

## **Explanatory Memorandum**

### **Assurance Engagements Exposure Drafts and Proposed Withdrawal of ISA 120 “Framework of International Standards on Auditing”**

#### **Introduction**

This memorandum provides some background to, and explanation of, the proposed *International Framework for Assurance Engagements* and International Standard on Assurance Engagements (ISAE) 2000, *Assurance Engagements on Subject Matters Other Than Historical Financial Information*, which have been approved for exposure by the International Auditing and Assurance Standards Board (IAASB). It is proposed that these documents will replace ISAE 100, *Assurance Engagements* and that ISA 120, *Framework of International Standards on Auditing* will be withdrawn.

Currently, the IAASB literature establishes basic principles and essential procedures for:

- (a) both the audit and review of historical financial information; and
- (b) what ISAE 100 terms “high level” assurance engagements on subject matters other than historical financial information.

It does not however establish basic principles and essential procedures for what ISAE 100 terms “moderate level” assurance engagements. An objective of this proposal is to establish basic principles and essential procedures for all assurance engagements.

#### **Background**

In August 1997, the International Auditing Practices Board (IAPC) (predecessor to the IAASB) issued an Exposure Draft, *Reporting on the Credibility of Information*. This initiative recognized the increasing demand for information on a broad range of subject matters to meet the needs of decision-makers, and the consequent need in both the private and public sectors for services that enhance the credibility of that information. The Exposure Draft introduced the concept of a continuum of levels of assurance that could be provided, with the level of assurance provided in a particular engagement being dependent upon the interrelationship of four variables:

- (a) Subject matter;
- (b) Criteria;
- (c) Nature, timing, and extent of procedures; and
- (d) Quantity and quality of evidence available

The IAPC received strong support for the aims of the 1997 Exposure Draft. The vast majority of respondents agreed with the concept of a continuum of levels of assurance. However, many respondents believed that the concept would be difficult to apply in practice, and in particular that it would be difficult to ensure that any report would convey the level of assurance with the necessary precision.

In order to address the concerns expressed by respondents, the IAPC concluded that significant changes needed to be made to the 1997 Exposure Draft and, as a result, issued a second Exposure Draft “Assurance Engagements” in March 1999. This ED retained the concept of the continuum, but restricted the levels of assurance being provided to two levels: a high level and a moderate level.

The responses to the 1999 Exposure Draft continued to support the underlying concepts in the document. There was agreement on how the concepts would be applied to assurance engagements intended to provide a high level of assurance. However, there was disagreement as to how the concepts would be applied to assurance engagements intended to provide a moderate level of assurance. A number of respondents believed that the model did not provide sufficient guidance, as it did not explain adequately the interaction of the variables and how they result in a moderate level of assurance. In addition, there was not consensus on how the moderate level of assurance is best communicated. Two alternative models for the moderate level of assurance were identified: one based on the interaction of the variables and the other based on work effort.

In June 2000, the IAPC issued ISAE 100 “Assurance Engagements”, taking into account the comments received on the 1999 Exposure Draft. In view of the support that the framework received, and the fact that there was agreement on the requirements for a high level assurance engagement, ISAE 100 provides a framework for all assurance engagements – both moderate level and high level assurance engagements – and establishes basic principles and essential procedures for the performance of engagements intended to provide a high level of assurance. In view of the lack of agreement on a Standard for engagements intended to provide a moderate level of assurance however, the IAPC decided not to publish such a Standard at that time.

During 2001, IAPC commissioned research from an international consortium of academics. The research comprised:

- (a) A survey of practitioners in 12 countries, asking them to provide example moderate assurance reports, and to complete a questionnaire about those reports and about other aspects of moderate assurance;
- (b) A survey of the national institutes in each of those 12 countries, including questions about national standards, regulations, practices etc.; and
- (c) A literature review, covering not only literature from the accounting/auditing field, but also relevant literature from other disciplines.

The researcher’s findings were published in 2002 in the monograph: “Determination and Communication of Levels of Assurance Other Than High”, which is available on the IAASB’s website at [www.iaasb.org](http://www.iaasb.org).

### **The current Exposure Draft**

#### **STRUCTURE**

As explained in the IAASB’s November 2002 Exposure Draft, *Proposed Terms of Reference, Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services and Operations Policy No 1 – Bold Type Lettering*, the IAASB intends to restructure its Auditing and Assurance Handbook. As part of that restructure, the current ISAE 100 will be split into 2 documents:

- (a) *International Framework for Assurance Engagements* (the Framework), the purpose of which is to define, and describe the elements of an assurance engagement, and identify those engagements to which International Standards on Auditing (ISAs) and International Standards on Assurance Engagements (ISAEs) apply. It provides a frame of reference for professional accountants in public practice (practitioners) and others involved with assurance engagements, such as those engaging a practitioner, and for the development by the IAASB of International Standards on Auditing (ISAs) for audits and reviews of historical financial information, and International Standards on Assurance Engagements (ISAEs) for assurance engagements on other subject matters.
- (b) ISAE 2000, *Assurance Engagements on Subject Matters Other Than Historical Financial Information*, the purpose of which is to establish basic principles and essential procedures for, and provide guidance to, practitioners for the performance of assurance engagements on subject matters other than historical financial information, which are covered by International Standards on Auditing, where no specific ISAE(s) exists.

The November 2002 Exposure Draft also noted the IAASB's intention to create a further document called ISA 100, *Audits and Reviews of Historical Financial Information* comprising a merged and revised ISA 120, *Framework of International Standards on Auditing* and ISA 200, *Objective and General Principles Governing an Audit of Financial Statements*. Apart from the changes to ISA 200 that are currently on exposure as part of the October 2002 Exposure Draft *Audit Risk*, and the addition of the current ISA 120.19<sup>1</sup>, the IAASB does not intend to make further changes to ISA 200 before re-designating it as ISA 100, *Audits and Reviews of Historical Financial Information*. When this happens and the revisions to ISAE 100 as exposed herein are finalized, the existing ISA 120 will be withdrawn without replacement.

#### “WORK EFFORT” VERSUS “INTERACTION OF VARIABLES”

As indicated above, the main issue outstanding when ISAE 100 was issued in June 2000 related to differences between the interaction of the variables view and the work effort view. The rationale for each of these views is described in a report published with ISAE 100 (available at [www.iaasb.org](http://www.iaasb.org)).

The approach adopted in the Exposure Draft has elements of both the work effort view and the interaction of variables view but is not predicated solely on either of these two views. For example, the form of expression to be used in the practitioner's conclusion in an assurance report will be determined by the level of evidence gathering procedures performed, but the assurance report will also need to disclose characteristics of the subject matter when they are relevant to the assurance obtained.

<sup>1</sup> ISA120.19 states: “An auditor is associated with financial information when the auditor attaches a report to that information or consents to the use of the auditor's name in a professional connection. If the auditor is not associated in this manner, third parties can assume no responsibility of the auditor. If the auditor learns that an entity is inappropriately using the auditor's name in association with financial information, the auditor would require management to cease doing so and consider what further steps, if any, need to be taken, such as informing any known third party users of the information of the inappropriate use of the auditor's name in connection with the information. The auditor may also believe it necessary to take other action, for example, to seek legal advice”.

The significant characteristics of the approach adopted with respect to each of the four variables previously identified are outlined below.

- (a) *Nature, timing, and extent of evidence gathering procedures:* The Exposure Draft recognizes that variations in the nature, timing and extent of evidence gathering procedures will affect the assurance obtained by the practitioner. It also recognizes that in theory, it may be possible to have infinite variations in the nature, timing and extent of evidence gathering procedures, but that in practice, it is not ordinarily possible to communicate fine gradations in a clear and unambiguous manner. Therefore, the Exposure Draft establishes that in any assurance engagement, the practitioner reports in the form appropriate to one of only two distinct levels of evidence gathering procedures, which are called for ease of reference: an audit-level and a review-level. The major differences between an audit-level engagement and a review-level engagement are outlined in the Appendix to the Framework.
- (b) *Subject matter:* The Exposure Draft requires the subject matter of an assurance engagement to be identifiable, capable of consistent evaluation or measurement against suitable criteria and in a form that can be subjected to procedures for gathering evidence to support that evaluation or measurement. It also recognizes that variations in the characteristics of the subject matter will affect the quantity and quality of evidence available and the assurance obtained by the practitioner. The Exposure Draft therefore establishes that relevant characteristics of the subject matter, such as the extent to which it is: qualitative versus quantitative, objective versus subjective and historical versus prospective, are to be described in the assurance report, regardless of whether an audit-level engagement or a review-level engagement is performed.
- (c) *Criteria:* The IAASB has taken the position in the Exposure Draft that variations in criteria will not affect the assurance obtained by the practitioner. Rather, the Exposure Draft establishes that for all assurance engagements, criteria need to be suitable to enable reasonably consistent evaluation or measurement of the subject matter within the context of professional judgment. An implication of this approach is that the test for suitability of criteria is the same for both audit-level engagements and review-level engagements. Therefore, if particular criteria are not suitable for an audit-level engagement they will not be suitable for a review-level engagement.
- (d) *Quantity and quality of evidence available:* As noted in the discussion of “subject matter” in (b) above, characteristics of the subject matter affect the quantity and quality of evidence available. The Exposure Draft also notes that limitations on the quantity and quality of evidence available due to the particular circumstances of the engagement other than the characteristics of the subject matter can be a variable, i.e. the particular circumstances of an engagement may occasionally make it possible to express an unqualified review-level conclusion but not an unqualified audit-level conclusion. In circumstance such as these, the practitioner needs to consider whether it is appropriate to provide a review-level conclusion. More commonly however, a limitation in the quantity and quality of evidence that is not related to the characteristics of the subject matter will result in a qualified assurance report at either the audit-level or the review-level (or withdrawal from the engagement).

### “LEVEL(S) OF ASSURANCE”

This Exposure Draft does not use the term “level(s) of assurance”. As noted above, it does however establish that practitioners report in the form appropriate to one of only two distinct levels of evidence gathering procedures: an audit-level and a review-level. While it is accepted that each of these levels of evidence gathering procedures will, all else remaining equal, produce a different level of assurance, using the term “level(s) of assurance” tends to:

- overemphasize the relative importance of the quantitative aspects of that assurance rather than aspects of its nature, both of which are affected by the variables mentioned above; and
- invite oversimplification of the complex relationships that exist among these variables.

For example, it is not helpful to attempt to equate or compare the “level” of assurance for two engagements that are distinguished by both:

- totally different subject matters, one being highly quantitative but entirely future oriented and the other being highly qualitative but entirely historical; and
- totally different procedures, possibly in terms of both timing and extent, as well as nature.

Similarly, the Exposure Draft does not use the terms “high assurance” and “moderate assurance”, but rather, “reasonable assurance” and “limited assurance”.

### TERMINOLOGY

The terminology in both the Framework and ISAE 2000 has been amended to consistently refer to the fact that practitioners *obtain* assurance and *provide* a conclusion that conveys that assurance. This terminology recognizes the substance and reality of how assurance engagements add value to information and that the assurance a user takes from a practitioner’s assurance report may be different from the assurance the practitioner obtains from the evidence gathering processes that represent the essence of what a practitioner does to reach a conclusion. Existing ISAs will also be amended in future to consistently adopt this terminology.

### WRITTEN REPORTS

The current ISAE 100 allows for assurance reports to be oral or symbolic. The Exposure Draft requires that all assurance reports be issued in writing. This is done to avoid misunderstandings that could result from oral and other forms of expressing conclusions without the support of a written report.

### DEFINITION OF “ASSURANCE ENGAGEMENT”

While the current version of ISAE 100 lists elements that should be found in any “assurance engagement”, it does not provide a definition of the term. The Exposure Draft proposes a concise definition, which includes all the essential characteristics that make an engagement an assurance engagement. Other characteristics not included in the definition, e.g., sufficient appropriate evidence, are required for engagements that display the essential characteristics included in the definition.

### MUTUAL CONSENT ENGAGEMENTS

The Exposure Draft introduces the concept of mutual consent engagements, in which intended users of an assurance report are sufficiently knowledgeable as to the purpose and limitations of an engagement as a result of their participation in establishing its nature and scope that their specific, legitimate objectives can be achieved when the practitioner and they agree that aspects of the Framework or the ISAEs need not be applied. When certain stringent conditions are met that ensure there is no contravention of the public interest role of assurance

standards (e.g., any written report is not distributed beyond those parties who participated in establishing the nature and scope of the engagement so that those who are not intimately involved with the engagement are not accidentally misled in any way) practitioners are not required to follow the Framework or the ISAEs in performing such an engagement. They are however required to comply with the IFAC *Code of Ethics for Professional Accountants* (the Code)<sup>2</sup> and International Standards on Quality Control (ISQCs),

In introducing this concept, the IAASB has taken the view that it is not appropriate to prevent practitioners from satisfying the legitimate needs of knowledgeable intended users when adherence to the Code and ISQCs, but not the detailed technical requirements of ISAEs, is adequate to protect the public interest. The IAASB also believes that introducing the concept of mutual consent engagements will allow scope for experimentation and innovation regarding new subject matters and developing criteria.

### **Comments requested**

The IAASB is seeking comments on the issues identified in this Explanatory Memorandum, as well as any other matters that interested parties believe are relevant to the IAASB's consideration of the changes proposed in the Exposure Draft.

<sup>2</sup> The IAASB is liaising with the IFAC Ethics Committee to ensure relevant sections of the Code are reviewed for application to mutual consent engagements.