

## **ASSURANCE OF NON-FINANCIAL INFORMATION STATEMENTS, A NEW CHALLENGE FOR THE AUDIT PROFESSION**

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### **ABSTRACT**

**Background:** The issuance of European Directives 2014/95/EU and 2013/34/EU has forced large European companies to issue a statement of non-financial information. Most of them had already been reporting similar statements: social responsibility or sustainability reports. For the first time, it has been detailed what type of information should be included in such a statement and it is recommended to have it assured. While the extent to which verification is mandatory will depend on each member state, it is logical to assume that in order to give more credibility to the information included, most companies will choose to request verification by an independent accredited body.

**Purpose of the research:** In most countries, it is audit firms that are taking the initiative in verifying statements of non-financial information. But obviously, this verification is far from being similar to the audit of financial statements, mainly due to the lack of systematization of non-financial information and the lack of measurement criteria. Our objective is to point out those aspects that should be regulated or required to ensure that the assurance is carried out in a homogeneous way and guaranteeing the quality of the process.

**Methodology:** We have carried out a bibliographic review of the state of the art, raising research issues that will need to be addressed in future research.

**Results and mayor conclusion:** Internationally agreed standards are crucial to ensure the credibility of NFI statements in a financial market without borders. In this regard, issues such as materiality and independence must be revisited by the policy maker. Further research needs to be carried out on strategies to place higher value on NFI reporting, by means of increasing transparency or avoiding that audit independence is impaired by becoming provider for NFI assurance.

### **KEYWORDS**

Assurance, audit profession, non-financial reporting, integrated reporting

### **JEL CLASSIFICATION CODES**

M42, M48.

### **INTRODUCTION**

The Directive 2014/95/EU on Non-financial and Diversity Information (NFI) applicable to both large companies and certain groups, came into force on 6 December 2014. This Directive amends Directive 2013/34/EU on the annual financial statements, consolidated financial statements and related reports of certain types of companies. The companies to which it refers started to apply the Directive from 2018, in relation to information for the financial year 2017. The NFI report should include

information on the environment, social and employment issues, respect for human rights and anti-corruption and anti-bribery measures.

The NFI Directive indicates a series of aspects that will have to be regulated by each of the member states, such as defining what a large company is, considering what are entities of public interest, determining whether or not assurance is mandatory and defining sanctions in the case of noncompliance. Before this regulation came into force, the UK, Germany and Sweden had already established the mandatory nature of this document. Following KPMG (2017), the real impact of the Directive will start to become evident during 2019 or even 2020, following these relays in transposition and a transitional period as companies become familiar with the legislation and introduce new internal reporting systems or adapt their existing ones.

Not only the countries subject to this Directive, but in general most developed countries, had already developed channels for large companies or specific industrial sectors to report non-financial aspects through sustainability or corporate social responsibility statements. In most cases, these statements were being verified on a voluntary basis creating an unregulated assurance market largely controlled by international audit firms. Therefore, our objective is, through the analysis of this background, to understand how the NFI statement assurance is expected to evolve, to point out the major challenges for the providers of this service and to determine which precautions should be established by the regulatory bodies to guarantee the quality of the assurance services.

The remainder of this paper is organised as follows: First, the introduction and the general background are displayed. Second, the research context for Assurance of NFI Statement is presented. Then, the NFI assurance highlights are stated. Next, we focus on the assurers of the NFI followed by two aspects of the reporting that need to be improved: Materiality and impact on users.

Finally, the Conclusion section contains issues for discussion, recommendations for further research, and concluding remarks.

## **ASSURANCE OF NON-FINANCIAL INFORMATION STATEMENT**

Directive 2014/95/EU was a response to the growing demand for criteria and standardization by companies themselves, as the number of companies that already submitted information of this type on a voluntary basis has been increasing in recent years: 78% of the world's largest companies publish non-financial information, according to KPMG (2017). Taking the 100 largest companies in 49 countries as a sample, this study determines that at least 60% of companies in each sector issue non-financial information, being GRI<sup>1</sup> the most used standard (66%). This behaviour is framed within the need of companies to demonstrate that they are operating under the rules and limits imposed by the society in which they are established. Therefore, the tendency to report can be sustained by the theory of legitimacy (Manes-Rossi *et al.*, 2018). The legitimacy theory states that organizations are bound by a social contract in which they agree to perform various socially desired actions in return for approval of their objectives and other rewards, and which ultimately guarantees their continued existence proving that there exist a link between the entity and society (Di Maggio and Powell, 1983). Legitimacy has been defined as a “generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, value, beliefs, and definitions” (Perrow, 1970).

The public concern in the last decades about the fraudulent activities of firms and auditors could drive organizations to be thoughtful about how they can maintain their reputation. Hence, assurance might be a strategy to enhance its credibility and therefore legitimize the existence of the organization in the eyes of the investors and citizens.

In the same vein, this social contract, as any voluntary agreement, implies a mutual commitment and accountability. The survival of entities will be endangered if society perceives that organizations have not fulfilled that contract (Deegan, 2002). This applies to firms as much as to public organizations

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<sup>1</sup> Global Reporting Initiative (GRI) is an independent international organization that has pioneered sustainability reporting since 1997, [globalreporting.org](http://globalreporting.org).

and governmental bodies. Most researchers agree that the theory of the legitimacy is the suitable framework to carry out studies about social and environmental information disclosure (Gray et al., 1997), since this communication entail the link between enterprises and society. If they remain opaque, it risks losing credibility further support. For this reason, stakeholder theory applies to our setting as well. Stakeholder theory relies on the concept that enterprises should benefit not only economically but also in other aspects to their counterparties and even third parties such as society. The interests of all agents involved in business activities must be taken into account: employees, consumers, investors, local authorities, government bodies or NGO's. This theory recognizes that some groups within the society are more powerful than others and therefore, managers use the disclosure of information to influence to the most powerful stakeholders, namely, the reporting may be a way of managing the expectations of the different stakeholders (Gray et al., 1996). There is an overlap between the legitimacy theory and the stakeholder theory, due to the fact that both theories understand the organization as part of a broader social system that interacts with other groups within society (Deegan, 2002, pp. 295). Both theories focus on the expectations of the society towards the organization, expressed as the "social contract". While legitimacy theory discusses the social contract between organizations and society as a whole, the stakeholder theory focus on the different expectations that different groups hold towards the organization. The stakeholder theory explicitly accepts that there are different social contracts that the organization negotiates with different stakeholders groups and that their relative power affects to the negotiating capacity and the results of those negotiations.

Given that NFI reporting is indeed used to indicate a superior social and environmental strategy to the market and assurance increases the credibility of that message, Cho *et al.* (2014) suggest that signalling theory may apply to propose that market participants would value more highly those disclosing companies with assured reports. Moreover, the independent assurance of sustainability reports is not only seen as an instrument to improve the credibility and quality (GRI, 2002; Simnett *et al.*, 2009) but also improves internal controls, creates more stringent sustainability reports, and helps an organization to be more transparent to their stakeholders (Park and Brorson, 2005; GRI, 2011; Junior *et al.* 2014). From the agency theory perspective, assurance reduces information asymmetry and the cost of capital (Casey and Grenier, 2015), reducing the agency costs (Carey *et al.*, 2000; Fifka, 2012; Stanny, 2012; Sierra *et al.*, 2015). In this line, KPMG (2017) reports that 67% of the NFI statements are assured.

Although assurance of non-financial information is not mandatory in all countries<sup>1</sup>, it is understandable that most companies show an interest in having their IFRS status verified. This is the way to give credibility to this information in the eyes of a wide variety of stakeholders with sometimes conflicting interests (Casey and Grenier, 2015). Following these authors, NFI assurance is particularly important for positive information, the predominant type of corporate social responsibility information, as reporting negative information is viewed as credible without assurance. Among the factors that have turned out to be related to assurance we can find stakeholder orientation (Simnet *et al.*, 2009, Kolk and Parego, 2010), firm size (Simnet *et al.*, 2009; De Belde and Tuybens, 2015), industry affiliation (Simnet *et al.*, 2009; Kolk and Parego, 2010), the presence of an audit committee (Beasley *et al.*, 2009), common law countries (Kolk and Parego, 2010), weaker legal enforcements countries (Kolk and Parego, 2010), and higher institutional pressure for corporate sustainability (Kolk and Parego, 2010).

In this line, international evidence shows an increase in the number of corporations providing third-party assurance of their Corporate Social Reports (Park and Brorson, 2005; Kolk and Parego, 2010; Mock *et al.*, 2013). Geographically, the European Union companies show the highest percentage of assured reports, being the electric and energy, and the oil and gas the industry sectors that assured the NFI statement more frequently (Mock *et al.*, 2007; Mock *et al.*, 2013). Regarding the industry affiliation, Simnet *et al.* (2009) point out that companies having a greater social or environmental impact are more exposed to social and environmental risks and then need to increase user confidence in the credibility

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<sup>1</sup> The study "Member State Implementation of Directive 2014/95/EU" by Accountancy Europe, CSR Europe and GRI is available as a reference:

[https://www.globalreporting.org/resourcelibrary/NFRpublication%20online\\_version.pdf](https://www.globalreporting.org/resourcelibrary/NFRpublication%20online_version.pdf)

of the information contained in the sustainability reports they produce. Guidry and Patten (2010) show that third-party assurance increased the confidence in the reporting of NGO reports.

Obviously, and following KPMG (2017), reporting is only an instrument, the benefits will come once corporate responsibility objectives and practices are fully embedded in the business, which reporting can demonstrate but cannot achieve on its own. But giving visibility to the sustainability or social responsibility practices developed by companies encourages their implementation in those other companies that were initially reluctant to include them, even if it is for the effect of mimicking those that do. And reporting on companies' non-financial risks opens up the possibility of greater understanding of corporate policies and interests by stakeholders. These objectives would be achieved provided that the published information was useful and credible to a wide variety of users. In fact, we should be moving towards an international framework that would both streamline the process for new reporters and also increase consistency between reports KPMG (2017). To this end, assurance of NFI statements becomes the most effective mean of achieving this.

## 2.1 Non-Financial Information assurance highlights

There are several international guidelines for assurance. The most famous frameworks used by assurers around the world are the AA1000 AS<sup>1</sup> and ISAE 300 (revised)<sup>2</sup>, although some countries have developed standards adapted to their particularities, for instance, the European Directive has issued their own guidelines (EU Guidelines 2017/C215/01). Moreover, the IAASB is preparing a non-binding implementation guide to facilitate the application of ISAE 300 (revised) which is already in the consultative phase and is expected to be published in 2020. This guide is named Extended External Reporting (EER) Assurance and includes integrated reporting, sustainability reporting and other about environmental, social and governance matters.

Assurance engagement is defined by ISAE 300 (revised) as an engagement in which a practitioner aims to obtain sufficient appropriate evidence in order to express a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the measurement or evaluation of an underlying subject matter against criteria.

Unlike financial information auditing, assurance offers two levels depending on the depth of the work performed. These two levels were already defined by the AA1000 AS. Thus, we find reasonable assurance or limited assurance. The former offers greater depth than the latter. Reasonable assurance is only possible when the content of the statement to be verified:

- It is part of the real and effective management process of the company,
- It is measurable and traceable over time through an information collection system,
- There is internal control, supervision and monitoring.

In all other cases, limited assurance should be applied. AA1000 AS establishes that limited assurance includes aspects such as inclusiveness, relevance and capacity, while reasonable assurance adds sustainability performance. Kend (2015) shows that most of the sustainability reports bring forward limited assurance.

In addition, the standards and criteria for the preparation of the NFI statement must be made explicit in the document itself, it must be a known international application standard (GRI or whatever) and its application must result in accurate, comparable and evaluable information. The assurer must know the applied standard before accepting the engagement. Once these requirements are met, the objective of the assurance is to verify that the non-financial information statement has been prepared according to the regulations and standard chosen for its preparation. Specifically, it is verified:

- The adequacy of the standard (applicable criteria)
- The uniform application of the criteria
- The process of elaboration of the contents
- The integrity of the information (materiality)

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<sup>1</sup> AA1000 Assurance Standard was issued in 2008 by Accountability.

<sup>2</sup> International Framework for Assurance Engagements (ISAE) 300 (revised), Assurance Engagements other than Audits or Reviews of Historical financial information was issued in 2013 by the International Auditing and Assurance Standards Board (IAASB).

- The appropriate presentation and breakdown.

ISAE 300 (revised) also recommends that the company include a table explaining where each piece of information is located and that the verification report details the scope of work performed.

In relation to the professional who provides the assurance service, the international standard (ISAE 300 revised) requires experience and technical competence. It allows him/her to use experts and he/she must show an ethical behaviour as stated in the IESBA Code of Ethics<sup>1</sup>. In relation to independence, this is defined in the same way as for auditing profession. There are also similarities between the audit engagement letter and the assurance engagement letter.

Assurance planning should contain the global strategy, professional scepticism, professional judgement, understanding of the business, procedures, work plan and experts to be used. The understanding of internal control is also included. The evidence obtained has to be sufficient and adequate, characteristics common to the auditing of financial statements. Reference is also made to substantive tests, analytical procedures, subsequent events, among others. Finally, the assurance report shows a defined structure (results, conclusions, recommendations and limitations on scope) and is the support of the assurer's conclusion, instead of auditor's opinion. This conclusion may be disclaimed if the assurer has not got all the evidence that is needed.

However, it is important to bear in mind that, although the procedures are structured in the same way and have similar names, there are substantial differences in the degree of certainty provided by audit and assurance. In fact, the use of terms "verification" and "audit" in relation to NFI reports has been questioned (FEE, 2002; Deegan *et al.*, 2006; De Belde and Tuybens, 2015) claiming that these could create an expectations gap in user that might mistakenly assume that there is more security than has actually been offered. Providing users with knowledge about what assurance is and what its objectives are, will help to reduce this expectations gap.

## 2.2 The assurers of Non-Financial Information

There are different types of assurers, but the most usual classification divides them into accounting professionals and non-accounting firms. The former tends to use frequently ISAE 300 (revised) (Junior *et al.*, 2014), and they provide a higher quality of assurance for aspects related to reporting format and procedures used (Parego, 2009). Companies operating in stakeholder-oriented countries (Simnett *et al.*, 2009) or from countries with weaker governance systems are more likely to choose the audit profession as assurance providers (Parego, 2009). Romero *et al.* (2010), in a Spanish sample of larger and listed companies, obtain that assurance statements issued by accountants are perceived to be of higher quality. Within this category, we can find the Big Four<sup>2</sup> and the rest of the audit firms, known as non-Big Four. Mock *et al.* (2007) obtain that non-Big Four auditors rely more on the AA1000 AS framework, while Big Four on the international statements. Following Mock *et al.* (2013), 51% of the assured NFI reports were issued by the Big Four. Instead, Kend (2015) obtains that less than 40% were conducted by members of the audit profession. Kend (2015) establishes that the existence of a sustainability committee is an important influence on the choice of the assurer and appear to prefer audit firms.

The non-accounting firms generally use the AA1000 AS. They focus more on completeness, fairness and overall balance in the opinion statement (Hodge *et al.* 2009) and provide a higher quality of assurance for aspects associated with recommendations and opinions (Parego, 2009). In general, differences are found in the scope, methodology and assurance statement (Mock *et al.* 2007).

Besides accounting and non-accounting firms, we can find both independent third-party review (stakeholders panels, government bodies, civil society assurers, opinion leaders, academic institutions, NGOs...) which are non-professional assurance providers and mixed approach which mix two of the three above mentioned categories. In this last case, each assurer gives a conclusion about different areas

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<sup>1</sup> <https://www.ethicsboard.org/international-code-ethics-professional-accountants>

<sup>2</sup> The Big Four Auditing Companies are Deloitte, Ernst & Young, PwC and KPMG. These audit firms have worldwide networks and sign a high percentage of the audit reports in most countries. The Non-Big Four audit firms constitute a heterogeneous group made up of big, medium and small firms with different structure and way to organize the audit work.

of the statement and both reports are divulged (Junior *et al.* 2014). These two types of providers are not as widespread as the previous ones, depending a lot on the tradition of the country.

The above mentioned explain that some authors claiming that there is substantial variability in assurance scope, independence of the assurance provider, external criteria and the level of assurance provided (Deegan *et al.*, 2006; O'Dwyer and Owen, 2005, 2007; Manetty and Becatti, 2009; Cassey and Grenier, 2015). As stated by AccountAbility (1999), different levels of confidence are derived from different types of assurance providers, because the quality of assurance statements is highly dependent upon the type of provider (Parego and Kolk, 2012). In this line, Zorio-Grima *et al.* (2012) state that the variables presenting the strongest impact on assurance quality are: the fact that the assurance is provided by an auditor and the size of the reporting firm.

Arguments for appointing an audit firm can be the result of the convergence of basic principles between auditing and assurance, the trust in the independence and credibility of auditors, the well-developed global standards, the ethic and independence requirements and the quality-control mechanisms of these firms (Simnett *et al.*, 2009; Dixon *et al.*, 2004; De Belde and Tuybens, 2015). On the other hand, these authors point out that the drawbacks of an audit firm would be the lack of competence, since non-accountants may have more experience in the content of these reports and the threats to independence. Hiring its auditor for NFI assurance could in appearance compromise the auditor's independence as these other assurance services have been perceived as lucrative. This may also increase the fee dependency of the firm on that one audit client (Kend, 2015). Regarding the stakeholder engagement, the main drawbacks are the lack of technical expertise and understanding of corporate affairs, a narrow vision that does not cover the interests of all stakeholders, the trustworthiness perceived by all stakeholders and the threat to their task as an alarm watch in society (De Belde and Tuybens, 2015).

In summary, the audit profession's best position to lead the NFI assurance market internationally is clear. They are internationally known firms that have been characterized by offering a homogeneous level of quality in their work, with extensive specialized and standardized knowledge and with the experience of working with the largest companies around the world. This knowledge can be used by the audit firm to enrich the NFI assurance only when acting both as auditor and assurer. However, in these cases, the independence may be undermined by compromising the credibility of the audit report.

### **2.3 Other aspects of assurance to be improved**

In addition to the lack of homogeneity in the standards applied and the disparity of service providers, we can highlight two more aspects that must be addressed by international regulatory bodies in relation to assurance: The effects of the consideration of materiality and the value that some stakeholders place on assured reports.

#### **2.3.1 Materiality**

ISAE 300 (revised) states that in order to ensure the status of non-financial information, the standard applied by the company must contain a series of characteristics such as relevance, integrity, reliability, neutrality and comprehensibility. Likewise, an analysis of materiality must have been carried out by the company. The assurer must check that what is left out is motivated and explained in the statement itself. When the materiality analysis carried out by the company is not adequate, the assurer must issue a qualification. But the fact is that sustainability reports, even GRI-based ones, tend to disclose environmental, social and governance information separately from financial information, without providing an integrated and comprehensive picture of these issues and their interconnections, varying in terms of materiality and completeness (Manes-Rossi *et al.*, 2018).

The first obstacle is that materiality is considered differently by the most relevant standards (Manes-Rossi *et al.*, 2018). The GRI standard includes those aspects that reflect the substantive social, economic or environmental impacts or influence of the organization on the assessments and decisions of stakeholders. These requirements presuppose the concept of materiality as a threshold for the

disclosure of information based on a wide range of impacts and stakeholders. Instead, IIRF proposes a four-step process of identifying those relevant issues that have or may have an effect on the organization's ability to create value considering their effects on strategy, governance, results or projects. In other words, materiality is connected to the specificity of the company and the sector in which it operates. In this same line, we find the EU Guidelines. The EER Assurance Consultation Paper relates materiality with a process in which has to be verified if the information selected has the characteristics of relevance and integrity. In this case, assertions are the result of applying the requirements of the chosen standard.

Taking into account this diverse approach to materiality (Baumüller *et al.*, 2018), two main problems stand out: information overload and greenwashing. Both problems are important to the companies that produce the reports and to those that assure them. The lack of clear and widely accepted criteria on this concept creates a lot of uncertainty for companies that have to prepare the NFI statement. On the other hand, the assurer's task of minimizing information overload and the incentives to use it as greenwashing becomes trickier, as it will be more difficult to maintain its position against the issuing company.

### **2.3.2 The lack of impact of the assured non-financial information statements on users.**

The assurance does not appear to be valued by investors (Cho *et al.*, 2014), especially in countries like the United States. Thus, some authors point out that, without strong market regulation for this service, the value of the assurance processes and of the assurance reports themselves is questionable (Ball *et al.*, 2000; Laufer, 2003; Smith *et al.*, 2011). The lack of certainty about the objectives of the assurance as well as the processes carried out to obtain the evidence that leads to the conclusions of the report, justify the fact that users do not find it useful for their decision making.

It may be necessary for the audit profession to allure the investment community, not only about the social but also the economic benefits that assured NFI could provide. Audit firms and professionals need to improve their communication strategy to convey these benefits to prospective clients.

## **CONCLUSIONS**

Once the commitment of the international markets and regulatory bodies to the issue of NFI reporting has become clear, it is time to take steps towards the homogenisation of criteria and procedures to assure this kind of reporting. This is the way to avoid that uncertainty about these aspects, criteria and procedures, damage the usefulness of this service. The audit experience should serve as an example of how, in the end, the use of internationally agreed standards has been crucial to ensure the credibility of financial statements in a financial market without borders. This will be the path that the assurance of NFI statements will have to follow, with the audit profession being able to lead the process due to its long experience and its implementation all over the world. And now is the right time, because assurance of sustainability reports is still not regulated in most countries, organizations could be seeking just a statement to be included in their sustainability reports regardless of the quality of the assurance process performed (Junior *et al.* 2014).

In this sense, if the audit profession wants to set up itself as the provider of transparency for sustainability reports, the current assurance process must be transparent first (Junior *et al.* 2014). The independence of the assurance provider is crucial to guarantee this transparency (De Belde and Tuybens, 2015). However, in depth study needs to be carried out to find out how to ensure that such independence is not impaired when the auditor's financial dependence on his audit client is increased by the engagement of assurance services. If dependency was already a concern when only audit services were provided, the problem may become more difficult to solve now. It will be up to the audit profession to demonstrate that the mutual enrichment between audit and assurance outweighs the costs associated with independence issues. Greater transparency in the processes of obtaining and evaluating evidence could help to understand and comprehend the work of the service provider and increase the usefulness of the opinion or conclusion rendered. This may be the challenge for the audit profession if it wants to establish itself as the guarantor of the credibility of the NFI reporting.

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