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Michael A. Tursi

TIPS 2 AUDIT PLANNING Revised 1990 AICPA

Technical
Information for
Practitioners
Series

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AUDIT PLANNING

Revised 1990

AICPA

American Institute of Certified Public Accountants

NOTICE TO READERS

This book appears as sections 3100 through 3175 in the looseleaf AICPA *Audit and Accounting Manual* (as of April 1990), which is updated quarterly.

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2

AUDIT PLANNING

Revised 1990

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American Institute of Certified Public Accountants

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PREFACE

AUDIT PLANNING

This book is a revision of *Audit Planning,* the second in the Technical Information for Practitioners series. Each book in the series is designed to give practical guidance to one aspect of an accounting or audit engagement. This revision also appears as sections 3100 through 3175 of the looseleaf AICPA *Audit and Accounting Manual* (as of April 1990), which is updated quarterly.

This book 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 book 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 may 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, *Professional Standards,* vol. 2, ET sec. 201.01), 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 sec. 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 internal control structure.
2. Evaluating management integrity.

g. Establish an agreement with the client, preferably with an engagement letter.

h. Assess control risks.

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 engagement; *(b)* understand if reports on compliance, internal control structure, 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 managers.

.02 A sample checklist documenting the procedures listed in this section is located in section 3165.

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 Quality Control Policies and Procedures for CPA Firms, *Establishing Quality Control Policies and Procedures* (AICPA, *Professional Standards,* vol. 2, QC sec. 90.11-.12).

Engagement Planning Procedures

.03 A time budget for the engagement should generally be prepared to determine manpower requirements and to schedule field work. The engagement partner should approve the time budget prior to the beginning of field work. A time budget should have columns for budgeted time (in hours) for preliminary and final field work. 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 3170.01 for "Audit Time Budget—Sample A"), whereas others combine these reports into one form (see section 3170.02 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 pre-determined number of staff hours (for example, one hundred hours; see section 3170.03 for "Audit Time Analysis—Short Form") and a longer form for jobs requiring more time (see section 3170.04 for "Audit Time Analysis—Long Form"). Some firms use a weekly (or daily) progress report (see section 3170.05, 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 3165.

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 Code of Professional Conduct. Interpretation 101-1 of rule 101 of the rules of conduct (AICPA, *Professional Standards,* vol. 2, ET sec. 101.02) 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 Quality Control Policies and Procedures for CPA Firms, *Establishing Quality Control Policies and Procedures,* paragraphs .09–.10 (AICPA, *Professional Standards,* vol. 2, QC sec. 90).

.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 sec. 543, "Part of the 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* (AICPA, *Professional Standards,* vol. 1, AU sec. 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 3165.

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 audit 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 audit. 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.[1]

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 audit. Other 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

[1]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 sec. 411.04 and .09).

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 audit, to understand the nature of internal control structure policies and procedures, or to design and perform audit 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 audit procedures. The accountant's responsibilities for using such a professional are equivalent to those for using assistants.[2]

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

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.[3]

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.[4] Using computer-assisted audit techniques may also provide the

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[2]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 sec. 336), a computer audit specialist requires the same supervision and review as any assistant.

[3]See SAS No. 44, *Special Purpose Reports on Internal Accounting Control at Service Organizations* (AICPA, *Professional Standards,* vol. 1, AU sec. 324), and the related AICPA Audit and Accounting Guide, *Audits of Service-Center-Produced Records,* for guidance concerning the use of a service center for computer processing of significant accounting applications.

[4]See the AICPA Audit and Accounting Guide, *Computer-Assisted Audit Techniques,* for guidance relating to this specialized area.

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).[5]

.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 3165.

[5]SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329) describes the usefulness of and guidance pertaining to such procedures.

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.[1] 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 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,

[1]Throughout this section, references to audit opinions regarding generally accepted accounting principles also include other comprehensive bases of accounting.

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 a sophisticated internal control structure. Neither a formalized and complex accounting system nor a sophisticated control structure is required for a small business to be auditable.

SAS No. 55 Requirements

.05 The auditor should obtain a sufficient understanding of each of the three elements (control environment, accounting system, and control procedures) of the entity's internal control structure to plan the audit of the entity's financial statements. The understanding should include knowledge about the design of relevant policies, procedures, and records and whether they have been placed in operation by the entity. In planning the audit, such knowledge should be used to:

a. Identify types of potential misstatements.

b. Consider factors that affect the risk of material misstatement.

c. Design substantive tests.

.06 Whether an internal control structure policy or procedure has been placed in operation is different from its operating effectiveness. In obtaining knowledge about whether policies and procedures have been placed in operation, the auditor determines that the entity is using them. Operating effectiveness, on the other hand, is concerned with how the policy, procedure, or record was applied, the consistency with which it was applied, and by whom. The auditor is not required to obtain knowledge about operating effectiveness as part of the understanding of the internal control structure used in planning the audit.

.07 The auditor's understanding of the internal control structure may sometimes raise doubts about the auditability of an entity's financial statements. Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted. Concerns about the nature and extent of an entity's records may cause the auditor to conclude that it is unlikely that sufficient competent evidential matter will be available to support an opinion on the financial statements.

Understanding the Internal Control Structure

.08 In making a judgment about the understanding of the internal control structure necessary to plan the audit, the auditor considers the knowledge obtained from other sources about the types of misstatements that could occur, the risk that such misstatements may occur, and the factors that influence the design of substantive tests. Other sources of such knowledge include previous audits and the understanding of the industry in which the entity operates. The auditor also considers his assessment of inherent risk, his judgment about materiality, and the complexity and sophistication of the entity's operations and systems as discussed in section 3140.

Understanding of Control Environment

.09 The auditor should obtain sufficient knowledge of the control environment to understand management's attitude, awareness, and actions concerning the control environment. The auditor should concentrate on the substance of management's policies, procedures, and related actions rather than their form because management may establish appropriate policies and procedures but not act on them. The auditor must be knowledgeable about the entity's organizational structure. Although there are obviously limits on the formality of organization in a small business, some segregation of duties and designation of authority and responsibility generally can be accomplished. In addition, someone is responsible for engaging the auditor, responding to audit results, and exercising financial reporting oversight. How employees are told what is expected of them, how they are delegated authority and responsibility, and how their performances are monitored and evaluated also affect control consciousness in an entity. In addition, the planning and reporting system used, such as budgeting and forecasting, and personnel management practices are indications of attitudes and actions about internal control. Auditors should know how management has acted on these matters.

Understanding of Accounting System

.10 The auditor should obtain sufficient knowledge of the accounting system to understand:

a. The classes of transactions in the entity's operations that are significant to the financial statements.

b. How those transactions are initiated.

c. The accounting records, supporting documents, machine-readable information, and specific accounts in the financial statements involved in the processing and reporting of transactions.

d. The accounting processing involved from the initiation of a transaction to its inclusion in the financial statements, including how the computer is used to process data.

e. The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.

Understanding of Control Procedures

.11 Generally, control procedures pertain to the proper authorization of transactions, segregation of duties, design and use of adequate documents and records, safeguards over assets and records and independent checks on performance, such as reconciliations, comparing documents, and management review of reports. Because some control procedures are integrated in specific components of the control environment and accounting system, as the auditor obtains an understanding of the control environment and accounting system, he is also likely to obtain knowledge about some control procedures. For example, in obtaining an understanding of the documents, records, and processing steps in the accounting system that pertain to cash, the auditor is likely to become aware of whether bank accounts are reconciled.

The auditor should consider the knowledge about the presence or absence of control procedures obtained from the understanding of the control environment and accounting system in determining whether it is necessary to devote additional attention to obtaining an understanding of control procedures to plan the audit. Ordinarily, audit planning does not require an understanding of the control procedures related to each account balance, transaction class, and disclosure component in the financial statements or to every assertion relevant to those components.

Procedures to Obtain Understanding

.12 In obtaining an understanding of the internal control structure policies and procedures that are relevant to audit planning, the auditor should perform procedures to provide sufficient knowledge of the design of the relevant policies, procedures, and records pertaining to each of the three internal control structure elements and whether they have been placed in operation. This knowledge is ordinarily obtained through previous experience with the entity and procedures such as inquiries of appropriate management, supervisory, and staff personnel; inspection of entity documents and records; and observation of entity activities and operations. The nature and extent of the procedures performed generally vary from entity to entity and are influenced by the size and complexity of the entity, the auditor's previous experience with the entity, the nature of the particular policy or procedure, and the nature of the entity's documentation of specific policies and procedures. The auditor's assessments of inherent risk and judgments about materiality for various account balances and transaction classes also affect the nature and extent of the procedures performed to obtain the understanding. For example, the auditor may conclude that planning the audit of the prepaid insurance account does not require specific procedures to be included in obtaining the understanding of the internal control structure.

Documentation of Understanding

.13 The auditor should document the understanding of the entity's internal control structure elements obtained to plan the audit. The form and extent of this documentation is influenced by the size and complexity of the entity, as well as the nature of the entity's internal control structure. For example, documentation of the understanding of the internal control structure of a large complex entity may include flowcharts, questionnaires, or decision tables. For a small business, however, documentation in the form of a memorandum may be sufficient. Generally, the more complex the internal control structure and the more extensive the procedures performed, the more extensive the auditor's documentation should be.

Management Integrity

.14 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.[2]

.15 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.

.16 The auditor should also assess the risk that management has misstated the financial statements. SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AICPA, *Professional Standards,* vol. 1, AU sec. 316.12 and .16-.17), includes a discussion of managerial characteristics. Section 3145 discusses the assessment of risk of errors and irregularities in audit planning.

.17 Statement of Quality Control Standard No. 1, *System of Quality Control for a CPA Firm,* paragraph 7h (AICPA, *Professional Standards,* vol. 2, QC sec. 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."

.18 A sample checklist documenting procedures listed in this section is located in section 3165.

[2]R. K. Mautz and Hussein A. Sharaf, *The Philosophy of Auditing,* American Accounting Association (Sarasota, Fla.: 1961), p. 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.[1]

.02 Any limitations the client imposes on the scope of the engagement 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 printers' 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 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.

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[1]Statement on Standards for Accounting and Review Services (SSARS) 1, *Compilation and Review of Financial Statements,* paragraph 8 (AICPA, *Professional Standards,* vol. 2, AR sec. 100.08), states: "The accountant should establish an understanding with the entity, preferably in writing, regarding the services to be performed."

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 misunderstandings 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 while 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. 58, *Reports on Audited Financial Statements,* paragraph 42 [AICPA, *Professional Standards,* vol. 1, AU sec. 508.42]).
- Significant litigation or other matters exist which may affect the opinion.

b. Whether 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 audited, 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 sec. 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 audit. 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 the 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 engagement.

d. A study and evaluation 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 reportable conditions in the internal control structure 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. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* [AICPA, *Professional Standards,* vol. 1, AU sec. 325]).

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

a. Reference in the letter to audit of the books and records rather than to audit 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 control structure as one of the services when what is really intended is a consideration of the internal control structure 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 whomever 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 investigative 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 scope of the investigation.[2]

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

Filing of Engagement Letters

.17 The signed engagement letter (or original of the conforming 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 3165.

.19 See section 3175 for sample engagement letters.

AAM Section 3135

Assessment of Control Risk

General Comments

.01 Upon obtaining an understanding of the elements of the internal control structure as discussed in section 3125, the auditor must assess control risk for financial statement assertions to determine the nature, timing and extent of tests of controls and substantive testing. The risk of material misstatement in financial statement assertions consists of inherent risk, control risk, and detection risk as discussed in section 3140. Assessing control risk is the process of evaluating the effectiveness of an entity's internal control structure policies and procedures in preventing or detecting material misstatements in financial statements. Control risk should be assessed in terms of financial statement assertions.

Consideration of the Internal Control Structure in Assessing Control Risk

.02 After obtaining the understanding of the internal control structure the auditor may assess control risk at the maximum level for some or all assertions because he believes policies and procedures are unlikely to pertain to an assertion, are unlikely to be effective, or because evaluating their effectiveness would be inefficient.

.03 Assessing control risk at below the maximum level involves:

a. Identifying specific internal control structure policies and procedures relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions

b. Performing tests of controls to evaluate the effectiveness of such policies and procedures

.04 In identifying internal control structure policies and procedures relevant to specific financial statement assertions, the auditor should consider that the policies and procedures can have either a pervasive effect on many assertions or a specific effect on an individual assertion, depending on the nature of the particular internal control structure element involved. The control environment and accounting system often have a pervasive effect on a number of account balance or transaction classes and, therefore, can often affect many assertions.

.05 Conversely, some control procedures often have a specific effect on an individual assertion embodied in a particular account balance or transaction class. For example, the control procedures that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the existence assertion for the inventory account balance.

.06 Internal control structure policies and procedures can either be directly or indirectly related to an assertion. The more indirect the relationship, the less effective that policy or procedure may be in reducing control risk for that assertion.

.07 Procedures directed toward either the effectiveness of the design or operation of an internal control structure policy or procedure are referred to as tests of controls. Tests of controls directed toward the effectiveness of the design of an internal control structure policy or procedure are concerned with whether that policy or procedure is suitably designed to prevent or detect material misstatements in specific financial statement assertions. Tests to obtain such evidential matter ordinarily include procedures such as inquiries of appropriate entity personnel, inspection of documents and reports, and observation of the application of specific internal control structure policies and procedures.

.08 Tests of controls directed toward the operating effectiveness of an internal control structure policy or procedure are concerned with how the policy or procedure was applied, the consistency with which it was applied during the audit period, and by whom it was applied. These tests ordinarily include procedures such as inquiries of appropriate entity personnel, inspection of documents and reports indicating performance of the policy or procedure, observation of the application of the policy or procedure, and reperformance of the application of the policy or procedure by the auditor. In some circumstances, a specific procedure may address the effectiveness of both design and operation. However, a combination of procedures may be necessary to evaluate the effectiveness of the design or operation of an internal control structure policy or procedure.

.09 The conclusion reached as a result of assessing control risk is referred to as the assessed level of control risk. In determining the evidential matter necessary to support a specific assessed level of control risk at below the maximum level, the auditor should consider the characteristics of evidential matter. Generally, however, the lower the assessed level of control risk, the greater the assurance the evidential matter must provide that the internal control structure policies and procedures relevant to an assertion are designed and operating effectively.

.10 The auditor uses the assessed level of control risk (together with the assessed level of inherent risk) to determine the acceptable level of detection risk for financial statement assertions. The auditor uses the acceptable level of detection risk to determine the nature, timing, and extent of the auditing procedures to be used to detect material misstatements in the financial statement assertions. Auditing procedures designed to detect such misstatements are substantive tests.

Documentation of the Assessed Level of Control Risk

.11 In addition to the documentation of the understanding of the internal control structure, the auditor should document the basis for his conclusions about the assessed level of control risk. Conclusions about the assessed level of control risk may differ as they relate to various account balances or classes of transactions. However, for those financial statement assertions where control risk is assessed at the maximum level, the auditor should document his conclusion that control risk is at the maximum level but need not document the basis for that conclusion. For those assertions where the assessed level of control risk is below the maximum level, the auditor should document the basis for this conclusion that the effectiveness of the design and operation of internal control structure policies and procedures supports that assessed level. The nature and extent of the auditor's documentation are influenced by the assessed level of control risk used, the nature of the entity's internal control structure and the nature of the entity's documentation of its internal control structure.

Further Reduction in the Assessed Level of Control Risk

.12 After obtaining the understanding of the internal control structure and assessing control risk, the auditor may desire to seek a further reduction in the assessed level of control risk for certain assertions. In such cases, the auditor considers whether additional evidential matter sufficient to support a further reduction is likely to be available, and whether it would be efficient to perform tests of controls to obtain that evidential matter. The results of the procedures performed to obtain the understanding of the internal control structure, as well as pertinent information from other sources, help the auditor to evaluate those two factors.

.13 In considering efficiency, the auditor recognizes that additional evidential matter that supports a further reduction in the assessed level of control risk for an assertion would result in less audit effort for the substantive tests of that assertion. The auditor weighs the increase in audit effort associated with the additional tests of controls that is necessary to obtain such evidential matter against the resulting decrease in audit effort associated with the reduced substantive tests. When the auditor concludes it is inefficient to obtain additional evidential matter for specific assertions, the auditor uses the assessed level of control risk based on the understanding of the internal control structure in planning the substantive tests for those assertions.

.14 For those assertions for which the auditor performs additional tests of controls, the auditor determines the assessed level of control risk that the results of those tests will support. This assessed level of control risk is used in determining the appropriate detection risk to accept for those assertions and, accordingly, [in determining the appropriate detection risk to accept for those assertions and, accordingly,] in determining the nature, timing, and extent of substantive tests for such assertions.

.15 A sample checklist documenting procedures listed in this section is located in section 3165.

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 all material respects . . . 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 explicit in the phrase "presents fairly in all material respects in conformity with generally accepted accounting principles."

Audit Risk

.02 SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards,* vol. 1, AU sec. 312), 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 audit of financial statements. Business risk is present even though the auditor conducts the audit 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 transactions 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 internal control structure. Control risk is a function of the effectiveness of the internal control structure. Some control risk will always exist because of the inherent limitations of any internal control structure.

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 misstatements occurs when the auditor considers inherent risk.

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

.07 Even when a client has effective internal control structure policies and procedures, certain misstatements can bypass the structure because of special circumstances. For example, if a client had an unusual exchange of nonmonetary assets, no internal control structure policies and procedures may have been established to detect a misstatement in this special circumstance.

.08 If the client's internal control structure does not detect and remove misstatements, 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 misstatements do not remain in financial statements.

.09 The auditor will never have absolute assurance that no material misstatements exist in the financial statements. From a cost-benefit perspective, an audit providing absolute assurance that no material misstatements exist in the financial statements is impractical. Thus, the auditor designs audit tests to provide *reasonable assurance* that there are no material misstatements in the financial statements. There is always some risk that (*a*) material misstatements will exist; (*b*) they will not be detected by the client's internal control structure;

(*c*) they will not be detected by the auditor; or (*d*) they will affect the financial statements. The auditor's responsibility is to reduce audit risk to an acceptably low level. Both the tests of details (tests of balances and tests of transactions) and analytical procedures are means by which the auditor detects material misstatements.

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 misstatement 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 misstatements could be included in the financial statements without precluding the auditor from expressing an opinion that the financial statements are fairly presented in all material respects 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 audited.

In Planning

.16 In planning the audit, materiality should be viewed as an allowance for likely and potential undetected misstatements. 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 audit. 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 sec. 312.03]). 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 pretax income. Some auditors apply this rule of thumb so that items less than 5 percent of normal pretax 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 below for a sample planning materiality worksheet.)

Exhibit

	Initials	Date
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 *1* or *2*	____
4. Select a multiplier if audit risk is normal, or, if better than normal, select .01	____
5. Multiply *3* times *4*	____
6. Unaudited pretax 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 *6* times *7*	____
9. Evaluate *5* and *8* along with other relevant factors and determine materiality for audit planning purposes	____

.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 pretax income is not meaningful.

.22 A sample checklist documenting procedures listed in this section is located in section 3165.

AAM Section 3145

Errors and Irregularities

General Comments

.01 The auditor should assess the risk that errors and irregularities may cause the financial statements to contain a material misstatement. Based on that assessment, the auditor should design the audit to provide reasonable assurance of detecting errors and irregularities that are material to financial statements.

.02 The auditor should exercise:

a. Due care in planning, performing, and evaluating the results of audit procedures.

b. The proper degree of professional skepticism to achieve reasonable assurance that material errors or irregularities will be detected.

Consideration of Audit Risk at the Financial Statement Level

.03 An assessment of the risk of material misstatements should be made during planning. The auditor's understanding of the internal control structure should either heighten or mitigate the auditor's concern about the risk of material misstatements.

.04 Factors such as those listed below may be considered:

a. Management characteristics (e.g., management's attitude toward reporting is unduly aggressive).

b. Operating and industry characteristics (e.g., profitability of an entity relative to its industry is inadequate or inconsistent).

c. Engagement characteristics (e.g., significant and unusual related party transactions not in the ordinary course of business are present).

.05 The size, complexity, and ownership characteristics of the entity have a significant influence on the risk factors considered to be important.

.06 The auditor should assess risk of management misrepresentation by reviewing information obtained about risk factors and the internal control structure. Matters such as the following may be considered:

a. Are there known circumstances that may indicate a management predisposition to distort financial statements, such as frequent disputes about aggressive application of accounting principles that increase earnings?

b. Are there indications that management has failed to establish policies and procedures that provide reasonable assurance of reliable accounting estimates, such as personnel who develop estimates appearing to lack necessary knowledge and experience?

c. Are there conditions that indicate lack of control of activities, such as constant crisis conditions in operating or accounting areas?

d. Are there indications of a lack of control over computer processing, such as a lack of control over access to applications that initiate or control the movement of assets (e.g., a demand-deposit application in a bank)?

e. Are there indications that management has not developed or communicated adequate policies and procedures for security of data or assets, such as not investigating employees in key positions before hiring?

The Auditor's Response to Risk at the Financial Statement Level

.07 The auditor's overall judgment about the level of risk in an engagement may affect engagement staffing, extent of supervision, overall strategy for expected conduct and scope of audit, and degree of professional skepticism applied.

.08 Ordinarily, higher risk requires more experienced personnel or more extensive supervision by the auditor with final responsibility for the engagement during both the planning and conduct of the engagement.

.09 Higher risk may cause the auditor to expand the extent of procedures applied, apply procedures closer to or as of the balance sheet date, or modify the nature of procedures.

Consideration of Audit Risk at the Balance or Class Level

.10 Examples of factors that may influence the auditor's consideration of risk of material misstatement at balance or class level are:

a. Complexity and contentiousness of accounting issues affecting balance or class

b. Nature, cause, and amount of known and likely misstatements detected in the balance or class in the prior audit

c. Susceptibility of related assets to misappropriation

d. Extent of judgment involved in determining the total balance or class

Professional Skepticism

.11 An audit should be planned and performed with an attitude of professional skepticism. The auditor neither assumes that management is dishonest nor assumes unquestioned honesty.

.12 When approaching difficult-to-substantiate assertions, the auditor should recognize the increased importance of factors that bear on management integrity. A presumption of management dishonesty, however, would be contrary to the accumulated experience of auditors. Moreover, if dishonesty were presumed the auditor would potentially need to question the genuineness of all records and documents obtained from the client and would require conclusive rather than persuasive evidence to corroborate all management representations. An audit conducted on these terms would be unreasonably costly and impractical.

Professional Skepticism in Audit Planning

.13 Whenever the auditor has reached a conclusion that there is significant risk of material misstatement, the auditor reacts in one or more ways.

.14 The auditor should consider this assessment in determining the nature, timing or extent of procedures, assigning staff, or requiring appropriate levels of supervision.

.15 The auditor may identify specific transactions involving senior management and confirm the details with appropriate external parties and review in detail all material accounting entries prepared or approved by senior management.

.16 The auditor should consider whether accounting policies are acceptable in the circumstances. Increased risk of intentional distortion of the financial statements should cause greater concern about whether accounting principles that are otherwise generally accepted are being used in inappropriate circumstances to create a distortion of earnings.

.17 When evaluation at the financial statement level indicates significant risk, the auditor requires more or different evidence to support material transactions than would be the case in the absence of such risk. For example, the auditor may perform additional procedures to determine that sales are properly recorded, giving consideration to the possibility that the buyer has a right to return the product. Transactions that are both large and unusual, particularly at year-end, should be selected for testing.

.18 A sample checklist documenting procedures listed in this section is located in section 3165.

AAM Section 3150

Illegal Acts

General Comments

.01 The term "illegal acts" refers to violations of laws or governmental regulations. Illegal acts by clients do not include personal misconduct by the entity's personnel unrelated to their business activities.

.02 Whether an act is illegal is a determination that is normally beyond the auditor's professional competence. The auditor's training and experience may provide a basis for recognition that some client acts coming to his attention may be illegal.

Direct and Material Effect Illegal Acts

.03 The auditor considers laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts (except disclosure of contingencies). For example, tax laws affect accruals and the amount recognized as expense in the accounting period; applicable laws and regulations may affect the amount of revenue accrued under government contracts.

.04 The auditor considers such laws or regulations from the perspective of their known relation to audit objectives derived from financial statement assertions rather than from the perspective of legality *per se.*

.05 The auditor's responsibility to detect and report misstatement resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for material errors and irregularities as described in SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AICPA, *Professional Standards,* vol. 1, AU sec. 316).

Other Illegal Acts

.06 Entities may be affected by many other laws or regulations, including those related to securities trading, occupational safety and health, food and drug administration, environmental protection, equal employment, and price-fixing or other antitrust violations. Generally, these laws and regulations relate more to an entity's operating aspects than to its financial and accounting aspects and their financial statement effect is indirect.

.07 An auditor ordinarily does not have sufficient basis for recognizing possible violations of such laws and regulations. Their indirect effect is normally the result of the need to disclose a contingent liability because of the allegation or determination of illegality.

Engagement Planning Procedures

.08 The auditor should assess the risks that the entity has not complied with laws and regulations that have a direct and material effect on the determination of financial statement amounts (except disclosure of contingencies) in the planning phase of the audit.

.09 Matters that may influence the auditor's assessment include:

a. Management's understanding of the requirements of laws and regulations pertinent to audit objectives.

b. The nature and extent of noncompliance noted in prior audits.

c. Changes in requirements since the last audit.

d. Internal control structure elements designed to give management reasonable assurance that the entity complies with those laws and regulations.

e. The client's policy relative to the prevention of illegal acts.

.10 Normally, there is no need to include audit procedures specifically designed to detect illegal acts.

.11 A sample checklist documenting the procedures listed in this section is located in section 3165.

AAM Section 3155

Analytical Procedures

General Comments

.01 Understanding financial relationships is essential in planning and evaluating the results of analytical procedures and generally requires knowledge of the client and the industry or industries in which the client operates. An understanding of the purposes of analytical procedures and the limitations of those procedures is also important. Accordingly, the identification of the relationships and types of data used, as well as conclusions reached when recorded amounts are compared to expectations, requires judgment by the auditor.

.02 Analytical procedures are used for the following purposes:

a. To assist the auditor in planning the nature, timing, and extent of other auditing procedures.

b. As a substantive test to obtain evidential matter about particular assertions related to account balances or classes of transactions.

c. As an overall review of the financial information in the final review stage of the audit.

Analytical procedures should be applied to some extent for the purposes referred to in (*a*) and (*c*) above for all audits of financial statements made in accordance with generally accepted auditing standards. In addition, in some cases, analytical procedures can be more effective or efficient than tests of details for achieving particular substantive testing objectives.

.03 Analytical procedures involve comparisons of recorded amounts or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the auditor's understanding of the client and of the industry in which the client operates. Following are examples of sources of information for developing expectations:

a. Financial information for comparable prior period(s) giving consideration to known changes.

b. Anticipated results—for example, budgets or forecasts including extrapolations from interim or annual data.

c. Relationships among elements of financial information within the period.

d. Information regarding the industry in which the client operates—for example, gross margin information.

e. Relationships of financial information with relevant nonfinancial information.

Engagement Planning Procedures

.04 The purpose of applying analytical procedures in planning the audit is to assist in planning the nature, timing, and extent of auditing procedures that will be used to obtain evidential matter for specific account balances or classes of transactions. To accomplish this, the analytical procedures used in planning the audit should focus on (*a*) enhancing the auditor's understanding of the clients' business and the transactions and events that have occurred since the last audit date, and (*b*) identifying areas that may represent specific risks relevant to the audit. Thus, the objective of the procedures is to identify such things as the existence of unusual transactions and events, and amounts, ratios and trends that might indicate matters that have financial statement and audit planning ramifications.

.05 Analytical procedures used in planning the audit generally use data aggregated at a high level. Furthermore, the sophistication, extent and timing of the procedures, which are based on the auditor's judgment, may vary widely depending on the size and complexity of the client. For some entities, the procedures may consist of reviewing changes in account balances from the prior to the current year using the general ledger or the auditor's preliminary or unadjusted working trial balance. In contrast, for other entities, the procedures might involve an extensive analysis of quarterly financial statements. In both cases, the analytical procedures, combined with the auditor's knowledge of the business, serve as a basis for additional inquiries and effective planning.

.06 Although analytical procedures used in planning the audit often use only financial data, sometimes relevant nonfinancial information is considered as well. For example, number of employees, square footage of selling space, volume of goods produced, and similar information may contribute to accomplishing the purpose of the procedures.

.07 A sample checklist documenting procedures listed in this section is located in section 3165.

AAM Section 3160

Audit Strategies and the Audit Program

.01 The nature, timing, and extent of audit testing is discussed in section 5000.

.02 A sample checklist documenting procedures listed in section 5000 is located in section 3165.

AAM Section 3165

Illustrative Planning Checklist

	Done by	Date
.01 A. *Understanding the Assignment*		
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 audit, have engagement personnel—		
a. Discussed the type, scope, and timing of the audit 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?	____	____
.02 B. *Assigning Personnel to the Engagement*		
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:		
a. Engagement size and complexity?	____	____
b. Personnel availability?	____	____
c. Special expertise required?	____	____
d. Timing of the work performed?	____	____

	Done by	Date
e. Continuity and periodic rotation of personnel?	____	____
f. 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?	____	____

.03 C. *Independence*

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?	____	____
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, *Association With Financial Statements* (AICPA, *Professional Standards,* vol. 1, AU sec 504.06–.10)?	____	____

.04 D. *Knowledge of the Entity's Business*

1. Has an initial, overall understanding of the clients' operations been obtained by—		
a. Reviewing the prior years' working papers, permanent file, auditors' reports, 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 years?	____	____
c. Reviewing most recent management letters?	____	____
d. Reviewing the client' correspondence file?	____	____
e. Obtaining copies of the minutes of meetings of stockholders and the board of directors?	____	____
f. Considering possible impact of nonaudit services rendered to client on the audit?	____	____

	Done by	Date
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?	____	____
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 audit?	____	____
6. Have the following matters been considered in evaluating the effect of the entity's computer processing on the audit 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?	____	____

	Done by	Date
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 audit?	____	____

.05 E. *Assessing Auditability*

	Done by	Date
1. Has the adequacy of the accounting records been assessed for the following factors:		
a. Are transactions described in sufficient detail to permit appropriate classification in financial statements?	____	____
b. Are transactions described in a manner that permits the recording of monetary value in the financial statements?	____	____
c. Do 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 design of the relevant policies, procedures, and records, pertaining to the control environment, accounting system, and control procedures of the internal control structure and whether they have been placed in operation been obtained through:		
a. Previous experience with the entity?	____	____
b. Inquiries of appropriate management, supervisory, and staff personnel?	____	____
c. Inspection of entity documents and records?	____	____
d. Observation of entity activities and operations?	____	____
3. Has the understanding of the entity's internal control structure elements obtained to plan the audit been documented?	____	____
4. 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?	____	____
b. A check of the client's credit rating?	____	____

.06 F. *Engagement Letter*

	Done by	Date
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 audited, compiled, or reviewed?	____	____

	Done by	Date
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 section 3175)?	____	____
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. That, in new engagements, the client should take the responsibility for getting the cooperation of the prior auditor and the successor auditor to communicate with the predecessor auditor prior to accepting the engagement?	____	____
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. Study and evaluation 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. Acknowledgment 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 acknowledgment may be particularly appropriate for such clients.)	____	____

	Done by	Date
h. A statement that the client will be informed of any reportable conditions in the internal control structure 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. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* [AICPA, *Professional Standards,* vol. 1, AU sec. 325].)	____	____

.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?	____	____
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. *Assessment of Control Risk*

1. If control risk is assessed at the maximum level for some or all financial statement assertions, has that conclusion been documented?	____	____
2. Have the following procedures been performed in assessing control risk at below the maximum level for some or all financial statement assertions:		
a. Identifying specific internal control structure policies and procedures relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions?	____	____
b. Performing tests of controls to evaluate the effectiveness of the design and operation of such policies and procedures?	____	____
3. If a further reduction in the assessed level of control risk is desired for some financial statement assertions, have additional tests of relevant controls been performed?	____	____
4. Has the basis for the conclusion that control risk is assessed at below maximum level for some or all financial statement assertions been documented?	____	____

	Done by	*Date*

.09 I. ***Errors and Irregularities***

1. Have the following factors been considered in assessing the risk of material misstatement at the financial statement level:

    a. Management characteristics (e.g., management's attitude toward financial reporting is unduly aggressive)? ____ ____

    b. Operating and industry characteristics (e.g., profitability of entity relative to its industry is inadequate or inconsistent)? ____ ____

    c. Engagement characteristics (e.g., significant and unusual related party transactions not in the ordinary course of business are present)? ____ ____

2. Have the following factors been considered in assessing the risks of management misrepresentation at the financial statement level:

    a. Are there known circumstances that may indicate a management predisposition to distort financial statements, such as frequent disputes about aggressive application of accounting principles that increase earnings? ____ ____

    b. Are there indications that management has failed to establish policies and procedures that provide reasonable assurance of reliable accounting estimates, such as personnel who develop estimates appearing to lack necessary knowledge and experience? ____ ____

    c. Are there conditions that indicate a lack of control of activities, such as constant crisis conditions in operating or accounting areas? ____ ____

    d. Are there indications of a lack of control over computer processing, such as a lack of controls over access to applications that initiate or control the movement of assets (e.g., a demand-deposit application in a bank)? ____ ____

    e. Are there indications that management has not developed or communicated adequate policies and procedures for security of data or assets, such as not investigating employees in key positions before hiring? ____ ____

3. Have the following factors been considered in assessing the risk of material misstatement at the balance or class level:

    a. Complexity and contentiousness of accounting issues affecting balance or class? ____ ____

    b. Nature, cause, and amount of known and likely misstatements detected in the balance or class in the prior audit? ____ ____

    c. Susceptibility of related assets to misappropriation? ____ ____

    d. Extent of judgment involved in determining the total balance or class? ____ ____

	Done by	*Date*
4. Has the assessment of risk of material misstatement been considered in determining:		
a. The nature, timing or extent of audit procedures?	____	____
b. Assigning staff?	____	____
c. Requiring appropriate levels of supervision?	____	____
5. If it is determined that significant risk of material misstatement exists:		
a. Have the details of specific transactions involving senior management been identified and confirmed with the appropriate external parties?	____	____
b. Have the details of all material accounting entries prepared or approved by senior management been reviewed?	____	____
c. Has it been considered whether accounting policies are acceptable in the circumstances?	____	____

.10 J. *Illegal Acts*

1. Have the following matters been considered in the assessment of risk that the entity has not complied with laws and regulations that have a direct and material effect on the determination of financial statement amounts:		
a. The client's policy, if any, relative to the prevention of illegal acts?	____	____
b. Management's understanding of the requirements of laws and regulations pertinent to audit objectives?	____	____
c. The nature and extent of noncompliance noted in prior audits?	____	____
d. Internal control structure elements designed to give management reasonable assurance that the entity complies with those laws and regulations?	____	____

.11 K. *Analytical Procedures*

1. Have analytical procedures been used that focus on:		
a. Enhancing the auditor's understanding of the client's business and the transactions and events that have accrued since the last audit date?	____	____
b. Identifying areas that may represent specific risks relevant to the audit?	____	____

	Done by	Date
.12 L. ***Audit Strategies and the Audit Program***		
1. Has the proposed audit program been developed for the engagement?	___	___
2. Has the final audit program been approved by the engagement partner?	___	___

AAM Section 3170

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		
General supervision and planning		
Review computer programs and auditability		
Review of internal control		
Review and update permanent files		
Travel		
Report and statement review		
Other matters		
Total budgeted hours		

(Excludes tax and report departments' time)

.02 Audit Time Budget—Sample B

Date	Total hours				General														Cash			Inventories																			Other (describe)		
	Accountant's initials color-coded																																										
	Total	Supervisor or manager	Senior	Assistant	Audit program	Prior period reports Working papers, etc	Trial balance and adjusting entries	Permanent file	Financial statement comparison	Transactions since balance sheet date	Preparation of reports	Internal control quest and mgmt letter	Time summary	Supervision	Correspondence and conferences	Review in-house computer programs	Audit of/with computer	General ledger and journal entries	In banks and on hand	Receipts and disbursements	Notes/accts rec and allowance for losses	Observation	Comparison of quantities	Valuation	Clerical accuracy and analytical review	Prepaid expenses	Other current assets	Fixed assets and depreciation	Investments	Other assets	Notes payable and long-term debt	Accounts payable	Other current liabilities	Other long-term liabilities and deferred income	Stockholders' equity	Contingent liabilities	Sales and revenue	Payrolls	Other expense and income tests and analyses	Preparation of tax returns			
Budget																																											
Actual																																											

.03

Audit Time Analysis (*Short Form*)

Client ______________________________ Year ended ______________________________

	Prior years		Budgeted hours											Actual daily hours																				Next year's budget
			Total	Week beginning																														Total	
Administration																																			
Accounting systems review																																			
Confirmations																																			
Permanent file																																			
Client advisory comments																																			
Report preparation																																			
Tax returns																																			
Initial review																																			
Overall review																																			
Detailed review																																			
Tax accrual review																																			
Trial balance																																			
Cash																																			
Receivables																																			
Inventories																																			
Other assets																																			
Liabilities																																			
Equity																																			
Operating accounts																																			
Totals																																			
Accountants																																			
In-Charge																																			
Totals																																			

.04 Audit Time Analysis (*Long Form*)

Client ________________________ Year ended ________________________

	Prior Years		Budgeted Hours											Actual Daily Hours																				Next year's budget
				Week beginning																															
			Total																															Total	
Administration																																			
Client conferences																																			
Planning and scheduling																																			
Staff supervision																																			
Accounting systems review																																			
Internal control																																			
EDP installation																																			
General ledger																																			
Cash																																			
Sales																																			
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																																			

Audit Time Analysis (*Long Form*) (continued)

Client ______________________ Year ended ______________________

	Prior Years		Budgeted Hours											Actual Daily Hours																				Next year's budget
			Total	Week beginning																													Total	
Year-end verification																																		
Trial balance																																		
Cash																																		
Notes receivable																																		
Accounts receivable																																		
Inventories																																		
Prepaid expenses																																		
Intercompany accounts																																		
Securities and investments																																		
Fixed assets																																		
Other assets																																		
Notes payable																																		
Accounts payable																																		
Tax grouping and accrual																																		
Accrued liabilities																																		
Deferred credits																																		
Contingencies and commitments																																		
Equity																																		
Audit of/with computer																																		
Operating accounts																																		
Subtotal from previous page																																		
Totals																																		
Accountants																																		
Manager																																		
In-charge																																		
Totals																																		

.05

Weekly Progress Report

Date ____________

Supervisor ____________ In-charge accountant ____________

Client ____________ Case ____________

	Staff days—seven hours				
	Original Estimate	Used to date	Unused	Est. to complete	Variance
In-charge accountant					
Assistants *(list)*:					
Total assistants					
Grand total					

AAM Section 3175

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 audit of the financial statements of Anonymous Company, Inc., for the year ending [*date*].

We will audit the Company's balance sheet at [*date*], and the related statements of income, retained earnings, and cash flows for the year then ended, for the purpose of expressing an opinion on them. The financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements based on our audit.

We will conduct our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit will provide a reasonable basis for our opinion.

Our procedures will include tests 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 audit, we will request certain written representations from you about the financial statements and matters related thereto.

Our audit is subject to the inherent risk that material errors and irregularities, including fraud or defalcations, if they exist, will not be detected. However, we will inform you of irregularities that come to our attention, unless they are inconsequential.

If you intend to publish or otherwise reproduce the financial statements and make reference to our firm, you agree to provide us with printers' proofs or masters for our review and approval before printing. You also agree to provide us with a copy of the final reproduced material for our approval before it is distributed.

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 acknowledgment, in which case their letter would omit the paragraph beginning "If this letter . . . " and the spaces for the acknowledgment. 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 audit the Corporation's balance sheet as of [*date*], and the related statements of income, retained earnings, and cash flows for the year then ended. The financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements based on our audit.

We will conduct our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit will provide a reasonable basis for our opinion.

Our procedures will include tests 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 audit, 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 audit 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 audit is subject to the inherent risk that material errors and irregularities, including fraud or defalcations, if they exist, will not be detected. However, we will inform you of irregularities that come to our attention, unless they are inconsequential.

If you intend to publish or otherwise reproduce the financial statements and make reference to our firm, you agree to provide us with printers' proofs or masters for our review and approval before printing. You also agree to provide us with a copy of the final reproduced material for our approval before it is distributed.

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 $10,000 and $12,000. 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 acknowledgment, in which case their letter would omit the paragraph beginning "Please indicate your . . . " and the spaces for the acknowledgment. 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 audit 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 internal control structure policies and procedure, allows us to use alternative procedures to satisfy ourselves on this part of the audit. 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 $5,000 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 acknowledgment, in which case their letter would omit the paragraph beginning "Please indicate your . . . " and the spaces for the acknowledgment. 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
ZYX, Inc.
1234 West Street
Noplace, New York 10000

Dear Ms. Brown:

Our March 15, 19XX letter described our present engagement as an audit 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 him 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 where—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 audit the consolidated balance sheet of Odin Company, Inc., as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the three years then ended, which will be included in a Form S-1,* registration statement. The financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements based on our audit.

We will conduct our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit will provide a reasonable basis for our opinion. We will also audit the financial information necessary for the schedules required by Regulation S-X of the SEC.

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 audit 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 properly be 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.

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 printers' 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.

Our audit is subject to the inherent risk that material errors and irregularities, including fraud or defalcations, if they exist, will not be detected. However, we will inform you of irregularities that come to our attention, unless they are inconsequential.

If you intend to publish or otherwise reproduce the financial statements and make reference to our firm, you agree to provide us with printers' proofs or masters for our review and approval before printing. You also agree to provide us with a copy of the final reproduced material for our approval before it is distributed.

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 $15,000 retainer, which will be applied to the final billing for this engagement.

We appreciate your exhibiting 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 $15,000.

Sincerely,

SWIFT, MARCH & COMPANY

....
Partner

APPROVED:

By.....................................

Date...................................

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

.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 cash flows 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 XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows 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 its cash flows. 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 and irregularities, including fraud or defalcations, that may exist. However, we will inform you of irregularities that come to our attention, unless they are inconsequential.

If you intend to publish or otherwise reproduce the financial statements and make reference to our firm, you agree to provide us with printers' proofs or masters for our review and approval before printing. You also agree to provide us with a copy of the final reproduced material for our approval before it is distributed.

Our fees for these services . . .

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

Acknowledge:

ZYXWV Freight Corporation

. . . .

President

. . . .

Date

*Some accountants prefer not to obtain an acknowledgment, in which case their letter would omit the paragraph beginning "If the foregoing . . . " and the spaces for the acknowledgment. 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 cash flows 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. A review does not contemplate obtaining an understanding of the internal control structure or assessing control risk, tests of accounting records and responses to inquiries by obtaining corroborating evidential matter, and certain other procedures ordinarily performed during an audit. Thus, a review does not provide assurance that we will become aware of all significant matters that would be disclosed in an audit. 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 matter that comes to our attention.

   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 cash flows 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 audit conducted 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 and irregularities, including fraud or defalcations, that may exist. However, we will inform you of irregularities that come to our attention, unless they are inconsequential.

If you intend to publish or otherwise reproduce the financial statements and make reference to our firm, you agree to provide us with printers' proofs or masters for our review and approval before printing. You also agree to provide us with a copy of the final reproduced material for our approval before it is distributed.

Our fees for these services...

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*]

Acknowledge:

ZYXWV Freight Corporation

....
President

....
Date

*Some accountants prefer not to obtain an acknowledgment, in which case their letter would omit the paragraph beginning "If the foregoing . . . " and the spaces for the acknowledgment. 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 audited	Balance sheet at March 31, 19XX and statements of income, retained earnings, shareholders' equity and cash flows 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 leaseback 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 audit and the nature and limitations of the services we will provide.

We will perform the following service(s):

1. We will audit 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 audit 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 audit 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 audit is subject to the inherent risk that material errors and irregularities, including fraud or defalcations, if they exist, will not be detected. However, we will inform you of irregularities that come to our attention, unless they are inconsequential.

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 and irregularities, including fraud or defalcations, that might exist. However, we will inform you of irregularities that come to our attention, unless they are inconsequential.

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 and irregularities, including fraud or defalcations, that might exist. However, we will inform you of irregularities that come to our attention, unless they are inconsequential.

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)

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