



## **EXPLANATORY GUIDE Au1**

### **Overview of Auditing and Assurance Standards**

**This compilation was prepared in November 2013 and incorporates amendments up to and including September 2013.**

This Explanatory Guide sets out the role and functions of the External Reporting Board (XRB) and its sub-Board the New Zealand Auditing and Assurance Standards Board (NZAuASB) in issuing auditing and assurance standards. It outlines the auditing and assurance standards that should be applied by assurance practitioners and the extent of their legal obligation to do so. It also describes the definition and objective of an assurance engagement and the elements of an assurance engagement.

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ISBN 978-1-927174-45-6

## EXPLANATORY GUIDE Au1

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## History of Amendments

### Table of pronouncements – EG Au1 *Overview of Auditing and Assurance Standards*

This table lists the pronouncements establishing and amending EG Au1.

<b>Pronouncements</b>	<b>Date approved</b>	<b>Early operative date</b>	<b>Effective date</b>
Amendments to the International Standards on Auditing (New Zealand) to Promote Improved Audit Quality	September 2013		Effective for audits of financial statements for periods ending on or after 31 December 2014

<b>Table of Amended Paragraphs in ISA (NZ) EG Au1</b>		
<b>Paragraph affected</b>	<b>How affected</b>	<b>By...[date]</b>
15	Amended	Amendments to the International Standards on Auditing (New Zealand) to Promote Improved Audit Quality [September 2013]
16	Inserted	Amendments to the International Standards on Auditing (New Zealand) to Promote Improved Audit Quality [September 2013]

## Introduction

- 1 This Explanatory Guide provides an overview of auditing and assurance standards in New Zealand. It covers six main topics:
  - The roles and responsibilities of the External Reporting Board (XRB Board), and its sub-Board the New Zealand Auditing and Assurance Standards Board (NZAuASB);
  - Assurance practitioners required to comply with auditing and assurance standards issued by the XRB;
  - The Standards and other documents issued by the XRB, and the legal standing of those documents;
  - The definition and objective of an assurance engagement;
  - The Standards that assurance practitioners are required to comply with (the auditing and assurance standards framework); and
  - The elements of an assurance engagement.
- 2 A separate Explanatory Guide (EG Au2: *Overview of the Auditing and Assurance Standard Setting Process*) provides an overview of the process that the XRB Board expects the NZAuASB to follow in developing or adopting, and issuing auditing and assurance standards.

## Roles of the XRB Board and the NZAuASB

- 3 The XRB is an independent Crown Entity established under section 22 of the Financial Reporting Act 1993 (the Act) and subject to the provisions of the Crown Entities Act 2004. For the purposes of this Explanatory Guide the organisation as a whole is referred to as the XRB while the Board itself is referred to as the XRB Board.
- 4 The functions of the XRB are specified in the Act. In relation to auditing and assurance standards they comprise:
  - Developing and issuing auditing and assurance standards (including professional and ethical standards for assurance practitioners) and amendments to auditing and assurance standards for application by statutory auditors or other assurance practitioners required to comply with those standards (section 24(1)(b));
  - Developing and implementing strategies for the issue of auditing and assurance standards in order to provide a framework for the XRB's overall direction in the setting of standards (section 24(1)(c));
  - Liaising with international or national organisations that have responsibility for auditing and assurance standard setting (section 24(1)(g)); and
  - Consulting with persons or organisations (or their representatives) who, in the opinion of the XRB Board, would be affected by the issue or amendment of an auditing or assurance standard (section 26).
- 5 While all the functions and responsibilities of the XRB ultimately rest with the XRB Board, the XRB Board has decided to delegate the responsibility for auditing and

assurance standard setting to a sub-board, the NZAuASB. The NZAuASB has been established in accordance with the powers vested in the XRB Board under Schedule 5 of the Crown Entities Act.

- 6 Accordingly, the role of the XRB Board under these arrangements is three-fold: organisational governance; financial reporting strategy setting; and appointing and monitoring the performance of the NZAuASB. The financial reporting strategy setting function (required by section 24(1) (c) of the Act) includes the establishment of the auditing and assurance standards framework.
- 7 The NZAuASB is responsible for developing and issuing auditing and assurance standards. In doing so the NZAuASB must:
  - (a) Operate within the auditing standards framework established by the XRB Board;
  - (b) Liaise with the Australian Auditing and Assurance Standards Board (AUASB) with the objective of harmonising auditing and assurance standards in Australia and New Zealand; and
  - (c) Ensure an appropriate consultation process (due process) is followed – see EG Au2: *Overview of the Auditing and Assurance Standard Setting Process* for an explanation of these requirements.
- 8 The NZAuASB operates under delegated authority from the XRB Board.

### **Requirement to comply with Auditing and Assurance Standards**

- 9 The Auditor Regulation Act 2011 requires all auditors of issuers to comply with the auditing and assurance standards issued by the XRB (including professional and ethical standards for assurance practitioners) from 1 July 2012 (or such earlier date as shall be determined by Order in Council).
- 10 Professional bodies, for example the New Zealand Institute of Chartered Accountants (NZICA), may require their members who are assurance practitioners to comply with the auditing and assurance standards issued by the XRB (including professional and ethical standards for assurance practitioners).
- 11 Other assurance practitioners may voluntarily comply with the auditing and assurance standards issued by the XRB (including professional and ethical standards for assurance practitioners).

### **Types of Documents Issued by the XRB**

- 12 As outlined in paragraph 9, compliance with auditing and assurance standards is a legal requirement for certain assurance practitioners and in these cases the Standards have legal standing. Further, under section 32 of the Act, auditing and assurance standards issued under section 24(1) (b) are classified as Regulations for the purposes of the Regulations (Disallowance) Act 1989. They are therefore legislative instruments.
- 13 However, not all the documents issued by the XRB have this legal status. Between them the XRB Board and the NZAuASB issue four types of documents:
  - Auditing and assurance standards which are issued under section 24(1)(b) of the Act;

- Guidance Statements and Practice Statements which provide guidance on interpreting and applying auditing and assurance standards, that have no legal status;
- Consultation documents, such as consultation papers and exposure drafts, that have no legal status; and
- Explanatory documents (such as this Explanatory Guide), that have no legal status.

Only the documents issued under section 24(1) (b) have legal standing.

- 14 The XRB Board considers it important that the legal status of each document issued by the XRB or the NZAuASB is clear. Accordingly, its policy is to indicate on the front page of each document the legal standing of that document.

## **Auditing and Assurance Standards Framework**

### **Auditing and Assurance Standards**

- 15 Auditing and assurance standards issued by the XRB or the NZAuASB are the primary indicators of good assurance practice in New Zealand. The standards contain objectives, definitions, requirements, application and other explanatory material, inductory material and appendices. They set out the requirements or basic principles and essential procedures that assurance practitioners should follow when conducting an assurance engagement, and the behaviours that they should display as part of, and surrounding, that work. The assurance practitioner should apply the mandatory components of the auditing and assurance standards when conducting assurance engagement. The mandatory components are included under the headings listed below:

- Effective date;
- Objectives(s);
- Definitions(s);
- Requirements.

- 16 The assurance practitioner should have an understanding of the entire text of the standard, including its application and other explanatory material, to understand its objectives and to apply its requirements properly. The explanatory material is included in each standard under the headings listed below:

- Introductions(s);
- Application and Other Explanatory Material;
- Conformity with International Standards;
- Appendices

Appendices, which form part of the application material, are an integral part of a standard. The purpose and intended use of an appendix are explained in the body of the related standards or within the title and introduction of the appendix itself. Explanatory material does not create or extend mandatory components.

## Definition and Objective of an Assurance Engagement

- 17 “Assurance engagement” means an engagement in which an assurance practitioner expresses a conclusion in the form of an opinion 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.
- 18 The outcome of the evaluation or measurement of a subject matter is the information that results from applying the criteria to the subject matter. For example:
- The recognition, measurement, presentation and disclosure represented in the financial statements (outcome) result from applying a financial reporting framework for recognition, measurement, presentation and disclosure, such as New Zealand equivalents to International Financial Reporting Standards (NZ IFRSs) (criteria) to an entity’s financial position, financial performance and cash flows (subject matter).
  - An assertion about the effectiveness of internal control (outcome) results from applying a framework for evaluating the effectiveness of internal control, such as COSO<sup>1</sup> or CoCo<sup>2</sup> (criteria) to internal control, a process (subject matter).
- 19 In the remainder of this Explanatory Guide, the term “subject matter information” will be used to mean the outcome of the evaluation or measurement of a subject matter. It is the subject matter information about which the assurance practitioner gathers sufficient appropriate evidence to provide a justifiable basis for expressing a conclusion in an assurance report.
- 20 Subject matter information can fail to be properly expressed in the context of the subject matter and the criteria, and can therefore be misstated, potentially to a material extent. This occurs when the subject matter information does not properly reflect the application of the criteria to the subject matter, for example, when an entity’s financial statements do not give a true and fair view of (or present fairly, in all material respects) its financial position, financial performance and cash flows in accordance with NZ IFRSs, or when an entity’s assertion that its internal control is effective is not fairly stated, in all material respects, based on COSO or CoCo.
- 21 In some assurance engagements, the evaluation or measurement of the subject matter is performed by the responsible party, and the subject matter information is in the form of an assertion by the responsible party that is made available to the intended users. These engagements are called “assertion-based engagements.” In other assurance engagements, the assurance practitioner either directly performs the evaluation or measurement of the subject matter, or obtains a representation from the responsible party that has performed the evaluation or measurement that is not available to the intended users. The subject matter information is provided to the intended users in the assurance report. These engagements are called “direct reporting engagements.”
- 22 Under this Explanatory Guide, there are two types of assurance engagement an assurance practitioner may perform: a reasonable assurance engagement and a limited

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<sup>1</sup> “Internal Control – Integrated Framework” The Committee of Sponsoring Organizations of the Treadway Commission.

<sup>2</sup> “Guidance on Assessing Control – The CoCo Principles” Criteria of Control Board, The Canadian Institute of Chartered Accountants.



assurance engagement (also outlined in the Appendix). The objective of a reasonable assurance engagement is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement<sup>3</sup> as the basis for a positive form of expression of the assurance practitioner's conclusion. Reasonable assurance means a high, but not absolute, level of assurance. The objective of a limited assurance engagement is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the assurance practitioner's conclusion. Limited assurance means a moderate level of assurance.

### **Auditing and Assurance Standards Applying to Different Assurance Engagements**

- 23 The auditing and assurance standards comprise four suites of standards:
- (a) Professional and Ethical Standards;
  - (b) International Standards on Auditing (New Zealand) (ISAs (NZ));
  - (c) Review Engagement Standards (RS); and
  - (d) Other Assurance Engagements Standards - Standards on Assurance Engagements (SAEs) and International Standards on Assurance Engagements (New Zealand) (ISAEs (NZ)).
- 24 XRB Standard Au1 *Application of Auditing and Assurance Standards* (XRB Au1) establishes which suite of standards applies to which type of assurance engagement. In summary this is as follows:
- All assurance practitioners are required to apply the professional and ethical standards in preparing for and conducting an assurance engagement.
  - Assurance practitioners conducting an audit of historical financial information are required to apply International Standards on Auditing (New Zealand).
  - Assurance practitioners conducting review engagements are required to apply Review Engagement Standards.
  - Assurance practitioners conducting assurance engagements other than audits or reviews of historical financial information are required to apply Other Assurance Engagement Standards.
- 25 The specific standards to be applied are detailed in XRB Au1.

### **Professional and Ethical Standards**

- 26 There are two Professional and Ethical Standards:
- Professional and Ethical Standard 1 (Revised): Code of Ethics for Assurance Practitioners (Compiled)
  - Professional and Ethical Standard 3 (Amended): *Quality Control for Firms that*

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<sup>3</sup> Engagement circumstances include the terms of the engagement, including whether it is a reasonable assurance engagement or a limited assurance engagement, the characteristics of the subject matter, the criteria to be used, the needs of the intended users, relevant characteristics of the responsible party and its environment, and other matters, for example events, transactions, conditions and practices, that may have a significant effect on the engagement.

*Perform Audits and Reviews of Financial Statements, and Other Assurance Engagements*

- 27 Professional and Ethical Standard 1 (Revised) is based on the Code of Ethics issued by the International Ethics Standards Board for Accountants (IESBA) as it applies to assurance engagements. Professional and Ethical Standard 3 (Amended) is based on International Standard on Quality Control (ISQC) 1 issued by the International Auditing and Assurance Standards Board (IAASB).

International Standards on Auditing (New Zealand) (ISAs (NZ))

- 28 An audit is designed to provide a high, but not absolute, level of assurance, expressed positively in the auditor's report as reasonable assurance, that the information subject to audit is free of material misstatement.
- 29 International Standards on Auditing (New Zealand) (ISAs (NZ)) are based on the equivalent International Standards on Auditing issued by the IAASB.
- 30 ISAs (NZ) follow the format of the pronouncements issued by the IAASB. However, ISAs (NZ) cross refer to other New Zealand Standards (rather than ISAs) and state an application date as determined by the XRB or the NZAuASB.
- 31 ISAs (NZ) are supported by Audit Guidance Statements (AGs). The AGs provide guidance on the application of ISAs (NZ) but have no legal standing.
- 32 The initial suite of ISAs (NZ) was issued by the XRB Board on 1 July 2011 and applies to audits of historical financial statements for periods beginning on or after 1 September 2011. In accordance with the requirements of the Act, these Standards are substantively similar to the equivalent Standards issued by NZICA prior to that date.
- 33 ISAs (NZ) are written in the context of an audit of financial statements<sup>4</sup> by an independent auditor. They are to be applied, as appropriate, to all audits.

Review Standard (RS-1)

- 34 A review is a limited assurance engagement designed to provide a moderate level of assurance.
- 35 The objective of a review engagement of financial information is to enable the reviewer 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 reviewer's attention to cause the reviewer to believe that the financial information does not present a true and fair view of the matters to which it relates. A review report helps lend some credibility to the financial information. The user, however, should be informed that an audit has not been performed.
- 36 There is currently one review standard – RS-1 *Statement of Review Engagement Standards*.
- 37 RS-1 was issued by the XRB Board on 1 July 2011 and applies to reviews of historical financial statements for periods beginning on or after 1 September 2011, and to other review engagements beginning on or after 1 September 2011. In accordance with the requirements of the Act, this Standard is substantively similar to

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<sup>4</sup> Unless otherwise stated, "financial statements" means financial statements comprising historical financial information.

the equivalent Standard issued by NZICA prior to that date. RS-1 is a domestic standard and is not directly derived from the international standard issued by the IAASB.

- 38 RS-1 is written in the context of a review of financial information but is to be applied, as appropriate, to all reviews.

#### Other Assurance Engagement Standards

- 39 The Other Assurance Engagements Standards ((SAEs) and (ISAEs (NZ))) apply to assurance engagements other than those relating to audits or reviews of historical financial statements. These engagements may provide either reasonable or limited assurance, depending on the nature of the engagement. These Standards are issued by the XRB and the NZAuASB in accordance with section 24(1) (b) (v) of the Act which allows the XRB to issue other standards for purposes approved by the Minister responsible for the XRB.
- 40 The Other Assurance Engagements Standards were issued by the XRB Board on 24 August 2011. In accordance with the requirements of the Act, these Standards are substantively similar to the equivalent Standards issued by NZICA prior to that date.
- 41 The SAEs are domestic standards and are not directly derived from the international standards issued by the IAASB.
- 42 The ISAEs (NZ) are based on the equivalent international standards on assurance engagements issued by the IAASB. They follow the format of the pronouncements issued by the IAASB.

#### Elements of an Assurance Engagement

- 43 The following elements of an assurance engagement are discussed in this section:
- (a) A three party relationship involving an assurance practitioner, a responsible party, and intended users;
  - (b) An appropriate subject matter;
  - (c) Suitable criteria;
  - (d) Sufficient appropriate evidence; and
  - (e) A written assurance report in the form appropriate to a reasonable assurance engagement or a limited assurance engagement.

#### Three Party Relationship

- 44 Assurance engagements involve three separate parties: an assurance practitioner, a responsible party and intended users.
- 45 The responsible party and the intended users may be from different entities or the same entity. As an example of the latter case, a governing body may seek assurance about information provided by the senior management of that entity. The relationship between the responsible party and the intended users' needs to be viewed within the context of a specific engagement and may differ from more traditionally defined lines of responsibility. For example, an entity's senior management (an intended user) may engage an assurance practitioner to perform an assurance engagement on a particular aspect of the entity's activities that is the immediate responsibility of a lower level of

management (the responsible party), but for which senior management is ultimately responsible.

### *Responsible Party*

- 46 The responsible party is the person (or persons) who:
- (a) In a direct reporting engagement, is responsible for the subject matter; or
  - (b) In an assertion-based engagement, is responsible for the subject matter information (the assertion), and may be responsible for the subject matter. An example of when the responsible party is responsible for both the subject matter information and the subject matter is when an entity engages an assurance practitioner to perform an assurance engagement regarding a report it has prepared about its own sustainability practices. An example of when the responsible party is responsible for the subject matter information but not the subject matter is when a government organisation engages an assurance practitioner to perform an assurance engagement regarding a report about an entity's sustainability practices that the organisation has prepared and is to distribute to intended users.

The responsible party may or may not be the party who engages the assurance practitioner (the engaging party).

- 47 The responsible party ordinarily provides the assurance practitioner with a written representation that evaluates or measures the subject matter against the identified criteria, whether or not it is to be made available as an assertion to the intended users. In a direct reporting engagement, the assurance practitioner may not be able to obtain such a representation when the engaging party is different from the responsible party.

### *Intended Users*

- 48 The intended users are the person, persons or class of persons for whom the assurance practitioner prepares the assurance report. The responsible party can be one of the intended users, but not the only one.
- 49 Whenever practical, the assurance report is addressed to all the intended users, but in some cases there may be other intended users. The assurance practitioner may not be able to identify all those who will read the assurance report, particularly where there are a large number of people who have access to it. In such cases, particularly where possible readers are likely to have a broad range of interests in the subject matter, intended users may be limited to major stakeholders with significant and common interests. Intended users may be identified in different ways, for example, by agreement between the assurance practitioner and the responsible party or engaging party, or by law.
- 50 Whenever practical, intended users or their representatives are involved with the assurance practitioner and the responsible party (and the engaging party if different) in determining the requirements of the engagement. Regardless of the involvement of others however:
- (a) The assurance practitioner is responsible for determining the nature, timing and extent of procedures; and

(b) The assurance practitioner is required to pursue any matter the assurance practitioner becomes aware of that leads the assurance practitioner to question whether a material modification should be made to the subject matter information.

51 In some cases, intended users (for example, bankers and regulators) impose a requirement on, or request the responsible party (or the engaging party if different) to arrange for, an assurance engagement to be performed for a specific purpose. When engagements are designed for specified intended users or a specific purpose, the assurance practitioner should consider including a restriction in the assurance report that limits its use to those users or that purpose.

### Subject Matter

52 The subject matter, and subject matter information of an assurance engagement can take many forms, such as:

- Financial performance or conditions (for example, historical or prospective financial position, financial performance and cash flows) for which the subject matter information may be the recognition, measurement, presentation and disclosure represented in financial statements;
- Non-financial performance or conditions (for example, performance of an entity) for which the subject matter information may be key indicators of efficiency and effectiveness;
- Physical characteristics (for example, capacity of a facility) for which the subject matter information may be a specifications document;
- Systems and processes (for example, an entity's internal control or IT system) for which the subject matter information may be an assertion about effectiveness;
- Behaviour (for example, corporate governance, compliance with regulation, human resource practices) for which the subject matter information may be a statement of compliance or a statement of effectiveness.

53 Subject matters have different characteristics, including the degree to which information about them is qualitative versus quantitative, objective versus subjective, historical versus prospective, and relates to a point in time or covers a period. Such characteristics affect the:

- (a) Precision with which the subject matter can be evaluated or measured against criteria; and
- (b) The persuasiveness of available evidence.

The assurance report should note characteristics of particular relevance to the intended users.

54 An appropriate subject matter is:

- (a) Identifiable and capable of consistent evaluation or measurement against the identified criteria; and
- (b) Such that the information about it can be subjected to procedures for gathering sufficient appropriate evidence to support a reasonable assurance or limited assurance conclusion, as appropriate.

## Criteria

- 55 Criteria are the benchmarks used to evaluate or measure the subject matter including, where relevant, benchmarks for presentation and disclosure. Criteria can be formal, for example: in the preparation of financial statements, the criteria may be NZ IFRSs; when reporting on internal control, the criteria may be an established internal control framework or individual control objectives specifically designed for the engagement; and when reporting on compliance, the criteria may be the applicable law, regulation or contract. Examples of less formal criteria are an internally developed code of conduct or an agreed level of performance (such as the number of times a particular committee is expected to meet in a year).
- 56 Suitable criteria are required for reasonably consistent evaluation or measurement of a subject matter within the context of professional judgement. Without the frame of reference provided by suitable criteria, any conclusion is open to individual interpretation and misunderstanding. Suitable criteria are context-sensitive, that is, relevant to the engagement circumstances. Even for the same subject matter there can be different criteria.
- 57 Suitable criteria exhibit the following characteristics:
- (a) **Relevance:** relevant criteria contribute to conclusions that assist decision-making by the intended users;
  - (b) **Completeness:** criteria are sufficiently complete when relevant factors that could affect the conclusions in the context of the engagement circumstances are not omitted. Complete criteria include, where relevant, benchmarks for presentation and disclosure;
  - (c) **Reliability:** reliable criteria allow reasonably consistent evaluation or measurement of the subject matter including, where relevant, presentation and disclosure, when used in similar circumstances by similarly qualified assurance practitioners;
  - (d) **Neutrality:** neutral criteria contribute to conclusions that are free from bias; and
  - (e) **Understandability:** understandable criteria contribute to conclusions that are clear, comprehensive, and not subject to significantly different interpretations.

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

- 58 The assurance practitioner should assess the suitability of criteria for a particular engagement by considering whether they reflect the above characteristics. The relative importance of each characteristic to a particular engagement is a matter of judgement. Criteria can either be established or specifically developed. Established criteria are those embodied in laws or regulations, or issued by authorised or recognised bodies of experts that follow a transparent due process. Specifically developed criteria are those designed for the purpose of the engagement. Whether criteria are established or specifically developed affects the work that the assurance practitioner carries out to assess their suitability for a particular engagement.
- 59 Criteria need to be available to the intended users to allow them to understand how the subject matter has been evaluated or measured. Criteria are made available to the intended users in one or more of the following ways:

- (a) Publicly;
- (b) Through inclusion in a clear manner in the presentation of the subject matter information;
- (c) Through inclusion in a clear manner in the assurance report; or
- (d) By general understanding, for example the criterion for measuring time in hours and minutes.

Criteria may also be available only to specific intended users, for example the terms of a contract, or criteria issued by an industry association that are available only to those in the industry. When identified criteria are available only to specific intended users, or are relevant only to a specific purpose, use of the assurance report is restricted to those users or for that purpose.<sup>5</sup>

## Evidence

- 60 The assurance practitioner should plan and perform an assurance engagement with an attitude of professional scepticism to obtain sufficient appropriate evidence about whether the subject matter information is free of material misstatement. The assurance practitioner should consider materiality, assurance engagement risk, and the quantity and quality of available evidence when planning and performing the engagement, in particular when determining the nature, timing and extent of evidence-gathering procedures.

### Professional Scepticism

- 61 The assurance practitioner should plan and perform an assurance engagement with an attitude of professional scepticism recognising that circumstances may exist that cause the subject matter information to be materially misstated. An attitude of professional scepticism means the assurance practitioner makes a critical assessment, with a questioning mind, of the validity of evidence obtained and is alert to evidence that contradicts or brings into question the reliability of documents or representations by the responsible party. For example, an attitude of professional scepticism is necessary throughout the engagement process for the assurance practitioner to reduce the risk of overlooking suspicious circumstances, of over-generalising when drawing conclusions from observations, and of using faulty assumptions in determining the nature, timing and extent of evidence gathering procedures and evaluating the results thereof.
- 62 An assurance engagement rarely involves the authentication of documentation, nor is the assurance practitioner trained as or expected to be an expert in such authentication. However, the assurance practitioner should consider the reliability of the information to be used as evidence, for example photocopies, facsimiles, filmed, digitised or other electronic documents, including consideration of controls over their preparation and maintenance where relevant.

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<sup>5</sup> While an assurance report may be restricted whenever it is intended only for specified intended users or for a specific purpose, the absence of a restriction regarding a particular reader or purpose does not itself indicate that a legal responsibility is owed by the assurance practitioner in relation to that reader or for that purpose. Whether a legal responsibility is owed will depend on the circumstances of each case and the relevant jurisdiction.

*Sufficiency and Appropriateness of Evidence*

- 63 Sufficiency is the measure of the quantity of evidence. Appropriateness is the measure of the quality of evidence; that is, its relevance and its reliability. The quantity of evidence needed is affected by the risk of the subject matter information being materially misstated (the greater the risk, the more evidence is likely to be required) and also by the quality of such evidence (the higher the quality, the less may be required). Accordingly, the sufficiency and appropriateness of evidence are interrelated. However, merely obtaining more evidence may not compensate for its poor quality.
- 64 The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained. Generalisations about the reliability of various kinds of evidence can be made; however, such generalisations are subject to important exceptions. Even when evidence is obtained from sources external to the entity, circumstances may exist that could affect the reliability of the information obtained. For example, evidence obtained from an independent external source may not be reliable if the source is not knowledgeable. While recognising that exceptions may exist, the following generalisations about the reliability of evidence may be useful:
- Evidence is more reliable when it is obtained from independent sources outside the entity.
  - Evidence that is generated internally is more reliable when the related controls are effective.
  - Evidence obtained directly by the assurance practitioner (for example, observation of the application of a control) is more reliable than evidence obtained indirectly or by inference (for example, enquiry about the application of a control).
  - Evidence is more reliable when it exists in documentary form, whether paper, electronic, or other media (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of what was discussed).
  - Evidence provided by original documents is more reliable than evidence provided by photocopies or facsimiles.
- 65 The assurance practitioner ordinarily obtains more assurance from consistent evidence obtained from different sources or of a different nature than from items of evidence considered individually. In addition, obtaining evidence from different sources or of a different nature may indicate that an individual item of evidence is not reliable. For example, corroborating information obtained from a source independent of the entity may increase the assurance that the assurance practitioner obtains from a representation from the responsible party. Conversely, when evidence obtained from one source is inconsistent with that obtained from another, the assurance practitioner should determine what additional evidence-gathering procedures are necessary to resolve the inconsistency.
- 66 In terms of obtaining sufficient appropriate evidence, it is generally more difficult to obtain assurance about subject matter information covering a period than about subject matter information at a point in time. In addition, conclusions provided on processes ordinarily are limited to the period covered by the engagement; the



assurance practitioner can provide no conclusion about whether the process will continue to function in the specified manner in the future.

- 67 The assurance practitioner should consider the relationship between the cost of obtaining evidence and the usefulness of the information obtained. However, the matter of difficulty or expense involved is not in itself a valid basis for omitting an evidence-gathering procedure for which there is no alternative. The assurance practitioner should use professional judgement and exercise professional scepticism in evaluating the quantity and quality of evidence, and thus its sufficiency and appropriateness, to support the assurance report.

### *Materiality*

- 68 Materiality is relevant when the assurance practitioner determines the nature, timing and extent of evidence-gathering procedures, and when assessing whether the subject matter information is free of misstatement. When considering materiality, the assurance practitioner should understand and assess what factors might influence the decisions of the intended users. For example, when the identified criteria allow for variations in the presentation of the subject matter information, the assurance practitioner should consider how the adopted presentation might influence the decisions of the intended users. Materiality is considered in the context of quantitative and qualitative factors, such as relative magnitude, the nature and extent of the effect of these factors on the evaluation or measurement of the subject matter, and the interests of the intended users. The assessment of materiality and the relative importance of quantitative and qualitative factors in a particular engagement are matters for the assurance practitioner's judgement.

### *Assurance Engagement Risk*

- 69 Assurance engagement risk is the risk that the assurance practitioner expresses an inappropriate conclusion when the subject matter information is materially misstated.<sup>6</sup> In a reasonable assurance engagement, the assurance practitioner reduces assurance engagement risk to an acceptably low level in the circumstances of the engagement to obtain reasonable assurance as the basis for a positive form of expression of the assurance practitioner's conclusion. The level of assurance engagement risk is higher in a limited assurance engagement than in a reasonable assurance engagement because of the different nature, timing or extent of evidence-gathering procedures. However in a limited assurance engagement, the combination of the nature, timing and extent of evidence gathering procedures is at least sufficient for the assurance practitioner to obtain a meaningful level of assurance as the basis for a negative form of expression. To be meaningful, the level of assurance obtained by the assurance practitioner is likely to enhance the intended users' confidence about the subject matter information to a degree that is clearly more than inconsequential.

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<sup>6</sup> (a) This includes the risk, in those direct reporting engagements where the subject matter information is presented only in the assurance practitioner's conclusion, that the assurance practitioner inappropriately concludes that the subject matter does, in all material respects, conform with the criteria, for example: "In our opinion, internal control is effective, in all material respects, based on XYZ criteria."  
 (b) In addition to assurance engagement risk, the assurance practitioner is exposed to the risk of expressing an inappropriate conclusion when the subject matter information is not materially misstated, and risks through loss from litigation, adverse publicity, or other events arising in connection with a subject matter reported on. These risks are not part of assurance engagement risk.

- 70 In general, assurance engagement risk can be represented by the following components, although not all of these components will necessarily be present or significant for all assurance engagements:
- (a) The risk that the subject matter information is materially misstated, which in turn consists of:
    - (i) Inherent risk: the susceptibility of the subject matter information to a material misstatement, assuming that there are no related controls; and
    - (ii) Control risk: the risk that a material misstatement that could occur will not be prevented, or detected and corrected, on a timely basis by related internal controls. When control risk is relevant to the subject matter, some control risk will always exist because of the inherent limitations of the design and operation of internal control; and
  - (b) Detection risk: the risk that the assurance practitioner will not detect a material misstatement that exists.

The degree to which the assurance practitioner considers each of these components is affected by the engagement circumstances, in particular by the nature of the subject matter and whether a reasonable assurance or a limited assurance engagement is being performed.

#### *Nature, Timing and Extent of Evidence-gathering Procedures*

- 71 The exact nature, timing and extent of evidence-gathering procedures will vary from one engagement to the next. In theory, infinite variations in evidence gathering procedures are possible. In practice, however, these are difficult to communicate clearly and unambiguously. The assurance practitioner should attempt to communicate them clearly and unambiguously and use the form appropriate to a reasonable assurance engagement or a limited assurance engagement.<sup>7</sup>
- 72 “Reasonable assurance” is a concept relating to accumulating evidence necessary for the assurance practitioner to conclude in relation to the subject matter information taken as a whole. To be in a position to express a conclusion in the positive form required in a reasonable assurance engagement, it is necessary for the assurance practitioner to obtain sufficient appropriate evidence as part of an iterative, systematic engagement process involving:
- (a) Obtaining an understanding of the subject matter and other engagement circumstances which, depending on the subject matter, includes obtaining an understanding of internal control;
  - (b) Based on that understanding, assessing the risks that the subject matter information may be materially misstated;
  - (c) Responding to assessed risks, including developing overall responses, and determining the nature, timing and extent of further procedures;

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<sup>7</sup> Where the subject matter information is made up of a number of aspects, separate conclusions may be provided on each aspect. While not all such conclusions need to relate to the same level of evidence gathering procedures, each conclusion is expressed in the form that is appropriate to either a reasonable assurance or a limited assurance engagement.

- (d) Performing further procedures clearly linked to the identified risks, using a combination of inspection, observation, confirmation, recalculation, re-performance, analytical procedures and enquiry. Such further procedures involve substantive procedures including, where applicable, obtaining corroborating information from sources independent of the responsible party, and depending on the nature of the subject matter, tests of the operating effectiveness of controls; and
- (e) Evaluating the sufficiency and appropriateness of evidence.

73 “Reasonable assurance” is less than absolute assurance. “Limited assurance” means a moderate level of assurance. Reducing assurance engagement risk to zero is very rarely attainable or cost beneficial as a result of factors such as the following:

- The use of selective testing;
- The inherent limitations of internal control;
- The fact that much of the evidence available to the assurance practitioner is persuasive rather than conclusive;
- The use of judgement in gathering and evaluating evidence and forming conclusions based on that evidence; and
- In some cases, the characteristics of the subject matter when evaluated or measured against the identified criteria.

74 Both reasonable assurance and limited assurance engagements require the application of assurance skills and techniques and the gathering of sufficient appropriate evidence as part of an iterative, systematic engagement process that includes obtaining an understanding of the subject matter and other engagement circumstances. The nature, timing and extent of procedures for gathering sufficient appropriate evidence in a limited assurance engagement are, however, deliberately limited relative to a reasonable assurance engagement. For some subject matters, there may be specific pronouncements to provide guidance on procedures for gathering sufficient appropriate evidence for a limited assurance engagement. In the absence of a relevant pronouncement, the procedures for gathering sufficient appropriate evidence will vary with the circumstances of the engagement, in particular, the subject matter, and the needs of the intended users and the engaging party, including relevant time and cost constraints. For both reasonable assurance and limited assurance engagements, if the assurance practitioner becomes aware of a matter that leads the assurance practitioner to question whether a material modification should be made to the subject matter information, the assurance practitioner should pursue the matter by performing other procedures sufficient to enable the assurance practitioner to report.

#### *Quantity and Quality of Available Evidence*

75 The quantity or quality of available evidence is affected by:

- (a) The characteristics of the subject matter and subject matter information. For example, less objective evidence might be expected when information about the subject matter is future oriented rather than historical (see paragraph 52); and
- (b) Circumstances of the engagement other than the characteristics of the subject matter, when evidence that could reasonably be expected to exist is not available because of, for example, the timing of the assurance practitioner’s appointment,

an entity's document retention policy, or a restriction imposed by the responsible party.

Ordinarily, available evidence will be persuasive rather than conclusive.

- 76 An unqualified conclusion is not appropriate for either type of assurance engagement in the case of a material limitation on the scope of the assurance practitioner's work, that is, when:
- (a) Circumstances prevent the assurance practitioner from obtaining evidence required to reduce assurance engagement risk to the appropriate level; or
  - (b) The responsible party or the engaging party imposes a restriction that prevents the assurance practitioner from obtaining evidence required to reduce assurance engagement risk to the appropriate level.

### Assurance Report

- 77 The assurance practitioner provides a written report containing a conclusion that conveys the assurance obtained about the subject matter information. The auditing and assurance standards establish basic elements for assurance reports. In addition, the assurance practitioner should consider other reporting responsibilities, including communicating with those charged with governance when it is appropriate to do so.
- 78 In an assertion-based reasonable assurance engagement, the assurance practitioner's conclusion can be worded either:
- (a) In terms of the responsible party's assertion (for example: "In our opinion *the responsible party's* assertion that internal control is effective, in all material respects, based on *XYZ criteria*, is fairly stated"); or
  - (b) Directly in terms of the subject matter and the criteria (for example: "In our opinion internal control is effective, in all material respects, based on *XYZ criteria*").

In a direct reporting engagement, the assurance practitioner's conclusion is worded directly in terms of the subject matter and the criteria.

- 79 In a reasonable assurance engagement, the assurance practitioner expresses the conclusion in the positive form, for example: "In our opinion internal control is effective, in all material respects, based on *XYZ criteria*." This form of expression conveys "reasonable assurance." Having performed evidence gathering procedures of a nature, timing and extent that were reasonable given the characteristics of the subject matter and other relevant engagement circumstances described in the assurance report, the assurance practitioner has obtained sufficient appropriate evidence to reduce assurance engagement risk to an acceptably low level.
- 80 In a limited assurance engagement, the assurance practitioner expresses the conclusion in the negative form, for example, "Based on our work described in this report, nothing has come to our attention that causes us to believe that internal control is not effective, in all material respects, based on *XYZ criteria*." This form of expression conveys a level of "limited assurance" that is proportional to the level of the assurance practitioner's evidence-gathering procedures given the characteristics of the subject matter and other engagement circumstances described in the assurance report.

81 An assurance practitioner should not express an unqualified conclusion for either type of assurance engagement when the following circumstances exist and, in the assurance practitioner's judgement, the effect of the matter is or may be material:

- (a) There is a limitation on the scope of the assurance practitioner's work (see paragraph 75). The assurance practitioner expresses a qualified conclusion or a disclaimer of conclusion depending on how material or pervasive the limitation is. In some cases the assurance practitioner considers withdrawing from the engagement;
- (b) In those cases where:
  - (i) The assurance practitioner's conclusion is worded in terms of the responsible party's assertion, and that assertion is not fairly stated, in all material respects; or
  - (ii) The assurance practitioner's conclusion is worded directly in terms of the subject matter and the criteria, and the subject matter information is materially misstated,<sup>8</sup>

the assurance practitioner expresses a qualified or adverse conclusion depending on how material or pervasive the matter is.

- (c) When it is discovered after the engagement has been accepted, that the criteria are unsuitable or the subject matter is not appropriate for an assurance engagement. The assurance practitioner should express:
  - (i) A qualified conclusion or adverse conclusion depending on how material or pervasive the matter is, when the unsuitable criteria or inappropriate subject matter is likely to mislead the intended users; or
  - (ii) A qualified conclusion or a disclaimer of conclusion depending on how material or pervasive the matter is, in other cases.

In some cases the assurance practitioner should consider withdrawing from the engagement.

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<sup>8</sup> In those direct reporting engagements where the subject matter information is presented only in the assurance practitioner's conclusion, and the assurance practitioner concludes that the subject matter does not, in all material respects, conform with the criteria, for example: "In our opinion, except for [...], internal control is effective, in all material respects, based on XYZ criteria," such a conclusion would also be considered to be qualified (or adverse as appropriate).

## Appendix

## Differences Between Reasonable Assurance Engagements and Limited Assurance Engagements

This Appendix outlines the differences between a reasonable assurance engagement and a limited assurance engagement discussed in this Explanatory Guide.

Type of Engagements	Objective	Evidence-gathering procedures	The assurance report
<b>Reasonable assurance engagement</b>	A reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement, as the basis for a positive form of expression of the assurance practitioner's conclusion	Sufficient appropriate evidence is obtained as part of a systematic engagement process that includes: <ul style="list-style-type: none"> <li>• Obtaining an understanding of the engagement circumstances;</li> <li>• Assessing risks;</li> <li>• Responding to assessed risks;</li> <li>• Performing further procedures using a combination of inspection, observation, confirmation, recalculation, reperformance, analytical procedures and enquiry. Such further procedures involve substantive procedures, including, where applicable, obtaining corroborating information, and depending on the nature of the subject matter, tests of the operating effectiveness of controls; and</li> <li>• Evaluating the evidence obtained. (Paragraphs 71 and 72)</li> </ul>	Description of the engagement circumstances and a positive form of expression of the conclusion (Paragraph 72)
<b>Limited assurance engagement</b>	A reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the assurance practitioner's conclusion	Sufficient appropriate evidence is obtained as part of a systematic engagement process that includes obtaining an understanding of the subject matter and other engagement circumstances, but in which procedures are deliberately limited relative to a reasonable assurance engagement (Paragraph 73)	Description of the engagement circumstances and a negative form of expression of the conclusion (Paragraph 79)