ICAEW

AUDIT &
ASSURANCE
FACULTY

# Assuring the appropriateness of business information

**THE JOURNEY: MILESTONE 3**

## ICAEW and Assurance Services

All types of business, public and voluntary bodies, investors, governments, tax authorities, market regulators and their stakeholders need to be able to rely on credible information flows to make decisions. Confidence suffers when there is uncertainty about the integrity of information or its fitness for purpose.

ICAEW's Audit and Assurance Faculty is a leading authority on external audit and other assurance services. It is recognised internationally by members, professional bodies and others as a source of expertise on issues related to audit and assurance.

The re: Assurance thought leadership programme aims to:

- Find out where assurance services could strengthen markets and support economic confidence by making information flows more credible.
- Ask how the International Framework for Assurance Engagements can be applied and developed.
- Answer demands for practical guidance to meet emerging market needs.
- Share best practice examples and promote the high-quality assurance engagements already carried out by many ICAEW members.

## What are Assurance Services?

Assurance services are engagements in which an independent chartered accountant takes a close look at some specified business information, comparing it to agreed criteria. The accountant is then able to gather evidence to support a conclusion, which is provided in a written report.

The purpose of any assurance engagement is to build trust. When a chartered accountant signs an assurance report, they attach their reputation for expert knowledge and integrity. This makes the business information covered by the report more credible, and gives confidence  to the people using that information.

To learn more about what assurance can do, take a look at the articles, guidance and reports on icaew.com/assurance or telephone Ruth Ward on +44 (0)20 7920 8639.

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# Introduction

The journey towards assurance over a wider range of business information will only take place if that information is seen as valuable by the people who rely on it. Assurance is meaningful when it adds necessary confidence, for example by reducing risk for investors who can take comfort that the information on which they are making decisions is reliable. In the first paper of the Milestone series we discussed the growing practice of assurance on KPIs that are used by management and investors.[1]

That paper included questions about assurance over the proper preparation of individual KPIs themselves, but did not ask whether and how an assurance provider can form an opinion about the range of KPIs disclosed. But that is of vital interest to stakeholders, particularly investors. Business information which is accurate but incomplete might be more misleading than information which is just plain wrong. For example, a company could discuss high levels of customer satisfaction reports from completed projects without mentioning the number of projects that had been delayed or cancelled. We assume here that investors (the primary users of this information) want to make investment decisions based on knowledge of risk adjusted results; something that KPIs help them to assess.

The question is, how can an assurance provider be confident that disclosures made by a business give a fair picture of what is going on in that business, thus meeting the needs of stakeholders?

This paper uses the example of KPIs to explore the ways in which practitioners can be sure they are providing assurance over the right disclosures.

1 See *Milestone 1: Assurance over key performance indicators*, ICAEW 2014.

# Defining the KPIs

The KPIs for a company can't be pre-determined by standards in the same way that the broader requirement of financial reporting might be. This is because companies operate in many business sectors and adopt a wide range of business models. The KPIs need to reflect the business strategy, the operating model and the way the business is being managed. In retail, footfall and sales per sq. metre are vital measures; whereas in web retailing clicks, pages opened and sales per customer are more relevant. While these are fundamentally different KPIs, they each provide proxies for how well the sales side of the respective businesses are doing.

Although it is not possible to pre-define standard KPIs for all business sectors, any company can devise principles and policies explaining how it identifies and decides which KPIs to use. The purpose of these principles is to enable the company to identify the needs of its investors in the context of the business. A set of KPIs prepared in accordance with these principles and policies could then be assured. In the case of KPIs it would be important, of course, that the business strategy should be sufficiently clear and robust to support the analysis and selection of indicators. The selection should be anchored in the key business drivers.

In addition to identifying these principles it is important to understand how they need to be applied in order to achieve the desired end goal. Where KPIs are included in a company's strategic report in order to address the requirements of Companies Act 2006 s414C(4) and (7), the directors' approach to determining the relevance, materiality and comprehensiveness of KPIs will be influenced by the Financial Reporting Council's (FRC) guidance on the strategic report (the FRC guidance). While this guidance recognises that the information in a company's annual report may be of interest to stakeholders other than investors, it guides directors to include in the strategic report only those KPIs that could influence the economic decisions shareholders take. KPIs that are of interest to other stakeholder groups could be included in sections of the annual report that are clearly identified as non-statutory, or in other information on a company's website.

The annual report as a whole should be fair, balanced and understandable, and should provide the information necessary for shareholders to assess the entity's position and performance, business model and strategy.[2] These same principles, extended so as to apply to other expected users of the accounts, should apply when deciding upon the most suitable set of KPIs for a company.

2 The UK Corporate Governance Code Provision C.1.1 amended to include 'position'.

## How can we apply these principles in practice to create meaningful business information?

Management know what information they use to run the business and why. In our example of KPIs, that will include a range of financial and non-financial data and indicators; both historic and prospective.

The set of KPIs used by management should have been developed based on the business model and the key drivers and is likely to include both historic and prospective indicators. For example, while historic sales are important, the state of the order book and sales pipeline, and so the future prospects, are potentially more important when considering the views of investors and the share price.

The process by which management has established which KPIs are to be disclosed and assured should be documented. The process needs to be both robust and objective, and will include the management process for identifying its KPIs and the consultation process with investors to improve and refine the selection until it meets both of their needs. In practice it should not be difficult to agree on a set of KPIs that satisfies the investors' needs.

We would expect the company to consider and explain any material concerns or considerations. For example, the company is required to pay staff the living wage in its business. However, does that also include its outsourced services providers that may be based overseas and the related working conditions of staff there? It is through a dialogue with the investors that any such boundaries might be more readily defined.

## A practical approach to legitimacy in reporting

Most large public companies already have an active dialogue with their investor community. Consulting with that community (and with other stakeholders as appropriate) should be relatively simple. Identifying exactly what stakeholders are interested in should bring improved reporting focus as well as additional legitimacy: companies can target their reporting towards those areas which have a meaningful impact on the primary readers of those reports. Investors are already well used to making requests for additional data, eg, through quarterly briefings, many of which are granted. Therefore, this process could be developed to become a natural part of any such investor dialogue.

The assurance of individual KPIs was addressed in *'The Journey Milestone 1'*.

# Obtaining independent assurance over completeness

Assurance must be independent, rigorous, and evidence-based if it is going to add value to a report. The criteria for a good set of financial statements are set out in financial reporting standards. Criteria can be developed for other kinds of reporting but where these do currently exist they are often very high level. For example, the '*Integrated Reporting Framework'* published by the IIRC provides a set of principles that should be applied to create an integrated report, but does not contain any detailed criteria.

The independent assurer will need to consider whether the criteria established by management in such circumstances meet the pre-conditions for an assurance engagement under ISAE 3000.

There are five characteristics[3] which suitable criteria must have:

- relevance;
- completeness;
- reliability;
- neutrality; and
- understandability.

These characteristics will need to apply not to the information reported, but to the process for defining that information. The KPI example includes the management process and the consultation process with investors that resulted in a selection of KPIs being made.

In addition to evaluating the process the practitioner will need to use suitable subject matter experts with appropriate knowledge and experience to consider such matters as:

a) the extent to which management have conducted such evaluations;

b) the state of compliance with the FRC Guidance; and

c) whether the KPIs themselves appear, as a set, to be the most relevant for the industry and business model.

In practice what management and subsequently the independent assurance provider should both be seeking to establish is that the KPI set includes indicators that are both necessary and sufficient to explain the company's business performance, and to act as warning signs to prompt users to ask further questions of management. We can expand on this.

## Necessary

### Relevant

- Is each KPI relevant in some way to the interests of management and/or the investors in ensuring the effective management of the business?
- Where there are differences of opinion or disagreement, why do they arise and how have those differences been resolved?
- Are there any remaining questions as to the relevance of each indicator?

### Material

- Is each KPI significant to an understanding of the business? That is, are they primary indicators of performance, past or prospective? Are they, indeed, key?
- In the event that they might be secondary measures, how important are they and do they need to be included?
- If they do need to be included are we satisfied that there is a rational and substantive argument as to their importance?

## Sufficient

- Do the KPIs as a set paint a sufficiently comprehensive and balanced picture of performance across all significant areas of the business to satisfy the Investors? Are they fair, balanced and understandable?

It is this process for determining what is the most appropriate set of KPIs that forms the criteria. The most appropriate set will not be a complete set. Achieving completeness in its literal sense is probably impossible and, in any case, increasing the number of KPIs beyond a certain point (which will be different for different companies) will be counterproductive and would overwhelm the users of accounts with a plethora of unusable information.

Based on practical experience we know that it is possible to construct a process with sufficient checks and balances to achieve the five characteristics required of criteria. This process and the associated principles are in fact very similar to those that have been used in the field of corporate responsibility reporting for many years.

3 As defined in the IFAC Framework and ISAE 3000.

# What the practitioner needs by way of evidence

The last thing to consider in assuring that the set of KPIs is appropriate is: what evidence does the practitioner need?

The main focus of the practitioner's work should be the process used by management to select the KPIs. This means understanding the process, evaluating the design and testing the effectiveness of its operation. A sense check, utilising the practitioner's professional judgment, knowledge of the client and knowledge of the industry, of the KPI set that it provides is the final test.

Such processes are best tested by reference to control objectives. These are likely to vary according to the company and its circumstances but might be summarised in the context of the characteristics of suitable criteria as:

## Relevance

- KPIs selected reflect key aspects of the strategy and business model as determined by management to help their decision making;
- the selection is confirmed by the primary stakeholders through dialogue; and
- where there are industry benchmarks, these are consistent with the selection made.

## Completeness

- All aspects of the strategy and business model likely to impact business management are included in the KPI set with no material omissions;
- that selection and the prioritisation are confirmed through primary stakeholder dialogue; and
- where there are industry benchmarks these are consistent with the selection made.

## Reliability

- The KPIs selected are capable of calculation by management in a consistent manner at the desired frequency;
- the KPIs selected are capable of validation by a practitioner in a consistent manner; and
- the underlying data collection processes are robust and reliable.

## Neutrality

- The KPIs selected reflect all aspects of interest to primary stakeholders including negative aspects of performance. That is, the selection is free from bias; and
- changes are not made arbitrarily to the KPI set to remove negative aspects of performance year-on-year.

## Understandability

- All KPIs selected are explained and presented in a way that makes their significance clear and understandable to a reader.

This is an application of the characteristics of criteria as defined in ISAE 3000. The type of evidence necessary will vary according to the nature of the process adopted by management but is likely to include:

- evaluating the relationship between the KPIs and the company's business model and strategy;
- challenging the basis upon which KPIs have been identified as primary and secondary, ie their prioritisation;
- evaluating the nature, extent and thoroughness of the dialogue and validation with the primary stakeholders.
- evaluating the way disagreements and uncertainties have been analysed and resolved; and
- understanding and evaluating the materiality bases used by the company in making selections and determining priorities.

## Summary

The nature of this work is that it will inevitably make use of industry and subject matter specialists. It will also require the application of professional judgement; to a greater extent than practitioners might expect to apply during an audit.

The final element of the evidence in relation to the process and the KPI set that has been developed is the review by the subject matter and industry specialists engaged to consider how appropriate the selected KPIs are as a set to the company and to its activities.

## Discussion Points

It would appear that auditors and assurance practitioners already have the tools under existing standards to provide reasonable and limited assurance over the appropriateness of a set of KPIs.

What's your view? Should companies take the initiative to demonstrate that they have selected a fair and comprehensive set of KPIs? Should the methodology used in the process of selecting KPIs be disclosed in the Annual Report or elsewhere? Do investors want assurance over the completeness of reporting in key areas? And if they do, what are those key areas and what level of assurance is required?

Please share your views with us by email or on twitter.
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