 

Profile: Richard Deutsch and Jan McCahey

At a Fork in the Road

Two Australia-based accounting professionals discuss why the profession is at a crossroads.

Intro

Richard Deutsch and Jan McCahey have a wealth of combined experience as both accountants and auditors, working in Australia and the wider business community. In this interview, Mr. Deutsch and Ms. McCahey explain how Australia managed to weather the global financial crisis relatively well.

That does not mean that there is nothing to be further improved in Australia; corporate governance,auditing, and financial reporting could all be further improved.

In response to the crisis, they suggest a collaborative effort to develop additional principles-based guidelines and standards, as opposed to a heavy legislative response. The accounting profession, they say, must play a critical role in this effort if business reporting is to achieve greater relevance in tomorrow's world.

Richard Deutsch and Jan McCahey: Brief bios

Richard Deutsch is the national assurance leader for PricewaterhouseCoopers Australia (PwC). Mr. Deutsch has led the external audits of a number of PwC's major clients in the insurance, property, and investment management sectors. He has also provided advice to some of Australia's largest companies on a range of accounting-related services, including acquisition and due diligence, internal controls, and corporate governance services. Mr. Deutsch just completed a one-year term as president of the Institute of Chartered Accountants in Australia for 2009 and served as a director on the Institute's board for six years.

Jan McCahey is lead partner of financial reporting standards for PwC, and one of the pre-eminent accounting experts in Australia, with extensive experience in accounting and financial reporting regulation. She is a former chief accountant at the Australian Securities and Investments Commission (ASIC), a former member of the Australian Accounting Standards Board, and was an inaugural member of the Financial Reporting Council (FRC).

The financial crisis emphasized the importance of good corporate governance

How is corporate governance in Australia and how has it been affected by the global financial crisis?

(Jan McCahey) "In Australia, we have been operating reasonably well at a corporate governance level. The series of reviews that have been undertaken over the last 10 years have meant the Australian corporate governance community is in pretty good shape. Companies are aware of the importance of corporate governance, and boards tend to have a good level of focus on governance issues. My sense is that over the last couple of years—as we have lurched into the global financial crisis—the need for good corporate governance has been emphasized. While there will always be pockets of surprise, on the whole, I don't think that corporate governance is a weak spot for us in Australia."

Improved prudential supervision regime for the banking sector

What can we learn from the fact that Australian companies have been doing reasonably well, notwithstanding the financial crisis?

(Jan McCahey) "One of the reasons Australia is doing a little better in the financial area is that the regulation for our banking sector was reformed some years ago, and the result was an improved prudential supervision regime. So we have not had our banks undertaking the same volume or sort of investment-banking-type activities, compared with US or UK banks."

(Richard Deutsch) "As a result, Australia now has 4 of the top 10 banks by market capitalization globally!"

Revised Australian corporate governance guidelines

(Jan McCahey) "The Australian Securities Exchange (ASX) worked with the Australian Securities and Investments Commission (ASIC) to bring together parties representing the wider reporting chain, such as the Australian Institute of Company Directors, the large professional accounting firms, and the Business Council of Australia, to implement a set of corporate governance guidelines into the listing rules. All listed companies are required to honor these guidelines and report against them. If companies don't follow some of the guidelines, they are required to explain why they don't in their annual report. This has led to companies taking the best practice guidelines seriously."

Can you mention some important best practices?

(Jan McCahey) "In Australia, we have embedded a very clear distinction between the role of executive and non-executive director in the make-up of company boards. For example, it's common to have a chairperson of the board who is not an executive of the company. This brings a greater degree of independence to boards; the chairperson can objecively review management's performance, ask tough questions to satisfy him- or herself that financial information is accurate, and help determine appropriate levels of remuneration for senior executives."

(Richard Deutsch) "It's worth mentioning that in Australia we haven't had anywhere near the same degree of executive remuneration excesses that we have seen in the US and other countries.While we have some examples of highly paid executives, the issue isn't widespread. There are a couple of reasons for this.

"Having non-executive directors on company boards and in the role of chairperson helps to ensure that management are remunerated fairly and responsibly, and that their remuneration is in line with their performance and that of the company.

"Secondly, it's not common for employees of particular companies to have all of their stockholdings through pension plans in the company they work for. While this doesn't relate directly to the issue of good corporate governance, it does help to create an environment that is more resistant to crisis."

Australian rules governing the appointment of non-executive directors should be relaxed

How can corporate governance in Australia be further improved?

(Richard Deutsch) "Because we are a small country and the pool of experienced non-executive directors is shallow, the problem we have in Australia is that the independence rules around the appointment of non-executive directors are a little too tough.

"According to the current rules, many potential non-executive directors seem to be conflicted and cannot act on more than one board in the same industry. This creates a lack of experience and knowledge for boards in certain organizations.

"A relaxation of the rules that govern the appointment of non-executive directors would enable us to better use our small pool of highly experienced, qualified non-executive directors across the broader range of companies and industries."

Other respondents to our business reporting studies pointed out the increasingly litigious environment in which non-executives now have to operate.

(Jan McCahey) "In Australia, there have been a number of court cases in which there was considerable focus on the role of directors. We had some quite high-profile legal action taken against some directors, which underlined the common law duties and responsibilities of their role."

(Richard Deutsch) "A recent court decision about the role of the non-executive directors at James Hardie, one of Australia's listed corporates, brought to light a number of issues about the responsibilities of non-executive directors (see also 'Tough penalties for James Hardie directors')."

Tough penalties for James Hardie directors

In the James Hardie case, the directors and non-executives of this Australia-based producer of building materials were held personally responsible for approving the publication of a misleading press release. According to an article in the Australian news source Business Day (April 19, 2010), "[Last year] … ten former directors and executives had breached their duties to the company over the media release, which said a new compensation trust was 'fully funded.' It was later found to be underfunded by an estimated $1.5 billion."

(Richard Deutsch) "The outcome of this court case is a real challenge to the non-executive director community in Australia. I think we'll either see some real reluctance from some non-executive directors to continue in their roles, or a smaller brigade of people wanting to be non-executive directors."

(Jan McCahey) "One of the penalties in this case saw the majority of the board banned from operating as a company director for five years. A particular issue at hand is whether or not the board members approved the text of the media release. One of the issues coming out of that is that we need to strike the right balance between boards providing oversight and boards playing the role of management."

See also the ASIC website.

Stakeholder-driven governance is preferable to a heavy legislative response

What do you recommend going forward in the corporate governance area?

(Jan McCahey) "I wouldn't recommend a heavy legislative response. We get the best outcome in the corporate governance area when there is a reasonable amount of peer pressure, and so I feel as though there should be some collaborative efforts with the parties that are affected. What we have done in Australia with the corporate governance guidelines—the 'apply or explain' approach—has a stronger chance of success than a heavy legislative response. The alternative is that we are going to end up with people saying, 'Well, I no longer want to participate as a non-executive director. Instead, I will develop my own privately owned business opportunities, and I will create wealth for me and my friends who are happy to have everything stay private, and I won't share that expectation in a wider public scene.' That would be very unfortunate."

> *"It would be nice to see our principles-based model of corporate governance applied globally." –Richard Deutsch*

(Richard Deutsch) "I agree entirely. We have a model here that works quite well, and it would be nice to see our principles-based model of corporate governance applied globally."

Stakeholders should avoid asking for additional financial reporting guidance

Many respondents to IFAC's previous surveys point to the complexity of current financial reporting standards. [1] *Standard setters say that when they issue a more principles-based standard, the big accounting firms immediately ask for further explanation.*

(Jan McCahey) "That is the standard line of the chairman of the International Accounting Standards Board (IASB), Sir David Tweedie,[2] and in some respects, he is right. It is one of the tensions in the standard-setting process. One of the things that we at PwC are trying to do, as a global accounting firm, is to avoid doing exactly what Sir. David is critical of. When we prepare comment letters on IASB proposals, we are extremely careful not to ask for more guidance. Instead, we often ask them to put principles back in place.

"Sometimes we feel that what they are suggesting in a standard is more like a rule than a principle. This can come through when they put examples into their principles-based standards; it is important that people understand how the example is truly a reflection of the underlying principle (see also 'Examples included in principles-based standards should be a true reflection of the underlying principle').

[1] See, *Financial Reporting Supply Chain: Current Perspectives and Directions* (IFAC, 2008), and *Developments in the Financial Reporting Supply Chain—Results from a Global Study among IFAC Member Bodies* (IFAC, 2009).

[2] See also the interview with David Tweedie in this business reporting series at www.ifac.org/frsc.

Examples included in principles-based standards should be a true reflection of the underlying principle

(Jan McCahey) "When the IASB issued its exposure draft on changing the recognition and measurement rule for financial instruments, one of the proposals was to price at fair value all financial assets, except debt instruments that are managed on a contractual-yield basis. Now, most people have a good understanding of what that would be. But then the IASB included some examples that made us think, 'Oh gosh, we would not have expected that. We would have expected that these ones would have qualified or those would not.' In these cases, we return to the IASB and say, 'Look we are not sure that your example is quite clear, because we would not have come to that answer.'

"Sir David might say, 'Well, they are just looking for more rules,' but one of the things that we are really trying to challenge ourselves on is to say, 'No, we don't want lots of guidance and lots of rules, but we do want a principle to be stated clearly and with enough clarity in the example so that we can go away and use it as a basis for applying that to other sorts of transactions that are not specifically covered."

"So I think we have heard Sir. David's call, and we are certainly trying to address it. I think, though, it's easy to blame the accounting firms; there are also examples in which, through the IASB's processes, the Board tries to solve a problem for a particular group of entities, and they end up steering away from their own commitment to principles and instead implementing rules."

Disclosure details in financial reports should be reduced

(Jan McCahey) "A particular issue that I am passionate about is reducing the detailed disclosures in financial reports. This is one of the main problems we have in financial reporting.When I look at a set of financial reports, I sometimes see pages and pages of information, for example, related to property, plant, and equipment, and in the majority of cases, that detailed information does not add anything to anyone's knowledge about the business. All those details obscure the most meaningful information. So we have to reduce the clutter in financial reporting and do something in accounting standards to promote that. Otherwise, we run the risk of financial reporting becoming completely unmanageable.

"Simply adding more disclosures will not fix the issues with financial reporting." –Jan McCahey

"One of the things that we have been conscious of doing when responding to financial reporting proposals is trying to push the IASB to take up the challenge of reducing the disclosure obligations. It is not an easy task for them to take up, because—even though everybody agrees that we should reduce the number of pages in financial reports—in response to every crisis, the call tends to be for more disclosure. If you think about all the meetings of the Group of Twenty (G-20) Finance Ministers and Central Bank Governors to address the financial crisis, a lot of what came out of those meetings was, 'We need more information about these financial transactions,' and, 'We need more disclosure about that.' Simply adding more disclosures will not fix the issues with financial reporting. We have got to get people away from thinking more disclosure is the answer.

"In addition, standard setters often seem to add disclosures, but they never take out disclosures that are already required. Therefore, we have to get the standard setters to focus on working out what their disclosure principles are, and then hold them to that, so that they are only asking for additional information when that information genuinely meets their disclosure principles."

The devil is often in the details, but do you believe that overly detailed financial reports may cause users to completely overlook the crucial points?

(Jan McCahey) "It is the same point—the reason users of financial reports sometimes miss the essential points is because there is so much clutter. If a company's focus were genuinely on making sure that they were disclosing the key information about their major events that occurred during the year and how that affected their approach to managing certain risks, users would get all of the information that they need. But at the moment, it is all cluttered with other stuff, so users are not able to easily extract the key points or understand the issues that had, or could have, a material impact on the business. I do understand the comment that the devil is in the details, but I think it becomes the devil because there is too much detail!"

Additional disclosures should go into a website database

What should we do with all these detailed disclosures?

(Jan McCahey) "One of the challenges with this is that the standard setters will tend to say, 'Financial reports are prepared for the user community, so it is not for you as an auditor or you as a preparer to judge what the level of detail should be in there. That should be for the users of financial reports to determine.' But my experience in dealing with the user community is if they are asked the question, 'We are proposing to put all this information into the accounts, what do you think about that?' Well, that group is going to say, 'Fine.' And if they were asked, 'Which of this could you do without?' they are not going to come up with anything. So while I very much agree with the view that financial reports are prepared for the benefit of users, I do think we need to get a better collective understanding of what will be the drivers of the disclosures to go into the financial reports. If there is some basis for users of financial reports to have a whole lot more information, then maybe that should go into a database on a company's website. Maybe this is where XBRL will come into play."

Companies should continue their more open approach to reporting

Do you also see a greater role for narrative reporting or management commentary to emphasize the main issues in the financial report?

(Jan McCahey) "Australian companies have provided more balanced narrative reports over the last couple of years. In this turbulent financial environment, companies needed to focus very carefully on whether or not their assets were impaired. They have become used to sharing more information about the assumptions they have made in performing these calculations—that sort of information is very important.

"Similarly, companies are preparing their accounts on a going-concern basis, and yet times have been so tough that many companies needed to question whether the going-concern basis was still appropriate for them. Generally it was, but often they needed to put additional explanatory information into their accounts, such as, 'The company has these challenges around getting financing, but it has these plans in place to mitigate them …' One of the good things that might come out of this crisis is that companies and their boards would retain that kind of open, balanced approach. Now that they have done it once, it is not so scary to write about the potential risks the second time."

A global transition to IFRS would lead to greater credibility for the accounting community

How important is the transition to a set of global accounting standards?

(Richard Deutsch) "I am sure this is no surprise, but I think the single biggest issue in regards to credibility with financial reporting is about whether or not we are going to adopt the International Financial Reporting Standards (IFRS) globally. It seems we are at crossroads. Australia adopted IFRS early and has gone through the pain of transitioning, and is now pretty close to using the full IFRS. However, some of the major global capital markets are still not reporting under IFRS.We are talking about 2015 or 2016 in Japan's case, and for the US, it is still unclear whether or not they will adopt IFRS. This leaves us weak as a global profession and accounting community. We are at a fork in the road in terms of what is going to play out over the next few years. I absolutely endorse a global set of international financial reporting standards, and the sooner the community can get to that position, the greater our potential to have more credibility in the marketplace. We would be in a challenging position if the US, the EU, or Japan were all backtracking."

The adoption of IFRS should coincide with a change to a more principles-based culture

What are the main issues impeding global adoption of IFRS?

(Richard Deutsch) "The cultural difference among countries is a major issue to address. The proper application of IFRS requires a more principles-based approach—but how do you ask countries such as Japan and the US to move to a principles-based approach when they are steeped in a rules-based approach? It is almost a cultural behavioral journey that needs to be considered to assist some of these countries in their move to IFRS (see also 'We could not answer that one question')."

We could not answer that one question

(Richard Deutsch) "Our Institute of Chartered Accountants in Australia recently hosted a delegation of the Japanese Institute of Certified Public Accountants, Japanese business professionals, and a Japanese accounting firm's delegation. This group was doing some early thinking and planning around their move to IFRS in 2015 or 2016, and this trip to Australia was very much about understanding some of the learning points from our transition and how they could benefit. That was all a great discussion, but the thing that really stuck in my mind is that when we got to this principles- versus rules-based approach, we realized that the Japanese accountancy profession—as well as the wider Japanese business community—has a much more rules-based culture than we do here in Australia. The question that we could not answer is, 'How do you move from a rules-based culture to a principles-based culture?' In Australia, we come from a principles-based approach and never had to make that cultural change."

Through education and other forms of assistance, professional accounting bodies and IFAC should help countries transition to IFRS

What are the other lessons we could learn from Australia's adoption of IFRS?

(Jan McCahey) "When we moved to IFRS here in Australia, we found that it was very challenging for our practitioners to continue to work with their clients in the way that they were used to. Everybody here at PwC was very knowledgeable about our former Australian accounting standards, and so their habit was to be very confident in dealing with clients. Whenever a client had a question about an accounting issue, they could provide a very confident answer. But then the standards changed to IFRS, and, all of a sudden, those people didn't have quite the same confidence in their knowledge anymore, and it took a while to get that back. In the US, they have a lot more detailed accounting literature then we ever did in Australia. That gives them a particular challenge, because the professionals operating there are feeling pretty knowledgeable about their 25,000 pages of accounting literature, and, all of a sudden, they have got to work from around 3,000 new pages. In a large part of the world, there are going to be professional accountants who are not so confident about their professional capability any longer. And a loss of confidence could easily lead to a call for more guidance, either from the standard setters or from their technical departments, which is not where we want to go. So this is very challenging not only for those people individually, but also for IFAC and its professional accounting member bodies."

What would be your proposed solution?

(Richard Deutsch) "My strong recommendation would be that professional accountancy bodies, in conjunction with IFAC, think about how they can assist and educate their members to help them along this journey. So there needs be some sort of education—such as the sharing of case studies or interpretation workshops—to support accounting professionals. I can't see a better way of trying to make this cultural journey easier."

Qualifications should be developed and required for preparers of financial statements

(Richard Deutsch) "A related issue I feel very strongly about is around the qualifications for preparers of financial statements. I would love to see the development of a set of required qualifications for preparers. At the end of day, the financial statements are only as strong as the weakest link in the chain of preparers, boards, auditors, etc.[3] Some companies have professionally qualified CFOs signing off on financial statements before they go to the board. In other instances—and this is even in listed companies—there are preparers of financial statements who do not have any accounting qualifications. When something goes wrong, people forget that it was the preparer's responsibility to prepare the accounts and take them to the board. It was the board's responsibility to assess how the accounts were prepared, and yet 9 times out of 10, the first shot out of the cannon is aimed at the auditors. I obviously have a vested interest in this argument, but I do think it is a huge weakness of our overall reporting framework, and I would love to see a set of qualifications that would apply to preparers of financial statements."

[3] See also the comments of James Kroeker, Chief Accountant of the US Securities and Exchange Commission (SEC), on professional competencies of accounting staff in this business reporting series at www.ifac.org/frsc.

How do you see that happening?

(Richard Deutsch) "I think the only way you can do it is through the qualifications of the preparer, as opposed to a set of standards to which the preparer should adhere. One of the lessons learned through the Australian transition to IFRS was that a significant proportion of companies needed to source external experts to help put their IFRS financial statements together. So I would like to get to some sort of minimal level of qualification for preparers."

You can also turn it around and say that the accountancy profession has made financial reporting so difficult that companies now need a qualified person to solve this mess.

(Richard Deutsch) "That is a good point and not an easy one to answer. I don't have the research to support this assertion, but I wonder in how many corporate collapses or instances of poor disclosure there was a correlation with the qualifications of the team that was putting together the financial statements. If we look back at a high level at the strength and robustness across the financial reporting supply chain, it is clear that the preparer represents a critical component of this process."

Don't let "analyst packs" put regular financial reporting in the shadows

Do Australian investors find current financial reports more or less useful than before?

(Richard Deutsch) "Something that has occurred in Australia over the last few years—as a result of the increased complexity of financial reporting and the transition to IFRS—is that a number of corporations produce what we now call 'analyst packs.' These are the packages of financial information that companies present to the analyst community. Sometimes, there are significant differences in what is presented in the financial statements and what is presented in the analyst packs. There might be items being taken out to normalize how people would have historically viewed the performance of a company prior to its transition to IFRS. In a number of organizations, the financial statements are no longer looked at, and everyone focuses on these analyst packs. This is another weakness in the financial reporting area, because people are relying on analyst packs, which are not necessarily in accordance with financial reporting standards. In addition, these analyst packs have actually not been audited in any way."[4]

What is your recommendation in regard to these analyst packs?

(Richard Deutsch) "If we were able to simplify the regular financial statements and take away some of the burden associated with their preparation, and at the same time implement a requirement that analyst packs must be reviewed, that might be a nice outcome, but it will be a challenge to get there."

(Jan McCahey) "With things like the analyst packs, the market is responding as best as it can to provide information in a meaningful way to stakeholders, and the accounting profession needs to be cognizant of that. There is a need to get some assurance around that information, but it also points to the need for the accounting profession to take a lead in trying to sort out the expectation gap that exists in financial reporting. We are still suffering to a large degree from the gap between what the information in the financial report is purporting to do and what it is that people wish that it did."

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[4] See also the interview with Tanya Branwhite in this business reporting series, who signals "the disturbing emergence of shadow reporting" at www.ifac.org/frsc.

Business reporting should include more non-financial information and be more forward looking

To finalize this interview, how would you like to see business reporting develop?

(Richard Deutsch) “What I would like to see happening in 5 or 10 years time is for the profession to simplify the financial accounts to the things that really matter, and for business reporting to achieve a greater relevance, for example by including more of the non-financial measures that organizations are increasingly being held to account for. That could be, for example, in the area of sustainability or in the area of social responsibility, but I think reporting has to be more holistic and relevant to what people want to understand of organizations in tomorrow’s world.

“My other recommendation would be that business reporting needs to be more prospective rather than backward looking.We all know that the current set of financial statements are a snapshot of a certain point in time, and we are signing off after the event. We need to move to the ability to give some sort of assurance on the outlook of an organization as part of the audit process, and if we don’t, I fear the accountancy profession will lose its relevance over time.”

Key recommendations from Richard Deutsch and Jan McCahey

1. Companies should consider clearly distinguishing between the role of executive and non-executive director on company boards. This includes having a non-executive chairperson of the board to ensure a greater degree of independence.
2. A non-executive chairperson and non-executive directors help to ensure that management are remunerated fairly and responsibly.
3. The independence rules around the appointment of non-executive directors should be relaxed to enable better use of the limited pool of highly experienced, qualified non-executive directors.
4. Governance regulation should strike the right balance between boards providing oversight and boards playing the performance role of management.
5. A principles-based stakeholder-driven approach to corporate governance—implementing guidelines in accordance with the "apply or explain" principle—has a stronger chance of success than a heavy legislative approach.
6. Examples included in principles-based financial reporting standards should provide enough clarity so that the principle can easily be applied to other transactions.
7. The level of detail in financial report disclosures should be reduced. To achieve this, standard setters should be frugal in their requests for more disclosures in the mainstream report and additional disclosures should go into a database, rather than the report.
8. Companies should continue their more open approach to business reporting by sharing their assumptions, identifying potential risks, and providing additional explanatory informations.
9. The international accounting community, including professional accounting bodies and IFAC, should promote a swift global transition to International Financial Reporting Standards (IFRS) by, for example, providing professional accountants with education and other forms of assistance.
10. As financial statements are only as strong as the weakest link in the financial reporting supply chain, a minimum level of qualification should be required for preparers of financial statements.
11. In order to achieve greater relevance, business reporting should include more prospective non-financial measures, and the accountancy profession should push for assurance requirements of this forward-looking information.

We welcome your feedback on these recommendations. To provide us with your feedback, please complete this brief survey.