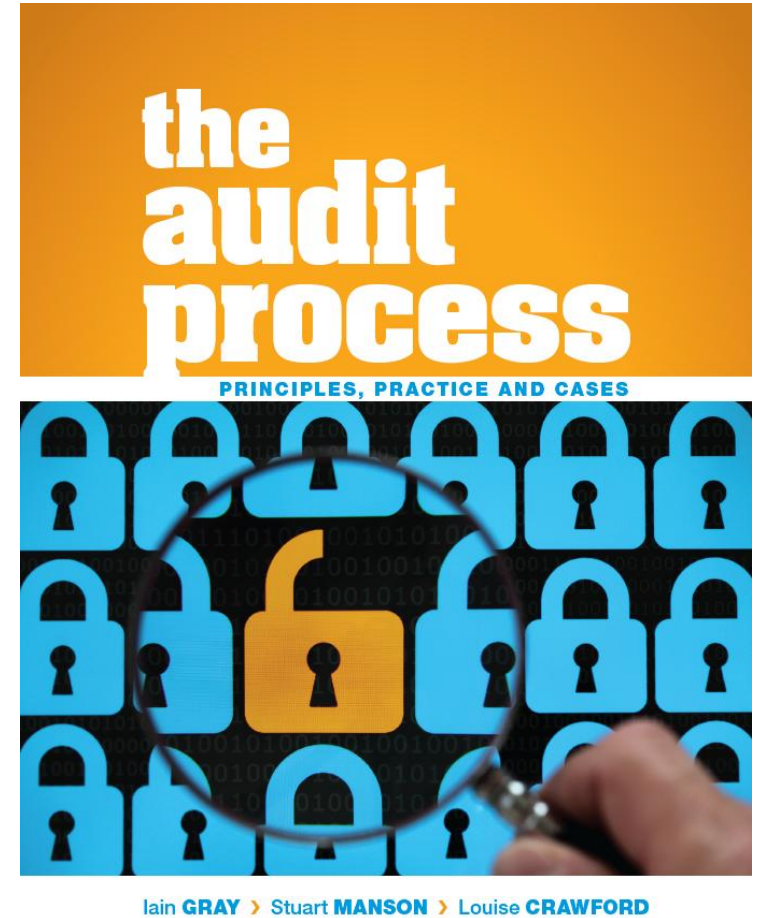


Chapter 15

Assurance engagements and internal audit



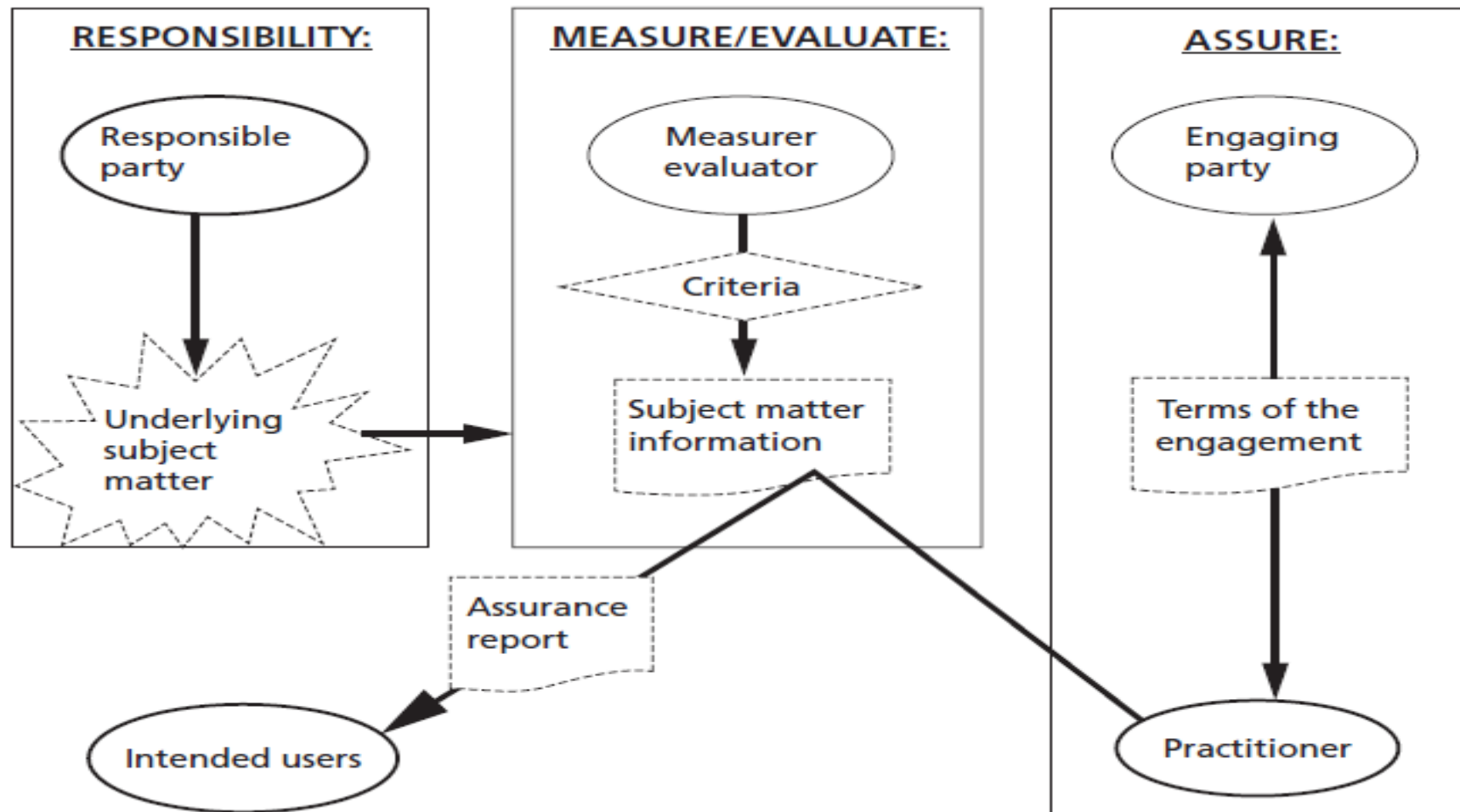
Learning objectives

- To explain the nature and role of assurance engagements.
- To describe the characteristics that should be possessed by an assurance engagement.
- To explain the degrees of assurance that may be given for different kinds of assurance engagement.
- To describe typical work carried out by the internal audit function.
- To explain the relationship between internal and external audit, and work of the former in achieving audit objectives.
- To suggest ways in which the audit function as a whole may be rendered more useful.
- To understand the nature of audit in the public sector and charities

Assurance engagement: definition

- An engagement in which a practitioner aims to obtain sufficient appropriate evidence in order to express a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the subject matter information (that is, the outcome of the measurement or evaluation of an underlying subject matter against criteria).

Assurance engagements other than audits or reviews of historical financial information: roles and responsibilities (Figure 15.1)



Assurance engagement

- Practitioner expresses a *conclusion* to enhance *degree of confidence* of intended users about the **outcome** of the evaluation or measurement of a subject matter against criteria.
- True and fair view audit = assurance engagement

Subject matter information and subject matter re financial statements

- Subject matter – Example: set of financial statements
- Subject matter information – ‘assertion’ about the financial statements – that they give a true and fair view

Assurance engagement (1)

- Five elements:
 1. Three-part relationship – practitioner, responsible party, intended users
 2. Appropriate subject matter
 3. Suitable criteria
 4. Sufficient appropriate evidence
 5. Reasonable or limited assurance.

Assurance engagement (2)

- *Subject matter* is:
 - a) identifiable, capable of consistent evaluation or measurement against identified criteria
 - b) information about it can be subjected to procedures for gathering sufficient appropriate evidence to support a reasonable or limited assurance conclusion.

Assurance engagement (3)

- *Criteria* – benchmarks to evaluate/measure subject matter, including presentation/disclosure. Criteria given to intended users to allow understanding of how subject matter evaluated or measured
- Financial statements (example of subject matter)
- Users need to know accounting policies (part of criteria)

Characteristics of suitable criteria

- Relevance
- Completeness
- Reliability
- Neutrality
- Understandability
- Criteria – specially developed or established criteria

Sufficient appropriate evidence

- Practitioners in an assurance engagement obtain evidence with these qualities to support conclusions.
- Assurance engagement performed with an attitude of 'professional scepticism'.
- Materiality and assurance engagement risk considered.

Written assurance report

- Positive form for a reasonable assurance engagement.
- Negative form for a limited assurance engagement.

Activities

- **15.2:** Suggest subject matter other than financial statements that users might wish to be reliable and likely subject matter information. Ask yourself if experts in particular fields other than external auditors could provide assurance to users.
- **15.3:** Explain what is meant by the responsible party. Do you think that the responsible party might be one of the intended users?
- **15.4:** The Framework suggests that characteristics of suitable criteria are: relevance, completeness, reliability, neutrality and understandability. What do you think that these characteristics mean? Illustrate your answer by reference to performance indicators on punctuality issued by train operators.

Assurance engagement acceptance

- Ethical requirements
- Engagement possesses necessary characteristics
- Letter of engagement:
 - Description of the engagement objective
 - Scope of work
 - Form of report – content and assurance
 - Restrictions on use of reports
 - Fees and billing arrangements
 - Timetables and deadlines

Evidence-gathering procedures

- Amount and quality of evidence obtained determine conclusions practitioners can form and the kind of report that they can issue in the light of the engagement risk they face.
- Table 15.1: differences between reasonable assurance engagements and limited assurance engagements.

Assurance engagement

Table 15.1

Limited assurance	Reasonable assurance
<p>48L. Based on the practitioner's understanding (of the subject matter information – see above) the practitioner shall:</p> <ul style="list-style-type: none"> (a) Identify areas where a material misstatement of the subject matter information is likely to arise; (b) Design and perform procedures to address the areas identified in paragraph 48L(a) and to obtain limited assurance to support the practitioner's conclusion. <p>Determining Whether Additional Procedures Are Necessary in a Limited Assurance Engagement</p> <p>49L. If the practitioner becomes aware of a matter(s) that causes the practitioner to believe that the subject matter information may be materially misstated, the practitioner shall design and perform additional procedures to obtain further evidence until the practitioner is able to:</p> <ul style="list-style-type: none"> (a) Conclude that the matter is not likely to cause the subject matter information to be materially misstated; or (b) Determine that the matter(s) causes the subject matter information to be materially misstated. 	<p>48R. Based on the practitioner's understanding (of the subject matter information – see above) the practitioner shall:</p> <ul style="list-style-type: none"> (a) Identify and assess the risks of material misstatement in the subject matter information; and (b) Design and perform procedures to respond to the assessed risks and to obtain reasonable assurance to support the practitioner's conclusion. In addition to any other procedures that are appropriate in the engagement circumstances, the practitioner's procedures shall include obtaining sufficient appropriate evidence as to the operating effectiveness of relevant controls over the subject matter information when: <ul style="list-style-type: none"> 1 (i) The practitioner's assessment of the risks of material misstatement includes an expectation that controls are operating effectively, or 2 (ii) Procedures other than testing of controls cannot alone provide sufficient appropriate evidence. <p>Revision of Risk Assessment in a Reasonable Assurance Engagement</p> <p>49R. The practitioner's assessment of the risks of material misstatement in the subject matter information may change during the course of the engagement as additional evidence is obtained. In circumstances where the practitioner obtains evidence which is inconsistent with the evidence on which the practitioner originally based the assessment of the risks of material misstatement, the practitioner shall revise the assessment and modify the planned procedures accordingly.</p>

Content of assurance report

- Title referring to independent assurance report
- Addressee
- Subject matter information and subject matter
- Identification of the criteria
- Any inherent or significant limitation
- Statement restricting use
- Responsible party and practitioner responsibilities
- Performed in accordance with ISAEs
- Summary of the work performed
- Practitioner's conclusion
- Report date
- Name of firm/practitioner and location

Levels of assurance (1)

Table 15.3

Levels	Examples
No assurance	<p><i>Compilation report.</i> We discussed this kind of report briefly in Chapter 6. This kind of engagement involves practitioners in acquiring an understanding of the accounting principles and practices of the client's industry. Practitioners would also acquire an understanding of the client's business, the nature of its transactions and the accounting records maintained. They would consider the quality of accounting personnel and review the financial statements. On this basis the practitioner would prepare the financial statements, state in their report that they have done so, but would also state that they have <i>not</i> carried out an audit or a review.</p> <p><i>Preparation of tax returns</i> but no conclusion given on their acceptability.</p> <p><i>Consulting (or advisory) engagements, such as management or tax consulting.</i></p> <p><i>Engagements to testify in legal proceedings regarding accounting, auditing, taxation or other matters.</i></p> <p><i>Engagements that include professional opinions, views or wording from which a user may derive some assurance, if certain conditions apply (see above).</i></p>
Limited assurance	<p><i>A report on review of interim financial statements.</i> As we have seen above, practitioners would make enquiries and perform analytical reviews of the subject matter. They would then issue a negative assurance report – which would be a form of disclaimer.</p>

Levels of assurance (2)

Table 15.3 (continued)

Levels	Examples
	<p><i>Agreed-upon procedures.</i> In this case practitioners would carry out procedures that have been agreed upon by them, the responsible party and the intended users of the report. These procedures would not normally be sufficient to allow the practitioner to give positive assurance. The report would state the agreed-upon procedures, give the results of the procedures, but would also state that an audit has not been carried out. The proposed international framework on assurance engagements does not regard an agreed-upon-procedures engagement as an assurance engagement because it does not meet the definition, presumably because the report is intended for a responsible party who is the only user.</p> <p><i>Report on a company's corporate governance statement.</i> In this case (as we discuss in Chapter 19) practitioners review the directors' statements concerning corporate governance matters. The review is normally not sufficient to express an opinion on the effectiveness of internal financial control or corporate governance procedures, nor on the ability of the company to continue in operational existence. Practitioners then give an opinion that the directors have complied with identified rules and that the directors' statements are not inconsistent with the information of which they are aware from audit work on the financial statements. They then go on to say that based on their enquiries of certain directors and officers of the company and examination of relevant documents, the directors' statements appropriately reflect compliance with identified criteria. Some of these conclusions are expressed in positive form, but in a very limited way, in that practitioners are merely stating that certain rules have been adhered to.</p>

Levels of assurance (3)

Table 15.3 (continued)

Levels	Examples
Long-form and short-form reports on the effectiveness of internal control	<p><i>Comfort letters.</i> These are frequently issued by practitioners in relation to financial statements included in new share issues. The practitioner may have given a full true and fair opinion on the statements, but carries out an extended subsequent events review from the issue of the audit report to the date of the prospectus issue. The practitioner would describe the procedures performed and issue a negative assurance report.</p> <p><i>Report on internal control using generally accepted auditing standards.</i> The report would indicate that there are inherent limitations in any internal control system and that such systems may deteriorate over time. The practitioner may then give assurance on the management assertion that the internal control system is effective, except for any weaknesses identified, and acknowledging the inherent limitations. In 2001, the APB issued a briefing paper entitled 'Providing Assurance on the Effectiveness of Internal Control'. This briefing paper highlights inherent limitations in internal control and suggests that a long-form narrative report would be necessary to enable users to understand the context in which the opinion is given or the judgements that have to be made in reaching the conclusion and the reasons underpinning those judgements.</p>

Levels of assurance (4)

Table 15.3 (continued)

Levels	Examples
Positive assurance	<p>The briefing paper indicates an evaluation of internal controls is highly judgemental and that generally accepted criteria do not exist. The question of reports on the effectiveness of internal control is very controversial. You should note that in the US, post-Enron, auditors are now issuing short-form reports on management's assessment of the effectiveness of internal controls in accordance with criteria established in <i>Internal Control – Integrated Framework</i> issued by the Committee of Sponsoring Organizations of the Treadway Commission. Note that this is not a direct reporting engagement but an engagement leading to a report on a management assertion. A typical management assertion would be: 'XYZ Inc. maintained effective internal control over financial reporting as of 31 December 2015.' The US standard notes that there may have been weaknesses in internal control in the period up to the date (in this case 31 December 2015) and that management could only make this assertion if those weaknesses have been eliminated before the quoted date. The assurance is limited in the sense that the reports state that systems of internal control have inherent limitations. See our comments in Chapter 7.</p> <p><i>Statutory audit of financial statements</i>, using the techniques and procedures described earlier in this book. The practitioner would assess the evidence gathered and give a positive assurance on the view shown by the financial statements. If the evidence gathered does not support the true and fair view assertion or evidence is not available, the practitioner will 'qualify' the report. We discuss qualifications in audit reports in Chapter 16.</p>

Two illustrative case studies

- 15.1: Protecting the environment in an area of scenic beauty
- 15.2: Gilling Limited – pleasure boat company

Extended Assurance Reporting? (1)

- ICAS suggestion ‘front end’ of annual report should tell a logical story Board believes is ‘balanced and reasonable’, as well as confirming that financial statements are true and fair
- The logical story to include rational for concluding that the business is a going concern, disclosing:
 - key assumptions on which Board has based its assessment
 - a clear exposition of the business model and strategy
 - an articulation of the key risks facing the business
- The front end of the annual report to include significant judgements of the Board in producing the annual report and financial statements
- NOTE: ICAS discussion documents containing these suggestions are not the only contributions to the debate (see chapter 2).

Extended Assurance Reporting? (2)

- **Balanced**: the views expressed by company officers should reflect a realistic perspective of the business and not be subject to 'spin' or 'bias' – in particular to avoid the situation where the directors 'cherry pick' the information reported/provided and focus on promoting mainly the positive aspects of the company's performance
- **Reasonable**: The word 'reasonable' was chosen to highlight that the auditor would need to ensure that the views expressed by the company's officers were appropriate, based on the information available at the time, and that a similarly skilled professional would have considered the information to be truthful and honestly expressed, and that any assumptions and judgements made by the directors were sensible and justifiable in the circumstances.

Extended Assurance Reporting? (3)

- ICAS discussion paper 'Balanced and Reasonable' included a controversial suggestion that the auditor could give a positive form of medium assurance based upon knowledge of the business and professional judgement over the reasonableness of the future-oriented information available at the time (see Table 15.4).

Extended Assurance Reporting? (4)

Level of assurance	Description	Examples	Nature of opinion	Nature of work
High	Assurance where the majority of information is capable of being externally and/or objectively verified.	Financial statement items and disclosures, and narrative disclosures which are objectively verifiable or 'auditable'.	Positive.	Developing and undertaking tests and procedures. Responding to the assessed risks that the information disclosed is not independently or objectively verifiable.
Medium	Assurance where in certain areas no sufficient, appropriate external evidence is available but the auditor is able to exercise professional judgement.	Future-oriented information.	Positive, possibly with a disclaimer relating to the inherent uncertainty of some types of information.	Assessment based upon knowledge of the business and professional judgement over the reasonableness of the future-oriented information available at the time.
Low	Generally, assurance where there is nothing to indicate that the information in the management commentary is not in accordance with the relevant framework.	Review engagement.	Generally expected to be negative.	Consists mainly of enquiry and analytical procedures.

Internal audit: definition (Chartered Institute of Internal Auditors)

- Internal auditing is an **independent**, objective assurance and consulting activity designed to **add value** and improve an organization's operations.
- It **helps an organization accomplish its objectives** by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.

Types of internal audit

- Compliance auditing
- Efficiency auditing
- Effectiveness auditing
- Other terms:
 - Operational auditing
 - Management auditing
 - Value for money auditing (VFM)
 - Evaluation

Internal audit – illustrative case study

- 15.5: Barnton plc

Barnton plc

- Audits of **internal control systems**, of **subsidiaries** of **construction contracts**.
- **Financial auditing** – of financial systems at Barnton subsidiaries, periodic joint audits of associated undertakings and post-completion audits of major capital expenditure projects.
- **Management auditing** – including efficiency and effectiveness of information processing and investment appraisal process.
- **Participative auditing** – including audits of companies prior to acquisition, leading to management decisions to proceed.
- **One-off audits** – including audit of funds set up for specific purposes, fraud investigations and other special reviews and projects.

Internal audit work – very wide-ranging – see Barton

- Monitoring of internal control.
- Examination of financial/operating information
- Review of operating activities – economy, efficiency and effectiveness
- Review of compliance with laws and regulations
- Risk management
- Governance

How to make the internal audit function effective

- Support of top management.
- Independence of the internal auditor from parts of the organization subject to audit.
- Appointment of motivated staff with good educational background, combined with continuing education and training.
- Steps to ensure that staff behave in a professional way.
- Avoidance of 'short-stay syndrome'.

Reliance on internal audit by the external auditor

Internal audit – reliable element of internal control?

- Planning extent of reliance on internal audit.
- Assessment of objectivity, competence and exercise of due professional care by internal auditors.
- Extent of reliance:
 - Scope decision.
 - External auditor to audit all material matters where significant risk of misstatement.
 - Agree timing and extent of internal audit work and record decision in audit files.
- Using work of internal audit in respect of specific assertions relating to the financial statements.

The responsibility of external auditor when relying on work of internal audit

- *Irrespective of the degree of autonomy and objectivity of the internal audit function, such function is not independent of the entity as is required of the external auditor when expressing an opinion on financial statements. The external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the external auditor's use of the work of the internal auditors.'* (ISA 610, para 4)

Outsourcing of internal audit work

- Some organizations employ professional firms to provide an audit function whether external or internal.
- But very controversial and in the US company auditors cannot perform internal audit functions.
- ICAS Working Group on Non-Audit Services concluded that the provision of internal audit services by external auditors to their listed clients should be specially approved by the audit committee.

Auditing in the public sector

- Financial audits
- Legality audits
- Regularity audits
- Systems examinations
- Probity audits
- Value for money audits
- Performance audits
- Management letters in the public sector
- Audit committees and corporate governance in the public sector

Audit committees in the public sector

- **Main audit committee principles** in Scottish local government identified in CIPFA 2004 report:
 1. **Control environment:** independent assurance of the adequacy of risk management framework and associated control environment within the authority.
 2. **Risk related performance:** independent scrutiny of authority's financial and non-financial performance. Authority's exposure to risk and control environment.
 3. **Annual accounts and external auditor:** assurance issues arising from process of drawing up, auditing and certifying authority's annual accounts properly dealt with.
- Example: *Scottish Government Audit Committee Handbook: good practice principles*
- ISAs contain references to public sector.

The Audit of Charities

- A charity is a not-for-profit organization that operates in ‘the third sector’. The test of charitable status is legally determined and requires that, to be a charity, two key elements must be satisfied: the organization must have exclusively charitable objectives and the organization must exist for public benefit.
- The public benefit test includes assessment to ensure that: there is no disparity in benefits accruing to members of the charity compared to the public; members of the public should not be restricted from accessing the benefits of the charity.

Definitions of audit and independent examination – see Table 15.2 also

- **Office of the Scottish Charity Regulator (OSCR)** (2011) defines an independent examination and audit as follows:
- An **independent examination** is a form of external scrutiny of the accounts which is less rigorous than an audit and offers an assurance that nothing has been found that needs to be brought to the attention of readers of the accounts, rather than the positive expression of a professional opinion based on an audit
- An **audit** provides reasonable assurance that the accounts are free from material misstatement, whether caused by fraud or other irregularity or error. In undertaking an audit, a registered auditor must comply with the UK Auditing Practices Board's ethical standards for auditors and International Standards on Auditing (UK and Ireland).

Duties of charity trustees

- Because of their public interest status, charities are very tightly regulated by charity law within their own jurisdictions and onerous duties placed on trustees.
- Thus OSCR states on its website that charity law in Scotland requires that ‘... charity trustees, irrespective of the employment of staff, are and remain responsible for the **governance and strategy** of the charity. It is the principal duty of charity trustees to **maintain general overall control** of the charity. They need to ensure that the charity is **administered effectively** and is **able to account for its activities and outcomes** to OSCR and the public.’

Typical income received by charities

- Typical income received by charities:
 - cash donations
 - legacies
 - gifts in kind and donated services
 - contractual income
 - grants, for example, from public authorities or other charities
- Important note: Some of these funds may only be used for specific purposes; they are known as 'restricted funds' and must be accounted for as such.

Charity Audit

- ACTIVITY 15.19

What particular problems might be faced by trustees in respect of cash donations and what steps might be taken to ensure that they are genuine, accurate and complete

- ACTIVITY 15.20

Consider how gifts in kind and donated services might be identified and valued for accounting purposes.

Charity accounting and control systems (1)

- Some charities are very large and will have sophisticated accounting and control systems.
- The majority of charities are small and will have problems typical of small organizations, including lack of division of duties, which will make supervisory controls exercised by trustees of importance.

Charity accounting and control systems (2)

- ACTIVITY 15.21
- What particular problems might be faced by small charities run by volunteers and/or paid staff with small fees, particularly if the trustees are not well-informed of their responsibilities? Would there be a likelihood of enhanced audit risk? What recommendations would you make to trustees?

Figure 15.1 Assurance engagements other than audits or reviews of historical financial information: roles and responsibilities

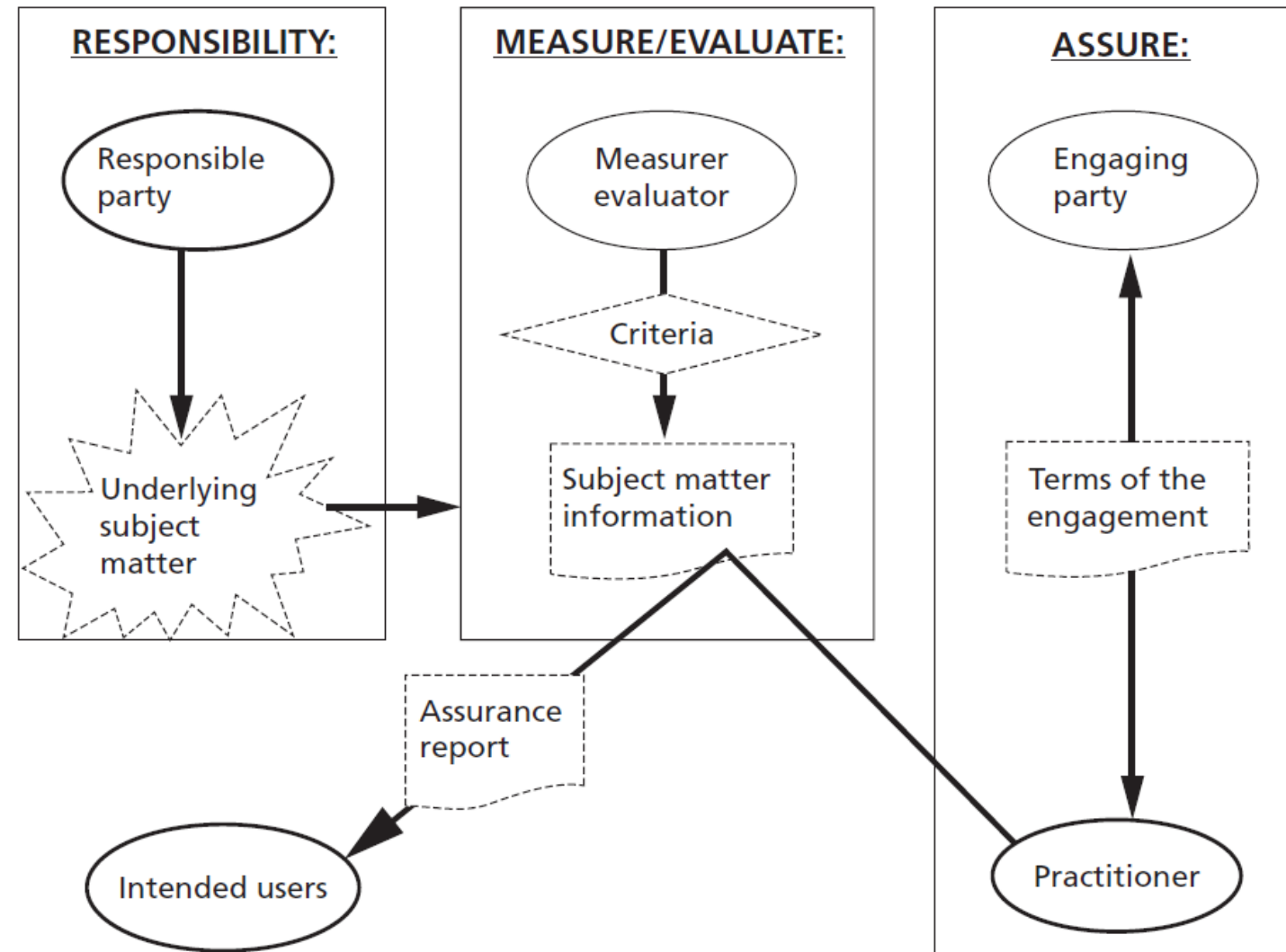


Figure 15.2 Position of the Troston plc internal audit department within the organization

