Profile: David Phillips

Uniting Financial, Non-Financial, and Narrative Information in the Business Reporting Jigsaw

A self-proclaimed activist—Americans would probably call him a maverick—David Phillips has a very long track record of constructive proposals on what exactly could be done to make the business reporting world a better place.

Intro

Although the recent financial crisis has put corporate governance on top of the agenda, the UK-based PricewaterhouseCoopers (PwC) partner and co-author of *The Value Reporting Revolution*, David Phillips, argues that we would be missing a big opportunity if we tried to rebuild the system without adjusting the business reporting model as well. "This requires a substantive debate about the health of business reporting," says Mr. Phillips. "There are fewer and fewer people who understand the regulated financial reporting model." And, "the less understandable financial reporting becomes, the greater the risk that it will lose its value and relevance." Instead, "business reporting should be about financial, non-financial, and narrative information brought together in simple building blocks of information, to explain what has happened to the business," according to Mr. Phillips. Improving the business reporting model is also beneficial to corporate governance as "the best test to determine whether or not a company is well governed is whether or not the company leadership can present a cohesive explanation of the business, including what it has achieved and where it is trying to go."

David Phillips: A brief bio

David Phillips is a partner with PricewaterhouseCoopers (PwC) in the Assurance Practice. He is a graduate of Nottingham University, where he read industrial economics, and is a chartered accountant. Mr Phillips is a founding member of the team that developed PwC's Value Reporting conceptual model. He has led a large proportion of the research work, undertaken in 14 countries and across six industry groups, into the information needs of the investment community.

He has written a number of research papers, including *Reporting Gaps in the United Kingdom: The Chief Executive's Perspective.* Mr Phillips is co-author of the book *The Value Reporting Revolution: Moving Beyond the Earnings Game*, published in March 2001. He was a member of the Institute of Chartered Accountants' steering group, which wrote the discussion paper *Inside Out – Reporting on Shareholder Value,* published in 1999. In addition, he has worked with a number of leading companies to enhance their corporate reporting processes and to help them determine the information that needs communicating externally. He is also the inspiration behind and editor of *Trends in Corporate Reporting*, an annual publication looking at the progressive steps being taken by the world's leading companies to enhance communications.

See also his blog at http://pwc.blogs.com/corporatereporting.

Governance is more about behavior than about process

After what happened in the financial crisis, what needs to be done to improve governance?

"Due to the financial crisis, corporate governance has risen to the top of the agenda. Arguably, it has been there for some time, but it is a very difficult nettle to grasp because it is about behavior rather than process. Therefore, we need to work on two fronts. One is changing the regulatory part of the system—and there are many parties that convene in regulation—and the other one is trying to find market mechanisms that will change corporate behavior, which is perhaps more subtle, but arguably more important and longer lasting. We need to look at the two areas, because, at times, I think it is easier to make regulatory changes than changing market mechanisms."

People management should be high on the agenda

What can senior management and boards do to make this long-lasting change in corporate behavior happen?

"A lot of big organizations now recognize that their leadership teams need to spend more time leading. It has been an argument for a long time. And many books have been written about how much time senior management should spend on people management. Perhaps it should be 40–60 percent of their time. Different people would have different views though.

"Another interesting issue is about the shape of businesses. Businesses that have grown organically often have a stronger culture and set of beliefs than those that have grown rapidly through a series of acquisitions and have been bolted together. They are very different animals, from a business perspective, in terms of how you manage them, and I think it is an area which arguably has not been given enough time and attention. "

Growing organizations need clarity about leadership roles and responsibilities

Have some of these companies become too big for their boards to lead, govern, and oversee the business effectively?

"It is about clarifying roles and responsibilities, and it is about what leaders see as their goals; people in leadership positions need to have a clear understanding of what they are accountable for and need to align their goals with the wider organizational goals. It does present some interesting questions about the roles and responsibilities of boards and senior management in these big organizations, such as:

- What is it that the board should be doing in its board meetings? It would be fascinating to do a straw-pole of the top 350 companies in the UK and say, 'Let's look at how the boards in those companies spend their time during the year, let's analyze it.' And one of the things that I have a genuine concern about—which also vastly pervades the reporting agenda—is that we have drifted into a world with lots of process, where only part of it actually has any value. And so, the board's time is being spent on the stuff that they feel they need to do legally. They do what lawyers and others tell them they need to do. So they are not free agents in this space.

- What are the differences between the responsibilities of a non-executive director and an executive director? We have this debate in the UK at times around the fact that the world does not necessarily understand those differences, and if I am honest, they are not clearly defined. Here the work of Tomorrow's Company around the idea of a "board mandate" is very interesting.

- How much time and attention should a non-executive director give to an organization? It seems to be on the increase, but for some this trend can result in non-executives getting too involved in operational issues."

A system of self-regulation for non-executive directors should be considered

Shouldn't non-executive directors be held more responsible for their actions or inaction?

"You could argue it would have a greater impact on non-executive directors if they were held personally responsible. Perhaps we should develop some sort of self-regulation structure for the non-executive directors, similar to the system by which accountants and doctors, for example, are governed. If you are found to be doing something that is considered to be unacceptable to your peers, then you get marched out of the club. I think this would work because the majority of non-executive directors are more worried about their reputation than about anything else. Certainly this is the case in the UK, and I am confident it is the same around the world.

"However, self-regulation won't always get everybody to change their behavior, so at the other end you need to have some very clear sanctions. I get a sense that in the US the authorities are more intent about putting directors behind bars who have acted irresponsibly, than perhaps in other parts of the world. I think, ultimately, you need those sanctions."

Boards should set the tone at the top

It is argued that many managers have a one-way bet—being rewarded for success and only losing their job (but not their personal investment) if they fail—which might lure them into irresponsible risk taking. How can their behavior be better aligned with the interests of the shareholders?

"The big question is about whether or not management has been operating within the limits of what it has been given by the board. It is ultimately a board issue, because the board is responsible for setting the structure in which the organization operates, setting the expectations about how much risk managers are allowed to take, and identifying the sort of behaviors they will sanction or support. Then it becomes the management that needs to make sure that the rest of the business also operates within those confines.

"When people are given an almost entirely unfettered space to do whatever they fancy as long as they are making money—which you could argue was a factor that contributed to the financial crisis—it should really be exposed. This also goes back to the issue of reputation: Persons who have taken excessive risk and lost a lot of money should be less employable going forward; they should not get a job reference."

Tone at the top is also important for the external stakeholder

Would you say that an important purpose of all these corporate governance measures is to re-instill trust with the stakeholders?

"We are subtly moving—and maybe the financial crisis has accelerated the shift —toward a world that is more interested in the people within the organization: who they are and what they stand for. That interest may extend beyond the investors. Also, in broader society, there is an increasing interest about the values of companies. One wouldn't go quite so far as to ask, 'Can you show me where the line is that divides right and wrong?' But society is increasingly expecting companies to have a consistent culture and set of behaviors."

Companies should be able to present a coherent explanation of their business

What should companies do to better present themselves?

"The challenge for companies is going to be how they actually expose some of this tone at the top. Now, you could argue that with modern communications and reporting in its widest sense, it is perhaps easier today for companies to present themselves in such a way. The challenge for companies in this media-driven world is that their leaders no longer can hide behind the corporate veil, but have to be able to articulate their thinking and their ambitions for the business."

Why is that so important for companies?

"The best test to determine whether or not a company is well governed is whether or not the company leadership can present a cohesive explanation of the business, including what it has achieved and where it is trying to go. For critical areas, such as how companies are rewarding their people, they should be able to explain how remuneration has been determined, including how it is linked to the strategy and to the performance objective that management has been given. Other important reporting topics are, for example, the link between a company's strategy and its key performance indicators on strategy, and what companies are reporting around risk. So there is a network of topics, which—in a good company and with good reporting—should actually be combined into one coherent explanation of their business. But actually, what we note today is that most companies find it quite difficult to present that cohesive picture. And I am not saying it is easy, but trying to get people to present this information is an indication of whether or not a company is on top of its business."

Governance reporting should include both principles and specific actions taken

How can companies improve their reporting on corporate governance?

"Corporate governance is very aligned to the financial reporting agenda that is directly attached to it. Here in the UK we tend to have a slightly rose-tinted view of reporting around corporate governance, because there is a lot that has been going on in the UK in the corporate governance reporting space over the last 10 years, for example, in the area of executive remuneration reports, which are quite extensive. I think we actually should have more transparency to disclose the big picture more clearly and less transparency around what individual directors earn, because arguably

> *"Companies should have to produce a corporate governance statement every year that explains what they have done: the good, the bad, and the ugly."*

we seem to have gone over the top a little bit with some of that.

“However, even though there are some good parts to corporate governance reporting, actually a lot of it has become, dare I say, just boilerplate and box ticking. If we look at what companies are actually saying in their current corporate governance reports, the content is pretty much the same as it was five years ago. A lot is said about the form in committee structures and terms of reference, but little about the substance—‘What have they done?’ Companies should have to produce a corporate governance statement every year that explains what they have done: the good, the bad, and the ugly.”

Allow companies the freedom to draw up their own free form governance report

How can we reduce the boilerplate in governance reporting?

“I believe though that for corporate governance reporting, as well as for business reporting in general, we should allow companies the space to hang themselves. It would be nice—and this is just a pipedream because we are never going to get back here—to get back to a point where we ask from companies no more than, ‘You have to explain your actions.’ The more we structure things, the more we get people just filling in the boxes. With less requirements, we would get a better sense of the company by seeing what companies choose to report, or not report. Some would give a very good description of themselves on what they have done, and others would give you next to nothing. That in itself tells a vast amount about how the company in question has actually been doing with respect to governance.”

Financial reporting is at risk to lose its value and relevance

Do you think that the quality of business reporting in general has improved over the last 20 or so years?

“It might have improved a bit, but relative to the effort that has been put into it, I am not sure it has. There are fewer and fewer people who understand the regulated financial reporting model. The financial reporting knowledge that sits in the corporate sector is diminishing, even in the big companies, and certainly among investors and other users of financial reports. I have enormous concerns that the less understandable financial reporting becomes, the greater the risk that it will lose its value and relevance.”

A company’s operating results should not be cluttered by changes in fair value

What can we do to ensure that this trend of increasing complexity in financial reporting does not continue?

“One of the first actions is to tackle the issue of fair value. I have no problems with the use of fair value. There are situations in which fair value is a meaningful mechanism for management in running the business. Hence, it has relevance in financial services, because fair value is central to the way the business operates. Some people think, however, that fair value actually reduces complexity. I am not sure that it does, because what fair value actually means is incredibly complicated as we found out throughout the financial crisis.

"I have real concerns and reservations about the extended use of fair value into financial reporting for other than financial services companies that would typically not use fair value in their day-to-day businesses. I do recognize the shortcomings of the use of the historic cost model in financial reporting, and I do not mean to say that I would just expunge all fair value from other aspects of accounting, but I would be much more careful about increasing the use of fair value.

"However, looking at the upcoming agenda of the International Accounting Standards Board (IASB) and having participated in conversations with our technical department, I see fair value pervades so much of what is going on in the financial reporting arena.

"The biggest question—putting aside for a moment the issue of complexity—that needs to be asked at the moment around financial reporting is, 'How much more fair value do we allow to pervade into the mainstream corporate reports?' There are people who believe that the balance sheet should equal the value of the business. If we go down that track, the profession is dead. The balance sheet is a balancing statement in its original concept, it was not a statement to explain the value of the business. So that is the really big elephant in the room.

"Most investors want to understand the historic operating profit number. … They don't want the operating number cluttered."

"Most investors want to understand the historic operating profit number. That does not mean they are not interested in the impacts of fair value—they want to see that as well—but they don't want the operating number cluttered by it. Therefore, distinguishing fair value from the historic operating profit number is really important."

Increase the use of cost-benefit analysis in changing financial reporting standards

"Another issue that we should address is the absence of cost-benefit analysis in changing the financial reporting standards. I don't think the cost-benefit concept has ever been used properly. Nobody appears to analyze the big picture, trying to answer the question, 'What is the cost-benefit to making these changes?' One could also argue that if cost-benefit would have been taken into account, the whole convergence process of the various national accounting standards would have been looked at in a different way. I suspect the agenda may have been very different.

"Ultimately, cost-benefit analysis gets back to the economics, the relevance, and the value of financial reporting. And let's be clear, the biggest cost is difficult to quantify: people are switched-off and have stopped really relating to financial reports in the way they used to."

Create more building blocks of specific business information

How can we change that so investors get more engaged?

“One of the top equity investors in a London firm recently expressed his concern about the developments in accounting. He didn’t want go back to the accounting standards we had before, but said that, ‘At the end of the day, I am trying to get to some simple building blocks of information.’ That is what he really wants. And the way standard setters are trying to make the financial reporting model more sophisticated is actually hiding these simple building blocks of business information.

“The challenge is that the International Accounting Standards Board is focused, as the name over the door suggests, on accounting. It is principally interested in the measurement of financial activity, the back half of the annual report. However, there is a lot that company management can do to change the shape of the back half of the annual report within the constraints that the financial reporting standards place around the measurement of reporting.

“One example could be around a critically important topic like funding. Investors really want to understand how a business is funded. I think there should be a section in the financial report that says, ‘This is how the business is funded,’ and all those pieces of information that deal with that issue should be brought together, including some of the content in the front end of the report and in the narrative.

“Another example would be materiality. The back end of the report behind the primary financial statements is just a data dump. The question is, which information is more material in that dump? If you actually were to ask companies to put that information in order according to its materiality, you again would get a very different picture.

“So there are some things that can be done by preparers within the current financial reporting framework. As the IASB once said, ‘We just tell what the (financial) disclosure requirements are. Now it is up to company management to present them in a way that they think is appropriate. And if they want to add information, they can.’”

Expand financial reporting to wider business reporting

What about the non-financial business information that is of importance to investors?

“The biggest challenge that remains, though, is that the back half of the annual report—the financial report—is still too dominant compared to the company facts and management commentary in the front part of the annual report. Most investment decisions are driven by more qualitative information, such as the industry in which a specific company operates, the dynamics of that industry, as well as the company’s strategy and its market positioning. The financial report is more of a check for investors as to whether or not the company is delivering on its promises. It is only a little piece in the jigsaw.

“The IASB, however, focuses most of its time, attention, and efforts on strictly financial reporting. To be fair, this is its mandate, but at some point we need to get to a reporting model that is more holistic in nature and for this to happen we need to recognize this needs an institution with a different and broader mandate.”

Develop a formal standard on management commentary

Arguably, management commentary is the most important part of business reporting. Would you be comfortable with the development of a more formal standard instead of the current guidance?

"Yes, I certainly would. Sir David Tweedie,[1] the chairman of the IASB, is quoted as saying that management commentary has become even more important to having a proper explanation of what is going on with the business—given the impact that IFRSs has had on increasing volatility in the reported numbers."

We don't have any influence over the IASB

"Most people from outside the accountancy profession think that the IASB is controlled by the big accounting firms. When you tell people, 'Sorry, we don't have any influence over them, and neither has the corporate sector nor the investors,' they are very surprised."

Auditors should expand the scope of their audit

Should accountants be responsible for auditing the front end of the annual reports, specifically management commentary, given their cautiousness about liability and everything else?

"We need a debate on whether or not auditors should audit the whole document, and I think the profession is ready for it. The financial crisis has highlighted the need for an expanded audit. Now people are asking, 'What have you done on corporate governance or what do you do in risk?' To which the auditor's response is, 'We have audited the financial statements in compliance with reporting and auditing standards.' So there is an expectation gap.

"Now there is an opportunity to make the argument that corporate governance, remuneration, risk, the business model, all these issues that are not covered by financial reporting standards, are important to investors and that the auditor should be focused on them. We need a debate about the value to investors, what the scope of audit comfort might be, and the implications for the type of opinion we might give."

Rethink the auditor communication model

How else should auditors communicate, in addition to issuing an audit opinion?

"The good auditors today sit in audit committees, together with CEOs, CFOs, and board members, and talk broadly about the business and everything that is going on. They express their views about everything and anything that they see in the process, and many of their clients ask them to do that. They say, 'You have spent so many years with us, what else have you seen that is going on in our business?'

[1] See also the interview with David Tweedie in IFAC's business reporting project at www.ifac.org/frsc.

However, that is not part of the auditor's regulated responsibility, and I just think we are in danger of making the audit a narrow regulatory process, which crowds out judgment and real business acumen.

"The reason why I am cautious on this topic is that engaging on a broader agenda can look, and does look, self serving. You do need to have this debate about the effectiveness of the reporting model, but in the same bracket, we need to debate whether or not the audit is in the wrong space. I won't speak for the entire accountancy profession, but the world has moved on, and there is concern about the relevance of the profession. The profession has been incredibly defensive, which ultimately may come back to the issue of liability. But, actually, the position that it has taken, as long as I have been in the profession, has not helped. In the past, we have not heeded suggestions that we should, for example, expand the scope of the audit. Now is the time we need to have a serious discussion about it. What if we were to recalibrate how auditors spend their time? Would they spend time in a different way than they are doing today, and could we end up with a better outcome in terms of relevance and value?"

How should the auditor ensure that its communication with each of its various internal and external stakeholder groups is balanced?

"That could happen in the same debate. A very useful piece of the jigsaw is consideration of what the relationship and interaction should be between the auditor and executive management, the auditor and non-executive management, and the auditor and the shareholders.

"We are legally bound to report to the shareholder, but they sort of merge together with the non-executive members of the board. Audit committees, certainly in the UK, have become more critical and central to the role of auditors, but it still concerns me that auditors have no meaningful mechanism for engaging with their primary client—the shareholder."

Revision of audit model linked to revision of business reporting model

If auditors are to expand the scope of their audit, shouldn't they, at the same time, modify the composition of their audit teams and change their audit procedures?

"You pose an interesting question around where auditors should be pitching their tent. Having talked throughout my career to executives of companies and other stakeholders, a lot of them think that auditors should focus more on the top level—the effectiveness of the board, governance, and ultimately how the business was managed —and less on the nuts and bolts of accounting.

"But again, how auditors should spend their time would be an interesting debate—particularly in the context of some of the issues that have come out of the financial crisis. The danger is that if we open up this debate, some people will take the easy way out and say, 'We will just add to what we have got.' But this would not be the right answer.

"In a way, the question of how auditors should spend their time depends upon changes in the reporting model: How much time should be focused on the financial aspects of the business, and how much time should be spent on the state of the business as a whole? This is the key question we need to answer in the next few years (see also 'Was it a good audit?'). The other question we need to consider is, how can auditors innovate the substance of the audit, when the regulator and standard setters are the ones that create the environment in which we operate?"

Was it a good audit?

"A number of years of ago, before the Enron failure ignited a debate about the quality of the audit and the independence of the auditor, there was the sense that there were two audits being done, one by the audit partner and the other one by the audit team. I would not go so far as to say that both elements were excellent and could not be improved, but the reality was, the partner was looking at the bigger picture, testing the integrity of the people that he dealt with, trying to understand the business, and the rest of the team was ticking the boxes, kicking the tires, doing the nuts and bolts. And, arguably, that was quite an effective audit.

"Now we have moved to a model that is much more bottom up, because there is a greater focus on the process. The key questions we have to ask is, 'Have we done all we need to do to comply with regulations and standards that have been set?' But that can be completely different from asking, 'Was it a good audit?'"

Auditors should be more engaged in other types of work to get a broader business understanding

Do you think the audit profession is ready for an expanded role?

"One thing that concerns me is that the business skills in the accountancy profession are deteriorating. And they are deteriorating for two reasons:

- The increased regulation and increased focus on compliance just means that the approach to the audit has changed and there is no longer the space to build business knowledge as I did.
- Partly due to the world of specialization, but also partly due to the focus of regulators, our audit people are significantly less exposed to other types of work during their careers, such as acquisitions, due diligence, and business reviews. They are becoming professional auditors.

"I have a biased view on this, but people of my generation believe the most important skills auditors build around business understanding are not gained by doing audits, but through doing all this other work. The question is, 'How should we train our auditors?'"

A substantive debate about the health of business reporting is required

What point should the reader take away from this interview?

"That we should streamline the annual report to make it something that is more user-friendly and that the auditor should have a larger responsibility for all the pieces of information that are in there. This requires a substantive debate about the health of business reporting. Such a debate will happen when those who ultimately have responsibility for the system, such as the Group of Twenty (G-20) Finance

Ministers and Central Bank Governors, have had enough people coming to their door saying, 'There is an issue here. You are trying to reform the system and to create better stability. Extended business reporting has not directly been in the firing line, but if you are trying to rebuild the system without fixing the reporting model, you would be missing a big opportunity.'

"Ideally, those messages need to come from a broad group of stakeholders. I am greatly encouraged but the work of the International Integrated Reporting Committee (IIRC), as I believe it is a vehicle that can start the process of meaningful change. This year could be a critical watershed for the future of reporting."

Key recommendations from David Phillips

1. To make long-lasting changes in corporate behavior, company boards and management should spend more time on leadership and strategy than on compliance with regulation; regulators need to recognize that regulatory changes have less of an effect on corporate behavior than changes in market mechanisms.
2. To improve the performance of non-executive directors, a system of self-regulation should be developed and complemented by very clear sanctions for unacceptable behavior, such as ousting those who have failed the company and shareholders.
3. In a media-driven world, company leaders can no longer hide behind the corporate veil and should be able to present a cohesive explanation of the business, including what it has achieved and where it is trying to go.
4. Companies should produce corporate governance statements that include not only their policies and principles, but also the actions they have taken: the good, the bad, and the ugly.
5. Fair value can be a meaningful metric for companies that provide financial services; however, other companies need to be able to explain their operating performance and ensure impacts from fair value are clearly understood.
6. Before developing and changing their standards, standard setters should ensure a cost-benefit analysis is undertaken to take into account the economics, the relevance, and the value of the changes they are proposing.
7. A new, extended business reporting model should be developed that would bring together financial, non-financial, and narrative information, in topical building blocks of investor-relevant business information, to explain what has happened to the business and why.
8. To remain relevant, the audit profession should expand the scope of the audit to include all parts of the annual report, and rethink what the relationship and interaction should be between the auditor and executive management, the auditor and non-executive management (including the audit committee), and the auditor and the shareholders.
9. As regulators and others who are responsible for financial stability try to rebuild the (international) financial and economic system, they should take this opportunity to ensure the business reporting model is capable of supporting a changing business environment over the next 50 years.

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