Audit, Business Processes and Digitalization [BL 5]

Business Level II | CA Sri Lanka

Study Text

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D.1: Introduction to Assurance Engagements

Accountants in professional practice and also internal auditors undertake assurance engagements. An audit is one type of assurance engagement. This chapter explains the concept and nature of assurance, and situations in which assurance services are provided by practicing accountants

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D.1.1. Definition of assurance engagements

An assurance engagement is an engagement in which a practitioner (accountant) expresses an opinion or conclusion about a subject matter by applying certain criteria.

The opinion is provided to an intended user about information provided by another person (a 'responsible party')

A definition of an assurance engagement, based on the International Auditing and Assurance Standards Board (IAASB) International framework for assurance engagements, is as follows

An assurance engagement is an engagement:

- A practitioner (accountant in practice) expresses a conclusion
- Which is intended to enhance the degree of confidence of intended users
- About information on a subject matter ('the evaluation or measurement of a subject matter')
- That has been produced by applying certain criteria to the subject matter
- The information has been produced by someone who is not the intended user of the information

An external annual audit of the financial statements is one type of assurance engagement, and it may help to explain this definition of an assurance engagement in terms of an audit engagement. An external audit is an engagement in which a qualified practitioner expresses an opinion to the shareholders of a company about financial statements that have been produced by the company

D.1.2. Objectives of an assurance engagement

An assurance engagement provides either reasonable or limited assurance to the intended user

The objective of an assurance engagement is to provide assurance to the intended user of the information. Assurance may be either of the following:

- ✓ Reasonable
- ✓ Limited

Reasonable assurance

Reasonable assurance is a fairly high level of assurance, but it is not 100% absolute assurance

With reasonable assurance, the practitioner reduces the risk of expressing an incorrect opinion to an acceptably low level. By reducing the risk of an incorrect opinion to such a low level, the practitioner is able to express their opinion in a positive form

In order to give reasonable assurance, a significant amount of testing and evaluation is required to support the positive conclusion, such as the opinion given in the auditor's report on the financial statements

Limited assurance

Limited assurance is a lower level of assurance than reasonable assurance. It allows for a lesser amount of testing and evaluation. As a consequence, there is a greater risk ('assurance engagement risk') that the auditor may give an incorrect opinion

Because the risk of an incorrect opinion is greater than with a reasonable assurance engagement, the practitioner does not express their opinion in a positive form. Instead, the practitioner presents their conclusion with a negative form of expression

Reasonable and limited assurance	
Reasonable assurance	**Limited assurance**
An audit gives the reader **reasonable assurance** on the truth and fairness of the financial statements, which is a high, but not absolute, level of assurance. The auditor's report does not guarantee that the financial statements are correct, but that they are true and fair within a reasonable margin of error.	**Limited assurance** is a lower level of assurance than reasonable assurance. It reflects the limited amount of testing and evaluation possible, and the greater risk of the auditor opinion being incorrect.

Types of limited assurance engagement Limited assurance engagements do not have to relate to financial reports or accounting figures. They may relate to non-financial information, systems, controls and practices. Here are some examples

Subject of limited assurance engagement	
Prospective/future financial information	An assurance practitioner may be asked to report on a financial forecast that has been prepared by a company. It is not possible to perform a reasonable assurance engagement on information about the future.
Non-financial information	A limited assurance engagement may relate to non-financial information and key performance indicators reported by a company about non-financial aspects of performance.
Human Resource practices	An assurance practitioner may be engaged to provide an opinion on a statement or report by a company on its Human Resource practices.
Internal controls	A limited assurance engagement may report on information prepared by a company about its internal controls or internal control system.
Sustainability	Increasingly, stakeholders are interested in the sustainability of an organisation in terms of results and the impact on the environment. An assurance practitioner may be required to report on this.

Greenhouse gas emissions	An assurance practitioner may be engaged to provide an opinion on a statement or report by a company on its greenhouse gas emissions.
Corporate governance practices	An assurance practitioner may be asked to report on a statement by a board of directors about their compliance with a code of corporate governance.
IT systems	A company may issue a statement or report about one or more of its IT systems or practices, and an assurance practitioner may be asked to produce a limited assurance report on this statement or report.

Notice that a feature of a limited assurance engagement is that a report or statement is prepared by one party, typically a company, with the intention of presenting it to intended users of the information in the report. The assurance practitioner gives an opinion about the information produced by the preparer, to provide assurance (limited assurance) to its intended users

D.1.3. Elements of an assurance engagement

There are five key elements in an assurance engagement: a three-party relationship, a subject matter, suitable criteria, sufficient evidence to reach an opinion and a report

Element of assurance engagement	
There is a three-party relationship	The three parties are: • The intended user of the information • The accountant (practitioner) • The person providing the information (the responsible party)

Element of assurance engagement	
Subject matter	The assurance engagement relates to a subject matter. This is the data to be evaluated. It has been prepared by the responsible party. It can take many forms including financial performance (eg historical financial information), non-financial performance (eg key performance indicators), processes (eg internal control) and behaviour (eg compliance with laws and regulations).
Suitable criteria	The subject matter is evaluated or measured against criteria in order to reach an opinion. These criteria will depend on the nature of the subject matter.
Evidence	Sufficient appropriate evidence needs to be gathered to support the required level of assurance.
Assurance report	The practitioner presents their conclusion or opinion in an assurance report to the intended user.

One way to remember these five elements of an assurance engagement is using the mnemonic CREST.

C. Criteria

R. Report

E. Evidence

S. Subject matter

T. Three-party relationship

Objectives and scope of an assurance engagement

The objective of an assurance engagement is for the practitioner to provide either reasonable assurance or limited assurance on the subject matter.

The scope of the engagement – how much investigation work the practitioner undertakes – depends on both the subject matter and the level of assurance required. A limited assurance engagement has a narrower scope than an audit of the same subject matter

Three-party relationship

Every assurance engagement, whether a reasonable or a limited assurance engagement, involves three parties:

- ✓ Intended users. These are the person, persons or class of persons for whom the practitioner prepares the assurance report.
- ✓ The responsible party is the person (or persons) responsible for the subject matter (in a direct reporting engagement) or subject matter information of the assurance engagement. This is usually a company that engages the assurance practitioner to carry out an assurance engagement.
- ✓ The practitioner is the individual providing professional services that will review the subject matter and provide the assurance

Appropriate subject matter

The Sri Lanka Framework for Assurance Engagements states that an assurance engagement must have appropriate subject matter. Appropriate subject matter for an assurance engagement should be:

- ❑ Identifiable. It must also be capable of consistent measurement or evaluation against the criteria that have been identified for the engagement
- ❑ Collectable. It must be possible to subject information relating to the subject matter to procedures for gathering, so that sufficient appropriate evidence can be obtained for the purpose of the assurance engagement

Suitable criteria

Criteria are the benchmarks that are used to evaluate or measure the subject matter of the assurance engagements. The assurance practitioner provides assurance about the subject matter that has been prepared by relating it to the agreed criteria for the assurance engagement

The criteria for an assurance engagement must be clearly specified. They should have the following characteristics:

- ✓ Relevance: they should be relevant to the purpose
- ✓ Completeness
- ✓ Reliability
- ✓ Neutrality (freedom from bias)
- ✓ Understandability

Sufficient and appropriate evidence

An assurance practitioner reaches an opinion on the basis of the evidence that they are able to gather. The evidence available to the assurance practitioner must be sufficient and appropriate, to enable the practitioner to reach their professional judgement about the subject matter

- ✓ Sufficiency means that there should be a large enough quantity of evidence
- ✓ Appropriate means that the evidence must be of a sufficient quality: the evidence must be relevant and reliable

Reliability of evidence	
Source of evidence	Evidence is more reliable when it comes from an independent source than when it comes from the preparer of the information.
Obtained directly by the practitioner	Evidence is more reliable when it is gathered directly by the assurance practitioner (for example, by observation of a procedure or control) than when it is obtained indirectly (for example, by inquiry).
Documentary form	Evidence is more reliable when it is in documentary form than when it is in verbal form.
Original copies	Evidence provided by original documents is more reliable than evidence from photocopies or other forms of copy.

Engagements that are not assurance engagements: related services

Assurance practitioners may carry out services for a client which are not assurance engagements. The characteristics of an assurance engagement have been explained, and a related service is an engagement that does not have all these characteristics

- **Agreed-upon procedures** are engagements involving a client and the practitioner. SLSRS 4400 Engagements to perform agreed-upon procedures regarding financial information provides guidance for accountants carrying out agreed-upon procedures and sets out the objective of such an engagement
- **Compilation work** where the practitioner is engaged to put together (compile) information for the client. An example of this is tax work, where a practitioner may be asked to put together the information that the client needs to submit a tax return to the tax authorities

D.1.4. Types of assurance engagement

The objective of an assurance engagement is to provide either reasonable assurance or limited assurance. The scope of an assurance assignment depends on the subject matter as well as the level of assurance required

There are different types of assurance engagement, ranging from external audits to review engagements. Sometimes, the terms 'audit' and 'assurance' are used to describe different types of engagement. When this distinction is made, 'audit' refers to an engagement where the auditor gives an opinion that expresses reasonable assurance, and an 'assurance engagement' is one where the practitioner gives an opinion that expresses limited assurance.

However, it is probably better to think of assurance engagements as a general term for any engagement in which a practitioner is required to give an opinion. Using this definition, assurance engagements include both audits and review engagements

Comparison of audit and review engagements

'Assurance' means the practitioner's satisfaction as to the reliability of the assertion made by one party for use by another party

Directors prepare financial statements for the benefit of shareholders. They assert that the financial statements give a true and fair view. The auditors provide assurance on that assertion.

To provide such assurance, the auditors must:

- Assess the assurance risk
- Plan audit procedures that will be sufficient to reduce the assurance engagement risk to a level where reasonable assurance can be provided
- Conduct audit procedures
- Assess the results
- Express an opinion, giving reasonable assurance – an opinion expressed in a positive form

External audit	Review engagement
An external audit can be used to give assurance to a variety of stakeholders on many issues. However, an audit is an exercise designed to give a high level of assurance and involves a high degree of testing and so a high cost.	In some cases, the intended users may find that they receive **sufficient assurance** about an issue from a less detailed engagement, such as a **review**. A review can provide a cost-efficient alternative to an audit where an audit is not required by law.
The auditor provides a high, but not absolute, level of assurance that the information audited is free of material misstatement. This is expressed positively in the audit report as **reasonable assurance**.	The auditor provides a limited level of assurance that the information subject to review is free of material misstatement. This is expressed in the form of **negative assurance**.

Engagement	Type of assurance provided	Example
External audit	Reasonable	Statutory external audit
Review	Low level	Review of interim financial statements

D.1.5. Review engagements

External audits are reasonable assurance engagements. Review engagements are usually limited review engagements

A review engagement may require a practitioner to provide limited assurance about the information contained in financial statements.

The objective of a review engagement is to enable a practitioner to state whether:

- On the basis of procedures which do not provide all the evidence that would be required in an audit
- Anything has come to the practitioner's attention
- That causes the practitioner to believe that the financial statements are not prepared, in all material respects, in accordance with an applicable financial reporting framework

Types of review engagements

Review engagement	
Attestation engagement Attestation means confirming that something is correct or true. In an attestation engagement, the accountant declares that a given premise is either correct or is not correct.	An example: the accountant is asked to **review interim financial information**. In such an engagement, the auditor is asked to attest assertions made in the financial information, such as: • The accounting policies used are consistent with those used in the prior year accounts • No material modifications to the interim financial information are required
Direct reporting engagement The accountant provides a report on issues that have come to their attention during the course of a review into a subject matter.	An example is a '**due diligence**' engagement. When a company (Company A) is negotiating the takeover of another company (Company B), Company A may engage a firm of accountants to perform an assessment of the material risks associated with the transaction, to ensure the acquirer has all the necessary facts. This is important when determining the purchase price for acquiring Company B. The accountant carries out a due diligence investigation of Company B.

D.1.6. Internal audit

Assurance engagements are also undertaken by internal auditors. Internal auditors are usually employees of the company, but should remain as objective as possible.

Internal auditors help with the monitoring and review of the internal control system. As such, they are part of the internal control system

Internal audit function

Internal audit is an appraisal or monitoring activity established by an organization to carry out assurance engagements on behalf of management, the board of directors or the audit committee. The role of internal auditors includes examining, evaluating and monitoring the adequacy and effectiveness of internal control

Larger organizations may therefore appoint full-time staff whose function is to monitor and report on the running of the company's operations. Some of the work carried out by internal auditors is similar to that performed by external auditors; however, there are important distinctions between the two functions in terms of their responsibilities, scope and relationship with the company

Internal audit assignments

There are a number of different types of assignment that may be carried out by internal auditors. These could be either reasonable assurance or limited assurance engagements

Internal audit assignment	
Value for money (VFM) audit	This examines the **economy**, **efficiency** and **effectiveness** of an activity or business process. VFM audits include investigation of operational controls.
Information technology (IT) audit	This is an investigation of IT controls in a specific area of the business. An audit may investigate general controls or may be an audit of a specific IT application. It is likely to be necessary to have an IT specialist in the internal audit team to undertake an audit of the controls, as some of them will be programmed into the computer system.
Financial audit	This is similar to an audit by the external auditors. However, it is not a legal requirement, and internal auditors report to management or the audit committee, not the shareholders.
Operational audit	Operational audits are audits of the operational processes of the organisation. They are also known as management or efficiency audits. Their prime objective is the monitoring of management's performance, ensuring company policy is adhered to.
Procurement audit	This is an investigation into the procurement cycle, including its internal controls.

D.1.7. Value for money audits

Value for money (VFM) audits are investigations into a business process or activity to check for the three Es

Value for money (VFM) audits examine the economy, efficiency and effectiveness of activities and processes. These are known as the three Es of VFM audits.

(a) Economy means obtaining the appropriate quantity and quality of physical, human and financial resources (inputs) at lowest cost. An activity would not be economical if, for example, there is over-staffing or failure to purchase materials of requisite quality at the lowest available price
(b) Efficiency is the relationship between goods or services produced (outputs) and the resources used to produce them. An efficient operation produces the maximum output for any given set of resource inputs, or it has minimum inputs for any given quantity and quality of product or service provided
(c) Effectiveness is concerned with how well an activity is achieving its policy objectives or other intended objectives[

An illustrative list is shown below of the sort of spending areas that might be looked at, and the aspects of spending where value for money might be improved.

- Employee expenses
- Premises expenses
- Suppliers and services
- Establishment expenses
- Capital expenditure

D.1.8. Internal auditors and financial audit

The financial audit is a traditional role for internal auditors. It involves reviewing all the available evidence to substantiate information in management reporting and financial reporting. The procedures and tests used by external auditors are also used by internal auditors

The importance of controls in preventing financial reporting errors mean that it is necessary to review certain areas regularly, to ensure that the relevant controls continue to be in place. Many internal audit functions therefore adopt a cycle approach to financial internal audit engagements, auditing different aspects of the financial system in an ongoing cycle of audits, to ensure each area is reviewed on a regular basis

D.1.9. Assurance and reports

An auditors' report on a company's annual financial statements is expressed in terms of truth and fairness. This is generally taken to mean that the financial statements:

- ✓ Are factual
- ✓ Are free from bias
- ✓ Reflect the commercial substance of the transactions of the business

Truth and fairness

Below is an example of an auditor's report on an entity's financial statements. This is a report with an unmodified opinion (which means the financial statements are true and fair and properly prepared)

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC PLC

Report on the Audit of the Financial Statements

Opinion

We have audited the financial statements of ABC PLC, which comprise the statement of financial position as at 31 December 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements present fairly, in all material respects, (or **give a true and fair view of**) the financial position of the Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with Sri Lanka Accounting Standards (LKAS).

Basis for Opinion

We conducted our audit in accordance with Sri Lanka Auditing Standards (SLAuS). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ***Institute of Chartered Accountants of Sri Lanka Code of Ethics*** (CASL Code) together with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements and the CASL Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with SLAuS 701, which applies to audits of the financial statements of listed entities.]

Other Information

Management is responsible for the other information. The other information comprises the information included in the X report, but does not include the financial statements and our auditor's report thereon.

Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

Responsibilities of Management and Those Charged with Governance for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with Sri Lanka Accounting Standards and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SLAuS will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with SLAuS, we exercise professional judgment and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.

- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Report on Other Legal and Regulatory Requirements

[*The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities prescribed by local law, regulation, or national auditing standards.*]

The engagement partner on the audit resulting in this independent auditor's report is [name].

[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]

[Auditor Address]

[Date]

(The above is taken from SLAuS 700 (Revised))

D.1.10. Auditing standards

Sri Lanka Auditing Standards (SLAuS) are published by the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka)

Readers want assurance when making comparisons that the reliability of the financial statements does not vary from company to company. This assurance will be obtained not just from knowing that each set of financial statements has been audited, but also from knowing that this has been done to common standards

Hence there is a need for audits to be regulated so that auditors follow the same standards. Auditors have to follow rules issued by a variety of bodies. Some obligations are imposed by governments in law or statute. Some obligations are imposed by the professional bodies to which auditors are required to belong, such as the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka).

Sri Lanka Auditing Standards (SLAuS) are produced by CA Sri Lanka and are based on the International Standards on Auditing (ISAs) produced by the International Auditing and Assurance Standards Board (IAASB), a technical standing committee of International Federation of Accountants (IFAC), which also issues standards relating to review engagements, other assurance engagements, quality control and related services

Chapter review questions

1. Complete the definition of an audit:

   The objective of an audit of financial statements is to enable the auditor to _______ an ________ on whether the financial statements are prepared, in all _________ respects, in accordance with an identified financial reporting framework

2. Link the correct definition to each term.

   Terms:
   (i) Accountable (iv) True (ii) Steward (v) Fair (iii) Agent (vi) Materiality

   Definitions:

   (a) An expression of the relative significance or importance of a particular matter in the context of the financial statements as a whole.
   (b) A person employed to provide a particular service.
   (c) Factual and conforming to reality. In conformity with relevant standards and law and correctly extracted from accounting records.
   (d) A person employed to manage other people's property.
   (e) Free from discrimination and bias and in compliance with expected standards and rules. Reflecting the commercial substance of underlying transactions.
   (f) Being required or expected to justify actions and decisions

3. What level of assurance is provided by a review engagement?

4. Which of the following assurance engagements provides the highest level of assurance?

- ❑ External audit
- ❑ Review engagement

5. What are the three Es of a VFM audit?

6. Which two of the following statements are true?

   (a) The IAASB publishes Sri Lanka Auditing Standards (SLAuS).
   (b) In an agreed-upon procedures engagement the auditor expresses assurance based on the procedures carried out.
   (c) SLAuS give users of the financial statements comfort that common standards have been used when comparing two audit reports on the financial statements of two different companies.
   (d) An unmodified audit opinion means users of the financial statements can assume they are free from any errors
   (e) Compilation work does not involve providing assurance