Agenda Item
1-C

EER Assurance - Background and Contextual Information

The September 2018 draft of the guidance was divided into two sections, with section II containing background and contextual information. A partially-revised draft of this section was included as Agenda Item 8-C for the December 2018 IAASB meeting for information purposes only. The Task Force has made some further minor revisions and plans to include this as part of the consultation paper to be published for public comment, including asking whether it should be included as a separate section in the proposed IAEPN or published separately.

Introduction

1. The material below is divided into three areas which mainly relate to aspects of how an EER report is prepared:

   a) Understanding subject matter elements

   b) Understanding how subject matter information results from measuring or evaluating subject matter elements against the criteria

   c) 'Materiality processes'

2. These are areas which practitioners may find helpful to understand in applying the guidance (**Agenda Item 1-A**). The sections below explain general concepts underlying EER reports, as a form of subject matter information, and how these relate to key assurance concepts reflected in ISAE 3000 (Revised)[1]. Much of this relates to the role of a preparer of such EER reports, rather than to the role of a practitioner. However, an appropriate understanding of the nature of the preparer's role in preparing an EER report, and how it relates to assurance concepts, is likely to assist practitioners in performing effective EER assurance engagements.

3. Where possible, the explanations of general concepts in this section draw comparisons between EER and more established forms of reporting, as well as comparing and relating how these concepts appear in some major EER frameworks.

[1] International Standard on Assurance Engagements (ISAE) 3000 (Revised), *Assurance Engagements Other than Audits or Reviews of Historical Financial Information*

Understanding Subject Matter Elements

Introduction

4. EER encapsulates a wide variety of types of reporting by companies and other organizations. However, in general terms, an EER report describes particular qualities of particular elements that are associated with a particular underlying subject matter ('subject matter elements' or 'elements'). The particulars described, and the underlying subject matter that they are associated with, are those that are relevant to the purpose and users of the EER report.

5. The descriptions of qualities of elements included in the EER report are, importantly, made by reference to the applicable criteria. They are not therefore merely descriptions of unique expressions of the qualities of each element. Rather, the descriptions reflect a categorization of the elements into relevant well-defined classes, by reference to how their qualities are exhibited. This allows the information about elements to be aggregated, which makes it more useful to the users.

6. For EER, the subject matter elements may be very diverse. They might include things within and outside the legal and financial boundaries of the entity, which may be of significance to, or affected by, the entity in operationalizing its strategy and business model. Elements might, for example, include:

   a) natural resources;

   b) employees;

   c) customer relationships;

   d) goods and services provided by other entities or manufactured and delivered by the entity;

   e) the entity's strategy; or

   f) the entity's governance, management, risk management and internal control infrastructure, including its policies and procedures, processes and related resources.

7. Subject matter elements may be parts of larger elements or may consist of parts themselves. Not all the qualities of a composite element are necessarily evident in any of its parts. Some qualities emerge only in the larger element. For example, the capability of a control, which consists of a design and a set of implementation and operational steps, does not exist in any of its individual parts.

Comparison to Financial Statements

8. The concept of elements is perhaps most easily explained by reference to similarities and differences with the corresponding concept for financial reporting (specifically for financial statements), which many professionals may be more familiar with.

9. Financial statements provide information about the financial condition and performance of an entity. This is another way of saying that the underlying subject matter for financial statements is the financial condition and performance of the entity. The information provided in financial statements is primarily about the quality 'economic value' for well-defined financial statement subject matter 'elements' ('financial statement elements'). This is because that quality of those elements is of primary relevance to the purpose and users of financial statements.

10. The defined financial statement elements are:

a) The entity's economic resources and claims on those resources (for example, assets and liabilities); and

b) The transactions, other events and conditions (for example, sale or purchase transactions, or an agreement to purchase a property), the effects of which cause changes in the entity's economic resources and claims (for example, settling an expense incurred may reduce the entity's cash).

11. Financial statements represent the economic value of the financial statement elements, by describing it, in words and numbers, in the primary statements or in the notes. The criteria, by reference to which the economic value is described, include an established measurement basis (the particular concept of economic value), which is usually set out in accounting standards. When observation is not sufficient to do this, the criteria may also include a conceptually valid process or method to measure the economic value on the measurement basis. Such a method reflects established knowledge and may apply prediction or allocation techniques. The resulting information may be presented in the financial statements at different levels of aggregation, for example by type of asset, liability, income or expense, or by type of activity.

12. The criteria are established in the applicable financial reporting framework (for example, IFRS) or in the entity's accounting policies. The accounting values and related disclosures in the primary financial statements and notes are the subject matter information which results from applying the criteria to the underlying subject matter.

Subject Matter Elements in an EER Report

13. In an assurance context, ISAE 3000 (Revised) uses the terms 'underlying subject matter', 'criteria' and 'subject matter information', however it does not explicitly address subject matter elements or their qualities and does not use these terms.

14. The underlying subject matter of an EER report is always closely related to the EER report's intended purpose and users. The concepts described above for financial statements are, at a high level, applicable in a similar manner for EER reports. However, underlying subject matter for EER reports is often broader and more diverse than simply the financial condition and performance of an entity.

15. As a result, the underlying subject matter of an EER report often encompasses a much broader range of elements than the entity's financial statement elements. It may include elements of significance to the entity that do not meet the definitions of financial statement elements. Those elements may be of significance because they are of value to it, oblige or commit it, are parts of it, affect its other elements or are otherwise related to it. The underlying subject matter may also include elements associated with the entity's activities that have an impact on elements that are of significance to other entities, or groups of entities.

16. A typical EER report may describe some or all of the following:

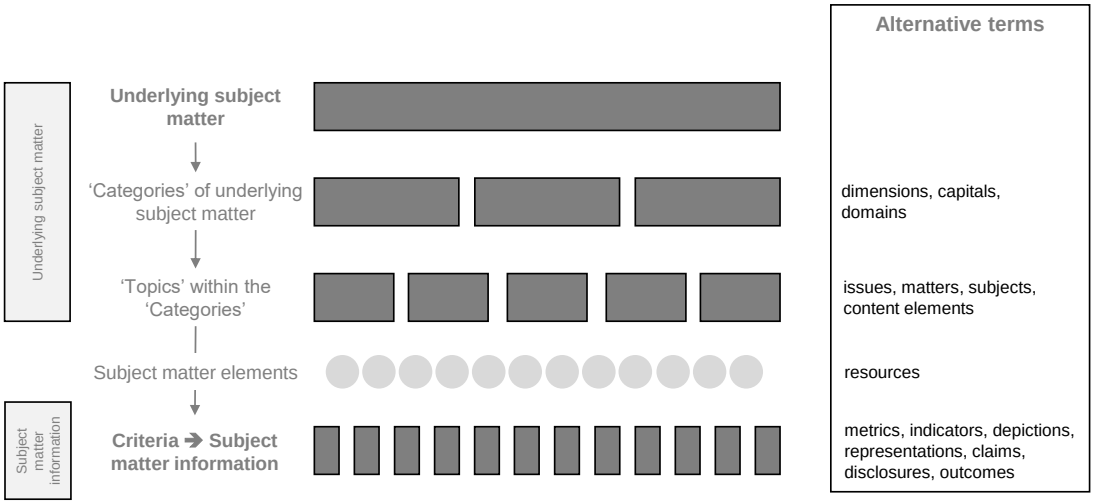
a) The elements relevant to the EER report and their condition at a point in time. This might include the entity itself, or parts of it, and other elements not (or only partly) under the control of the entity;

b) Changes in relevant qualities of those elements (compared to a time in the past, or a forecast of how they will or may change in the future); and

c) The elements that cause those changes (e.g., the entity's activities, or other events and conditions).

17. Often, but particularly when the underlying subject matter for an EER report is broader or more diverse, the elements and their defining qualities may be analyzed between general categories (and sub-categories) and specific topics (and sub-topics). This could result, for example, in a hierarchical analysis, recognizing that such categories and topics are often inter-related. Such a hierarchical analysis is useful both in structuring the EER report to make it understandable to users and in considering the information that should be included in the EER report to enable it to fulfil its purpose.

18. Established EER frameworks use a range of terms to describe such analysis. Some terms used to describe them in such EER frameworks are included in the generalized diagram below.



19. It is of note that the terms 'categories' and 'topics' are not explicitly used in ISAE 3000 (Revised). The diagram also reflects the position that 'topics' can relate to more than one 'category' and a piece of subject matter information can relate to more than one 'topic'.

Boundary of Elements Addressed in an EER Report

20. Every EER report has a reporting boundary to determine what is in scope to be addressed in the EER report.

> **EXAMPLE**
>
> If considering a construction company's supply chain, this includes materials suppliers, as well as subcontractors. Each of the suppliers and subcontractors have their own suppliers and subcontractors and so the supply chain can get extremely long and complex. The reporting boundary determines how far along this chain to go.

21. The boundary of the relevant elements, and their relevant qualities, is determined by reference to the intended users and purpose (intended use) of the EER report.

Relating Elements to Categories and Topics

22. Particularly where an EER report addresses a broad and diverse underlying subject matter, it is likely to address a broad and diverse range of elements covering many different categories and topics, as

described above. In these cases, it may be helpful, both in preparing the EER report and in understanding how it has been prepared, to identify the elements that relate to each category and topic.

EXAMPLE	A sustainability report could be analyzed into categories of environmental, social, economic and governance information, each of which could address several topics. The environmental information could include reporting on several different 'resources' affected by the entity (the elements), such as natural resources (for example, trees, air or water), and related causes of change in those resources relevant to the underlying subject matter category 'environmental' (for example, the entity's deforestation of trees, emissions into the air, or release of effluent into a water system).

23. Understanding the structure of an EER report in this way may be important for a practitioner when agreeing the scope of an assurance engagement, particularly where the scope does not address an EER report in its entirety.

Understanding How Subject Matter Information Results from Measuring or Evaluating Subject Matter Elements Against the Criteria

Understanding the Terms Used

24. ISAE 3000 (Revised) defines subject matter information as the outcome of the measurement or evaluation of the underlying subject matter against the criteria, that is, the information that results from applying the criteria to the underlying subject matter. It also defines criteria as the benchmarks used to measure or evaluate the underlying subject matter, and the underlying subject matter as the phenomenon that is to be measured or evaluated against the criteria.

25. These definitions are or contain various 'terms of art' that are used widely in ISAE 3000 (Revised) and in the International Framework for Assurance Engagements: subject matter information – measurement and evaluation – underlying subject matter – criteria – benchmarks – phenomena.

26. The concept of an assurance engagement is essentially a generalization of the concept of a financial statement audit, in which equivalent terms used might be:

- The entity's financial statements (subject matter information)
- Measurement, valuation and estimation (measurement and evaluation)
- The reporting entity's financial position and performance (underlying subject matter)
- Financial reporting standards and accounting policies (criteria)
- Measurement, recognition, presentation and disclosure bases (benchmarks)
- elements of the financial statements: the reporting entity's economic resources and claims against the reporting entity (i.e. assets, liabilities and equity) and the effects of transactions and other events and conditions that change those resources and claims (i.e. income and expenses) ([economic] phenomena, which may be referred to as the elements of the financial statements).

27. More commonly in the context of an EER assurance engagement, equivalent terms used might be as follows (where "EER" might be replaced by terms such as "Sustainability", "Integrated", "Non-financial", "Annual", "Environmental, Social and Governance" or "Strategic"):

- The entity's [EER] report (subject matter information)
- Measurement or estimation and assessment or appraisal (measurement and evaluation)
- The entity's economic, environmental, social or governance state, condition, prospects, performance or impact (underlying subject matter)
- [EER] Reporting Framework or Standards and reporting policies (criteria)
- Metrics or measurement protocols (benchmarks)
- The entity's economic, environmental, social or governance resources, claims and relationships, and the entity's actions or activities, and other events and conditions, that cause such states, conditions or prospects to change (performance) or that cause other entities' states, conditions or prospects to change (impact) ([EER] phenomena, which are referred to in this guidance as subject matter elements)

Understanding the Nature and Role of Criteria

28. Criteria specify both:

    a) the identification of the nature and scope of the topics and related elements of the underlying subject matter to be represented in the EER report (which are dealt with in definitions, underlying concepts and reporting boundaries); and

    b) the identification of the qualities of such elements elements to be measured or evaluated against the criteria to prepare the information to be included in the EER report, and the benchmarks to be used in measuring or evaluating those qualities.

29. Criteria establish the basis of preparation for the EER report. At its most simplistic, a subject matter element may be described in the EER report by measuring or evaluating a quality of a subject matter element and reporting the value of that measurement or the outcome of that evaluation in the EER report, together with how the measurement or evaluation was made.

30. Appropriate subject matter elements are identifiable (they can therefore be distinguished from other subject matter elements). However, as in financial reporting, subject matter elements may be measured or evaluated individually or collectively (for similar items) at different 'units of account', depending on what is relevant to the information needs of the intended users.

EXAMPLE	An apple is an individual item, distinct from all other individual apples and from all other individual fruits etc. It has several distinct parts: 'pips'; 'flesh'; 'skin'; and 'stalk'. It may also be a part of 'a fruit basket' which contains other individual fruits. Depending on the hypothetical information needs of the intended users, an EER report may be prepared on the apple, or its parts, or the fruit bowl by measuring or evaluating relevant qualities of the apple, its parts or the bowl against benchmarks and including the resulting information in the EER report.

31. Another way of thinking about criteria is that they embody the questions that need to be addressed when evaluating or measuring a subject matter element.

EXAMPLE

If the subject matter element was a machine in a factory some questions which might underpin the criteria and, in brackets, the resulting subject matter information, include:

a) When was the machine built? (expression of time)

b) Where is the machine? (expression of location)

c) What color is it? (expression of a quality)

d) What is the maximum number of widgets it can produce in an hour? (expression of a capability to act so as to cause change)

e) What is the actual number of widgets produced in the last year? (expression of performance or outcome of an action that causes change)

f) What is its financial value at a point in time? (expression of a quantity or measurement)

g) What has been the change in value over the last year? (expression of the outcome of a change in the machine's state or condition)

h) How did the change in value happen? (expression of the cause of a change)

i) Why have the directors decided to sell the machine? (expression of the intent of an action to cause a change)

EXAMPLE

Another example of an element might be a river next to a company's factory which it has access to. Questions which might underpin the criteria include:

a) Where is the river? (expression of location)

b) How much water flows through the river? (expression of characteristic)

c) How polluted is the river in terms of the chemical composition of the water? (a measurement)

d) How has the water quality changed over a period of time? (expression of change in condition)

e) What is the impact of the factory on the water quality of the river? (explanation of cause of change in condition)

32. The criteria can be selected or developed in a variety of ways, for example, they may be[2]:

    a) Embodied in law or regulation

    b) Issued by authorized or recognized bodies of experts that follow a transparent due process (for example, GRI or SASB standards)

    c) Developed collectively by a group that does not follow a transparent due process

[2] ISAE 3000 (Revised) paragraph A48

d) Published in scholarly journals or books

e) Developed for sale on a proprietary basis

f) Specifically designed for the purpose of preparing the subject matter information in the particular circumstances of the engagement

g) A combination of the above

Understanding the Nature of Qualities

33. A quality (such as color) is an aspect of a subject matter element. Individual subject matter elements may exhibit a quality in different ways (an item's color may be red, yellow, blue, etc.).

EXAMPLE	An apple may be described as red or green or brown, which are different ways that a quality called 'color' can be exhibited by an item. Some qualities may be modified by another quality. For example, color can be modified by qualities known as a tint, tone or shade.

34. A quality may describe aspects of a subject matter element such as:

- *where*, *when*, or *how* it is deployed or occurs
- *what* its nature is, *what* its relations to other subject matter elements are, or *how many* of the elements there are *or how much* of the quality (if quantifiable) it exhibits
- *how* it can cause a change, *how* it can be changed by a cause or *what* the effect on it is, of a cause of change.

Understanding the Nature of Evaluation and Measurement of Subject Matter Elements

35. Preparing subject matter information involves evaluating or measuring relevant qualities of relevant subject matter elements. Evaluation involves comparing the particular way in which a subject matter element exhibits a relevant quality with benchmarks that represent the known ways in which that quality can be exhibited. Those benchmarks are defined by the criteria. Such a comparison yields a classification of the subject matter element elements, by reference to the known ways in which the quality can be exhibited. Such a classification provides information about the qualities of the subject matter elements evaluated or measured, which could be answers to the types of questions about such elements referred to in the preceding paragraph.

36. Measurement is a special case of evaluation, in which the benchmarks used are standardized quantities or measures. In other cases, the benchmarks for evaluation are given category labels, such as letters, numbers, nouns, adjectives or adverbs. Some such non-quantitative benchmarks have no natural ordering (e.g., red, blue, yellow), whilst others may have different degrees of natural ordering (e.g., small, medium, large).

37. When making a measurement, the measuring instrument may be physical (a meter) or a defined process. In either case, the instrument must be aligned with the standardized measure (a process known as calibration).

38. There are different types of standardized measures but they are all based on a clearly specified point of reference, which has a defined relationship to a unit of measurement that is sufficiently precise for its purpose. For physical qualities, like length and time, the point of reference is usually a reference example of the quality that can be observed consistently in a well-defined particular subject matter element, in well-defined circumstances (e.g. a meter of length is defined as the distance travelled by light in a vacuum, in a specified fraction of a second of time).

39. In other circumstances, the quality to be measured may be a concept that is not directly observable or measurable. This is often the case in the fields of social and economic knowledge (e.g. intelligence is a quality that cannot be observed or measured directly, and economic value is not always observable or measurable directly).

40. In such cases, a generally accepted measurement model is needed, which may be used to measure the benchmarks or the way the quality is exhibited by a particular subject matter element. Such a model is generally based on a well-defined concept that defines observable indicators of the quality, standards for the measurement or evaluation of such indicators, and a mathematical or logical process that generates repeatable measures when applied.

EXAMPLE

Intelligence tests are designed to obtain measures of indicators of the quality 'intelligence'. Standard measures of intelligence are defined by sufficiently precise estimates of the distribution of measures of individual intelligence across a relevant population. These estimates are inferred from the results (scores) of a defined intelligence test (measuring instrument) taken by a sufficiently large sample of members of the population.

Accounting values are measured in currency units, but currency units may be used to measure different concepts of value. The benchmarks used for accounting value measurements that are not directly observable may be values that can be observed in historical outcomes of similar items, in defined circumstances that correspond with the accounting value concept being used (the measurement basis). Those benchmarks may be used to calibrate a defined measurement model (method) that uses data and assumptions about defined indicators of the accounting value (valuation attributes) and a defined process (method) to make measurements of the defined accounting value.

41. In practice, measurement instruments have an inherent limit of precision in their ability to discriminate differences in measures. The limit of precision possible is established by the smallest difference in quantity that can be discriminated using the instrument. For example, on a meter or ruler the smallest measurement that can be discriminated is determined by the closeness of the hatch marks. When the measurement instrument is a process, the degree of precision will be affected by inherent limitations in available data and knowledge to make measurements, which requires the use of assumptions.

'Materiality Processes'

Introduction and Context

42. Chapter 8 of the draft guidance explains how a practitioner may consider the entity's 'materiality process'. This section provides further information about how the preparer may approach undertaking a 'materiality process' to illustrate what the practitioner may expect when they come to review a 'materiality process'.

43. Undertaking a 'materiality process' may be a difference between preparing EER and preparing traditional financial reporting. In the latter, evaluating which topics and related subject matter elements are to be included in the EER report is straightforward as the financial reporting frameworks (e.g. IFRS) substantively address it by specifying the underlying subject matter and its elements and their qualities to be reported. This is widely understood by preparers, users and practitioners. The relevant subject matter elements and their relevant qualities are generally less comprehensively specified by EER frameworks and entities therefore have to develop their own processes to determine these matters and develop criteria.

44. It is principally the preparer's responsibility (as the measurer / evaluator) to determine what subject matter elements are relevant to include in the EER report, and what information about those content elements is included. In fulfilling its responsibilities for the subject matter information, in its roles as responsible party and as measurer or evaluator, the preparer may undertake some form of 'materiality process' to achieve this[3]. The degree of formality (including the extent to which it is documented) of the process may depend on the nature and size of the entity, the nature of the subject matter and the degree to which the EER framework addresses such considerations.

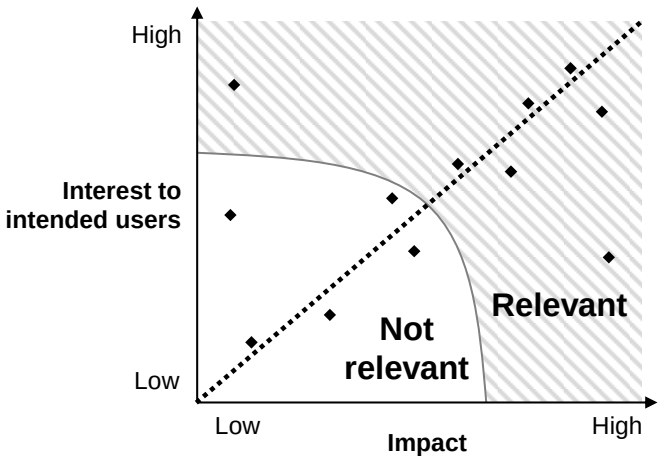
The Preparer's 'Materiality Process'

45. The starting point for the preparer's process to determine the content of their EER report may be the EER framework(s) being adopted. EER frameworks may specify the underlying subject matter and the criteria to varying degrees, and may specify, or be based on assumptions about who the intended users are[4]. EER frameworks differ widely in this respect. For example, an EER framework such as the <IR> framework only gives a high-level indication of the 'capitals' which may be relevant to the entity's creation of value and specifies broad 'content elements'. Others, for example SASB's standards, provide much more granular criteria for underlying subject matter and subject matter information for entities in specific industries based on what the EER framework-setter considers is likely to be relevant for specified groups of intended users.

46. In the suggested approach for practitioners in Chapter 8, step 2 suggests how the relevance of something could be assessed by considering its level of interest of intended users or its impact. Some preparers may choose to display the results of these approaches on a scatterplot:

[3] Refer to ISAE 3000 (Revised) paragraph A39.

[4] Some EER frameworks (for example, the GRI standards) consider the whole of society across the world to be the intended users.



47. This is a commonly used approach in practice, although there are slight differences between the approaches suggested by some of the commonly used EER frameworks. These are discussed below.

48. In a theoretical scenario where the interest of intended users in something was only affected by an accurate understanding of its expected impact, there would be a perfect correlation with all items plotted along the dotted x=y line. In reality some anomalies may well be expected, perhaps where intended users are considering different timescales, or where intended users are particularly sensitive to an issue by its nature (and therefore they have a high level of interest in it, for example executives' remuneration) even if the impact is not correspondingly high.

49. For many EER frameworks, for example the <IR> framework, 'impact' is considered to be the impact on the entity itself. This is common where the intended users are direct or indirect financial stakeholders (for example shareholders and lenders). An alternative approach, for example that included in the GRI standards, is to consider the impact on others, wider society and the environment.

50. The scatterplot suggests a topic or related element might be considered relevant if it had a high 'impact' but was of low 'interest to intended users'. This may represent a common reality where intended users have imperfect or incomplete information about the entity and are not fully aware of the high impact topic or related element. Alternatively, the time horizon of interest to intended users may be different to that of the entity or its management causing there to be a disconnect between the level of 'impact' and 'interest to intended users'.