

A critical system at risk

Corporate reporting is at a ‘tipping point’, **David Phillips** argues. It is time to take action and make sure that our reporting system does not fail

Much has been written in recent decades about the shortcomings of the corporate reporting model. Since the industrial revolution, this model has been predominantly focused on the output of business activity, measured in financial terms. Despite the world being transformed in so many ways over the past century and the limitations of this focus on financial measurement being recognised, it appears that the system has been constrained by its historic roots and become incapable of meaningful evolution.

As each economic crisis passes and as each new social challenge emerges, the system’s inability to evolve and change becomes a growing risk to society.

Without a reporting system capable of properly measuring all the resources being used by business, reported performance based on profitability will present a flawed view – business decisions will be sub-optimal, capital will be misallocated and society will have little ability to respond logically and responsibly to the demands of a world with nine billion people.

The case for change

The case for a new reporting model will be made imminently when the International Integrated Reporting Committee (IIRC) publishes its long-awaited discussion paper on integrated reporting. This discussion paper will be open to consultation, and later in the year the IIRC will be engaging governments on the need for reform to the current reporting model. This occurs at a time when global agreement on almost any issue is difficult to achieve. But as with banking reform, the reporting model is central to the operations of the economic system on which society is totally dependent for its future wealth and well-being.

While the IIRC will make the case for change, the reality is that no new model will emerge overnight, change will take time and rushing to a new end game will

be counter-productive. What is needed is a structured and properly sponsored global programme to critically analyse the case for change. It could take two years to properly assess the case and make recommendations, but the implications of this agenda are of such significance to long-term system stability that it can only have one sponsor – the G-20.

The work of the IIRC and its call for change has recently been supported and informed by a ground-breaking research study undertaken by Tomorrow’s Company, PwC and CIMA. Uniquely, the study – *Tomorrow’s corporate reporting* – has looked at the whole reporting system (people, organisations, rules and processes) rather than the reporting model (specific requirement). It has tried to throw light on the issues that can assist in a change agenda. For those considering the IIRC’s proposals, the study provides some important insights on how structure, behaviours and incentives are critical ingredients for any plan to effect system change. The report highlights the rigidity of the current system and the entrenched position taken by its key players. A picture emerges of a system that shows all the hallmarks of its original architects and a behavioural response from all its stakeholders – companies, investors, auditors and standard setters – that, while sufficient for the 19th century, have now become barriers to change.

A roadmap for change

Looking to the future, the research sets out a road map for change. It is this that sits comfortably alongside the progressive agenda encapsulated in the concept of integrated reporting and the ambitions of the IIRC. Central to this road map are a series of critical questions that need to be seriously addressed by those who oversee the reporting agenda, particularly its health, relevance and ability to explain business performance in a world that is constrained not just by financial capital, but also by our physical, human, natural and social capital.

Questions to answer

For the architects of our market-based system, here are perhaps the four most important questions that need considered answers.

1. What is the objective of corporate reporting, and is global convergence a worthwhile goal?

It is clear that the original objectives of corporate reporting differ around the world and are in a constant state of flux. Creating a path to the future requires these questions to be answered in the knowledge that it’s easier to get global agreement on issues at the outset of change rather than after a period of rapid domestic innovation.

2. Who has oversight of the system?

The way reporting has evolved, it is rare for any single organisation to have oversight of the whole reporting system in a particular territory. For some, this fragmentation creates a weakness in the system and is one reason why the development of a more holistic reporting model, such as integrated reporting, has not occurred.

3. Is the current reporting system itself a barrier to change?

The more one analyses the construct of today’s reporting system and the established role and behaviours of the key players, the more one recognises why there has been little innovation and change.

4. What are the implications for the structure and governance of established institutions that are central to the design and operations of the reporting system?

If integrated reporting is the future, then what are the implications for organisations such as the International Accounting Standards Board (IASB), the Global Reporting Initiative (GRI) and the Carbon Disclosure Standards Board (CDSB)?

The answer to these questions and others raised in the road map are important and cannot be taken lightly. As a minimum, we need a programme of structured discussion and dialogue, ideally commissioned by the G-20, to consider the need for and implications of introducing a new reporting model. Realistically, the world has no more than five years to bottom out these important issues if reporting is to play its central role in the operations of the world economy and help facilitate the shift in performance measurement that is vital in our resource-constrained world.

Encouragingly, the time may be right for this agenda. The evidence from around the world suggests that there is a growing realisation that reporting needs to change. For the most part, the focus is on selected elements of the reporting model, such as fair value and insights into the judgements and assumptions that underpin reported financial performance. But the prominence of other aspects of integrated reporting is rising too – for example, there is more focus on the business model and risk disclosures, resource usage and emissions, governance and remuneration, as those responsible for the system look for solutions to the last crisis.

This provides a real opportunity – a chance to bring all these elements of the reporting jigsaw together, to recognise the value that emerges from a more integrated model and the dangers that lurk in perpetuating a model that is ‘siloes’ in its architecture and its operation. While we focus on the separate elements in isolation, the synergistic value of an integrated model is lost.

And finally, we need to think through how change can occur so that our reporting system can evolve. How can we move from ‘grid lock’ to a system that can flow and move forward freely? Are there actions that can be taken to unlock processes of innovation even within the regulatory mode? Perhaps there are some clues in the thinking currently doing the rounds in the UK. Here, two particular developments are worthy of note.

Time to innovate

The Financial Reporting Council is one of the first regulators to publicly recognise that reporting has become too voluminous and cluttered by information that is not assisting user understanding. It has come up with a radical idea of introducing ‘reporting labs’ as a mechanism to promote ‘stakeholder-led’ innovation in a safe environment. This innovation model that is close to the market will encourage companies and investors to come up with practical ideas to deal with known shortcomings in reporting.

The FRC’s work is also supported by another branch of the UK government (The Department of Business Innovation and Skills) who are considering what actions can be taken to enable companies and their boards to create a shorter, more strategically-focused, report. This shift in thinking could provoke the positive behavioural response – where ‘less is seen as more’, where boards are more inclined to influence content, and where compliance information, while provided, is not allowed to clutter and undermine the critical elements of information that companies need to communicate.

For all the reasons set out above, it appears that we may be at a ‘tipping point’ in the future of corporate reporting. For those with overall leadership responsibility, for the economic system and its longer-term stability, now is the time to act. To kick off, a process to analyse the ability of the system to adapt to the economic and social needs of this century must be started, and should culminate in recommendations being made to the G-20. If we leave this agenda on the back burner for too long, financial reporting will survive, but the whole system may fail.

David Phillips is the senior corporate reporting partner at PwC.

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