EXTERNAL ASSURANCE AND DECISION USEFULNESS OF SUSTAINABILITY REPORTS

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Abstract

This study covers research conducted to assess the current state of external assurance of sustainability reporting. Stakeholders, Potential investors and rating agencies specialized on sustainability also rely on disclosures from corporate sustainability reporting in order to consider this information in their business decisions or in providing ratings to interested parties. This study explores the sustainability reporting universe regarding the assurance scope, assurance level and assurance provider of sustainability disclosures.

Keywords

Sustainability, Sustainability reporting, Assurance

JEL Classification

Q56, M42

Introduction

There is a growing awareness and understanding of the need for an active and coordinated response to fundamental global developments (climate change, population growth, urbanisation, etc.) by both the international community of states and the private sector. Regulation density is growing, and the complexity for companies and the requirements they and their reports must comply with, are also growing. This situation also provides companies with opportunities to better position themselves and to anticipate developments. At the same time, however, the necessity of recognising the associated risks and minimising their effects is also clear.

A growing number of stakeholders expect these factors to be considered in company reporting. Investors, especially professional investors, take sustainability factors into account because they recognise that unsustainable economic activities can cause operational problems for companies and thus have a negative impact on company profits. Thus, from this return-driven point of view, it is also necessary to take sustainability factors into account (Schmid, Olaru & Verjel, 2017). This applies above all to investors with a long-term perspective, for example, in the field of retirement planning.

Until the recent past, stakeholders and investors did not have an easy way to compare the sustainability performance of different companies. Those who wanted to invest sustainably were limited to a relatively small group of products bearing a sustainability stamp. These products, also known as socially responsible investments, often pursue strategies that are

either based on exclusion criteria or in which the fund management takes an activist approach to encourage companies to operate more sustainably.
Over time, the need to compare company sustainability has led to the development of sustainability rating agencies. The purpose of these agencies is mostly to research and measure the ecological and social performance and weaknesses of companies and countries. In particular, the results are eco-ratings and eco-rankings. An eco-rating is prepared by rating agencies that examine and evaluate companies according to ecological criteria.
In this case, the company is not subjected to a credit evaluation of its current and future liquidity, as is the case with conventional ratings, but rather to a rating based on its ecological creditworthiness. It reflects information about the sustainable overall responsibility of the company. The eco-rating evaluates the ecological impact of products or services over their entire life cycle. All areas of the operational value chain, such as procurement, production, sales, logistics, controlling, personnel, organisation and financing, are considered (Schäfer, 2016, pp. 449f). The aim of an eco-rating is to express the ecological performance of a company through a highly aggregated evaluation. An eco-rating serves as decision support for investors and consumers.
The basis of these eco-ratings is mainly information made available by the company. The fundamental question dealt with in this work is the quality and decision usefulness of sustainability information provided by companies in their sustainability reporting.
A key factor in assessing the usefulness for decision making is the question of how reliable company information published in sustainability reports is. This study is dedicated to analysing whether and to what extent companies sustainability reporting is verified by external assurance. This study is based on data from the Global Reporting Initiative ("GRI"), which was kindly provided to us by the GRI for the purpose of our analysis in the context of the GRI's Sustainability Disclosure Database.

1. Decision usefulness and information quality of an external audit in the context of sustainability reporting

Materiality for decision making is an international accounting principle. Basically, a piece of information on the financial market is considered useful for investors if they can use it to draw conclusions regarding the amount, temporal progress and degree of security or expected risk of future cash flows. From a different point of view, a piece of information on the financial market is considered useful if it could lead an investor to change investment decisions.
For example, concerning accounting, IAS 1 establishes the requirement to present all business transactions and other events and conditions in a company in such a way that all necessary information is made available to the recipients, allowing them to make decisions (Iasplus.com, 2018). This compliance requirement does not contradict the principle (overriding principle) of not applying a prescribed individual provision if it misleads the recipients instead of supporting them in making a decision.
The audit of the annual financial statements is intended to ensure their quality as an information tool for parties external to the company. The main function of an annual audit is to provide the recipients of the annual financial statements with a sound and correct information basis for their (investment) decisions. However, ensuring the information function of the annual financial statements is not solely the responsibility of the auditor, but also the responsibility and task of the company's management or Board of Directors.
Assuming that people act rationally, the expected returns are of particular importance for investment and financial planning decisions made by investors. The expected returns are occasionally determined on the basis of available information taken from data provided by the annual financial statements. Therefore, from the investor's perspective, a low-quality information is judged negatively, as it can have negative monetary consequences.

For the recipient of the annual financial statements, a low audit quality is particularly relevant when the quality of the information provided is also rather low. With high-quality information, at least in theory, even the complete waiver of an audit, e.g. by reducing the amount of work to (almost) zero, might not lead to any (financial) disadvantages for the investor, since the annual financial statements would be error-free, even without an audit. Since this is often not the case, or because of the existence of the most different information asymmetries, an audit of the annual financial statements is required by law.
In addition to the value-added function, the auditor also fulfils an authentication function and thus an assurance function vis-à-vis the recipient of the financial statements. In the context of this assurance function, the recipients of the financial statements may file a damage claim against the auditor if they have relied on the information of the audited financial statements assuming it to be true, but afterwards it has turned out to be incorrect. An investor (financial statements recipient) will generally be willing to pay a higher price for a company's shares or a participation therein if the information has been audited and there is a right to file damages against the auditor.
Those principles for auditing financial statements are a proper guideline for the audit of sustainability disclosures. The objective quality of sustainability reporting is thus characterised by the degree of compliance with the relevant standards, as is the case with published annual financial statements and the assurance thereon. In current discussions, the function of sustainability reports as an information tool for the capital market is being highlighted, because investors can base their investment decisions on information published by companies that is included in their sustainability disclosures.

2. Principles of sustainability report audits and assurance on sustainability reporting

In most cases, company reports no longer contain only financial information. In the context of the growing importance of "Integrated Reporting", additional, non-financial information, is also disclosed. Sustainability reports play a particularly important role here. In general, a sustainability report comprises the identification, publication and reporting of the company's performance to internal and external stakeholders concerning the goals of sustainable development.
Basically, the question as to whether or not companies should publish a sustainability report is no longer relevant. The question is rather whether the information reported is credible and reliable (Pfyffer/Jurt, 2011, p.17). Further remarks on sustainability report audits relate to voluntary audits in this field, but not to the statutory duty to audit sustainability-related information, e.g. as part of the management report. In contrast to statutory annual or group-consolidated financial statements, in most country's there is no obligation to have their sustainability reports audited by an external assurance provider even when reporting companies are exceeding size classifications or have publicly traded shares on stock exchanges. Thus, assurance audits on sustainability disclosures are predominantly voluntary. Currently the is no uniform assurance auditing standard due to the lack of obligation concerning the standards to be applied in the preparation of sustainability reports. Thus, it can be assumed generally difficult for stakeholders to make appropriate use of the information disclosed to obtain a comprehensive picture of a company's sustainability performance, as it often differs in scope and content. In order to provide credibility to sustainability reports and the information they contain and, for example, to counter the suspicion of so-called "greenwashing", domestic and international companies are increasingly submitting to voluntary external audits (Owen/O'Dwyer, 2008, p.399).
As counterarguments of sustainability report audits are their cost for the reporting company and uncertainties regarding an actual increase in credibility. In some cases, companies even consider that such an audit is rather the responsibility of the management or of an internal audit. However, it can be argued that there is a higher risk of a lack of independence for a

company's internal audit department and, consequently, the desired increase in credibility for the stakeholders may not be achieved at all.

In addition, a company may consider that it is not yet prepared for an external audit due to the relatively early stage of development of sustainability reports and of the underlying management and information systems. However, considering that the internal reporting systems are still under development, an external audit should precisely be able to strengthen the stakeholders' confidence in the information reported. In addition, it could also uncover potential for improvement in the company's internal decision-making, control and reporting processes, for example. In this context, the support function of an audit could serve to achieve a more consistent integration of the sustainability principle into the strategic and operational decisions of the company.

Conducting an external audit of sustainability reports does not constitute a statutory duty of the auditors. Thus, in addition to auditors and auditing firms, auditing services can also be requested from suitably specialised consulting firms, certification companies or experts specialising in technical audits, as well as non-profit organisations from the environmental sector. Furthermore, joint audits are also possible in the same way as statutory annual financial statements joint audits, whereby, in principle, different combinations of audit service providers are conceivable.

Sustainability report audits must be clearly distinguished from financial statements audits. There are substantial differences, e.g. concerning regulation, organisational position, client or approval and supervisory duties. Irrespective of the auditing standard used, and in addition to the subject matter of the audit, the scope and assurance level of sustainability report audits can be established individually between the company and the audit service provider.

There are several audit standards relating to sustainability reporting. International acceptance is given to the reporting standards ISAE 3000 and AA1000 AS. In addition, there are country specific standards like the German IDW PS 821 issued by the Institute of Public Auditors in Germany.

The individual audit assurance level is described differently, however the corresponding definition or interpretation is similar. While ISAE 3000 distinguishes between reasonable assurance and limited assurance, AA1000 AS refers to audit assignments with high assurance or moderate assurance. IDW PS 821 differentiates between the audit and the audit review of sustainability reports. In the case of an audit, there is sufficient assurance, but in the case of an audit review, there is limited assurance. In accordance with ISAE 3000, the other standards also offer a combination of assurance concepts for different report components.

Concerning the opinion report of the audit, each standard provides for the preparation of an audit certificate. Within the sense of the support function, the standards also offer room in the audit certificate for recommendations made by the audit service provider. While according to ISAE 3000 and IDW PS 821 certain facts even require a kind of obligation on part of the auditor to the legal representatives or the supervisory body of the company, and thus a supplementary report for the company is required in addition to the audit certificate, AA1000 AS foresees no such report to be submitted by the audit service provider. AA1000 AS only considers a separate report to the management in contractually agreed situations.

The subject matter and scope of the audit are agreed upon and are primarily determined by the company. Depending on its design, the audit offers reasonable assurance or limited assurance. Overall, the sustainability report audit process might be based on the financial statements auditing process.

3. Analysis

Quantitative-descriptive analysis

The analysis was conducted on the basis of the metadata of 5,224 sustainability reports published in calendar year 2017 to publicly available GRI's Sustainability Disclosure Database. The data comprises detail information of sustainability reports from 40 countries on six continents from 7 different organisation types of companies. The aim is to show quantitative-descriptive factors relating to assurance details of sustainability reports.

Results of the assurance analysis of sustainability reports

The analysis reveals that only 1,018 of 5,224 of the published sustainability reports are audited by a third, independent party. This represents 19,5% of the analysed population. In great part, this appears as a very limited response to widening regulation, business and public expectations about sustainability challenges. However, there are notable differences between countries, structure and sectors of reporting companies.

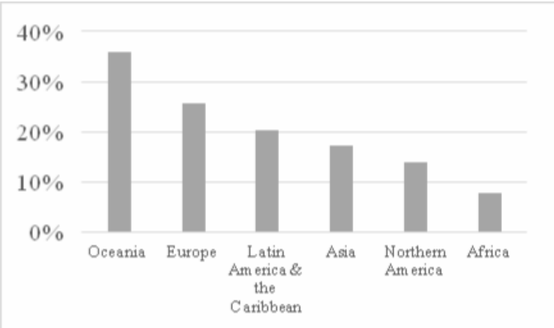

Fig. no.1: Percentage of reports that included some type of external assurance statement by continent

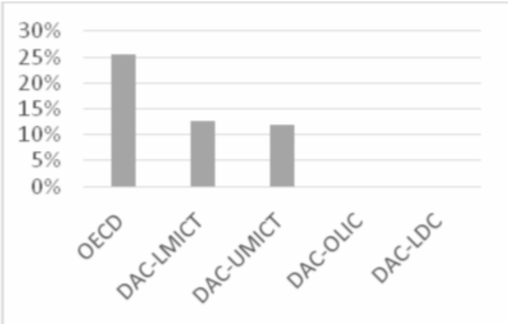

Fig. no.2: Percentage of reports that included some type of external assurance statement by country status

The comparison by continent (fig. no.1) reveals that sustainability reports from Oceania (36.0%) and Europe (25.7%) have the highest percentage of reports that included some type of external assurance statement. Regarding the observation for Oceania limitation arises due to the limited number of reports submitted to the GRI's Sustainability Disclosure Database (25 submitted reports in total for 2017). There is potential bias, as submitted reports for Oceanian are represented by listed companies with more than 76% of the Oceanian report population which is slightly higher than the average percentage of listed companies in total population. However, a comparison by overall listing status shows that listed companies (20.4%) have a slightly higher percentage of reports that included some type of external assurance statement in comparison to non-listed companies (17.4%) in the comprehensive population. The difference, which tends to be lower than initially expected by us, indicates that the demand for assurance by stakeholders from listed companies is not materially different in comparison to stakeholders from non-listed companies.

A reasonable explanation for the higher percentage in Europe might be the reinforced public focus on sustainability reporting due to the European Union Corporate Social Responsibility Guidelines from 2014, which were transformed in national laws e.g. applicable for German capital market-oriented companies for reporting periods starting January 1, 2017. On the other hand, sustainability reports from African companies (7.9%) show the lowest percentage of assurance statements. This is an indication that demand for assurance statements in African countries is lower than in other regions. However, due to highly dispersed economic performance of countries within each region, the analyses of continent-based sustainability reports cannot be considered as plenary picture.

By additionally analyzing the assurance by country status, the result provides are broader insight to the economic performance of the sustainability report country in which the organization's headquarters are located and the assurance status. Members of the Organization for Economic Co-operation and Development (25.6%) tend to have the highest percentage of reports that included some type of external assurance statement. Lower Middle Income Countries and Territories (12.7%) and Upper Middle Income Countries and Territories (11.7%) are represented by a significant lower percentage of the assurance status. For companies from Other Low Income Countries and Territories and Least Developed Countries there are no reports in the GRI's Sustainability Disclosure Database that included some type of external assurance, whereby 108 sustainability reports of those country status were subject to our analyses. It can be assumed that there is a positive relationship between the economic performance indicated by the specific country status and the percentage of reports that included some type of external assurance statement.

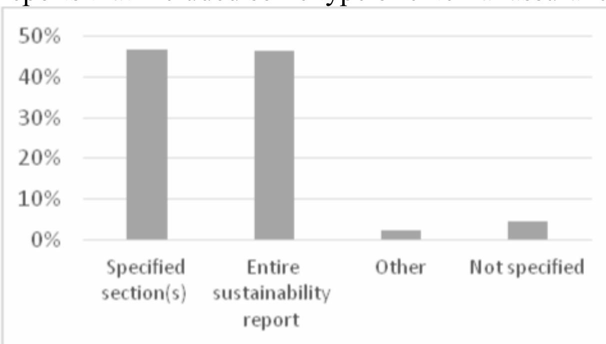

Fig. no.3: Percentage of different assurance scopes of reports

Table no. 1: Applied Standards segregated by company listing status

Applied Standard	listed	non-listed
ISAE 3000	429	101
AA1000 AS	218	54
Other (national Standards)	175	53

When the entire sustainability reporting is subject to the scope provided by assurance provider, a wide range of sustainability topics can be basis of the assurance. However, it needs to be noted that although a wide range of topics were assured, some assurance work only covered disclosure information whereas there are also instances covering underlying internal control processes. In contrast, assurance of specific sections indicates that only chosen, mainly environmental sustainability topics, such as water, carbon and waste disclosure are subject to the assurance work performed.

In terms of the assurance scope (fig. no.3) of the 1.018 reports that were subject to external assurance procedures it can be observed that a comparable number of audits were performed for specific sections (47.0%) and the entire report (46.4%). 2.2% of the reports were subject to other scopes while in 4.5% the cases it´s not specified which assurance scope was applied.

An analysis of the standards (table no.1) provides an overview to which reporting standards was referenced to in the analyzed sustainability reports.

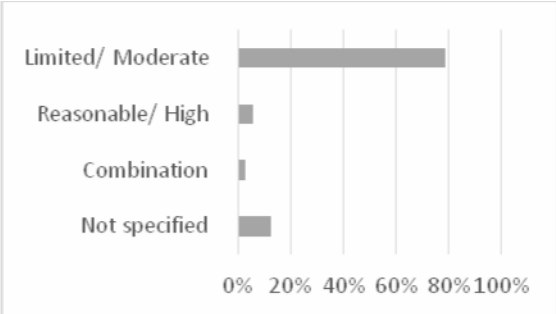

Fig. no.4: Percentage of different assurance levels of reports

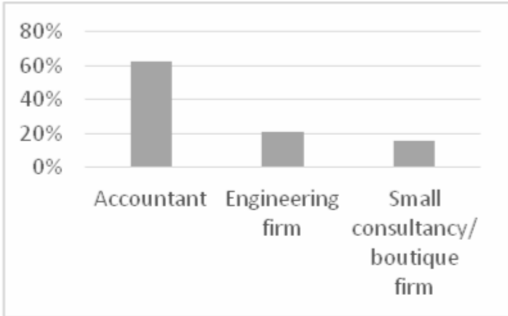

Fig. no.5: Providers of assurance

The most-referenced assurance standard was ISAE 3000, which was mentioned in 530 assurance reports. The AA1000 AS standard was referenced in 272 reports. Other Standards, which are mainly country specific sustainability standards, were referenced in 128 reports.

The level of assurance indicates the extent and depth of the assurance work the assurance provider undertakes in relation to sustainability reporting. It can be segregated into two levels. The 'reasonable/high' assurance is in general a more extended audit approach in comparison to 'limited/moderate' assurance but it´s still involving some risk of inappropriate conclusion.

From the analyzed assurance reporting, 78.9% indicated that limited/moderate assurance had been performed (fig. no.4). There were only 5.9% assurance reporting that claimed to perform reasonable/high assurance. A potential reason for the significant higher share of limited/moderate assurance in comparison to reasonable/high assurance might be cost considerations, as a higher level of assurance goes along with higher fees that an external assurance provider will charge to companies requesting assurance work to be performed. It can be assumed that companies see no significant additional benefits and that stakeholders might not strongly demand a higher level of assurance.

A variety of service providers offer external assurance of sustainability disclosures. In order to deliver an acceptable degree of reliance to stakeholders, external assurance providers are also expected to be independent from the organization in order to be able to conclude on an objective and impartial opinion or conclusion.

External assurance service providers in the context of this analysis are divided in three groups. Accountancy firms, which are normally connected to global professional accounting service networks. Their core competency is the expertise in financial and non-financial reporting in addition to specific sector-based market knowledge of a diversity of business sectors. Engineering firms, which offer technical certifications and engineering expertise. This group also comprises technical certification agencies. The third group are small consultancies and boutique firms. In general, those consultancy firms have a specific focus on sustainability related issues.

The analysis of the assurance providers (fig. no.5) shows that in most cases assurance work is performed by accountants (62.9%). Particularly noteworthy here is the involvement of the so called Big-4 accounting firms (PWC, KPMG, EY and Deloitte) because they represent the majority of accountants who audit sustainability reports in our analyzed population. It can be assumed that in addition to competency considerations, accountants are preferred assurance providers due to the fact that the audit of sustainability reports is partially based on company information that is also subject to financial statement audits performed by accountants.

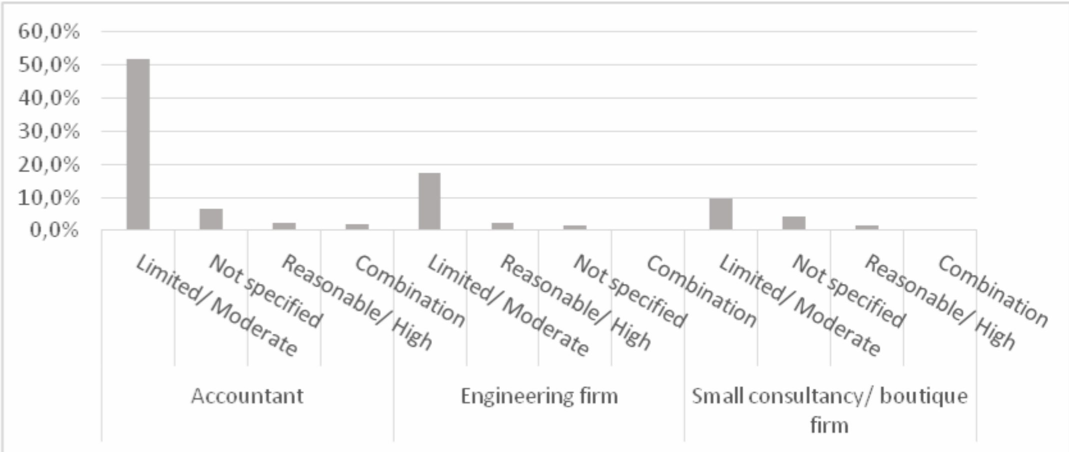

Fig. no.6: Assurance level by providers of assurance

Furthermore, especially reasonable and high level of assurance opinions or conclusions require a broad understanding of the company and its internal processes which is also subject of financial statement audits. By focusing on economic reasons in terms of the fee that an external provider charges for an audit of sustainability reports, engaged financial statements auditors might have an advantage in comparison to other providers like engineering firms (21.3%) and small consultancies/boutique firms (15.8%) that both have a significantly lower share as assurance providers in our analysis.
Regarding of the assurance level of assurance work provided by the mentioned assurance providers (fig.no.6) there are no significant differences in a direct comparison that can be noted except for that fact that not specified level of assurance work of small consultancy/ boutique firms is tending to exist more often in comparison to the other assurance providers.

Conclusion

The research shows that the large majority of sustainability reports is not audited by an external assurance provider. The focus on improving sustainability reports by utilizing external assurance is lagging behind substantially. Out sustainability reports published in 2017 from GRI's Sustainability Disclosure Database, only 19,5% underwent assurance procedures. While there are only limited conclusions possible in a by continent analysis, it can be assumed that there is a positive relationship between the economic country performance indicated by the specific country status and the percentage of reports that included some type of external assurance statement.
Regarding the assurance scope, it can be observed that a comparable number of audits were performed for specific sections and the entire report. As the assurance scope and extend of sustainability disclosures is first and foremost depending on company management decisions, its not surprising that many companies request assurance procedures for very specific parts of their sustainability disclosures. Reporting companies mostly request assurance work to be performed based on international assurance standards like ISAE 3000 and the AA1000 AS, while there are also notable instances where country specific sustainability standards were applied.
The assurance providers, ranging from accountants, engineering and other professional services firms is concentrating on the accountants as they carry out the majority of assurance work in the analyzed population. It will be interesting to see how external assurance trends will develop in the context of the increasing demands for reliable sustainability reporting. It is likely that more and more companies optimize sustainability reporting within the

boundaries of local laws and regulations, accompanied by stakeholders looking critically at the reliability of sustainability information

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