chapter 1

Concept of and need for assurance

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Learning objectives

- Understand the concept of assurance
- Recognise the criteria which constitute an assurance engagement
- Recognise subject matter suitable to be the subject of an assurance engagement
- Understand the different levels of assurance that can be provided in an assurance engagement, including reasonable assurance
- Understand the meaning of ‘a true and fair view’
- Understand the need for professional accountants to carry out assurance work in the public interest
- Understand why users desire assurance reports and recognise examples of the benefits gained from them
- Compare the functions and responsibilities of the different parties involved in an assurance engagement
- Understand the issues which can lead to gaps between the outcomes delivered by the assurance engagement and the expectations of users of the assurance reports
- Identify how these ‘expectations gaps’ can be overcome

Specific syllabus references for this chapter are: 1a, b, c, d, e, h.

Practical significance

Users of financial and non-financial information want to have confidence that the information they are using is reliable and that they can draw valid conclusions as a result of it. They want assurance about the quality of the information they are using to make decisions. Provision of assurance services is therefore a very important area of business for accountants. Accountants are able to provide assurance on a range of matters because they are skilled business professionals. As accountants are subject to strict ethical codes, they are perceived to be trustworthy, and therefore users of information believe that the assurance they give can be trusted.

Some forms of assurance are required by law in many countries. For example, in the EU, all but the smallest companies must have an annual audit of their financial statements. An audit is a high level of assurance service which we will introduce in this syllabus and look at in more detail in your later studies.

Stop and think

What other information (financial and non-financial) might users want assurance in relation to?

Working context

As an audit is a legal requirement for many companies, many of you are likely to carry out a lot of your practical training in audit. You will also focus on audit when you come to study for the Audit and Assurance paper at the Application stage of the exams. The broad principles of assurance services can be applied to many different engagements which may be carried out by your firm.
Syllabus links

You have studied the basic books, records and financial statements of a company in the Accounting paper. It is in relation to these records that the auditor will seek evidence to be able to give assurance.

As already mentioned, audit is a key form of assurance and you will be able to apply the basic principles learnt in this paper to that form of assurance service both here and in the Audit and Assurance Paper.
Exam requirements

It is crucial to the whole syllabus that you understand the concept of assurance, why it is required and the reason for assurance engagements being carried out by appropriately qualified professionals. You can therefore expect to see questions in the exam testing your understanding of the definition of assurance and the different levels of assurance.

In the sample paper, the first five questions relate to the subject matter you will cover in this chapter.

In the assessment, candidates may be required to:

- Describe the concept of assurance
- State the benefits of an assurance report
- Compare the functions and responsibilities of the different parties involved in an assurance engagement
- Describe the levels of assurance obtained from different types of assurance engagement
- Describe the concept of the ‘expectations gap’
What is assurance?

1.1 Definition (parties, subject matter, criteria)

Definition

An assurance engagement is one in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

The key elements of an assurance engagement are as follows:

- Three people or groups of people involved
  - The practitioner (accountant)
  - The intended users
  - The responsible party (the person(s) who prepared the subject matter)

- A subject matter
  As we shall see below, the subject matter of an assurance engagement may vary considerably. However, it is likely to fall into one of three categories:
  - Data (for example, financial statements or business projections)
  - Systems or processes (for example, internal control systems or computer systems)
  - Behaviour (for example, social and environmental performance or corporate governance)

- Suitable criteria
  The person providing the assurance must have something by which to judge whether the information is reliable and can be trusted. So for example, in an assurance engagement relating to financial statements, the criteria might be accounting standards. The practitioner will be able to test whether the financial statements have been put together in accordance with accounting standards, and if they have, then the practitioner can conclude that there is a degree of assurance that they are reliable.

  In the context of company behaviour, suitable criteria to judge whether something is reliable and can be trusted might be the Combined Code on Corporate Governance, or, if the company has one, its published Code of Practice.

- Sufficient appropriate evidence to support the assurance opinion
  The practitioner must substantiate the opinion that he draws in order that the user can have confidence that it is reliable. The practitioner must obtain evidence as to whether the criteria have been met. We will look at the collection of evidence in detail later in this Study Manual.
A written report in appropriate form

Lastly, it is required that assurance reports are provided to the intended users in a written form and contain certain specified information. This adds to the assurance that the user is being given, as it ensures that key information is being given and that the assurance given is clear and unequivocal.

**Worked example: Assurance engagement**

In order to demonstrate these elements of an assurance engagement, the Worked example is that of a house purchase. Imagine you are buying a house. There are certain issues you would want assurance about, particularly whether the house is structurally sound. In this situation, you would be unlikely just to trust the word of the person who was selling the house but would seek the additional assurance of a qualified professional, such as a surveyor.

You should already be able to see the first key element of an assurance engagement, which is the involvement of three people:

- You (the intended user)
- The house owner (the responsible party)
- The surveyor (the practitioner)

The subject matter of this assurance engagement is the house in question. The surveyor will visit the house to test whether it is sound and will draw a conclusion.

The surveyor will judge whether the house is sound in the context of building regulations, planning rules and best practice in the building industry. These are the criteria by which he will judge whether he can give you assurance that the house is structurally sound.

In order to make a conclusion, the surveyor will obtain evidence from the house (for example, by looking for damp patches and making inspections of key elements of the house).

Lastly, when he has drawn a conclusion, the surveyor will issue a report to you, outlining his opinion as to whether the house is sound or not. This report will contain any limitations to his work, for example, if he was unable to access any of the property or he was unable to lift fitted carpets to inspect the floor underneath them.

Ultimately, when you have read the surveyor’s report, you will have more assurance about the state of the property, and correspondingly, more confidence to pay the deposit, take out a mortgage and buy that house.

**Interactive question 1: Assurance engagement**

You are an accountant who has been approached by Jamal, who wants to invest in Company X. He has asked you for assurance whether the most recent financial statements of Company X are a reliable basis for him to make his investment decision.

Identify the key elements of an assurance engagement in this scenario, if you accepted the engagement.

See **Answer** at the end of this chapter.

**1.2 Levels of assurance**

The definition of an assurance engagement given above is taken from the International Framework for Assurance Engagements, which is issued by the International Federation of Accountants (IFAC), a global organisation for the accountancy profession, which works with its member organisations to protect the public interest by encouraging high quality practices around the world. ICAEW is a member of IFAC.
The UK’s Auditing Practices Board has adopted International Standards on Auditing (ISAs), some of which you will be introduced to in this Study Manual. However, the UK has not currently adopted the general international standards on assurance provision, and the international framework although these represent good practice anywhere in the world and some of the detail concerning assurance services you learn will be based on these standards.

The Framework identifies two types of assurance engagement:

- Reasonable assurance engagement
- Limited assurance engagement

### Definition

**Reasonable assurance**: A high, but not absolute, level of assurance.

The reason that there are two types of assurance engagement is that the level of assurance that can be given depends on the evidence that can be obtained by the practitioner. Using the surveyor example above, a surveyor can only give assurance that a property is structurally sound if he is allowed to enter the property to inspect it. If he is only given access to part of the building, he can only give limited assurance.

The key differences between the two types of assurance engagement are therefore:

- The evidence obtained
- The type of opinion given

We shall look in detail at obtaining evidence later in this Study Manual. The key point about evidence is that in all assurance engagements, sufficient, appropriate evidence must be obtained. We will look at what constitutes sufficient, appropriate evidence as we go through the course. What determines whether evidence is sufficient and appropriate is the level of assurance that the practitioner is trying to give, so it is tied in with the type of opinion being given, which we shall look at here. In summary, a lower level of evidence will be obtained for a limited assurance engagement.

The opinion given in an assurance engagement therefore depends on what type of engagement it is. As noted above, there are two levels of assurance expressed positively and negatively.

Say, for example, that a practitioner is seeking evidence to conclude whether the report issued by the Chairman of a company in the financial statements is reasonable or not. He could seek evidence, conclude that the statement is reasonable and state in a report something like this:

‘In my opinion, the statement by the Chairman regarding X is reasonable’.

This is a positive statement of his conclusion that the statement is reasonable. Alternatively, he could state in a report something like this:

‘In the course of my seeking evidence about the statement by the Chairman, nothing has come to my attention indicating that the statement is not reasonable.’

This conclusion is less certain, as it implies that matters could exist which cause the statement to be unreasonable, but that the practitioner has not uncovered any such matters. This is therefore called negative assurance. It is the conclusion that a practitioner gives when he carries out a limited assurance engagement and seeks a lower level of evidence.

### SUMMARY OF TYPES OF ENGAGEMENT

<table>
<thead>
<tr>
<th>Type of engagement</th>
<th>Evidence sought</th>
<th>Conclusion given</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reasonable assurance</td>
<td>Sufficient and appropriate</td>
<td>Positive</td>
</tr>
<tr>
<td>Limited assurance</td>
<td>Sufficient and appropriate (lower level)</td>
<td>Negative</td>
</tr>
</tbody>
</table>
1.3 **Examples of assurance engagements**

The key example of an assurance engagement in the UK is a statutory audit. We shall look briefly at the nature of this engagement in the next section.

Other examples of assurance engagements include other audits, which may be specialised due to the nature of the business, for example:

- Local authority audits
- Insurance company audits
- Bank audits
- Pension scheme audits
- Charity audits
- Solicitors' audits
- Environmental audits
- Branch audit (where an overseas company trades in the UK through a branch and requires an audit of that branch although an audit is not required by UK law)

There are also many issues users want assurance on, where the terms of the engagement will be agreed between the practitioner and the person commissioning the report, for example:

- Value for money studies
- Circulation reports (for example, for magazines)
- Cost/benefit reports
- Due diligence (where a report is requested on an acquisition target)
- Reviews of specialist business activities
- Internal audit
- Reports on website security, such as WebTrust
- Fraud investigations
- Inventories and receivables reports
- Internal control reports
- Reports on business plans or projections

1.4 **Audit**

An audit is historically the most important type of assurance service in the UK. This is because all large companies have been required by law to have an audit.

**Definition**

The objective of an **audit of financial statements** is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.
Worked example: Audit

The key criteria of an assurance engagement can be seen in an audit as follows:

- **Three party involvement**
  - The shareholders (users)
  - The board of directors (the responsible party)
  - The audit firm (the practitioner)

- **Subject matter**
  - The financial statements

- **Relevant criteria**
  - Law and accounting standards

- **Evidence**
  - As has been said earlier, sufficient and appropriate evidence is required to support an assurance opinion. The specific requirements in relation to evidence on assurance engagements will be looked at in Chapters 4 and 11.

- **Written report in a suitable form**
  - Again, as has been said, an assurance report is a written report issued in a prescribed form. We will look at the specific requirements for an audit report in Chapter 4.

In the UK, the auditor will normally express his audit opinion by reference to the ‘true and fair view’, which is an expression of reasonable assurance. Whilst this term is at the heart of the audit, ‘true’ and ‘fair’ are not defined in law or audit guidance. However, for practical purposes the following definitions are generally accepted.

**Definitions**

**True**: Information is factual and conforms with reality, not false. In addition the information conforms with required standards and law. The accounts have been correctly extracted from the books and records.

**Fair**: Information is free from discrimination and bias in compliance with expected standards and rules. The accounts should reflect the commercial substance of the company’s underlying transactions.

Auditors in the UK are subject to both legal and professional requirements. The legal requirements are currently contained in the Companies Act 1985. Over the next year the provisions of the Companies Act 1985 will be gradually replaced by the Companies Act 2006. The provisions of both Acts are the same for the purpose of the Assurance exam. Since the current wording of the UK audit report (see Chapter 4) refers to the Companies Act 1985 and new wording has not yet been issued, this text refers to the Companies Act 1985 throughout.

The Companies Act 1985 requires that auditors hold an ‘appropriate qualification’ and are members of a Recognised Supervisory Body (RSB). RSBs are required to have rules to ensure that those eligible for appointment as a company auditor are either:

- Individuals holding an appropriate qualification, or
- Firms controlled by qualified persons

The ICAEW is a Recognised Supervisory Body. Professional qualifications are a prerequisite of membership of an RSB, and these are offered by Registered Qualifying Bodies approved by the Secretary of State.

RSBs must also implement procedures for monitoring their registered auditors on a regular basis.
The Companies Act 1985 also sets out factors which make a person ineligible for being a company auditor, for example, if he or she is:

- An officer or employee of the company
- A partner or employee of such a person
- Any partner in a partnership in which such a person is a partner
- Ineligible by the above for appointment as auditor of any directly connected companies

As you will see later in this course, the professional ethics of the RSBs are usually far stricter in their criteria for ineligibility as an auditor.

In the UK, the responsibility for issuing auditing standards is delegated to the Auditing Practices Board (APB), which has adopted the international standards, augmented for UK requirements, referred to here. The APB is also responsible for issuing Ethical Standards (ESs) in relation to the independence, objectivity and integrity of auditors. The APB is a subsidiary of the Financial Reporting Council (FRC) to whom the UK Government has delegated the task of independent monitoring of the UK accountancy profession. These standards set professional requirements for auditors.

For example, ISA (UK and Ireland) 200 Objectives and General Principles Governing an Audit of Financial Statements states that auditors should comply with relevant ethical requirements relating to audit engagements. These will be outlined later in this Study Manual. An auditor should conduct an audit in accordance with ISAs. Relevant ISAs will be referred to in this Study Manual. Auditors are required to carry out their work with a degree of professional scepticism, meaning that they must make a critical assessment.

Auditors must assess the risks associated with the audit and seek to minimise those risks so that the risk of giving the wrong opinion on the financial statements is minimised. This risk is referred to as audit risk and it will be outlined in detail later in this Study Manual.

2 Why is assurance important?

Section overview

- Who the users are will depend on the nature of the subject matter.
- Users benefit from receiving an independent, professional opinion on the subject matter.
- Users may also benefit from additional confidence in the subject matter given to others.
- The existence of an assurance service may prevent errors or frauds occurring in the first place.

2.1 Users

In the key assurance service of audit, which we looked at above, the users were the shareholders of a company, to whom the financial statements are addressed. In other cases, the users might be the board of directors of a company or a subsection of them.

2.2 Benefits of assurance

The key benefit of assurance is the independent, professional verification being given to the users. This can be seen in the example of the house purchase given above. The importance of independence and objectivity in assurance provision will be looked at in Chapters 14 and 15.

In addition, assurance may have subsidiary benefits.

Although an assurance report may only be addressed to one set of people, it may give additional confidence to other parties in a way that benefits the business. For example, audit reports are addressed to shareholders, but the existence of an unqualified audit report might give the bank more confidence to lend money to that business, in other words, it enhances the credibility of the information.

The existence of an independent check might help prevent errors or frauds being made and reduce the risk of management bias. In other words, the fact that an assurance service will be carried out might make people involved in preparing the subject matter more careful in its preparation and reduce the chance of errors arising. Therefore it can be seen that an assurance service may act as a deterrent.
In addition, where problems exist within information, the existence of an assurance report draws attention to the deficiencies in that information, so that users know what those deficiencies are.

Assurance is also important in more general terms. It helps to ensure that high quality, reliable information exists, leading to effective markets that investors have faith in and trust. It adds to the reputation of organisations and even countries, so that investors are happy to invest in country X because there is a strong culture of assurance provision there.

3 Why can assurance never be absolute?

Section overview

- Assurance can never be absolute.
- Assurance provision has limitations which may not be understood by users.
- The expectations gap also adds to the lack of guarantee given by assurance.

Assurance can never be absolute. Assurance providers will never give a certification of absolute correctness due to the limitations set out below.

3.1 Limitations of assurance

A key issue for accountants is that there are limitations to assurance services, and therefore there is always a risk involved that the wrong conclusion will be drawn. We shall look in more detail at this issue of assurance engagement risk in Chapter 3.

The limitations of assurance services include:

- The fact that testing is used – the auditors do not oversee the process of building the financial statements from start to finish.
- The fact that the accounting systems on which assurance providers may place a degree of reliance also have inherent limitations (we shall look at control systems and their limitations in Chapter 5).
- The fact that most audit evidence is persuasive rather than conclusive.
- The fact that assurance providers would not test every item in the subject matter (this would be prohibitively expensive for the responsible party, so a sampling approach is used – see Chapter 11).
- The fact that the client’s staff members may collude in fraud that can then be deliberately hidden from the auditor or misrepresent matters to them for the same purpose.
- The fact that assurance provision can be subjective and professional judgements have to be made (for example, about what aspects of the subject matter are the most important, how much evidence to obtain, etc).
- The fact that assurance providers rely on the responsible party and its staff to provide correct information, which in some cases may be impossible to verify by other means.
- The fact that some items in the subject matter may be estimates and are therefore uncertain. It is impossible to conclude absolutely that judgemental estimates are correct.
- The fact that the nature of the assurance report might itself be limiting, as every judgement and conclusion the assurance provider has drawn cannot be included in it.

3.2 The expectations gap

The problems users may experience in connection with assurance provision also arise from the limitations and restrictions inherent in assurance provision. This is often because users are not aware of the nature of the limitations on assurance provision, or do not understand them and believe that the assurance provider is offering a service (such as a guarantee of correctness) which in fact he is not.

The distinction between reasonable and limited assurance may also be misunderstood by users.
We shall look at the concept of the expectations gap in more detail in Chapter 4, in the context of reporting, but in essence it is this lack of understanding which constitutes the expectations gap – meaning that there is a gap between what the assurance provider understands he is doing and what the user of the information believes he is doing.

Assurance providers need to close this gap as far as possible in order to maintain the value of the assurance provided for the user. This is done in a variety of ways, for example, by issuing an engagement letter spelling out the work that will be carried out and the limitations of that work (which we shall look at in the next chapter) and by regularly reviewing the format and content of reports issued as a result of assurance work.

Interactive question 2: Benefits of assurance  
Which three of the following are benefits of assurance work?

- An independent, professional opinion
- Additional confidence given to other related parties
- Testing as a result of sampling is cheaper for the responsible party
- Judgements on estimates can be conclusive
- Assurance may act as a deterrent to error or fraud

See Answer at the end of this chapter.
Summary

An assurance engagement is one in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

Levels of assurance:
- Limited
- Reasonable (high)

Key elements:
- Three party relationship
- Subject matter
- Suitable criteria
- Sufficient appropriate evidence
- Written report

Key example: audit
- Directors, auditors, shareholders
- Financial statements
- Law and accounting standards
- As prescribed by ISA 500
- Audit report

Benefits:
- Independent, professional opinion
- Added confidence to other users
- Deterrent to error/fraud

Limitations:
- Subjective, sampled, limitations of systems, information from third parties, limitations of reporting, includes estimates

Self-test

Now answer the following questions.

1. Assurance services are required by law.
   - True [ ]
   - False [ ]

2. What five elements are required for an engagement to be an assurance engagement?
   1. ........................................
   2. ........................................
   3. ........................................
   4. ........................................
   5. ........................................
Assurance

3 Name **four** limitations of an assurance service.

1........................................

2........................................

3........................................

4........................................

4 Reasonable assurance is a high level of assurance.

True  

False  

Now, go back to the Learning Objectives in the Introduction. If you are satisfied you have achieved these objectives, please tick them off.
## Answers to Self-test

1. False (an audit may be required by law if the company does not qualify as a small company)

2. **1.** Three party relationship  
   **2.** Subject matter  
   **3.** Suitable criteria  
   **4.** Sufficient appropriate evidence  
   **5.** Written report

3. From:  
   **1.** Subjective exercise  
   **2.** Sampling  
   **3.** Limitations in systems  
   **4.** Limitations in report  
   **5.** Information from third parties  
   **6.** Estimations

4. True
Answers to Interactive questions

Answer to Interactive question 1

1 Three party involvement:
   ▶ Jamal (the intended user)
   ▶ You (the practitioner)
   ▶ The directors of Company X as they produce the financial statements (the responsible party)

2 Subject matter
   The most recent financial statements of Company X are the subject matter

3 Relevant criteria
   It is most likely in this instance that the criteria would be accounting standards, so that Jamal was assured that the financial statements were properly prepared and comparable with other companies’ financial statements

4 Evidence
   You would have to agree the extent of procedures in relation to this assignment with Jamal so that he knew the level of evidence you were intending to seek. This would depend on several factors, including the degree of secrecy in the proposed transaction and whether the directors of Company X allowed you to inspect the books and documents

5 Report
   Again, the nature of the report would be agreed between you and Jamal, however, it would be a written report containing your opinion on the financial statements

Answer to Interactive question 2

An independent, professional opinion

Additional confidence given to other related parties

Assurance may act as a deterrent to error or fraud