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## Audit planning; Technical information for practitioners series, 2

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# AUDIT PLANNING

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American Institute of Certified Public Accountants

Technical  
Information for  
Practitioners  
Series

2

# AUDIT PLANNING

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Michael A. Tursi, CPA, *Technical Manager*

American Institute of Certified Public Accountants

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# **PREFACE**

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## **AUDIT PLANNING**

This is the second in a series entitled Technical Information for Practitioners (TIPS). Each book in the series is designed to give practical guidance to one aspect of an accounting or audit engagement.

This booklet includes illustrative audit assignment control forms, engagement letters, and an illustrative planning checklist that can be used by an accountant in the planning phase of an audit engagement.

This is a nonauthoritative kit of practice aids. Various formats of audit assignment controls, engagement letters, and planning checklists are in use; nevertheless, inclusion of the formats in this booklet in no way means that they are preferable. Readers are urged to refer directly to authoritative pronouncements when appropriate.

Illustrative formats of audit assignment controls, engagement letters, and planning checklists are often helpful in developing a consistent style within a firm. However, no set of illustrative formats can cover all the situations that are likely to be encountered in practice because the circumstances of engagements vary widely.

Readers should consider other sources of illustrative presentations, such as those in authoritative pronouncements and AICPA audit and accounting guides.

The sole responsibility for this material rests with the staff of the Technical Information Division. This material has not been approved, disapproved, or otherwise acted upon by the senior technical committees of the American Institute of Certified Public Accountants or the Financial Accounting Standards Board. Comments and suggestions should be addressed to the following:

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## AAM Section 3100

# Planning the Engagement

.01 The planning phase is an important part of every engagement. During this phase, the partner and the staff review the client's business and the industry in which the client operates, then develop an overall strategy for the expected conduct and scope of the engagement.

.02 The need for planning is highlighted in rule 201, General Standards, AICPA *Code of Professional Ethics*, which states: "A member shall adequately plan and supervise an engagement."

.03 The first standard of fieldwork of generally accepted auditing standards states: "The work is to be adequately planned and assistants, if any, are to be properly supervised." Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU section 311) provides authoritative interpretive guidance on the first standard of fieldwork.

.04 Proper planning also enhances the productivity of engagement personnel and should result in a more profitable engagement.

.05 The planning memo and the planning checklist are two commonly used planning documents. The style and complexity of these documents will depend on engagement needs and firm preference. The same memo or checklist may be referred to in the review process to ensure that the items highlighted in the planning phase are given adequate attention during the engagement.

.06 The steps in audit planning are as follows:

- a. Understand the scope of services and the nature of reports expected to be rendered.
- b. Decide whether or not to accept the engagement.
- c. Assign personnel to the engagement and prepare a preliminary time budget.
- d. Assess independence of firm and audit team.
- e. Understand the entity's business and the industry in which it operates.
- f. Assess the auditability of the entity by—
  1. Gaining an adequate understanding of the control environment, flow of transactions, and adequacy of records.

## 2. Evaluating management integrity.

- g.* Establish an agreement with the client, preferably with an engagement letter.
- h.* Decide on a preliminary basis the extent, if any, to rely upon internal control.
- i.* Make a preliminary judgment about materiality levels for audit purposes.
- j.* Estimate the level of audit risk and consider its interactive components.
- k.* Consider how components of audit risk relate to one another for each cycle or major account.
- l.* Consider cost-effectiveness of different audit strategies.
- m.* Write the audit program and finalize a time budget.

## **AAM Section 3105**

### ***Understanding the Assignment***

.01 The auditor should (a) meet with the client to understand the type, scope, and timing of the examination; (b) understand if reports on compliance, internal control, or segments of the entity are required; (c) understand the client's expectations, both stated and implied; and (d) review the expectations of both the owners and the managers.

.02 A sample checklist documenting the procedures listed in this section is located in section 3150 of this booklet.



## **AAM Section 3110**

# ***Assigning Personnel to the Engagement***

### **General Comments**

.01 Engagement planning should include procedures for assigning personnel to the engagement. The procedures established should provide the firm with reasonable assurance that work will be performed by persons having the degree of technical training and proficiency required in the circumstances. Generally, the more able and experienced the personnel assigned to a particular engagement, the less need for direct supervision.

.02 Some procedures regarding assignment of personnel to the engagement are discussed in this section. The specific procedures adopted by a firm would not necessarily include all the procedures or be limited to those discussed. Overall firm requirements for assigning personnel to engagements are addressed in the Statements on Quality Control Standards (QC section 90.11–.12).

### **Engagement Planning Procedures**

.03 A time budget for the engagement should generally be prepared to determine manpower requirements and to schedule fieldwork. The engagement partner should approve the time budget prior to the beginning of fieldwork. A time budget should have columns for budgeted time (in hours) and for preliminary and final fieldwork. Time budget forms differ depending upon firm preference and needs. Some firms use separate forms for the time budget report and the job progress report or analysis (see section 3155.01 for “Audit Time Budget—Sample A”) whereas others combine these reports into one form (see section 3155.02 for “Audit Time Budget—Sample B”).

.04 Other alternatives include longer, more detailed sets of forms. These forms combine the features of a time budget, a source document for staff scheduling, and a job progress report that compares each assigned person’s actual daily hours against the budget. Some firms use a shorter, less detailed form for jobs of less than a predetermined number of staff hours (for example, one hundred hours; see section 3155.03 for “Audit Time Analysis—Short Form”) and a longer form for jobs requiring more time (see section 3155.04 for “Audit Time Analysis—Long Form”). Some firms use a weekly (or daily) progress report (see section 3155.05,

for example). This report, submitted by the accountant in charge, shows the time actually spent in relation to the estimate, the estimated additional time required, and the estimated variance from the original estimate.

.05 When the combined time budget and progress report form (sample B) is used, it must be kept current as the assignment progresses. This form is carried in the working papers file and is filled in daily by the accountant in charge for all persons applying time on the engagement. This procedure is vital to identify and control time as it is applied so that it can be compared to the budgeted time for that phase of the engagement.

.06 The following factors should be considered in achieving a balance of engagement manpower requirements, personnel skills, individual development, and utilization:

- a. Engagement size and complexity
- b. Personnel availability
- c. Special expertise
- d. Timing of the work to be performed
- e. Continuity and periodic rotation of personnel
- f. Opportunities for on-the-job training

.07 The scheduling and staffing of the engagement should be approved by the partner with final responsibility for the engagement so that the partner can consider the qualifications, experience, and training of personnel to be assigned. The experience and training of the engagement personnel should be considered in relation to the complexity or other requirements of the engagement and the extent of supervision to be provided.

.08 It is recommended that all procedures discussed in this section be documented in the accountant's work papers. A sample checklist documenting the procedures listed in this section is located in section 3150.

## **AAM Section 3115**

# ***Independence***

### **General Comments**

.01 Engagement planning should include procedures to provide the firm with reasonable assurance that persons at all organizational levels maintain independence to the extent required by the AICPA's rules of conduct. Rule 101 (ET section 101.01) of the rules of conduct contains examples of instances wherein a firm's independence will be considered to be impaired.

.02 The procedures employed at the engagement level should be designed to ascertain whether the firm and its partners and employees have complied with all applicable independence rules, with emphasis on those related to financial interest, performance of accounting services for the client, and unpaid fees. Overall firm requirements for independence are addressed in the Statements on Quality Control Standards (QC section 90.9-.10).

.03 Some procedures regarding independence which a firm may employ in the planning phase of an engagement are discussed in this section. The specific procedures adopted by a firm would not necessarily include all these procedures or be limited to those discussed.

### **Engagement Planning Procedures**

.04 Annual independence questionnaires should be reviewed for all engagement personnel by the engagement partner to assure that those individuals assigned to the engagement are independent.

.05 Accounts receivable from the client should be reviewed to ascertain whether any outstanding amounts take on some of the characteristics of loans and may, therefore, impair the firm's independence.

.06 According to SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU section 543, "Part of Examination Made by Other Independent Auditors"), the firm, when acting as principal auditor, should obtain confirmation of the independence of another firm engaged to perform segments of the audit. Written confirmation enables the principal

auditor to document his assessment of the other auditor's independence in his audit work papers.

.07 In situations in which the accountant is not independent, the type of opinion to be issued should be discussed in the planning stage. A disclaimer of opinion should be issued as discussed in SAS No. 26, *Association With Financial Statements*, paragraphs 8–10 (AICPA, *Professional Standards*, vol. 1, AU section 504.08–.10), or the engagement should be turned into a compilation.

.08 It is recommended that all procedures discussed in this section be documented in the auditor's work papers. A sample checklist documenting the procedures listed in this section is located in section 3150 of this booklet.



## AAM Section 3120

### ***Knowledge of the Entity's Business***

.01 The accountant should obtain a level of knowledge of the entity's business that will enable the accountant to plan and perform the examination in accordance with generally accepted auditing standards. That level of knowledge should enable the accountant to obtain an understanding of the events, and may have a significant effect on the financial statements. The level of knowledge customarily possessed by management relating to managing the entity's business is substantially greater than that which is obtained by the accountant in performing the examination. Knowledge of the entity's business helps the accountant in—

- a. Identifying areas that may need special consideration.
- b. Assessing conditions under which accounting data are produced, processed, reviewed, and accumulated within the operation.
- c. Evaluating the reasonableness of estimates, such as valuation of inventories, depreciation, allowances for doubtful accounts, and percentage of completion of long-term contracts.
- d. Evaluating the reasonableness of management representations.
- e. Making judgments about the appropriateness of the accounting principles applied and the adequacy of disclosures.<sup>1</sup>

### **Engagement Planning Procedures**

.02 The accountant should obtain a knowledge of matters that relate to the nature of the entity's business, its organization, and its operating characteristics. Such matters include, for example, the type of business, types of products and services, capital structure, related parties, locations, and production, distribution, and compensation methods. The accountant should also consider matters affecting the industry in which the entity operates—such as economic conditions, government regulations, and changes in technology—as they relate to his examination. Other

<sup>1</sup>See SAS No. 5, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sections 411.04 and 411.11). (Reference changed by the issuance of SAS No. 43, *Omnibus Statement on Auditing Standards*.)

matters, such as accounting practices common to the industry, competitive conditions, and, if available, financial trends and ratios, should also be considered by the accountant.

.03 Knowledge of an entity's business is obtained through performing analytical procedures, prior experience with the entity or its industry, and inquiry of the entity's personnel. Working papers from prior years may contain useful information about the nature of the business, organizational structure, operating characteristics, and transactions that may require special consideration. Other sources an accountant may consult include AICPA audit and accounting guides, industry publications, financial statements of other entities in the industry, textbooks, periodicals, and individuals knowledgeable about the industry.

.04 The accountant should give thought to whether specialized skills are needed to consider the effect of computer processing on the examination, to understand the nature of internal accounting control procedures, or to design and perform examination procedures. If specialized skills are needed, the accountant should seek assistance from a professional who may be either on or outside the accountant's staff. If the use of such a professional is planned, the accountant should have sufficient computer-related knowledge to communicate the objectives of the other professional's work, to evaluate whether the specified procedures will meet the accountant's objectives, and to evaluate the results of the procedures applied as they relate to the nature, timing, and extent of other planned examination procedures. The accountant's responsibilities for using such a professional are equivalent to those for using assistants.<sup>2</sup>

.05 The accountant should consider the methods the entity uses to process accounting information in planning the examination because such methods influence the design of the accounting system and the nature of the internal accounting control procedures. The extent to which computer processing is used in significant accounting applications,<sup>3</sup> as well as the complexity of that processing, may also influence the nature, timing, and extent of examination procedures. Accordingly, when evaluating the effect of an entity's computer processing on an examination of financial statements, the accountant should consider matters such as—

- a. The extent to which the computer is used in each significant accounting application.

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<sup>2</sup>Since the use of a specialist who is effectively functioning as a member of the audit team is not covered by SAS No. 11, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU section 336), a computer audit specialist requires the same supervision and review as any assistant. (Footnote added by issuance of SAS No. 48.)

<sup>3</sup>Significant accounting applications are those that relate to accounting information that can materially affect the financial statements the auditor is examining. For further details, see SAS No. 48, *The Effects of Computer Processing on the Examination of Financial Statements*.

- b. The complexity of the entity's computer operations, including the use of an outside service center.<sup>4</sup>
- c. The organizational structure of the computer processing activities.
- d. The availability of data. Documents that are used to enter information into the computer for processing certain computer fields, and other evidential matter that may be required by the accountant, may exist only for a short period or only in computer-readable form. In some computer systems, input documents may not exist at all because information is entered directly into the system. An entity's data retention policies may require the accountant to request retention of some information for the review or to perform audit procedures at a time when the information is available.
- e. The use of computer-assisted audit techniques to increase the efficiency of performing audit procedures.<sup>5</sup> Using computer-assisted audit techniques may also provide the accountant with an opportunity to apply certain procedures to an entire population of accounts or transactions. In addition, in some accounting systems, it may be difficult or impossible for the auditor to analyze certain data or test specific control procedures without computer assistance.

In addition, certain information generated by the computer for management's internal purposes may be useful in performing substantive tests (particularly analytical procedures).<sup>6</sup>

.06 It is recommended that all procedures discussed in this section be documented in the accountant's work papers. A sample checklist for documenting the procedures listed in this section is located in section 3150 of this booklet.

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<sup>4</sup>See SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU section 324), and the related AICPA Audit Guide *Audits of Service-Center-Produced Records* for guidance concerning the use of a service center for computer processing of significant accounting applications. (Footnote added by issuance of SAS No. 48, *The Effects of Computer Processing on the Examination of Financial Statements*.)

<sup>5</sup>See the AICPA Audit and Accounting Guide *Computer-Assisted Audit Techniques* for guidance relating to this specialized area. (Footnote added by issuance of SAS No. 48.)

<sup>6</sup>SAS No. 23, *Analytical Review Procedures* (AICPA, *Professional Standards*, vol. 1, AU section 318), describes the usefulness of and guidance pertaining to such procedures. (Footnote added by issuance of SAS No. 48.)



## AAM Section 3125

### **Assessing Auditability**

.01 The third standard of fieldwork requires that the auditor obtain sufficient competent evidential matter to afford a reasonable basis for the expression of an opinion on whether an entity's financial statements are fairly presented in conformity with generally accepted accounting principles.<sup>1</sup> The determination of whether the auditor is able to obtain sufficient competent evidential matter to issue an opinion on the financial statements is an issue of auditability. Many factors can influence the auditability of financial statements. There are two primary considerations, however, in evaluating whether the financial statements of a small business are, in fact, auditable: (1) the adequacy of accounting records and (2) management integrity.

#### **Adequate Accounting Records**

.02 To provide sufficient competent evidential matter, an entity's accounting system should be designed to identify the types of transactions executed so that the transactions can be recorded in the appropriate amounts in the correct accounting period. Accounting records should include the following information:

- a. *Type of transaction.* Transactions should be described in sufficient detail to permit appropriate classification in the financial statements. Generally, accounting records need only indicate broad classes of transactions such as sales or payroll. In some circumstances, however, a more detailed description may be necessary, such as when payroll costs are to be allocated between inventory and expense. Identification of the type of transaction may be either explicit (for example, by using preprinted forms that describe the type of transactions, such as sales invoices) or implicit (for example, by using cash register tapes as a record of cash sales).
- b. *Size of transaction.* Transactions should be described in a manner that permits the recording of monetary value in the financial statements. Although accounting records generally include the dollar amount of transactions or the quantities involved and related unit prices, an indication of quantities

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<sup>1</sup>Throughout this section, references to audit opinions regarding generally accepted accounting principles also include other comprehensive bases of accounting.

only may be sufficient if the monetary value of transactions can be determined by reference to data such as price lists, wage rates, or contracts.

- c. *Period of time.* Accounting records should include the period in which the transactions occurred to permit the recording of transactions in the appropriate accounting period.

.03 The form of accounting records maintained by the client and the detail in which they are prepared varies because of a number of factors, such as the nature of the client's business, its size, and its organizational structure. For a small business to be auditable, there should exist adequate accounting records to identify the types of transactions executed and to record them at the appropriate amount in the correct accounting period.

.04 Many small businesses do not have elaborate accounting systems. Likewise, most small businesses have neither adequate segregation of duties nor sophisticated internal control systems. Neither a formalized and complex accounting system nor a sophisticated control system is required for a small business to be auditable.

### **SAS No. 43 Requirements**

.05 In August 1982, SAS No. 43, *Omnibus Statement on Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU section 320.53), was issued to clarify, among other matters, the minimum study and evaluation of internal control required if the auditor does not intend to rely on a client's control procedures to restrict substantive audit tests. According to SAS No. 43, the review of controls may be limited to obtaining an understanding of the control environment and the flow of transactions through the accounting system. This is referred to as the preliminary or first phase of the auditor's review of the system of internal accounting control.

.06 The requirements in SAS No. 43 for the study and evaluation of the control environment are illustrated in the flowchart on pages 16 and 17. As shown, the first phase of the auditor's review and evaluation of the control environment is required in all audits. If a determination is made that further study and evaluation of controls are likely to justify restriction of substantive tests, then the second phase is initiated; in the second phase, controls are identified and the assessment is made whether the benefits of restricted testing are likely to exceed the costs of compliance testing. If so, the auditor proceeds to the third phase of the study—the evaluation of controls on which compliance tests are performed. If the results of the compliance tests are satisfactory, substantive tests can be restricted.

.07 Ordinarily, the auditor is able to obtain an understanding of the control environment and the flow of transactions through a combination of previous experience with the client, inquiry, observation, reference to prior-year working papers, client-prepared descriptions of the system, or other appropriate documentation. The requirement that the auditor obtain an understanding of the control environment

and the flow of transactions helps the auditor assess auditability and properly design substantive tests.

## **Control Environment**

.08 The control environment includes the client's organizational structure, the methods used by the client to communicate authority and responsibility, financial reports prepared for management planning and control purposes, competence of personnel, and the methods used by management to supervise the control system.<sup>2</sup> In a small business, the control environment is significantly affected by owner or manager dominance and by limited segregation of duties. Obtaining an understanding of the control environment, as required by SAS No. 43, usually requires little time in a small business audit.

## **Flow of Transactions**

.09 The requirement that the auditor obtain an understanding of the flow of transactions specifies that the auditor should understand how accounting information flows through the accounts to the financial statements. The auditor should understand how debits and credits get into financial statements so that appropriate substantive tests can be designed.

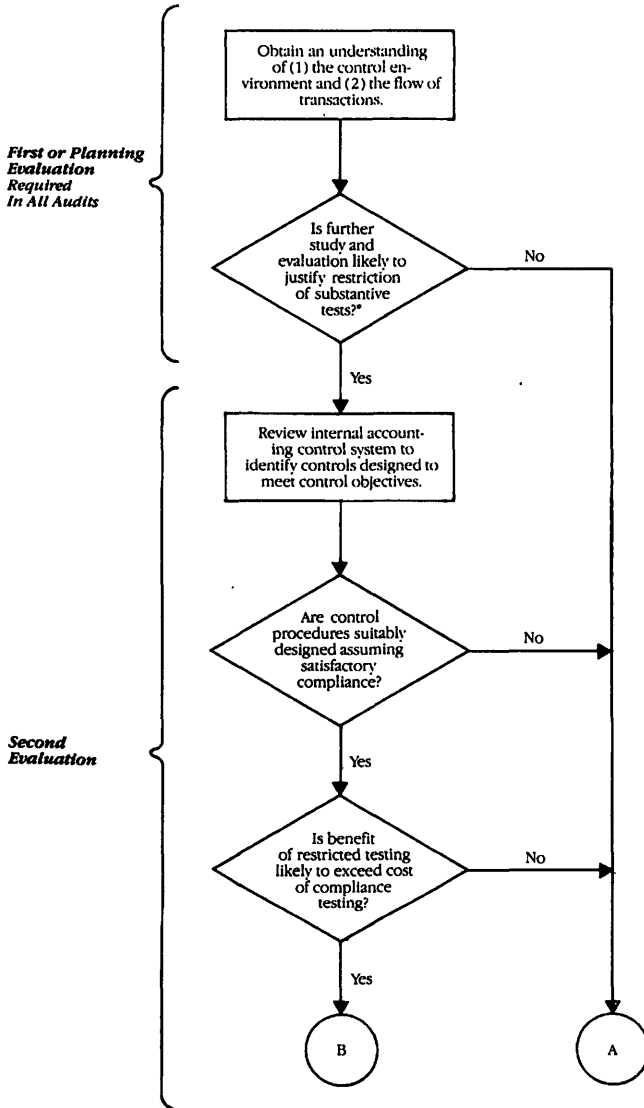
.10 An understanding of the accounting system, which must be obtained in all audits, should be distinguished from an understanding of the control environment, which must be obtained only if the auditor intends to rely on the control environment. The accounting system is composed of procedures that are established to process transactions as a means of maintaining the records of an entity's operations and financial position. Such procedures include those used to identify, assemble, classify, analyze, and record the entity's transactions. On the other hand, the control environment is composed of procedures intended to provide reasonable assurance that the financial records produced by the accounting system are reliable and that assets are safeguarded. An accounting system may include procedures that contribute to the achievement of control objectives. In practice, the two systems may partially overlap. But, theoretically, an accounting system is able to produce reliable financial records without a system of internal accounting control. Understanding the flow of transactions through the accounting system is essential to designing substantive tests.

.11 An important factor in designing substantive tests is knowledge of the existence and availability of documents and records. Designing tests of accounting documents and records is not possible unless the auditor knows their availability and understands their relationship to the accounts in the financial statements.

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<sup>2</sup>For further discussion of the control environment, see paragraph 14 of SAS No. 30, *Reporting on Internal Accounting Control* (AICPA, *Professional Standards*, vol. 1, AU section 642.14). See also the *Report of the Special Advisory Committee on Internal Accounting Control* (New York: AICPA, 1979), 12-19.

**Flowchart**  
**Phases in the Study and Evaluation of**  
**Internal Accounting Control**

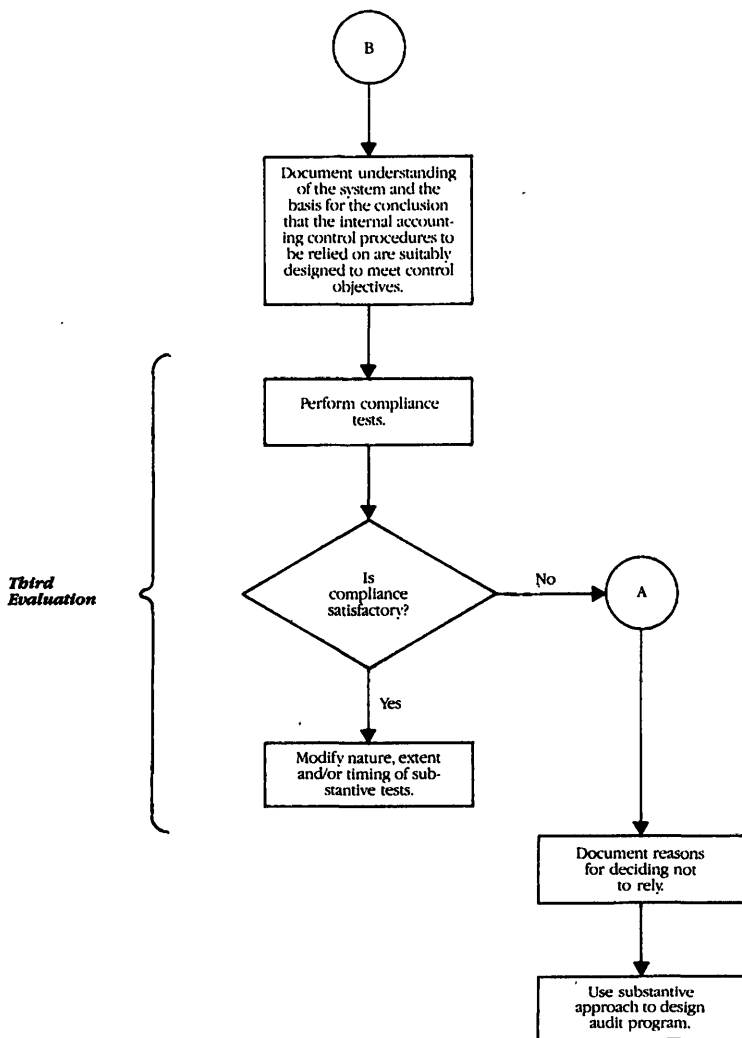


"Justify" here means it is likely that adequate internal accounting controls exist so that substantive tests may be restricted and that the cost of continued study and compliance testing does not exceed the expected benefit of reduced substantive testing.

Source: Auditing Procedure Study, *Audits of Small Businesses* (New York: AICPA, 1985), 20 and 21.



**Flowchart  
(continued)**



## Management Integrity

.12 Management integrity is an essential component of an audit engagement; without it, conflicts between management and the auditor are inevitable. As Mautz and Sharaf note, without management integrity

no management responses to questions or representations could be given any credence whatever. It is doubtful whether the statements of employees, who must be under management control, could be accepted as in any way useful. Certainly the records and documents under management control would be regarded as completely unreliable.<sup>3</sup>

.13 The auditor should recognize the importance of management integrity and its potential impact on the financial statements. If the auditor has reason to doubt management's integrity, careful consideration should be given to the auditor's ability to express an opinion on the entity's financial statements.

.14 The auditor should also consider whether there are factors, such as economic pressure on the industry or lack of working capital, that could encourage management to misstate the financial statements. Without evidence to the contrary, however, the auditor may assume management's integrity and that management has not made material misrepresentations or overridden control procedures. SAS No. 16, *The Independent Auditor's Responsibility for the Detection of Errors or Irregularities* (AICPA, *Professional Standards*, vol. 1, AU section 327.09–.10), includes a discussion of management integrity.

.15 Statement of Quality Control Standard No. 1, *System of Quality Control for a CPA Firm* (QC 10.07h), states:

In Acceptance and Continuance of Clients, "Policies and procedures should be established for deciding whether to accept or continue a client in order to minimize the likelihood of association with a client whose management *lacks integrity*."

Suggesting that there should be procedures for this purpose does not imply that a firm vouches for the integrity or reliability of a client, nor does it imply that a firm has a duty to anyone but itself with respect to the acceptance, rejection or retention of clients. However, prudence suggests that a firm be selective in determining its professional relationships."

.16 A sample checklist documenting procedures listed in this section is located in section.3150.

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<sup>3</sup>R. K. Mautz and Hussein A. Sharaf. *The Philosophy of Auditing*. American Accounting Association (Sarasota, FL: 1961), 45.

## **AAM Section 3130**

### ***Preparing an Engagement Letter***

.01 In an engagement letter, the firm and the client indicate their mutual understanding and agree to the nature and terms of the engagement. Engagement letters are a matter of sound business practice rather than a professional requirement. They cover the scope of services rendered and the responsibility the firm assumes. Therefore, they should be prepared with the care exercised in entering into other contracts.<sup>1</sup>

.02 Any limitations the client imposes on the scope of the audit are specifically stated. Every letter covering audit, compilation, and review services should point out the limitations in the accountant's responsibility for the discovery of fraud and other irregularities.

.03 The engagement letter should also describe the terms of billing and payment. If unusual or extraordinary services are to be performed, the engagement letter should completely describe them.

.04 If the auditor has reason to believe the client may publish all or a portion of an audit report, he should advise the client (preferably in the engagement letter) that firm policy is to read printer's proofs of the report and any other accompanying material. This precaution will protect both the client and accountant against condensation of financial statements, omission of footnotes, erroneous layout, and other errors such as misstatement of figures used in a president's letter, other narrative, or statistics.

.05 An engagement letter should be used for every engagement. A letter need not be issued more often than annually. Thus, interim audits or unaudited financial statement preparation can all be provided for in one annual letter. The letter should be sent to the client in duplicate so that a copy may be signed and returned for the accountant's files. Alternatively, the accountant may decide not to request that the client sign and return a copy of the letter. In that case, the letter should be sent to the client with an additional paragraph stating that, unless the client replies to the contrary, the accountant will assume the client agrees to the arrangements described

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<sup>1</sup>Paragraph 8 of Statement on Standards for Accounting and Review Services (SSARS) No. 1, *Compilation and Review of Financial Statements*, states: "The accountant should establish an understanding with the entity, preferably in writing, regarding the services to be performed."

in the letter. In those rare instances when the accountant decides that even this approach is not suitable, an engagement memorandum should be prepared for the file. This should provide all relevant information that would have been included in an engagement letter.

## **Reasons for Engagement Letters**

.06 The advantages of using engagement letters are summarized below.

- *Type of engagement.* Describe the type of engagement (audit, compilation or review, or other accounting service) to be rendered.
- *Avoiding misunderstanding with the client.* In today's litigious environment, an engagement letter is needed for both old and new clients. To avoid misunderstandings, the engagement letter should describe in detail the services to be rendered, the fee, and other terms and conditions of the engagement. Oral agreements may result in differences of recollection or understanding between the accountant and the client, and become completely valueless on the death of either.
- *Avoiding misunderstandings with the staff.* The members of the staff working on the engagement must have a complete understanding of what is required of them. A copy of the engagement letter in the working papers provides them an authoritative reference to supplement their oral instructions. This will eliminate confusion and misunderstanding about the type of engagement to be performed, the date and period covered by the financial statements, and the nature of the report expected to be rendered.
- *Legal liability.* The engagement letter should establish the scope and nature of the accountant's contractual obligation to the client by setting forth, clearly and specifically, the duties the accountant has agreed to perform. Many adverse consequences may result from failure to obtain a written engagement letter.
- *Practice management.* Generally, the executive (managing) partner reviews an engagement letter before the firm issues it. A timely review may be the vehicle that permits the executive partner to correct or amend the terms of the engagement, review the proposed fee and method of payment, and set up guidelines to minimize possible collection problems.
- *Contractual obligation.* Engagement letters recognize that a contract is created when the accountant agrees to render services and a client agrees to pay for them. The engagement letter should be clear-cut in delineating the duties and responsibilities of the client and of the firm.
- *Other.* An engagement letter permits the orderly assessment and review by partners and staff of the services performed and the terms of the engagement. This review facilitates drafting extensions or amendments to current or succeeding years' engagements.

.07 Some firms use one engagement letter to cover several types of services; others use separate engagement letters for each service rendered. In any case, firms should consider keeping separate internal records for time incurred on the separate types of services.

## **Special Considerations**

.08 The following matters should be considered when preparing an engagement letter:

- a. Whether the circumstances preclude an unqualified opinion, as in these examples:
  - The auditor is retained after the beginning of the client's fiscal year, did not observe inventories or confirm receivables at the beginning of the year, and was unable to satisfy self through application of alternative procedures.
  - The client imposes restrictions on the scope of the audit (SAS No. 2, *Reports on Audited Financial Statements*, paragraph 12, AICPA, *Professional Standards*, vol. 1, AU section 509.12).
  - Significant litigation or other matters exist which may affect the opinion.
- b. Whether the fee should be stated as a range, in hourly rates, as standard per diem charges for the engagement, or as a maximum or flat fee
- c. The person or persons to whom reports should be addressed
- d. The number of copies needed of the report and the people to whom they are to be distributed
- e. Deadlines for reports or analyses
- f. Out-of-pocket costs
- g. Additional work not contemplated in the original engagement
- h. The condition of records or circumstances other than those contemplated in the engagement letter (for example, deficient internal control)
- i. A retainer
- j. One-time engagements
- k. Start-up costs when the client changes accountants
- l. Underwriters' requirements in connection with public offerings
- m. Long-time clients who have not previously been requested to approve engagement letters
- n. The part of the work to be done by other accountants

## Contents of Engagement Letters

.09 Following are the items ordinarily covered in engagement letters:

- a. The name of the entity (and subsidiaries, if any) and its year end
- b. Statements to be examined, compiled, or reviewed
- c. The scope of services, as detailed as necessary, including limitations imposed by the client
- d. The kind of opinion, disclaimer, or other report to be rendered
- e. A disclaimer of responsibility for detecting fraud
- f. Obligations of the client's staff to prepare schedules and statements (see item 2)
- g. The requirement that the accountant read all printed material in which his report appears
- h. The responsibility for preparation or review of tax returns and subsequent tax examinations
- i. The fee, or the method of determining the fee
- j. The frequency of billing and the client's obligations for payment, including a retainer if applicable
- k. A provision for the client's acceptance signature, and the date
- l. An expression of thanks for being selected as auditors or to perform other services
- m. Before acceptance of a new engagement, an attempt that the successor auditor should make at certain communications with the predecessor auditor, as required in SAS No. 7, *Communications Between Predecessor and Successor Auditors*, paragraph 4 (AICPA, *Professional Standards*, vol. 1, AU section 315.04)

.10 The following is a list of instructions to a client's accounting staff. It includes analyses an accountant may expect the staff to prepare for the examination. Either include this list (or part of it) in the engagement letter, or refer to it and then submit it as a separate memorandum.

- Balance the general ledger.
- Prepare a reconciliation for each bank account.
- Fill in and sign bank confirmation forms, to be provided by the accountant.
- Prepare a trade accounts receivable aging.
- Prepare accounts receivable confirmation letters, using drafts to be provided by the accountant.
- Prepare a schedule of accounts receivable from officers and employees.

- Prepare a schedule of bad debts written off during the year.
- Prepare a schedule of notes receivable. The notes should be available for inspection.
- Prepare a schedule of transactions with affiliated enterprises.
- Price, extend, and foot the original inventory sheets, and have them available.
- Analyze all transactions affecting marketable securities.
- Prepare an insurance schedule. The policies should be available for inspection.
- Prepare a schedule of property and equipment additions and retirements.
- Prepare a depreciation schedule.
- Prepare a schedule of life insurance for officers.
- Prepare a schedule of accounts payable. The creditor's regular monthly statements for [date] should be retained and made available.
- Prepare a schedule of notes payable.
- The corporate stock book and minutes should be up to date and available for inspection.
- Prepare a schedule of all transactions to partners' capital and drawing accounts.
- A copy of the partnership agreement or corporate charter should be available for inspection.
- Copies of all leases, including equipment rental contracts, should be available for inspection.
- Copies of employment contracts with salesmen or executives should be available for inspection.
- Copies of pension, profit-sharing, deferred compensation, and stock option agreements, and letters of acceptance from the Treasury Department should be available for inspection.
- Prepare a schedule of repairs in excess of \$\_\_\_\_\_.
- Prepare a schedule of each officer's salary and expense account payments.
- Prepare a schedule of contributions.
- Prepare a schedule of tax expense.
- Prepare a schedule of professional fees.

.11 An engagement letter may optionally include—

- a. A description of a particular audit procedure, if requested by the client or deemed necessary for protection of the auditor. (The detailed audit program should not be made available to client personnel, orally or otherwise.)
- b. The extent and timing of interim auditing.

- c. The name of the client's personnel to be contacted during the engagement.
- d. A review of internal control and a report thereon. (This would be a special engagement, not a part of the normal audit routine.)
- e. Interim contact and cooperation with the internal auditor.
- f. A list of services specifically excluded.
- g. Acknowledgement by the client of its responsibility for the financial statements. (Because auditors of smaller, nonpublic entities often may maintain accounting records, prepare financial statements, and advise management about appropriate accounting principles, such an acknowledgement may be particularly appropriate for such clients.)
- h. A statement that the client will be informed of any material weaknesses in the internal accounting control that come to the auditor's attention during the audit of financial statements. (Such a communication, either orally or in writing, is required by SAS No. 20, *Required Communication of Material Weaknesses in Internal Accounting Control* [AICPA, *Professional Standards*, vol. 1, AU section 323].)

.12 Following is a list of common engagement letter deficiencies.

- a. Reference in the letter to examination of the books and records rather than to examination of financial statements
- b. Adverse comments about other firms
- c. Failure to specify *in detail* the services to be rendered when a maximum fee is quoted
- d. Inclusion of a review of the internal accounting control as one of the services when what is really intended is a study and evaluation of internal control as required by auditing standards
- e. Failure to identify accounting or other problems that may have an effect on the opinion
- f. Failure to change, in writing, the terms of the engagement when conditions are found to be different (such as the inability to express an opinion without extensive additional auditing because the internal controls were found deficient)
- g. Failure to include fee basis and payment terms
- h. Failure to identify subsidiaries
- i. Failure to identify specific tax returns to be prepared

## **Client Approval**

.13 It is recommended that the client's written approval of general arrangements for the engagement be secured by the accountant before proceeding with the



engagement (especially in new engagements). The addressee of the letter is usually the one asked to approve the engagement. In some situations, the accountant may not deem it advisable to send a client an engagement letter that requests his signature. An alternative approach might be to send the client a letter confirming the terms of the engagement, without asking him to sign it, but asking him to reply if he does not agree with the terms.

## **Addressee of Letter**

.14 Ordinarily, the accountant should address the letter to whoever retained the firm. If it is a corporate client's board of directors, the letter should be addressed to the board, its chairperson, or the chief executive, depending on the arrangement. If the accountant is appointed by an audit committee, it is appropriate to address the letter to the committee chairperson. If the engagement was arranged with a corporate official, the letter may be addressed to the official, personally, indicating the official's title, followed by the name of the corporation.

## **Investigatory Procedures for Individuals**

.15 When credit information is requested about individuals who are new clients, the investigatory procedures are subject to the Fair Credit Reporting Act of 1971.

.16 An individual should be informed in writing that an investigative consumer report, including information about the individual's character, general reputation, personal characteristics, and mode of living, is being made. The individual should also be advised, within three days of the time the report is requested, that he may within a reasonable time, by written request, be furnished disclosure of the nature and the scope of the investigation.<sup>2</sup>

## **Filing of Engagement Letters**

.17 The signed engagement letter (or original of the confirming letter) is a contract and should be filed in the client's permanent file. A copy may also be filed with the current working papers, if desired, because of the possible overlapping of billing and collecting as compared to the term of the actual engagement. This also permits easy access when reference to the previous year's letter is needed to prepare the letter for the following year's engagement.

.18 A sample checklist documenting procedures listed in this section is located in section 3150.

.19 See section 3160 for sample engagement letters.

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<sup>2</sup> For a more complete discussion, see Carlos Martinez, "A Guide to the Fair Credit Reporting Act," *The Practical Lawyer*, December 1972.



## **AAM Section 3135**

# ***Reliance on Internal Control***

### **General Comments**

.01 On completing the preliminary phase of the internal accounting control review discussed in section 3125, “Assessing Auditability,” the auditor may conclude (a) that further study and evaluation are unlikely to justify any restriction of substantive tests or (b) that the audit effort to study and evaluate the design of the system of internal accounting control and to test compliance exceeds the reduction in audit effort that could be achieved by control reliance. Such a conclusion may result from consideration of the nature or amount of the transactions or balances involved, the data processing methods being used, and the auditing procedures that can be applied in performing the substantive tests. Regardless of the reasons that cause the auditor to reach the conclusion not to rely on internal accounting control, further study and evaluation may be discontinued and substantive tests may be designed that do not require a reliance on internal accounting control.

### **Engagement Planning Procedures**

.02 If the auditor decides not to rely on internal accounting controls to restrict substantive tests, documentation of compliance with the second standard of fieldwork may be limited to a record of the reasons for the decision not to extend the review beyond the preliminary phase. That documentation may be prepared for each audit client individually and placed in the working papers (for example, as a memo or questionnaire).

.03 If the auditor decides not to rely on internal accounting controls, generally accepted auditing standards do not require that the auditor’s understanding of the environment be documented or that compliance tests be performed. The auditor is required to understand the control environment and the flow of transactions, but there is no requirement to document that understanding. Of course, client service reasons or firm policy may suggest that the flow of transactions be documented or that an internal control questionnaire be used. For example, some firms require that a brief questionnaire designed for small businesses be completed to aid in the understanding of the accounting system and the design of the audit program. The questionnaire may also be used to provide constructive suggestions to the client.

.04 If the auditor decides to rely on internal accounting controls, the review should be completed to determine whether the control procedures are designed to provide reasonable assurance that material errors and irregularities will be prevented or detected and corrected.<sup>1</sup> The information required for review of the control system ordinarily is obtained through one or more of the following procedures: inquiry of appropriate client personnel, inspection of written documentation, and observation of the processing of transactions and the handling of related assets.

.05 The auditor should document the extent that the system of internal accounting control was relied on to limit or alter substantive testing.

.06 A sample checklist documenting procedures listed in this section is located in section 3150.

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<sup>1</sup>A list of illustrative internal accounting control questions an auditor might raise concerning a small manufacturing operation that is owned by one person who also serves as the general manager and has only a few employees involved in the accounting function is presented in AAM section 4300 of the *AICPA Audit and Accounting Manual*.

## AAM Section 3140

# Assessing Audit Risk and Materiality

.01 In rendering an unqualified opinion that states “In our opinion, the financial statements present fairly . . . in conformity with generally accepted accounting principles. . . .,” the auditor is giving implicit recognition to the concepts of audit risk and materiality. The existence of audit risk is implicit in the phrase “in our opinion.” Materiality is implicit in the phrase “presents fairly in conformity with generally accepted accounting principles.”

### **Audit Risk**

.02 SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, defines audit risk as “the risk that the auditor may unknowingly fail to appropriately modify his opinion on financial statements that are materially misstated.” In other words, audit risk is the risk that the auditor will give an unqualified opinion on financial statements that are materially incorrect.

.03 In addition to audit risk, the auditor is also exposed to business risk in every audit engagement. Business risk is the risk that the auditor’s professional practice will suffer loss or injury from litigation or adverse publicity in connection with an examination of financial statements. Business risk is present even though the auditor conducts the examination in accordance with generally accepted auditing standards. For example, the auditor may conduct a proper audit and yet be sued by a disgruntled party without cause. Even though the auditor may win the lawsuit in such circumstances, the auditor’s professional reputation may be damaged. This type of risk differs from audit risk. Business risk cannot be used to reduce audit risk under generally accepted auditing standards.

### **Risk Components**

.04 SAS No. 47 states that audit risk consists of three components:

- a. *Inherent risk* is the susceptibility of an account balance or class of transaction to error that could be material when aggregated with error in other balances or classes, assuming that there were no related internal accounting controls. The risk of such error is greater for some balances or classes than for others. For example, complex calculations are more susceptible to theft

than is an inventory of coal. Accounts consisting of amounts derived from accounting estimates pose greater risks than do accounts consisting of relatively routine, factual data. External factors also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement.

- b. *Control risk* is the risk that error that may occur in an account balance or class of transactions and that could be material, when aggregated with error in other balances or classes, will not be prevented or detected on a timely basis by the control environment. Control risk is a function of the effectiveness of internal accounting control. Some control risk will always exist because of the inherent limitations of any system of internal accounting control.
- c. *Detection risk* is the risk that the auditor's procedures will lead to the conclusion that error in an account balance or class of transactions that could be material, when aggregated with error in other balances or classes, does *not* exist, when in fact such error *does* exist. Detection risk is a function of the effectiveness of auditing procedures and of their application by the auditor. It arises partly from uncertainties that exist when the auditor does not examine 100 percent of an account balance or class of transactions and partly because of other uncertainties that exist, even if 100 percent of the balance or class has been examined. Other uncertainties arise because an auditor might select an inappropriate auditing procedure, misapply an appropriate procedure, or misinterpret audit results. These other uncertainties can be reduced to a negligible level through adequate planning, supervision, and conduct of a firm's audit practice in accordance with appropriate quality control standards.

.05 Inherent risk and control risk differ from detection risk in that they exist independently of the audit of the financial statements. Inherent risk and control risk are functions of the client and its environment, regardless of whether an audit is conducted. Detection risk, on the other hand, relates to the auditor's procedures and can be changed at the auditor's discretion. The assessment of the potential for material errors occurs when the auditor considers inherent risk.

.06 The client may install a system of internal accounting control to detect material errors and remove them from the accounting system. Ideally, the control system should detect all material errors before they enter the financial statements, but sometimes the control system may not detect a material error even though the error went through the control system. For example, there may be a weakness or breakdown in the client's system that allows an error to remain undetected.

.07 Even when a client has an excellent system of internal accounting controls, certain accounting errors can bypass the system because of special circumstances. For example, if a client had an unusual exchange of nonmonetary assets,

no internal accounting controls may have been established to detect an error in this special circumstance.

.08 If the client's system of internal accounting controls does not detect and remove errors, they will flow through and be included in the financial statements. The auditor's responsibility is to design audit procedures that provide reasonable assurance that material errors do not remain in financial statements.

.09 The auditor will never have absolute assurance that no material errors exist in the financial statements. From a cost-benefit perspective, an audit providing absolute assurance that no material errors exist in the financial statements is impractical. Thus, the auditor designs audit tests to provide *reasonable assurance* that there are no material errors in the financial statements. There is always some risk that (a) a material error will exist; (b) it will not be detected by the client's control environment; (c) it will not be detected by the auditor; or (d) it will affect the financial statements. The auditor's responsibility is to reduce audit risk to an acceptably low level. Both the tests of details (test of balances and tests of transactions) and analytical review procedures are the means by which the auditor detects material errors.

## **Risk Assessment and Planning**

.10 In planning the audit engagement, the auditor should assess inherent risk and control risk to determine how much detection risk can be accepted while still restricting audit risk to an acceptably low level. As the auditor's assessment of inherent risk and control risk decreases, the acceptable level of detection risk increases. The auditor should not rely on the assessments of inherent risk and control risk to the exclusion of performing substantive tests. In fact, for a small business with limited segregation of duties, the auditor often assesses inherent risk and control risk at their maximum and relies completely on substantive tests to reduce audit risk to an acceptably low level.

## **Quantifying Risk**

.11 The auditor's assessments of audit risk and its components of inherent risk, control risk, and detection risk are matters of professional judgment. Although the auditor may use quantitative tools such as decision tables and structured aids such as questionnaires to assist in assessing risk components, the ultimate assessment of audit risk is based on professional judgment.

.12 Some auditors confuse audit risk with risk associated with statistical sampling and thus erroneously assume that all audit risk can be quantified. Statistical sampling can be used to quantify the risk of error in determining the extent of audit testing; that is, by using statistical sampling techniques, the auditor can quantify the risk of relying on the results of applying a procedure to a sample, rather than to 100 percent of the items in an account balance or class of transaction.

However, quantitative assessment of risk using statistical sampling techniques is only one element of audit risk. As noted previously, audit risk is composed of control risk, detection risk, and inherent risk. Detection risk, which relates to audit procedures, is a function of the nature and timing of audit procedures as well as of the extent of their application.

.13 Generally accepted auditing standards do not require the auditor to quantify risk or to perform any additional analyses of risk. Those standards simply require the auditor to plan the audit so that there is a low level of risk that an unqualified opinion will be expressed when, in fact, the financial statements are materially misstated.

## **Materiality**

.14 SAS No. 47 states that audit risk is “the risk that the auditor may unknowingly fail to appropriately modify his opinion on financial statements that are *materially* misstated.” As SAS No. 47 observes, audit risk and materiality should be considered together in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures.

.15 Materiality is the criterion used by accountants and auditors to distinguish between unimportant and important matters. Obviously, some errors and misstatements could be included in the financial statements without precluding the auditor from expressing an opinion that the financial statements are fairly presented in conformity with generally accepted accounting principles. The auditor’s consideration of materiality is a matter of professional judgment and is influenced by a perception of the needs of the users of the financial statements. In determining the materiality of an item, the auditor should consider the nature and amount of the item in relation to the financial statements being examined.

## **Planning**

.16 In planning the audit, materiality should be viewed as an allowance for likely and potential undetected errors. Of course, in planning, the auditor cannot anticipate all the factors that will ultimately influence judgment about materiality in the evaluation of audit findings at the completion of the examination. Thus, materiality in planning may differ from materiality used in evaluating results at the conclusion of the audit. If the materiality amount used in evaluating audit findings is reduced significantly from the amount used in planning, the auditor should reevaluate—on the basis of planning materiality—the sufficiency of the auditing procedures that were performed. For example, an auditor may propose audit adjustments that significantly lower revenues. As a result of these adjustments, the auditor’s assessment of materiality at the conclusion of the audit may be reduced (for example, from \$1,000 to \$500). In view of the lower threshold of materiality, the auditor should evaluate whether the audit evidence obtained is sufficient.



## **Quantifying Materiality**

.17 Professional standards require auditors to make a preliminary judgment about materiality in the planning stage of an audit (SAS No. 47, paragraph 3, AICPA, *Professional Standards*, vol. 1, AU section 311.03). Although no authoritative body has established specific guidelines for materiality, some auditors believe that there are certain rules of thumb that can be used in making a preliminary assessment of materiality.

.18 Generally, auditors agree that materiality guidelines should be relative rather than absolute. In other words, materiality is usually set as a percentage rather than as an absolute amount. For example, an absolute amount such as \$100,000 may be immaterial to a large, multinational corporation but very material to a small, closely held company. To apply percentage guidelines, auditors must determine what base to use. Generally, auditors select a base that is relatively stable and predictable. Bases commonly used include net income before taxes, revenues, and total assets. Because financial statements are interrelated, and also for reasons of efficiency, auditors normally consider materiality in terms of the smallest amount that would be material to the financial statements. Generally, misstatements become material to income before they become material to the balance sheet. As a consequence, net income before taxes is often selected as the base.

.19 In small business audits, auditors sometimes make a number of significant audit adjustments. Thus, income before taxes may vary too much to be useful as a base. When net income before taxes is not used as a base, auditors sometimes use either total revenue or an average of net income for several prior periods.

### **Example**

.20 A common rule of thumb for materiality is 5 to 10 percent of pre-tax income. Some auditors apply this rule of thumb so that items less than 5 percent of normal pre-tax income are considered immaterial, whereas items that are more than 10 percent are material. For items between 5 and 10 percent, judgment is applied. For example, when unusual factors exist (perhaps the company is about to be sold for a multiple of audited earnings) auditors would tend to classify items between 5 and 10 percent as material. Others use 1 or 1.5 percent of the larger of total assets or revenues. (See the exhibit on page 34 for a sample planning materiality worksheet.)

.21 Consideration of which base to use should include such factors as income variability and the nature of the client's business and industry. For a nonprofit organization, for example, the auditor would probably use total assets or revenues as a base, since pre-tax income is not meaningful.

.22 A sample checklist documenting procedures listed in this section is located in section 3150.

***Exhibit***  
**Sample Planning Materiality Worksheet**

	<u>Initials</u>	<u>Date</u>
Done	_____	_____
Reviewed	_____	_____

Client Name \_\_\_\_\_  
Planning Materiality Worksheet \_\_\_\_\_  
Balance Sheet Date \_\_\_\_\_

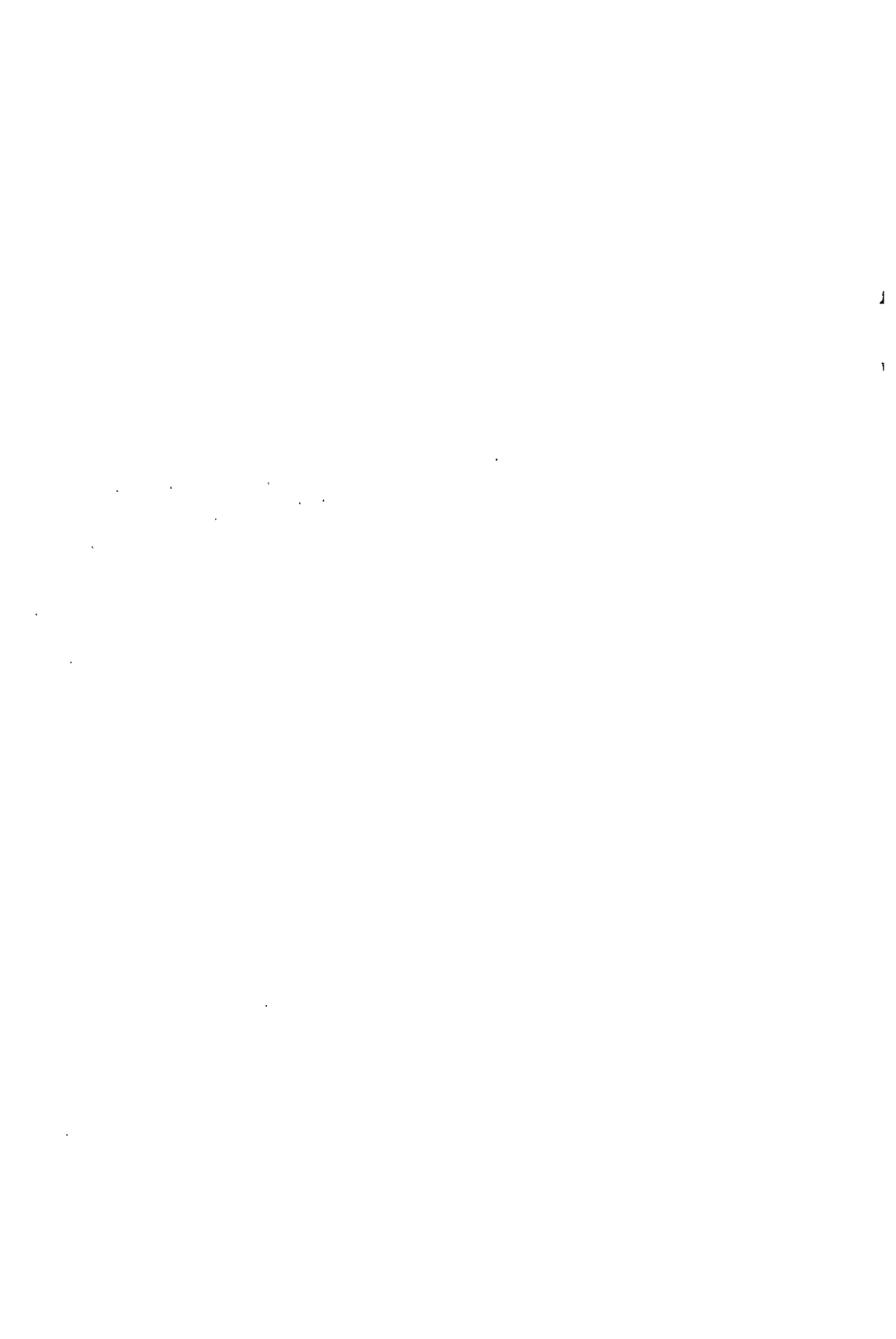
1. Unaudited total assets at balance sheet date \_\_\_\_\_
2. Unaudited total revenues at balance sheet date \_\_\_\_\_
3. Select the larger of line 1 or 2 \_\_\_\_\_
4. Select a multiplier if audit risk is normal, or, if better than normal, select .01 \_\_\_\_\_
5. Multiply line 3 by line 4 \_\_\_\_\_
6. Unaudited pre-tax income (or equivalent if not a for-profit entity) \_\_\_\_\_
7. Select a multiplier if audit risk is normal, or, if better than normal, select .1 \_\_\_\_\_
8. Multiply line 6 by line 7 \_\_\_\_\_
9. Evaluate lines 5 and 8 along with other relevant factors and determine materiality for audit planning purposes \_\_\_\_\_

## **AAM Section 3145**

### ***Audit Strategies and the Audit Program***

.01 The nature, timing, and extent of audit testing is discussed in AAM section 5000, *Audit Approach and Programs*.

.02 A sample checklist documenting procedures listed in AAM section 5000 is located in section 3150.



## AAM Section 3150

### **Illustrative Planning Checklist**

	<i>Done</i>	<i>Date</i>
	<u>by</u>	<u>        </u>
<b>.01 A. Understanding the Assignment</b>		
1. Have engagement personnel considered the following matters in planning the engagement:		
a. The entity's accounting policies and procedures?	_____	_____
b. Financial statement items likely to require adjustment?	_____	_____
c. The nature of reports expected to be rendered (for example, a report on consolidated or consolidating financial statements, reports on financial statements filed with the SEC, or special reports such as those on compliance with contractual provisions)?	_____	_____
2. In planning the examination, have engagement personnel—		
a. Discussed the type, scope, and timing of the examination with the entity's management, board of directors, or audit committee?	_____	_____
b. Considered the effects of applicable accounting and auditing pronouncements, particularly new ones?	_____	_____
c. Coordinated the assistance of entity personnel in data preparation?	_____	_____
d. Determined the extent of involvement, if any, of consultants, other independent auditors, specialists, and internal auditors?	_____	_____

		<u>Done</u>	<u>Date</u>
		<u>by</u>	<u></u>
<i>.02 B. Assigning Personnel to the Engagement</i>			
1.	Has a time budget for the engagement been prepared to determine manpower requirements and to schedule fieldwork?	_____	_____
2.	Has the engagement partner approved the time budget prior to the beginning of fieldwork?	_____	_____
3.	Have the following factors been considered in achieving a balance of engagement manpower requirements, personnel skills, individual development, and utilization:		
	<i>a.</i> Engagement size and complexity?	_____	_____
	<i>b.</i> Personnel availability?	_____	_____
	<i>c.</i> Special expertise required?	_____	_____
	<i>d.</i> Timing of the work performed?	_____	_____
	<i>e.</i> Continuity and periodic rotation of personnel?	_____	_____
	<i>f.</i> Opportunities for on-the-job training?	_____	_____
4.	Has the scheduling and staffing of the engagement been approved by the partner with final responsibility for the engagement, so that the partner can consider the qualifications, experience, and training of personnel to be assigned?	_____	_____
<i>.03 C. Independence</i>			
1.	If acting as principal auditor, has written confirmation of the independence of other firms engaged to perform segments of the audit been obtained?	_____	_____
2.	Have annual independence questionnaires been reviewed for all engagement personnel to assure that those individuals assigned to the engagement are independent?	_____	_____
3.	Have accounts receivable from the client been reviewed to ascertain whether any outstanding amounts take on some of the characteristics of loans and may, therefore, impair the firm's independence?	_____	_____

	<u>Done</u> <u>by</u>	<u>Date</u>
4. In situations in which the firm is not independent, has the issuance of a disclaimer of opinion been discussed in accordance with Statement on Auditing Standards (SAS) No. 26, <i>Association With Financial Statements</i> , paragraphs 8–10, (AICPA, <i>Professional Standards</i> , vol. 1, AU section 504.08–.10)?	_____	_____
.04 D. <i>Knowledge of the Entity's Business</i>		
1. Has an initial, overall understanding of the client's operations been obtained by—		
a. Reviewing the prior year's working papers, permanent file, auditors' report, and statements?	_____	_____
b. Reviewing any interim financial statements or reports for the current year, including filings with regulatory agencies; or, if such statements or reports have not been prepared, by scanning the general ledger (or trial balance) to determine whether the amounts and relationships appear reasonable in comparison with the prior year's?	_____	_____
c. Reviewing the most recent management letters?	_____	_____
d. Reviewing the client's correspondence file?	_____	_____
e. Obtaining copies of the minutes of meetings of stockholders and the board of directors?	_____	_____
f. Considering the possible impact of nonaudit services rendered to the client on the audit?	_____	_____
2. Have engagement personnel obtained a knowledge of matters that relate to the nature of the entity's business, its organization, and its operating characteristics, such as the following:		
a. The type of business?	_____	_____
b. Types of products and services?	_____	_____
c. Capital structure?	_____	_____
d. Related parties?	_____	_____
e. Locations?	_____	_____

	<i>Done</i>	<i>Date</i>
	<u>by</u>	<u>        </u>
f. Production?	_____	_____
g. Distribution methods?	_____	_____
h. Compensation methods?	_____	_____
3. Have engagement personnel obtained a knowledge of matters affecting the industry in which the entity operates, such as the following:		
a. Economic conditions?	_____	_____
b. Government regulations?	_____	_____
c. Changes in technology?	_____	_____
d. Accounting practices common to the industry?	_____	_____
e. Competitive conditions?	_____	_____
f. Financial trends and ratios?	_____	_____
4. Have engagement personnel consulted other sources of information that relate to the entity's business, such as the following:		
a. AICPA audit and accounting guides?	_____	_____
b. Industry publications?	_____	_____
c. Financial statements of other entities in the industry?	_____	_____
d. Textbooks, periodicals, and individuals knowledgeable about the industry?	_____	_____
5. Have methods the entity uses to process accounting information been considered in planning the examination?	_____	_____
6. Have the following matters been considered in evaluating the effect of the entity's computer processing on the examination of financial statements:		
a. The extent to which the computer is used in each significant accounting application?	_____	_____
b. The complexity of the entity's computer operations, including the use of an outside service center?	_____	_____
c. The organizational structure of the computer processing activities?	_____	_____



	<i>Done</i>	<i>Date</i>
	<u>by</u>	<u>_____</u>
d. The availability of data?	_____	_____
e. The use of computer-assisted audit techniques to increase the efficiency of performing audit procedures?	_____	_____
7. Have engagement personnel considered whether specialized skills are needed to consider the effect of computer processing on the examination?	_____	_____
.05 E. <i>Assessing Auditability</i>		
1. Has the adequacy of the accounting records been assessed for the following factors:		
a. Transactions described in sufficient detail to permit appropriate classification in financial statements?	_____	_____
b. Transactions described in a manner that permits the recording of monetary value in the financial statements?	_____	_____
c. Accounting records include the period in which the transactions occurred to permit the recording of transactions in the appropriate accounting period?	_____	_____
2. Has an understanding of the control environment and flow of transactions as required by SAS No. 43 been obtained through a combination of the following:		
a. Previous experience with the client?	_____	_____
b. Inquiry?	_____	_____
c. Observation?	_____	_____
d. Reference to prior-year working papers?	_____	_____
e. Client-prepared descriptions of the system?	_____	_____
f. Other appropriate documentation?	_____	_____
3. Have the following procedures been performed regarding the integrity of management:		
a. Inquiries of local attorneys, bankers, and other business leaders as to the client's standing in the business community?	_____	_____

	<u>Done</u>	<u>Date</u>
	<u>by</u>	<u>_____</u>
b. A check of the client's credit rating?	_____	_____
c. Analysis of the frequency of occurrence of errors and irregularities in financial statements from prior audits?	_____	_____

.06 F. *Engagement Letter*

1. Have the following items been included in the engagement letter:		
a. Name of entity (and subsidiaries, if any) and its year-end?	_____	_____
b. Statement(s) to be examined, compiled, or reviewed?	_____	_____
c. Scope of services, as detailed as necessary, including limitations imposed by the client?	_____	_____
d. Type of opinion, disclaimer, or other report to be rendered?	_____	_____
e. Disclaimer of responsibility for detecting fraud? (See AAM section 3160.)	_____	_____
f. Obligations of the client's staff to prepare schedule and statements?	_____	_____
g. Requirement that accountant read all printed material in which his report appears?	_____	_____
h. Responsibility for preparation or review of tax returns and subsequent tax examinations?	_____	_____
i. Fee or method of determining fee?	_____	_____
j. Frequency of billing and client's obligations for payment, including retainer if applicable?	_____	_____
k. Provision for client's acceptance signature and date?	_____	_____
l. Expression of thanks for being selected as auditors or to perform other services?	_____	_____
m. Statement that, in new engagements, the client should take the responsibility for getting the cooperation of the prior accountant?	_____	_____

	<u>Done</u> <u>by</u>	<u>Date</u>
2. Have the following optional items been included in the engagement letter:	_____	_____
a. Description of particular audit procedure, if requested by client or deemed necessary for protection of the auditor? (The detailed audit program should not be made available to client personnel, orally or otherwise.)	_____	_____
b. Extent and timing of interim auditing?	_____	_____
c. Name of client's personnel to be contacted during engagement?	_____	_____
d. Review of internal control and report thereon? (This would be a special engagement, not part of the normal audit routine.)	_____	_____
e. Interim contact and cooperation with internal auditor?	_____	_____
f. List of services specifically excluded?	_____	_____
g. Acknowledgement by the client of its responsibility for the financial statements? (Because auditors of smaller, nonpublic entities often may maintain accounting records, prepare financial statements, and advise management about appropriate accounting principles, such an acknowledgement may be particularly appropriate for such clients.)	_____	_____
h. A statement that the client will be informed of any material weakness in internal accounting control that come to the auditor's attention during his audit of financial statements? (Such a communication, either orally or in writing, is required by SAS No. 20, <i>Required Communication of Material Weaknesses in Internal Accounting Control</i> [AICPA, <i>Professional Standards</i> , vol. 1, AU section 323].)	_____	_____

**.07 G. Assessing Audit Risk and Materiality**

1. Have inherent and control risk been assessed to determine how much detection risk can be accepted while still restricting audit risk to an acceptably low level?	_____	_____
---	-------	-------

		<u>Done</u>	<u>Date</u>
		<u>by</u>	<u></u>
	2. Has a preliminary judgment about the dollar amount of misstatement that would be material to the financial statements been determined?	_____	_____
	3. Has that amount been related to tolerable error for specific account balances in planning audit procedures?	_____	_____
.08	H. <i>Reliance on Internal Control</i>		
	1. If further study and evaluation of the control system are unlikely to justify a restriction of substantive tests, has a record of the decision not to extend the review beyond the preliminary phase been documented?	_____	_____
	2. If further study and evaluation of the control system is likely to justify a restriction of substantive tests, has the review been completed to determine whether the control procedures are designed to provide reasonable assurance that material errors and irregularities will be prevented or detected and corrected?	_____	_____
	3. Have one or more of the following procedures been performed to obtain the information required for the review of the control system:		
	a. Inquiries of appropriate client personnel?	_____	_____
	b. Inspection of written documentation?	_____	_____
	c. Observation of the processing of transactions and the handling of related assets?	_____	_____
.09	I. <i>Audit Strategies and the Audit Program</i>		
	1. Has a proposed audit program been developed for the engagement?	_____	_____
	2. Has the final audit program been approved by the engagement partner?	_____	_____

# AAM Section 3155

## Audit Assignment Controls

.01

Audit Time Budget—Sample A

Client \_\_\_\_\_ Examination date \_\_\_\_\_

Prepared by \_\_\_\_\_

Approved

Supervisor \_\_\_\_\_ Date \_\_\_\_\_ Partner \_\_\_\_\_ Date \_\_\_\_\_

Preliminary work:

Start \_\_\_\_\_ End \_\_\_\_\_

Final work:

Start \_\_\_\_\_ End \_\_\_\_\_

	Budget (In hours)	
	May to Nov.	Dec. to April
Cash	_____	_____
Receivables	_____	_____
Confirmation of balances	_____	_____
Review ledgers, etc.	_____	_____
Inventories	_____	_____
Observation of physical counts	_____	_____
Price tests, etc.	_____	_____
Securities and investments	_____	_____
Property, plant, and equipment	_____	_____
Accumulated depreciation and amortization	_____	_____
Other assets	_____	_____
Notes and accounts payable	_____	_____
Tax accruals	_____	_____
Other liabilities	_____	_____
Capital stock	_____	_____
Retained earnings	_____	_____
Other equity accounts	_____	_____
Income accounts	_____	_____
Costs and expense accounts	_____	_____
Current provision for taxes	_____	_____
Other income and expense accounts	_____	_____
Minutes, agreements, etc.	_____	_____
Conferences with client	_____	_____

(continued)

*(continued)*

	<b>Budget (in hours)</b>	
	<b>May to Nov.</b>	<b>Dec. to April</b>
<b>General supervision and planning</b>	<hr/>	<hr/>
<b>Review computer programs and auditability</b>	<hr/>	<hr/>
<b>Review of internal control</b>	<hr/>	<hr/>
<b>Review and update permanent files</b>	<hr/>	<hr/>
<b>Travel</b>	<hr/>	<hr/>
<b>Report and statement review</b>	<hr/>	<hr/>
<b>Other matters</b>	<hr/>	<hr/>
<b>Total budgeted hours</b>	<hr/>	<hr/>
<i>(Excludes tax and report departments' time)</i>	<hr/>	<hr/>







Audit Time Analysis (Long Form)

Client \_\_\_\_\_ Year ended \_\_\_\_\_

	Prior Years		Budgeted Hours					Actual Daily Hours					Next year's budget	
		Total	Week beginning					Total						
Administration														
Client conferences														
Planning and scheduling														
Staff supervision														
Accounting systems review														
Internal control														
EDP installation														
General ledger														
Cash														
Notes														
Voucher register														
Payroll														
Journal entries														
Confirmations														
Permanent file														
Client advisory comments														
Report preparation														
Financial statements														
Footnotes														
Tax return preparation														
Review														
Initial review														
Overall review														
Detailed review														
Tax accrual review														
Subtotal to next page														







## AAM Section 3160

# Sample Engagement Letters

.01 Following are illustrative engagement letters (and one engagement memorandum). They may be used as guides in the design of specific letters, tailored to satisfy the terms of a particular engagement.

### **.02 Audit Engagement Leading to Opinion**

SWIFT, MARCH & COMPANY

Certified Public Accountants

[Date]

Mr. Thomas Thorp, President  
Anonymous Company, Inc.  
Route 32  
Nowhere, New York 10000

Dear Mr. Thorp:

This will confirm our understanding of the arrangements for our examination of the financial statements of Anonymous Company, Inc., for the year ending [date].

We will examine the Company's balance sheet at [date], and the related statements of income, retained earnings, and changes in financial position for the year then ended, for the purpose of expressing an opinion on them. Our examination will be made in accordance with generally accepted auditing standards and, accordingly, will include such tests of the accounting records and such other auditing procedures as we consider necessary in the circumstances.

Our procedures will include tests (by statistical sampling, if feasible) of documentary evidence supporting the transactions recorded in the accounts, tests of the physical existence of inventories, and direct confirmation of receivables and certain other assets and liabilities by correspondence with selected customers, creditors, legal counsel, and banks. At the conclusion of our examination, we will request certain written representations from you about the financial statements and matters related thereto.

Our engagement is subject to the inherent risk that material errors, irregularities, or illegal acts, including fraud or defalcations, if they exist, will not be detected. However, we will inform you of any such matters that come to our attention.

We will review the Company's federal and state [*identify states*] income tax returns for the fiscal year ended [*date*]. These returns, we understand, will be prepared by the controller.

Further, we will be available during the year to consult with you on the tax effects of any proposed transactions or contemplated changes in business policies.

Our fee for these services will be at our regular per diem rates, plus travel and other out-of-pocket costs. Invoices will be rendered every two weeks and are payable on presentation.

We are pleased to have this opportunity to serve you.

If this letter correctly expresses your understanding, please sign the enclosed copy where indicated and return it to us.\*

Very truly yours,

**SWIFT, MARCH & COMPANY**

.....  
Partner

APPROVED:

By .....

Date .....

---

\*Some accountants prefer not to obtain an acknowledgement, in which case their letter would omit the paragraph beginning "If this letter..." and the spaces for the acknowledgement. The first paragraph of their letter might begin as follows: "This letter sets forth our understanding of the terms and objectives of our engagement..."

**.03 Audit Engagement Leading to Opinion (Including Financial Information for Form 10-K)**

SWIFT, MARCH & COMPANY

Certified Public Accountants

[Date]

Mr. Frederick Mead, President  
Thor Tool Co., Inc.  
473 Canyon Road  
Noplace, NJ 07000

Dear Mr. Mead:

This letter confirms our arrangements with Thor Tool Co., Inc. for the year ended [date].

We will examine the Corporation's balance sheet as of [date], and the related statements of income, retained earnings, and changes in financial position for the year then ended. Our examination will be made in accordance with generally accepted auditing standards and, accordingly, will include such tests of the accounting records and such other auditing procedures as we consider necessary in the circumstances.

Our procedures will include tests (by statistical sampling, if feasible) of documentary evidence supporting the transactions recorded in the accounts, tests of the physical existence of inventories, and direct confirmation of receivables and certain other assets and liabilities by correspondence with selected customers, creditors, legal counsel, and banks. At the conclusion of our examination, we will request certain written representations from you about the financial statements and matters related thereto.

Your accounting department personnel will prepare the necessary detailed trial balance and supporting schedules. We will assemble and examine the financial information required for Form 10-K and for the annual report to stockholders. Both must be submitted to us for approval before publication.

Our engagement is subject to the inherent risk that material errors, irregularities, or illegal acts, including fraud or defalcations, if they exist, will not be detected. However, we will inform you of any such matters that come to our attention.

Fees for these services will be at our standard per diem rates. Invoices, including out-of-pocket expenses, will be submitted every two weeks as the work progresses, and are payable on presentation. We estimate that our fee for this engagement will be between \_\_\_\_\_ and \_\_\_\_\_. Should any situation arise that would materially increase this estimate, we will, of course, advise you.

Please indicate your agreement to these arrangements by signing the attached copy of this letter and returning it to us.\*

Sincerely,

SWIFT, MARCH & COMPANY

.....  
Partner

APPROVED:

By .....

Date .....

---

\*Some accountants prefer not to obtain an acknowledgement, in which case their letter would omit the paragraph beginning "Please indicate your..." and the spaces for the acknowledgement. The first paragraph of their letter might begin as follows: "This letter sets forth our understanding of the terms and objectives of our engagement..."



**.04 Change in Circumstances From Those Contemplated in Original Engagement Letter**

SWIFT, MARCH & COMPANY

Certified Public Accountants

[Date]

Mr. James Johnson, Treasurer  
Birdie Country Club  
64 Eagle Road  
Noplace, New York 10000

Dear Mr. Johnson:

As we agreed in our original engagement letter dated [date] we are notifying you that our examination of your [date] financial statements requires additional procedures.

We have found that certain guest checks are held for only three months after they are paid. Thus, a substantial number of guest checks are not available for examination. Fortunately, your system of internal control allows us to use alternative procedures to satisfy ourselves on this part of the examination. However, this will require substantially more time than examining guest checks.

The fee for these additional services will be billed at our standard per diem rates and added to the \_\_\_\_\_ fee quoted in our previous letter.

The problem has been discussed with your controller, who assured us that in the future all guest checks will be kept for two years.

Please indicate your acceptance of these added terms by signing the copy of this letter and returning it to us.\*

Very truly yours,

SWIFT, MARCH & COMPANY

.....  
Partner

APPROVED:

By .....

Date .....

\*Some accountants prefer not to obtain an acknowledgement, in which case their letter would omit the paragraph beginning "Please indicate your..." and the spaces for the acknowledgement. The first paragraph of their letter might begin as follows: "This letter sets forth our understanding of the terms and objectives of our engagement..."

**.05 Conditions Encountered Which Do Not Permit Expression of Opinion as Anticipated in Original Engagement Letter**

SWIFT, MARCH & COMPANY

Certified Public Accountants

[Date]

Ms. Helene Brown, President  
ZYG, Inc.  
1234 West Street  
Noplace, New York 10000

Dear Ms. Brown:

Our March 15, 19XX letter described our present engagement as an examination for the purpose of expressing an opinion on the company's [date] financial statements. This letter is to inform you that because of the circumstances described below, we will be required to qualify our opinion on these statements.

As you know, the Internal Revenue Service has proposed total income tax assessments of approximately \$180,000 for the three fiscal years ended [date]. Your tax counsel has advised us that although you have a defensible position and will protest the assessments, counsel cannot offer an opinion as to your ultimate liability. No provision for this assessment or any portion of it is included in your [date] financial statements, nor do you feel any is necessary. You agreed, however, that the proposed assessment and its present status will be disclosed in the notes to the financial statements.

Because of the uncertainty as to your ultimate liability, we will be unable to express an unqualified opinion. Our report will state that the financial statements are subject to the effects of such adjustments, if any, as might have been required had the outcome of this income tax matter been known.

You and your tax counsel have advised that you will inform us of any new developments in the proposed assessment before our report is issued so that we may consider their effect on your financial statements and on our report.

Very truly yours,

SWIFT, MARCH & COMPANY

.....  
Partner

---

*Note:* The client is not asked to sign this letter. Its purpose is to inform her of the altered circumstances and the effect on the opinion. There is no change in the terms of the engagement. However, it might be desirable to have the client acknowledge receipt of this letter by signing a copy and returning it when—for example—it is a problem client, or when there has been a history of misunderstandings.

**.06 SEC Engagement: Initial Registration, Form S-1**

SWIFT, MARCH & COMPANY

Certified Public Accountants

[Date]

Mr. John James, President  
Odin Company; Inc.  
3 Bay Drive  
La Mancha, California 99999

Dear Mr. James:

This letter confirms the arrangements for our services for the registration statement Odin Company will file with the Securities and Exchange Commission.

We will examine the consolidated balance sheet of Odin Company, Inc., as at December 31, 19XX, and the related statements of income, retained earnings, and changes in financial position for the three years then ended, which will be included in a Form S-1\* registration statement. Our examination will be made in accordance with generally accepted auditing standards and, accordingly, will include such tests of the accounting records and such other auditing procedures as we consider necessary in the circumstances. We will also examine the financial information necessary for the schedules required by Regulation S-X of the SEC.

Subsequent to issuance of our auditor's report, we will perform certain procedures required by Statement on Auditing Standards No. 37 (*Filings Under Federal Securities Statutes*) issued by the American Institute of Certified Public Accountants regarding execution of consent letters required for certain SEC filings. In connection therewith, all printer's proofs of reports to be filed with the Securities and Exchange Commission are to be submitted to us for review. This requirement extends to the entire registration statement and all other material which accompanies the financial statements.

We will perform these services as expeditiously as possible. Your accounting personnel will assist us and cooperate in the timely preparation of trial balances, schedules and account analyses, and provide clerical assistance as needed. Mr. John Brown of the law firm of Green & Brown will be liaison with counsel.

If during our engagement we find that we are unable to express an unqualified opinion on the financial statements or that we are otherwise unable to comply with the requirements of Form S-1,\* we will notify you of the problems encountered.

We will also fulfill the portion of the underwriter's agreement directed to the independent accountants, provided the requirements are within the purview of Statement on Auditing Standards No. 49 (*Letters for Underwriters*), issued by the American Institute of Certified Public Accountants, and provided the material can

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\*This should be edited to agree with the particular form to be filed.

be properly reported on by accountants pursuant to that Statement. In this regard, we require that a copy of the tentative underwriting contract be given us as soon as it is available. Should that portion of the underwriting contract that deals with the details of the comfort letter be available before the balance of the underwriting contract is completely drafted, you will arrange for us to receive a copy of it.

Our engagement is subject to the inherent risk that material errors, irregularities, or illegal acts, including fraud or defalcations, if they exist, will not be detected. However, we will inform you of any such matters that come to our attention.

Our fee for services will be computed at our standard per diem rates, and will be billed to you, together with out-of-pocket costs, every two weeks. Invoices are due and payable on presentation. Before our services begin, you have agreed to pay us a \_\_\_\_\_ retainer, which will be applied to the final billing for this engagement.

We appreciate your confidence in our firm by retaining us as your independent certified public accountants.

If this letter correctly expresses your understanding, please sign the enclosed copy where indicated and return it to us, together with your check for \_\_\_\_\_.

Sincerely,

SWIFT, MARCH & COMPANY

.....  
Partner

APPROVED:

By .....

Date .....

## **.07 Compilation of Financial Statements and Tax Services**

SWIFT, MARCH & COMPANY

Certified Public Accountants

[Date]

Mr. Tom Jones, President  
ZYXWV Freight Corporation  
648 Crystal Lane  
Noplace, Anystate 00000

Dear Mr. Jones:

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will perform the following services:

1. We will compile, from information you provide, the annual and interim balance sheets and related statements of income, retained earnings, and changes in financial position of ZYXWV Freight Corporation for the year 19XX. We will not audit or review such financial statements. Our report on the annual financial statements of ZYXWV Freight Corporation is presently expected to read as follows:

We have compiled the accompanying balance sheet of ZYXWV Freight Corporation as of December 31, 19XX, and the related statements of income, retained earnings, and changes in financial position for the year then ended, in accordance with standards established by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

Our report on your interim financial statements, which statements will omit substantially all disclosures, will include an additional paragraph that will read as follows:

Management has elected to omit substantially all of the disclosures required by generally accepted accounting principles. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the company's financial position, results of operations, and changes in financial position. Accordingly, these financial statements are not designed for those who are not informed about such matters.

If, for any reason, we are unable to complete the compilation of your financial statements, we will not issue a report on such statements as a result of this engagement.

2. We will assist your bookkeeper in adjusting the books of account so that he will be able to prepare a working trial balance from which financial statements can be compiled. Your bookkeeper will provide us with a detailed trial balance and any supporting schedules we require.

3. We will also prepare the federal and state [*identify states*] income tax returns for ZYXWV Freight Corporation for the fiscal year ended December 31, 19XX.

Our engagement cannot be relied upon to disclose errors, irregularities, or illegal acts, including fraud or defalcations, that may exist. However, we will inform you of any such matters that come to our attention.

Our fees for these services [*specify fees or terms*].

We shall be pleased to discuss this letter with you at any time.

If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.\*

Sincerely yours,

.....  
Swift, March & Company

Acknowledged:  
ZYXWV Freight Corporation

.....  
President

.....  
Date

---

\*Some accountants prefer not to obtain an acknowledgement, in which case their letter would omit the paragraph beginning "If the foregoing . . ." and the spaces for the acknowledgement. The first paragraph of their letter might begin as follows: "This letter sets forth our understanding of the terms and objectives of our engagement . . ."

## **.08 Review of Financial Statements and Tax Services**

SWIFT, MARCH & COMPANY

Certified Public Accountants

[Date]

Mr. Tom Jones, President  
ZYXWV Freight Corporation  
648 Crystal Lane  
Nowhere, Anystate 00000

Dear Mr. Jones:

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will perform the following services:

1. We will review the balance sheet of ZYXWV Freight Corporation as of [date], and the related statements of income, retained earnings, and changes in financial position for the year then ended, in accordance with standards established by the American Institute of Certified Public Accountants. We will not perform an audit of such financial statements, the objective of which is the expression of an opinion regarding the financial statements taken as a whole, and, accordingly, we will not express such an opinion on them. Our report on the financial statements is presently expected to read as follows:

We have reviewed the accompanying balance sheet of ZYXWV Freight Corporation as of [date], and the related statements of income, retained earnings, and changes in financial position for the year then ended, in accordance with standards established by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management of ZYXWV Freight Corporation.

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an examination in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

If, for any reason, we are unable to complete our review of your financial statements, we will not issue a report on such statements as a result of this engagement.

2. We will provide your chief accountant with such consultation on accounting matters as he may require in adjusting and closing the books of account and in drafting financial statements for our review. Your chief accountant also

will provide us with a detailed trial balance and any supporting schedules we require.

3. We will also prepare the federal and state [*identify states*] income tax returns for ZYXWV Freight Corporation for the fiscal year ended [*date*].

Our engagement cannot be relied upon to disclose errors, irregularities, or illegal acts, including fraud or defalcations, that may exist. However, we will inform you of any such matters that come to our attention.

Our fees for these services [*specify fees or terms*].

We shall be pleased to discuss this letter with you at any time.

If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.\*

Sincerely yours,

.....  
[*Signature of accountant*]

Acknowledged:  
ZYXWV Freight Corporation

.....  
President

.....  
Date

---

\*Some accountants prefer not to obtain an acknowledgement, in which case their letter would omit the paragraph beginning "If the foregoing . . ." and the spaces for the acknowledgement. The first paragraph of their letter might begin as follows: "This letter sets forth our understanding of the terms and objectives of our engagement . . ."



**.09 Sample Engagement Memorandum (When No Formal Engagement Letter is Sent)**

**Engagement Memorandum**

[Date]

Client	ABC, Inc.
Address	711 Easy Street, La Mancha, Calif. 99999
Phone	QUincy 7-1234
Final arrangements made with	Oscar Brown, President
Date final arrangements made	February 15, 19XX at a meeting in the ABC offices
Client's personnel responsible for accounting matters	Tom Smith, Treasurer Joe Green, Controller
Responsibilities of client's personnel in preparation for engagement	Trial balance of G/L and completion of schedules, a list of which we will submit two weeks before beginning of engagement
Reports to be addressed to	Board of Directors (twelve copies)
Financial statements to be examined	Balance sheet at March 31, 19XX and statements of income, retained earnings, shareholders' equity and changes in financial position for year ended March 31, 19XX
Nature of engagement	Opinion audit and federal and state income tax returns for year ended March 31, 19XX
Date audit to commence	Approximately April 24, 19XX (check with controller about April 10)
Estimated time required	About three weeks
Staff requirements	Manager, supervisor, an in-charge senior, and two staff assistants

**Billing arrangements**

Every two weeks, at standard plus out-of-pocket costs; invoices to attention of Tom Smith; payable on presentation

**Special accounting problems**

Client was involved in a substantial sale and lease-back transaction during the year

Imputed interest may be required on long-term liabilities resulting from purchase of business

**Other comments**

Client is presently negotiating with machinists union

**.10 Audit of Personal Financial Statements**

[Salutation]

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will perform the following service(s):

1. We will examine the statement of financial condition of James and Jane Person as of [date], and the related statement of changes in net worth for the [period] then ended. Our examination will be conducted in accordance with generally accepted auditing standards and, accordingly, will include such tests of the accounting records and such other auditing procedures as we consider necessary in the circumstances. The purpose of our examination is to enable us to express an opinion regarding whether the financial statements are fairly presented in conformity with generally accepted accounting principles. Our report on the financial statements is presently expected to read as follows:

[Standard Audit Report]

2. We will also [discussion of other services, if any].

Our engagement is subject to the inherent risk that material errors, irregularities, or illegal acts, including fraud or defalcations, if they exist, will not be detected. However, we will inform you of any such matters that come to our attention.

Our fees for these services [specify fees or terms].

We shall be pleased to discuss this letter with you at any time.

If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.

Sincerely yours,

.....  
[Signature of accountant]

Acknowledged:

.....  
.....  
.....

[Date]

[Source: AICPA Personal Financial Statements Guide.]

**.11 Compilation of Personal Financial Statements**

[Salutation]

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will perform the following service(s):

- 1. We will compile, from information you provide, the statement of financial condition of James and Jane Person as of [date], and the related statement of changes in net worth for the [period] then ended, in accordance with standards established by the American Institute of Certified Public Accountants. We will not audit or review such financial statements. Our report on the financial statements is presently expected to read as follows:

[Standard Compilation Report]

If, for any reason, we are unable to complete our compilation of your financial statements, we will not issue a report on such statements as a result of this engagement.

- 2. We will also [discussion of other services, if any].

Our engagement cannot be relied upon to disclose errors, irregularities, or illegal acts, including fraud or defalcations, that might exist. However, we will inform you of any such matters that come to our attention.

Our fees for these services [specify fees or terms].

We shall be pleased to discuss this letter with you at any time.

If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.

Sincerely yours,

.....  
[Signature of accountant]

Acknowledged:

.....  
.....  
.....

[Date]

[Source: AICPA Personal Financial Statements Guide.]

## **.12 Review of Personal Financial Statements**

[*Salutation*]

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will perform the following service(s):

1. We will review the statement of financial condition of James and Jane Person as of [*date*], and the related statement of changes in net worth for the [*period*] then ended, in accordance with standards established by the American Institute of Certified Public Accountants. We will not perform an audit of such financial statements, the objective of which is the expression of an opinion regarding the financial statements taken as a whole, and, accordingly, we will not express such an opinion on them. Our report on the financial statements is presently expected to read as follows:

[*Standard Review Report*]

If, for any reason, we are unable to complete our review of your financial statements, we will not issue a report on such statements as a result of this engagement.

2. We will also [*discussion of other services, if any*].

Our engagement cannot be relied upon to disclose errors, irregularities, or illegal acts, including fraud or defalcations, that might exist. However, we will inform you of any such matters that come to our attention.

Our fees for these services [*specify fees or terms*].

We shall be pleased to discuss this letter with you at any time.

If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.

Sincerely yours,

.....  
[*Signature of accountant*]

Acknowledged:

.....  
.....  
.....

[*Date*]

[*Source: AICPA Personal Financial Statements Guide.*]



### **TECHNICAL HOTLINE**

**The AICPA Technical Information Service answers inquiries about specific audit or accounting problems.**

**Call Toll Free**

**(800) 223-4158 (Except New York)  
(800) 522-5430 (New York Only)**

**This service is free to AICPA members.**