

TOWARDS TRANSPARENCY

Assurance on KPIs –
A practical guide for audit
committees and boards



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FOREWORD

In 2014, ICAS, in its publication: *Assurance on management commentary – where next?*¹ detailed a number of proactive initiatives to explore the provision of assurance on the management narrative, or parts of this narrative, in the front-half of companies' annual reports. The overriding objective of these initiatives is to ensure that users obtain the assurance they need at a cost which is acceptable. The views of the users are therefore fundamentally important in this debate, and we note that there is a wide range of users, with potentially varying needs. ICAS is committed to engaging with those users to ensure that they understand the assurance which they currently receive, and to explore what further assurance, if any, they would find helpful.

One of the initiatives is a project to consider what might be an appropriate level of assurance provided over discrete areas of the front-half of the annual report, such as key performance indicators (KPIs). In response to the increased audit committee/board focus on KPIs, in 2014, a working group was established, which included representatives from all Big 4 firms, investors, preparers, audit committees and internal auditors. The aim of the group was to determine whether it might be feasible to expand, or at least better explain, the assurance obtained by audit committees and boards, on the KPIs featured in the annual report and, if so, the nature of guidance that would be required to assist in the communication of that assurance.

Accordingly, this guidance seeks to fulfil this objective and advocates the development of a framework of best practice, to be adopted by audit committees and boards, encouraging them to consider the source of assurance obtained over their KPIs as a basis to help them:

1. Challenge the relevance of the KPIs to the company's strategic objectives and user needs and thereby ratifying their selection as the appropriate KPIs;
2. Compare the source of assurance obtained over each KPI against their desired level of comfort;
3. Communicate the sources of assurance in regard to each KPI to enhance users' understanding of the assurance process;
4. Facilitate increased dialogue between users and audit committees/boards as to whether this is the source of assurance they would expect/require.

The guidance includes an Assurance Matrix in section 3 detailing five different sources of assurance that might be obtained over each KPI. We hope that referring to the guidance in this paper will help audit committees/boards to determine the source of assurance obtained over each KPI and assess whether that source is the appropriate one.

Our ultimate objective is that this paper will encourage greater dialogue between users and audit committees/boards over the reliability that can be placed on each KPI. It is intended that this increased dialogue and engagement with users will enable audit committees/boards to determine whether the source of assurance obtained meets user expectations.

We therefore encourage audit committees/boards to use this guidance to help them communicate to users the degree of confidence they have obtained over the relevance and reliability of the KPI and the process undergone to acquire this confidence. We acknowledge that there will be challenges during this process and we welcome feedback from those companies that use the guidance on its relevance and practicality, as well as some of the challenges encountered.

On behalf of ICAS, I would like to thank the following working group members for their participation and contribution:

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1 INTRODUCTION

The corporate reporting landscape is highly dynamic. The increasing complexity of business models; growing awareness of climate change and resource scarcity; disruptive technologies; and 24/7 communication are challenging external perceptions and expectations of the role of business in the 21st century and how success should be measured.

The regulatory environment continues to respond to such a dynamic environment. In the UK, reporting developments such as the introduction of the strategic report; changes to the Corporate Governance Code (fair, balanced and understandable, risk management and going concern); and international reporting developments, such as the EU Directive on the disclosure of non-financial information; place greater emphasis on the predominantly narrative information included in the front-half of the annual report as a means of communicating the company's performance, position and prospects that is both relevant to, and understandable by, users.

These developments have changed the way companies are reporting on their progress, and the nature of KPIs being reported, with many companies now disclosing a broader set of non-gaap and non-financial KPIs. Companies are also changing the way these KPIs are being incorporated throughout the annual report and how these are linked to the company's strategy and business model, their risks and risk mitigation, and their incentive schemes. As initiatives, such as Integrated Reporting, continue to gain momentum, the spotlight on the depth, breadth and quality of KPIs being reported will only strengthen. The more that non-financial information becomes integrated into companies' decision-making processes, and their external reporting, the greater the need for users to place trust in these KPIs when making informed decisions, and the greater the likelihood that the level of comfort obtained by management over them might be questioned.

Furthermore, in the UK, the FRC's guidance supporting the 2014 Corporate Governance Code places greater responsibility on the board to identify the assurance it requires on matters such as risk management and internal controls, and to satisfy itself that the source of this assurance is reliable². With the trend towards a truly integrated account of strategy, actions and performance, it would therefore seem appropriate to suggest that this should be extended to include the nature of the assurance obtained on the company's reported KPIs.

For many companies, the identification and monitoring of KPIs sits with the management/ executive team however, the ultimate responsibility for the selection of KPIs sits with the audit committee/board and should reflect an individual company's circumstances.

This guidance seeks to facilitate the selection process and sets out some characteristics that may be applied when considering the appropriate KPIs. Rather than defining any specific indicators, the aim of the guidance is to provide insights to audit committees/boards on the source of assurance that might be attributable to each of their reported KPIs and to help them form a view on the relevance and degree of reliability that can be placed on each. This, in turn, will enable them to critically assess whether the existing source of assurance is optimal in responding to the needs of users and other key stakeholders, and how they communicate this.

2 THE KPI SELECTION PROCESS

There is no doubt that some of the recent regulatory changes referred to in the introduction have had a positive impact on the content of the narrative element of annual reports and have encouraged greater alignment between strategy, risks and KPIs. This has resulted in an increase in the number of FTSE 100 companies explicitly linking their strategy to KPIs in the 2013/14 reporting cycle. However, the challenge for the 2015 reporting period is how to build on these improvements and produce annual reports with even greater connectivity between a company's strategy, risks and KPIs, providing the user with a more holistic account of its performance.

As stated earlier, in many companies, the identification and monitoring of KPIs sits with the management/executive team however, the ultimate responsibility for the selection of KPIs sits with the audit committee/board.

To help audit committees/boards fulfil their responsibility in this area, we have suggested five characteristics that they might apply to each KPI. These are: Strategic, Linkage, Reliability, Consistency and Completeness. (See bubbles for expanded descriptions of each).

With these characteristics in mind, audit committees/boards should consider the following questions when deciding whether or not the KPIs are the appropriate ones:

- a. Is the KPI core to the company's performance - in either the short, medium or long term - and genuinely reflective of how strategic progress or performance is assessed by the board?
- b. Does the KPI enhance the communication of the company's story, ie its performance, position and prospects?
- c. Is there a clear alignment between the KPI and the company's business model, strategy and incentive schemes?
- d. Is the purpose of the KPI sufficiently clear and understandable to users?
- e. Is the selected KPI a consistent measure of performance against the previous year's KPI?
- f. To what extent is the selected KPI a comparable measure of performance amongst the company's peers and other organisations in similar sectors?
- g. Does the KPI reflect the underlying reality and would other methods for measuring performance yield similar results?
- h. How reliably can the KPI be measured? Are key uncertainties and judgements identified and explained?
- i. Is there a clear understanding of how each KPI influences/ impacts another one?
- j. Is the full range of KPIs complete in that they give a balanced view of the company's performance from both a financial and non-financial perspective?

5 suggested characteristics to be applied by audit committees/ boards in relation to each KPI

Strategic – each KPI should be derived from and reflect the company's strategy and be material in relation to the company's creation of value (in the broadest sense) and its ability to sustain value creation

Linkage – each KPI should be linked to the other information in the annual report on which it is based (where applicable), for example, the financial statements, the remuneration report; the risk management report

Reliability – each KPI should be accurate, capable of being re-performed and of withstanding challenge

Completeness – the combined KPIs should be complete in that they present a balanced view of the company's performance and not mislead users by reporting only positive messages

Consistency – each KPI should be capable of being compared with (or reconciled to) the previous year's KPI. A consistent company-wide approach to KPIs is also advised

3 DETERMINING THE SOURCE OF ASSURANCE

3.1 Assurance matrix

The Assurance Matrix below has been created to help audit committees/boards to determine the source of assurance obtained over each KPI and where each of their KPIs should be positioned in this matrix. It suggests five illustrative sources of assurance that might be obtained over each KPI which audit committees/boards may wish to tailor, along with their descriptions, to the individual company.

The completed matrix is intended to provide a clear, concise, complete and understandable means of communicating the assurance the audit committee/board has obtained over each KPI. The amount of narrative, if any, included in relation to each selected KPI will vary according to the nature of the KPI; the type of company; and the audit committee's/board's preference. In some instances, a tick in the relevant box might be sufficient, but for others, more narrative information might be required. It is suggested that this matrix should be completed by the audit committee/board as part of their review of the appropriateness of the KPIs. Thereafter, it will be at the discretion of the audit committee/board as to how the matrix should be presented, for example: online, with a cross reference in the annual report; signposting the matrix to another part of the annual report (for example, within an appendix); or in full within the annual report.

Source of assurance

	High level review	Management verification	Independent ³ internal assessment	Independent ³ external assessment (private report)	Independent ³ external assessment (public report)
	Internal scrutiny with some enquiry but no reliance on internal controls or formal reporting process other than to the audit committee/board	Management established controls and verification but no formal reporting process other than to the audit committee/board	Internal independent scrutiny and review but may be the subject of an internal report	External scrutiny and challenge resulting in issue of private report	External scrutiny and challenge resulting in the issue of a public report
KPI					
KPI					
KPI					
KPI					
KPI					

Further guidance on the definitions of each of the five sources of assurance listed above can be found in the explanatory notes in Section 3.3.

3.2 Considerations for completion of the assurance matrix

We envisage that the completion of the assurance matrix, will involve a two-stage process.

Stage 1 will involve discussions between audit committees/boards and management, once the KPI has been selected, on the characteristics of the KPI, including how it will be derived, and the assurance that might be expected.

Stage 2 will be undertaken at the period end once the KPIs have been calculated, involving discussions between audit committees/boards and management to determine the source of assurance obtained over each KPI and whether this corresponds to what was planned or expected by users.

There follows some possible questions that audit committees/boards might wish to ask at each of the above stages:

Stage 1 – selection of the KPI

- a. How relevant/important is the KPI to monitoring strategic progress/performance against plan?
- b. What is the optimal level of comfort/assurance desired over each KPI?
- c. What are the likely sources of assurance over the proposed KPIs?
- d. From what information/process has the KPI been produced/derived?
- e. Does the audit committee/board have confidence in the measurability and reliability of the data on which the KPI is based?
- f. Does the audit committee/board have confidence in the reliability of the processes that produce the KPI?
- g. Is the calculation of the KPI capable of being re-performed or verified by the user?
- h. If the answer to (g) above is no, have any adjustments been sufficiently explained to enable the calculation to be re-performed or verified?

Stage 2 – determination of assurance obtained

- a. What sources of assurance per the matrix above best describe those obtained over the KPI?
- b. Is the source of assurance likely to be sufficient to meet the needs of the various groups of stakeholders?
- c. To what degree has the KPI been subject to challenge (eg internal, external, independent, as per the matrix in Section 3.1)?
- d. Is it possible to obtain the source of assurance that users want over the individual KPI?
- e. If the answer to (d) above is no, should it be possible to obtain the desired source of assurance over the individual KPI?
- f. What would need to be done to obtain the desired source of assurance?
- g. Would the additional cost of obtaining the desired source of assurance be justified by the additional benefit to users?

3.3 Assurance matrix explanatory notes

The matrix in section 3.1 illustrates five suggested sources of assurance that would be determined by the audit committee/board to be obtained over each KPI. Each of these sources is explained in greater detail below to help users understand:

- The nature and extent of the oversight and scrutiny over each KPI;
- The independence and objectivity of the oversight process; and
- The nature of the reporting process.

High Level Review

Oversight – Here, the KPI and the process and information from which it is derived will have been reviewed by senior staff. This might involve some enquiry into the calculation of the KPI but no further challenge or verification.

Independence – The KPI will not be subject to any independent challenge, either internally or externally.

Reporting – The KPI will not be the subject of any reporting process other than to the audit committee/board.

Management verification

Oversight – Here, the KPI, and the process and information from which it has been derived, will have been subject to:

- Management established internal control procedures over the extraction and processing of the information; and
- Management scrutiny and verification of the calculation of the KPI.

Independence – Despite the existence of internal controls over the processing of the information and the verification of the calculation, the KPI will not be subject to any internal or external independent oversight, or any independent external scrutiny.

Reporting – The KPI will not be the subject of any reporting process other than to the audit committee/board.

Independent internal assessment

Oversight – Here, the KPI, and the process and information from which it has been derived, will have been subject to internal scrutiny and review.

Independence – This assessment is likely to have been performed by internal specialist functions, including internal auditors, who are independent of those responsible for the production of the KPI.

Reporting – The KPI may be the subject of an internal report.

Independent external assessment (private report)

Oversight – Here, the KPI, and the process and information from which it has been derived, will have been subject to external scrutiny and challenge, the extent of which will have been agreed in advance between the external third party scrutineer and the entity.

Independence – The external scrutiny and challenge will have been undertaken by an external party, independent of the preparer of the KPI.

Reporting – A report is made only to internal parties within the company but no opinion is expressed publicly. (Permission should be obtained from the external party if the information contained within this report is to be referenced publicly, eg, within the company's annual report.)

Independent external assessment (public report)

Oversight - Here, the KPI, and the process and information from which it has been derived, will have been subject to external scrutiny and challenge. This may be the subject of a separate engagement from the financial statements audit.

Independence - The external scrutiny and challenge will have been undertaken by an external party, independent of the preparer of the KPI.

Reporting - The outcome will be a report in which an opinion or conclusion is provided to third parties/publicly. Where this assurance is provided by the company's financial statements' auditor, this will be in accordance with the International Framework for Assurance Engagements⁴. Under this framework, the assurance expressed will be classed as:

- Limited Assurance – this level of assurance is lower than that of a financial statements' audit (see below) but still provides the user with some level of comfort over the integrity of the information. The nature, timing and extent of procedures performed in a limited assurance engagement is limited compared with that necessary in a reasonable assurance engagement, but is planned to obtain a level of assurance that is, in the practitioner's professional judgment, meaningful (ie clearly more than inconsequential).
- Reasonable Assurance – this level of assurance is equivalent to that provided in a financial statements' audit engagement and is greater than Limited Assurance (see above). This level of assurance may be possible where the KPI has been derived from the financial statements.

As a minimum, in the UK, KPIs published in the company's annual report will have been encompassed within the 'fair, balanced and understandable' review undertaken by external auditors, who would report by exception if they disagreed with the directors' 'fair, balanced and understandable' assertion.

External assurance may be provided by a range of experts and professionals. Ultimately, the level of comfort that the user may obtain will depend upon the rigour of the assurance framework applied, the scope of the work undertaken and the quality and experience of the assurance provider. In any event, the user is likely to be able to gain more confidence in the public report of an external assessor than from the other sources of assurance discussed above.

4 CONCLUSION

As stated in the introduction, this guidance has been targeted specifically at audit committees and boards to assist with their assessment of the source of assurance attributable to each of the KPIs and how this can be communicated to users and other stakeholders to provide them with greater insight and understanding as to the reliability, relevance and credibility of each KPI. With greater emphasis being placed by boards and stakeholders on the front-half of annual reports, and the narratives information contained therein, there is a need for the development and adoption of best practice in the selection and reporting of KPIs and our guidance is designed to support and assist this process.

Our hopes for this guidance are twofold:

- i. We hope that this document proves useful in allowing audit committees/boards to explore the sources of assurance over KPIs and provides the basis for fruitful engagement and dialogue with users over their needs; and
- ii. We hope that this dialogue and engagement will give us an insight into the practical application and completion of the matrix and inform further improvements and updates as the guidance is refined.

ENDNOTES

1. ICAS Assurance on management commentary – where next? Section 3 – Next Steps
2. <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Guidance-on-Risk-Management,-Internal-Control-and.pdf>
3. Throughout the document ‘independent’ means a party separate from the preparer of the KPI: this could be a party internal or external to the company
4. International Auditing and Assurance Standards Board (IAASB) International Framework for Assurance Engagements

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