is an issue as long as can they can find what they need. Different types of users need different types of information and some may not need the full report and accounts.

Some information is required by regulators, not the investors. To satisfy all, you may have to have very long reports.

“There is a problem, though, with the usability of much of the output. Business information should, therefore, be well organized and presented in the clearest way possible. Company reports and accounts are getting bigger but not necessarily better.

“If bulkiness and complexity are masking real issues, however, that is a real concern because that might result in less confidence. Investors and other users may have less confidence that they fully understand the company, its prospects, and the risks that it faces. Therefore, companies should genuinely try to

“Users or investors don’t necessarily think bulkiness or complexity is an issue as long as can they can find what they need.”

produce financial accounts that are informative. In our opinion, this is a better way forward than introducing new regulations that just add to the compliance burden.”

Improve narrative reporting

Would financial reports become more informative if the quantitative accounting numbers were supplemented with qualitative information, for example in the form of narrative reporting?

“If boards could write down their views more simply, that would be very refreshing. As a starting point, it is a good test for the board to see if it is capable of producing a meaningful narrative. It does not have to be long, but it should put the financial numbers into context. It should be a basic story. It should not evolve into a PR document, though.

“Preparation of useful management commentary is an opportunity to confirm that the board is on top of what it is doing and the direction it is going. So investors should get a better impression (feel) of a company. Investors like directors to talk in good faith on how they see matters in order to make better-quality investment decisions.

“Boards could really improve their narrative reporting by being more open, transparent, and forward looking. Let company boards really explain themselves. Liability concerns should not limit the board’s communication with stakeholders. As long as they are making their disclosures in good faith, then there should be no grounds for concern over liability. UK shareholders have traditionally seen governance, including narrative reporting, as a matter on which boards and shareholders should have a cooperative and not adversarial relationship.

“An important question is around the reliability of these outlooks. Do preparers pursue particular outcomes? There is a need to achieve an appropriate balance between openness and reliability of forward-looking information. To better assess the reliability of their narrative reporting, an assessment of the (personal) quality of the board is required.”

Do you think that the IASB exposure draft on management commentary is a good way forward?

“I am not yet sure if the IASB with their exposure draft on management commentary has moved the debate forward really. Essentially, it is based on the already existing UK guidance (see also: ‘IASB exposure draft on management commentary’). We see plenty of scope for greater use of narrative reporting to be used to explain the accounting approaches chosen and judgments made especially in complex matters, such as reporting on financial instruments and on the impact of the business model chosen or hedging policy adopted.”

IASB exposure draft on management commentary

In June 2009, the IASB issued an exposure draft on management commentary with a comment period until March 2010. According to the IASB, management commentary provides a context within which to interpret the financial position, financial performance, and cash flows of an entity. It also provides an opportunity to understand management's objectives and its strategies for achieving those objectives. Users of financial reports in their capacity as capital providers routinely use the type of information provided in management commentary as a tool for evaluating an entity's prospects and its general risks, as well as the success of management's strategies for achieving its stated objectives.

See also www.ifrs.org/Current+Projects/IASB+Projects/Management+Commentary.

Safe harbor provisions should not be necessary in the UK

Would the institution of safe harbor provisions provide an incentive for boards to further improve their narrative reporting?

"The idea of safe harbors is well developed in the US, but less so in the UK where the legal background is different. In the UK, investors generally give boards and senior executives the room to express and account for themselves. As long as that happens in good faith and people work to the best of their ability, they should not need these provisions.

"In addition, I do not believe that a lack of safe harbor discourages people from acting as director."

International convergence of accounting standards: Principles preferable to rules

From an investor's point of view, how valuable is further international convergence of accounting standards?

"International convergence of accounting standards is valuable and desirable because of the increased international comparability. It is a matter of debate, however, whether this is also necessary for small- and medium-sized enterprises.

"In many countries around the world, transition to IFRS is a fact. Unfortunately, the US remains one of the countries that, so far, has not adopted or converged yet to IFRS. We hope that progress on this can be made, but it is more important that the right converged standards are reached than that this process be achieved quickly.

"There remains a great deal of skepticism about the usefulness of accounting standards, whether IFRS is an improvement or not. Some of that, however, is natural whenever international convergence is being sought and compromises are required. Going forward, I recommend we continue to develop along the UK approach of principles rather than rules."

Meeting the challenges of fair value

How important is fair value accounting for investors?

“The reporting of (changes in) fair values is without doubt of interest for investors. There is also an assumption that most investors, especially on the buy side, are therefore primarily interested in fair value approaches to accounting, but this does not follow and is not, in fact, true. We see a clear consensus for a mixed-model approach.

“The practical application of fair value can give results that are difficult for investors to understand, such as how changes in market values relate to changes in ‘underlying value.’

The IASB and individual companies should better listen to investors about whether and how fair value should be used and calculated. In the move to fair value accounting, some of the key accounting principles, such as the matching and prudence principles, have been downplayed. There is an important role for prudence in accounting. At the peak of the economic boom, assets were fair valued, but this did not constitute a real and reliable reflection of the changes in net worth of the entities. It would be helpful to use fair value when it provides a better reflection of the current value, but not to pursue fair value as an end in itself.

“Another important question for investors is about the reliability of these fair value measurements. That is where the role of auditors becomes particularly important. If they are clearly required to exercise a due degree of prudence in the face of uncertainty about the reliability or significance of apparent market values, or theoretical modeling of such values, they will have the ability to exercise appropriate professional skepticism and also be able to push back against unduly optimistic views.”

Audits are part of governance

How important is the audit of financial statements for investors and what could be done to further improve the audit?

“In our view, the audit of financial statements is part of a company’s governance framework. The audit should have a beneficial behavioral effect on management and their judgments. The auditor is not a messenger, not just one of the links in the supply chain. Instead, the auditor has a behavioral impact on how the company makes its judgments. The auditor should be the umpire, rather than the scoreboard operator!”

“The auditor should be the umpire, rather than the scoreboard operator!”

Audit objective should be truth and fairness, rather than compliance

How could auditing standards be further improved?

“There needs to be an appropriate level of auditing standards, of course, but above all auditors should exercise professional judgment. Auditors should consider arriving at a view that is true and fair, rather than compliance, as their main objective. Retaining principles-based approaches to accounting and auditing would encourage this.”

Auditor choice should be increased

What is your opinion on the increasing concentration of audit firms?

“We really need to increase choice in selecting an audit firm. If the audit supply continues to be limited, there will be a tendency toward overregulation, restricted audit scopes, and less useful products. More competition among audit firms, if achieved through modification of regulatory requirements around firm ownership, could also bring considerable benefits in the form of reducing the cost of capital for those firms. I realize, however, that this is easier said than done.

“Should there be an introduction of outside capital into audit firms? Should there be some sort of audit liability reform? There is a need to pursue the debate. We support further investigation of the European Union into auditor concentration.”¹

Improving auditor communication

How could auditors better communicate the results of their audits with investors and other stakeholders?

“Auditors communicate in a limited way via the audit report. More length, however, does not necessarily mean more informative audit reports. The real question is how their role influences directors in communicating with the shareholders. Does the threat of including an emphasis of matter paragraph, for example, encourage directors to make the disclosures in the appropriate way?

“There is a greater need for more discursive audit committee reports than for expanded (external) audit reports. The balance of advantage seems to be in getting communication from the directors of the company to their shareholders, and for shareholders to pursue dialogue with the directors, while the auditors concentrate on their overarching objective of delivering a clear opinion on the accounts.”

¹ See also the Oxera report, [Ownership rules of audit firms and their consequences for audit market concentration](#) (2007), prepared for DG Internal Market and Services of the European Commission.

Key recommendations from Michael McKersie

1. Companies should make governance part of their mindset, and operate on behalf of their shareholders—focusing on the long-term, sustainable performance of their organizations.
2. Boards should consist of directors with various backgrounds and diverse skills.
3. Directors need to make sure that compliance with regulations does not override their responsibility to analyze the big picture and make balanced decisions in the overall best interest of the company.
4. Boards should consider the right balance in executive remuneration between base and variable pay, including performance-linked remuneration. They also need to consider how much remuneration should be monetary, how much should be share based, and how much should be subject to deferral or retention.
5. Shareholders should receive sufficient information about the company they invest in, as it is only with that information that they can effectively engage with these companies.
6. The main purpose of financial reporting should be twofold: decision-usefulness and accountability or stewardship. The financial reporting process should start from the stewardship perspective, because stewardship will yield financial reports that are inherently decision-useful.
7. To improve their narrative reporting, boards should be more open, transparent, and forward looking. Liability concerns should not limit the board's communication with stakeholders. As long as they are making their disclosures in good faith, then there should be no grounds for concern over liability.
8. International convergence of accounting standards is useful, but quality in standards is more important than speed in achieving convergence.
9. The auditor has a beneficial behavioral effect on management and their judgments. The auditor should be thought of as the umpire, rather than the scoreboard operator.
10. Auditors should consider arriving at a view that is true and fair, rather than compliance, as their main objective. Retaining principles-based approaches to accounting and auditing would encourage this.
11. Rather than expanding their external audit reports, auditors should provide more discursive audit committee reports to enhance the communication between the directors and the shareholders of a company.

We welcome your feedback on these recommendations. To provide us with your feedback, please complete this brief [survey](#).