

Chapter 1

WHAT IS ASSURANCE?

1. Audit and assurance

It is often not possible to check things for yourself, whether quality, accuracy, performance or existence.

You might not have the skills or the time, or you might be in the wrong location. Therefore you must rely on someone else to give you assurance. This means you have to decide:

- What standards should be applied?
- What represents 'good', 'acceptable' or 'unacceptable'?
- How much checking should be done? All checking and assurance has an associated cost

Audit is one form of assurance.

An audit is defined as: the independent examination of and expression of opinion on the financial statements of an entity by a duly appointed auditor in pursuit of that appointment.

The important words here are 'independent' and 'opinion'.

Independence is essential and underlies the value of auditing.

Opinion really means that one auditor could look at a set of financial statements and disagree with the opinion of another auditor.

Judgment is essential to all auditing, there are no certainties and there are no certifications of correctness or accuracy.

2. Elements of an assurance engagement

The following are the five elements of an assurance engagement:

- (1) A three party relationship involving a practitioner, a responsible party, and intended users.
- (2) Appropriate subject matter.
- (3) Suitable criteria.
- (4) Sufficient appropriate evidence.
- (5) A written assurance report in the form appropriate to a reasonable assurance engagement or a limited assurance engagement.



2.1 Three party relationship

A three party relationship involving a practitioner, a responsible party, and intended users:

- Practitioner: for example an auditor. The practitioner is responsible for determining the nature, timing and extent of procedures and is required to pursue anything that leads the practitioner to question whether a material modification should be made to the subject matter information.
- A responsible party: the person responsible for the information and assertions.
- The intended users are the person(s) for whom the practitioner prepares the assurance report. The responsible party can be one of the intended users.

2.2 Appropriate subject matter

The subject matter can take many forms, such as:

- Financial performance
- Non-financial performance, for example the key indicators of efficiency and effectiveness.
- Physical characteristics, for example, the capacity of a facility.
- Systems and processes, for example, an entity's internal control or IT system.
- Behaviour, for example, corporate governance, compliance with regulation.

2.3 An appropriate subject matter is:

- Identifiable, and capable of consistent evaluation or measurement against the identified criteria; and
- Such that the information about it can be subjected to procedures for gathering sufficient appropriate evidence.

2.4 Criteria

Criteria are the benchmarks used to evaluate or measure the subject matter.

For example:

- When reporting on financial statements, The International Financial Reporting Standards.
- When reporting on internal control, the criteria may be an established internal control framework.
- When reporting on compliance, the criteria may be the applicable law, regulation or contract.

Without the frame of reference provided by suitable criteria, any conclusion is open to individual interpretation and misunderstanding.

Suitable criteria exhibit the following characteristics:

- **Relevance:** relevant criteria contribute to conclusions that assist decision-making by the intended users.
- **Completeness:** criteria are sufficiently complete when they include all relevant factors that could affect the conclusions.



- Reliability: reliable criteria allow reasonably consistent evaluation of the subject matter.
- Neutrality: neutral criteria so that conclusions that are free from bias.
- Understandability: conclusions that are clear, comprehensive, and not subject to significantly different interpretations.

The evaluation or measurement of a subject matter on the basis of the practitioner's own expectations, judgments and individual experience would not constitute suitable criteria.

Criteria need to be available to the intended users to allow them to understand how the subject matter has been evaluated or measured.

2.5 Evidence

The practitioner plans and performs an assurance engagement with an attitude of professional scepticism to obtain sufficient appropriate evidence about whether the subject matter information is free of material misstatement. An attitude of professional scepticism means the practitioner questions the validity of evidence and is alert to evidence that brings into question the reliability of documents or representations.

Scepticism means that you don't know. It does not mean that the practitioner assumes everyone is dishonest or that figures have been deliberately misrepresented. Nor does it mean that you believe all figures are statements are correct. It means you are aware that we can all be subject to optimism (perhaps too much), human error, giving quick answers because we are short of time, misunderstanding. It also recognises that sometimes people are deliberately misleading or dishonest.

Scepticism means that evidence is required to test statements or assumptions. You could almost summarise the process of assurance in the phrase 'collect evidence that supports everything that is being claimed'.

Sufficiency is the measure of the quantity of evidence. Appropriateness is the measure of the quality of evidence - its relevance and its reliability.

The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained, eg documentary evidence is better than oral, directly obtained evidence better than evidence provided by a client.

2.6 Assurance Report

The practitioner provides a written report containing a conclusion.

In a reasonable assurance engagement the practitioner's conclusion is worded in the positive form, for example: "In our opinion internal control is effective, in all material respects, based on XYZ criteria."

In a limited assurance engagement the conclusion is worded in the negative form, for example, "Based on our work described in this report, nothing has come to our attention that causes us to believe that internal control is not effective, in all material respects, based on XYZ criteria."



2.7 Positive and negative assurance

Examples:

Positive

- The financial statements show a true and fair view
- The value of amount of inventory lost is \$x

Negative

- We have discovered nothing wrong with the financial statements
- The basis of the forecast is not unreasonable
- There is no evidence of discrimination in the appointment.

All statutory audits attempt to provide positive assurance ie the financial statements show a true and fair view. There are some types of assurance assignment where giving a positive assurance is not possible. For example, it would be impossible to give assurances that a budget is correct because it depends on so many assumptions and factors that cannot be verified with certainty, such as the state of the economy next year, competitors' plan and sales forecasts.

Positive assurance is also known as **reasonable assurance** because even there practitioners will only offer reasonable assurance that the financial statements are free of material misstatement.

Negative assurance is also known as **limited assurance**.

A practitioner would not express an unqualified conclusion for either type of assurance engagement when:

There is a limitation on the scope of the practitioner's work ie sufficient appropriate evidence cannot be obtained; or

The assertion is not fairly stated, and the subject matter information is materially misstated (ie the assertion is incorrect).

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