Profile: Samuel A. DiPiazza, Jr.

Keeping the Pressure On

The recently retired CEO of PricewaterhouseCoopers International, and author of several books and articles, provides his views on the progress, the challenges, and the opportunities in the financial reporting supply chain.

Intro

Having dealt with financial reporting for the better part of three decades, Samuel DiPiazza, the recently retired CEO of PricewaterhouseCoopers International, and author of several books and articles, has seen significant progress around the globe in the areas of corporate governance, financial reporting, and financial auditing. On the other hand, he also sees several persistent issues in all these areas that still need to be resolved. In this interview, Mr. DiPiazza highlights a number of these challenges and provides recommendations on how to solve them. Most importantly, though, he outlines some important developments—such as the performance dimension of corporate governance, the need for an integrated business reporting and assurance framework, as well as the fight against corruption—that could be beneficial for all the stakeholders in the financial reporting supply chain. However, the journey to implement these developments will be long and difficult, according to Mr. DiPiazza. "Therefore," he says, "we just have to keep the pressure on."

Samuel DiPiazza: A brief bio

From 2002 until his recent retirement, Samuel A. DiPiazza, Jr. served as CEO of PricewaterhouseCoopers International Limited. Prior to that, he led the PricewaterhouseCoopers US firm as chairman and senior partner and was a member of the Global Leadership Team. Mr. DiPiazza currently serves as a Trustee of the International Accounting Standards Committee Foundation, is a former chairman of the World Business Council on Sustainable Development, and a member of the USA Foundation Board of the World Economic Forum. He has also served as a Trustee for the Financial Accounting Foundation.

Enormous strides in the area of corporate governance

What is your view on the developments in the area of corporate governance?

"With respect to corporate governance, we have made enormous strides in the capital markets around the world compared to where we were 10 years ago. The accountability, the understanding of oversight and strategic engagement, the commitment to transparency at the board level, the quality of boards—in all these areas, we have made tremendous progress.

"We have had some issues, of course, such as the influence of compliance versus true strategic involvement. We have to remember that governance is both. It is not just compliance; it is a deep involvement in the strategic direction of enterprises. IFAC's previous surveys on the developments in the financial reporting supply chain also mention the checklist mentality. I think of it as a focus on compliance, and compliance for the sake of compliance is not useful. Compliance is a requirement, but compliance should not overwhelm the need for real oversight and real ownership and responsibility around strategic issues.[1]

"We also have made progress on the behavioral aspects of corporate governance in other parts of the world, such as Asia, where governance has traditionally been somewhat understated. I think now, it is much more sophisticated in Asia."

Accountability of boards needs to be kept in perspective

So what are our challenges with respect to corporate governance today?

"Our challenge is continuing to attract outstanding people to directorships, while staying focused on the real purpose of these roles, beyond compliance, while also continuing to deal with cultural obstacles. We have a risk that the liability issues and the enormous expectations that are placed on boards of directors and supervisory boards are at times impossible to meet. I think it will continue to erode the quality of directors.

"It takes a brave person to be a director today: What is the time commitment? What is the risk? And what can I both gain and give in the process? And, I think we need to keep the issue of governance in perspective. We have made enormous progress. Governance is not a defense against business failure. You will still have business failure. Boards need to have accountability, but that needs to be put in perspective."

Governance not a guarantee against business failures

How would you reconcile the progress in corporate governance with what happened in the recent financial crisis?

"If you go back to an earlier part of this decade when there was financial reporting fraud, it is very clear that some of those boards did not live up to the level of responsibility that they should have: one meeting per year, no financial experts, no independence… We have dealt with that.

"This financial crisis we have just gone through—not only did boards not see it coming, management did not see it, regulators did not see it, prudential regulators did not see it; enormous numbers of people missed the systemic risks built into the system. And I think it is unreasonable to say that boards alone failed here. The causes of this financial crisis were much deeper.

"If you look at how the subprime crisis became a liquidity crisis, then a credit crisis, and then a recession, I actually think most boards did an outstanding job of positioning their companies to survive. And those boards that didn't, that failed, you have to ask the question, what could they have done differently? There is likely an argument that the risk management processes of many of these financial institutions failed, but even places that have very strong risk management found themselves subject to significant losses and eventually lawsuits just because the crisis unfolded so quickly. I do not consider this crisis a

[1] See also IFAC's International Good practice Guidance, *Evaluating and Improving Governance in Organizations* (2009), which provides a framework and principles-based guidance for organizations to balance their performance and conformance dimensions of governance.

failure of corporate governance. I do think it was the failure of our risk management and ultimately, our financial system."

When board members feel that they no longer understand the business, they should step down

Should non-executive directors be better supported in their role?

"I believe that boards have to understand the responsibility of oversight. This brings with it a requirement that if they cannot reach a reasonable level of understanding of the business enterprise, then they have to question why they are there and, frankly, whether the business enterprise is rational. I would not suggest that if you are a board member of a big oil company, you have to completely understand all the intricacies of vertical and horizontal drilling, but you should understand the nature and risks of horizontal drilling. You should understand the sharing arrangements between the multinational oil companies and the national governments. If your company is trying to work on a deal in, for example, Brazil, you should understand the political implications of that country. If you cannot conceptualize the essence of a business, you have to ask yourself the question: how can I provide effective oversight?

"In financial institutions, we have found that the complexity of their business models—not of their financial reporting—was very poorly understood, even by the management. When the head of the Executive Committee of one of the big financial institutions said that he did not understand the obligations that they had in some of their off-balance sheet accounts, that was a management failure. And, of course, the boards are more likely to fail pretty quickly if management does not understand the inherent risks of a business.

"A board member governance requirement that I would recommend is that when board members feel that they no longer understand a significant area of the business, they should step down. If we can't understand the business, does it make sense for us to be here, or does the business even make sense? And I think that is part of our failure during the last crisis."

Financial reporting is one of the important governance issues

"Further improvement in corporate governance leads us right into the area of financial reporting. If you do not have financial reporting that is understandable and relevant, then it is very difficult to provide good governance and transparent information for an investor to make any rational economic decisions around allocation of capital.

"Financial reporting is not the only issue with respect to governance. There are multiple issues, but it is one of the really important ones, and I think that with financial reporting, having dealt with financial reporting for the better part of three decades, we are at a very delicate place, for example:

- The challenge we have with financial reporting today is that many people do not even read these reports, especially the footnotes. They are just too complex! When they are no longer relevant, CEOs will even admit that they do not understand the financials as relevant to the businesses they lead. They will tell you, 'That doesn't tell you how my company did last year; this other information is much more transparent in measuring how my company performed.'

- Financial reports often do not accurately reflect the true economic consequences of transactions as they flush through financial statements. These traditional financial reports are sometimes about standards; they are not about the economic performance of a company. This is particularly true with rules-based systems like US GAAP.

"If no one reads financial reports any longer, if no one understands pension footnotes and fair value reporting, except for a handful of buy-side analysts, what are we doing? If we fail to find a way to improve the relevance of our output, then we should expect that eventually our work will be discarded.

"Part of our problem is that we are great at creating new things to report, but what we haven't done well is create a framework to consolidate all the relevant information."

"It is, therefore, critical that as an accounting profession, we accept the fact that financial reporting must continue to evolve to achieve greater relevance to the various users. One of the users is the board, one user is investors, and the other user is management. I am not sure that our current form for financial reporting will be relevant in 10 years from now. And I think that is the challenge that the profession and the standard setters must continue to address."

A new, integrated business reporting framework is required

In your book, Building Public Trust: The Future of Corporate Reporting, *that you wrote in 2002 together with Robert Eccles, you presented a three-tier model of corporate transparency: (1) Convergence to global GAAP; (2) Industry-based standards; and (3) Company-specific KPIs. This was back in 2002, but all these points are all still highly relevant for boards and investors making strategic decisions. What do you think are the barriers that are preventing us from achieving this tree-tier model?*

"We actually have made some progress toward the model that Bob and I reflected in our book. It is frustrating because we haven't nearly made as much progress as we wanted. But let's be fair about what we have seen: the convergence toward a single set of high-quality principles-based accounting standards. We are close. It is very hard, especially in the US.

"Compared to 2002, we have made enormous progress around defining accounting standards—for public companies, for smaller and medium-sized companies, and public sector organizations—that are more principles-based and more consistent with the business models of companies and their economics. In fact, many of those standards are continuing to be repositioned and reworked to express pure economics, such as the leasing standard that the accounting standard setters are working on that would move us away from illogical reporting requirements with respect to off-balance sheet issues. We also made a lot of progress in converging our American accounting standards with International Financial Reporting Standards (IFRS).

"But the questions are, why is it taking so long, why is it so hard, and what are the obstacles?

- First, the world has become more complex in the last 10 years, and that is part of what we have been seeing in this financial crisis.
- Regulators continue to regulate—that is what they do—and that regulation adds compliance obligations, and the preparers are very afraid of a world in which regulators simply keep adding on to the requirements.

- We have a whole new set of reporting requirements that are coming in because of the climate change issues, and the preparer is trying to manage how much it costs to produce reasonable reports.

"And because of this need to integrate the various reporting requirements, I think that good business reporting needs a fresh start. To do this well, you need a different framework. We are very focused now on how you integrate sustainability reporting and financial reporting, because organizations now issue two sets of reports. How do you bring those reports together in a single framework? I actually think that the entire movement toward sustainability reporting is going to force financial reporting to adjust. It is eventually going to get consolidated in my view, and it will be the first thing that truly breaks the mold of financial reporting, because companies cannot apply the current practices in financial reporting to other aspects. We have to keep it in perspective though. This is a long and difficult process. We actually have made some progress though."

Business reporting has to become much broader

What if we were to segment business reporting to meet the information needs of the various stakeholders, for example, separate the information that is reported for filing requirements from the management discussion and analysis (MD&A)?

"If we are not careful, we will end up with a compliance report, a management financial report, a sustainability of social responsibility report, a shareholder report … Part of our problem is that we are great at creating new things to report, but what we haven't done well is create a framework to consolidate all these things.

"With all the technology that we have available today, why can't we come up with a different framework for *the* report, which includes key (financial) metrics and which allows a user who wants to drill deeper to go through XBRL or maybe more simply just through search engines, into industry comparatives, sustainability and carbon emission reporting, etc.?

"As accountants, we remain focused on quarterly earnings, income statements, balance sheets, but the real question is, what do the investors and the other stakeholders really want to know about a company? It is broader than just the financials. As long as the emphasis is on reporting last year's results, three months after the year end, and people are trading on next year's forecast, financial reporting will become less and less relevant.

"I would not say that we are yet at the point of irrelevancy since the basic knowledge of how a company is performing is derived from the historical financial statements. But I think business reporting has to become much broader."

Industries have to become much more aligned in their reporting

Can you envision this integrated reporting framework as, for example, a pyramid where the different sides represent the different aspects of the company and where users can drill down from various angles?

"Absolutely, and users can access the information via search engines or XBRL. But what we have to accept is that financial reporting is more than earnings. Financial doesn't just mean earnings, assets, liabilities, and income statements. It means a broader set of performance metrics and a lot of those are singular to certain industries. So the various industries have to become much more aligned on how they report things. We are beginning to see this emerging in e.g., the oil industry—reporting reserves in a much more logical way—and the pharmaceutical industry—making disclosures that are far more consistent—so we are getting there. It is just a slow journey."

Internal and external reporting should be more aligned

Shouldn't there be a stronger connection between a company's internal and external reporting?

"That is absolutely right. Over time, external financial reporting has become less and less aligned with how companies are running themselves internally. Consolidation is a classic case. If companies internally have knowledge of multiple off-balance sheet entities and they are managing themselves in a way to prevent the external reporting process from being transparent, you have to shake your head and ask: What are we doing here? What have we just enabled? You have enabled a company to run itself in a way that the investor won't understand. That doesn't make much sense."

Fair value has to find its way into the equation

Isn't there a similar problem with fair value accounting?

"The whole fair value issue is clearly a challenging one for all the players. You need to step away from the complexity of fair value and simply ask yourself: 'As an owner of a business, what is it that I would want to know about the assets and liabilities? What would be important to me in order to make prudential judgments about a company?'

"Fair value has to find its way into that equation, and to those who suggest that fair value is evil or irrelevant, I can say that I haven't talked to many investors who feel that way. I have talked a lot with preparers and CEOs who feel that fair value is not a disclosure that they should make. I frankly don't understand that answer.

"Now, with that as a backdrop, that does not mean that income statements have to become extraordinarily volatile, that you have to fair value your desks and chairs, that everything has to be treated the same way. But those assets that are included in your business operations and are highly sensitive to valuation movements should be fair valued. I think the investor needs to see that information.

"Fair values, however, could be disclosed in lots of different ways—in a footnote, in other comprehensive income, in the management analysis—that we can argue about, but to suggest that fair value is not relevant or important is a state of denial. If management has insight into the fair value of an asset, then everyone understands the facts other than the owner! (See also 'Shouldn't the investor know that?')"

Shouldn't the investor know that?

"Let's take a very simple example: a fixed income asset, sitting on the books of a bank. The bank goes out and loans money and is being paid back over a 10-year period. That is an asset that needs to be fair valued. Maybe not every quarter, but if a bank were sitting there with a bunch of 2% loans in a 12% market, shouldn't the investor know that the bank is slowly losing money and maybe even going broke?"

Audit profession has great opportunities in expanded reporting framework

How does all that tie in with developments in the audit of financial reports?

"From an auditing perspective, again, we have made significant progress in the last decade around the quality and risk focus of auditing, and around the capabilities and accountability of auditors. It is amazing to see the skill level that these accountancy firms—and not only the big ones—have in various parts of the world. We have also dramatically improved the auditor's focus on the investor and other stakeholders, as well as the auditor's independence and objectivity.

"There will be huge opportunities for the auditing profession in the future. If we redefine the reporting process, we are effectively redefining the need for assurance. Financial auditors will not be the only ones that provide assurance here. We are going to see forensic organizations, engineers, and technology companies doing this as well. But auditors will have great opportunities in this [broadened] space, if they maintain their objectivity, if they maintain their independence, and if they stay focused on the issue of transparent reporting and not just compliance."

Improved auditor communication is desirable, but difficult to achieve

Shouldn't auditors also become more transparent in the way they communicate, for example, in their audit report?

"I have always believed that our audit report is made much less valuable because it is so limited in what can be said. The entire framework of the auditors' relationships with their clients can make this challenging, but, in the end, it is all about the balance between transparency and auditor liability. 'Pass-fail' audit reports—financial reports that either do or do not fairly represent the performance of the company—do not reflect the full value that the knowledge of the auditor could provide.

"We should have the ability in our audit reports to address several strategic and organizational issues. As difficult as it was when we had to implement paragraph 404 of the US Sarbanes-Oxley Act of 2002, it was a step in the right direction. We found ourselves commenting on material weaknesses, material deficiencies. I do not have the single answer, but I do think limited auditor's communication is an obstacle to increased transparency that needs to be dealt with. However, until there is more respect for the professional judgment of the auditor and some logical approach to liability, I am not sure how we can resolve the lack of transparent auditor's communication."

The auditor's professional judgment should be better respected

What do you mean by "more respect for professional judgment?"

"Auditors have to apply professional judgment, and they must be in a position where that process is respected. We all understand that both auditing and accounting are more like art than science. There will be undetected frauds and different interpretations of accounting standards. But considerable weight should be given to the audit process when there is a disagreement about auditing or accounting. The auditor should be given the benefit of the doubt when errors occur if he/she has followed a robust process of consultation and discovery. We all know that not every patient survives a surgery. But not every death is caused by a mistake made by a doctor. In our case—in auditing— we are going to make judgments about auditing and accounting standards and audit processes, but if you do that thoughtfully, with consultation, then there should be some sort of allowance for that prudent judgment. Right now I have great concern for the audit profession, because I do not think regulators and investors understand the vulnerability of the profession.

Auditors are always going to have a challenge in detecting collusive fraud

How has the audit profession fared in the detection of fraud?

"First, auditors are generally better at detecting the material and major frauds than many people think, because they seldom hear about the (various) discoveries made in the audit process. However, auditors are always going to have a challenge in detecting collusive fraud and the market simply does not accept that fact. And we have not made enough progress in the processes that allow for more sophisticated use of technology in the detection of fraud. If we are not careful, the issue of fraud detection could be the most serious issue the profession faces today. Each of the larger firms is facing at least one litigation case where fraud was involved and since they haven't been able to consistently detect fraud in a collusive environment, that could put parts of the networks of these firms out of business ."

Fight against fraud and corruption provides opportunities for profession

"On the other hand, the prevention of fraud and corruption also provides huge opportunities for the audit profession. The prevention of fraud and corruption has to be driven from within the company, but the audit profession can play a huge role by assessing if these controls to prevent fraud actually work. From the profession's perspective, it is a great opportunity (see 'Auditing against corruption')."

Auditing against corruption

"I have been doing some work with a group called Partnership Against Corruption Initiative (PACI). It came out of the World Economic Forum, and it is now a stand-alone group that a number of major companies have been involved with. It is basically a business-led effort to build best practices and processes that companies can adopt to prevent themselves from participating in corruption with governments. The [underlying] concept is that every piece of corruption has a buyer and a seller. And the buyer might be the government official, but the seller is the company. And if you can stop it on the seller's side, you have come a long way in stopping corruption. And one of the vehicles in this initiative is financial reporting on the protocols that stop corruption, and auditing to see if these protocols are working, or at least if they are in place and enforceable.

"There are companies out there that are very anxious, from a competitive perspective, to make it very clear to all the companies in their industry, that they apply these standards. And the companies that do not apply these standards would become, by default, more 'guilty' of enabling corruption if you will. And they want auditors to come in to test whether or not the company is applying the protocols in a reasonable way.

"Some of the audit firms were concerned about this request because they do not want people to think that implementing these processes can prevent corruption 100%, since human failure is always a possibility.

"I think these kinds of reporting and auditing engagements are a great societal good and also a great opportunity for the accountancy profession! The profession would be delivering something that has a huge value add."
See also www.weforum.org/initiatives/paci.

"We finally did get all the audit firms to agree that they can do work in this anti-corruption space by making it clear that they were not assuring absolute compliance with the anti-corruption processes. Even good companies have a few bad people who do things under the screen. The question is, do companies build the robust processes to keep fraud from getting out of control? Then companies would have a high probability that they can control fraud, but no assurance!"

Assurance on carbon emissions is another opportunity for accountancy profession

In what other areas do you see great opportunities for the audit profession?

"I see many opportunities in all those areas where KPIs are seen as being so important that they need to be attested, for example, with respect to carbon emissions disclosure. Companies are going to be making claims that they are doing X and Y, and very quickly the market will demand some kind of assurance on whether companies are just being green in their words, or also in their actions. It is going to go from assurance of KPIs to disclosures, and the accountancy profession has huge opportunities here of adding value both to the companies and to the marketplace."

More transparency and assurance increases investor confidence and creates better companies

Do you have any final comments?

"Increased assurance on all these issues improves the confidence of the investor, creates more transparency and, frankly, that will create better companies. And the (accountancy) profession will be part of it.

"When I think of financial reporting and financial auditing and the relevance of all of it, I think it has to move toward integrated business reporting over time, and we have been moving, faster actually than I thought we would have in 2002. But, it is a painful journey. Therefore, we just have to keep the pressure on."

Key recommendations from Samuel DiPiazza

1. To establish good corporate governance, company boards should balance their focus on compliance requirements with value-adding strategic involvement.
2. We need to keep the issue of governance in perspective as good governance is not a guarantee against business failure. However, well-run and well-managed companies depend upon outstanding board directors who stay focused on the real purpose of their roles beyond compliance.
3. If board members do not understand the business model, they will not be able to provide strong oversight. Therefore, if they no longer understand the essence of the business, they should step down.
4. It is critical that financial reports continue to evolve and become more understandable and relevant to the various users. Otherwise, it is very difficult for boards to provide good governance and to provide good information for investors to make any rational economic decisions around allocation of capital.
5. A more integrated and holistic business reporting framework is required, capable of consolidating the social, environmental, and financial aspects of the overall performance of the company, including all the key metrics and allowing users to drill deeper into the details.
6. As many performance metrics are of specific relevance to a particular industry, the various companies in that industry should become much more aligned on how they measure and report them.
7. Fair value has an important role in business reporting, especially for those assets that are included in a company's business operations and that are highly sensitive to valuation movements.
8. The audit profession should seize the huge opportunities of a redefined, broadened, and more transparent reporting framework, which would effectively expand the need for assurance. In order to stay ahead of alternative providers of assurance, auditors need to maintain their objectivity, maintain their independence, and stay focused on transparent reporting and not just compliance.
9. The limited nature of auditor's communication to stakeholders is an obstacle to increased transparency that needs to be dealt with. To improve on the current situation, there should be more respect for professional judgment (of the auditor) and some logical approach to liability.

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