

CPA REVIEW SCHOOL OF THE PHILIPPINES

Manila

AUDITING THEORY

PRE-ENGAGEMENT

Related PSAs: PSA 210

PSA 210 - Terms of Audit Engagements

The auditor and the client should agree on the terms of the engagement. The agreed terms would need to be recorded in an audit engagement letter or other suitable form of contract.

It is in the interest of both client and auditor that the auditor sends an engagement letter, preferably before the commencement of the engagement, to help in avoiding misunderstandings with respect to the engagement.

The engagement letter documents and confirms:

1. the auditor's acceptance of the appointment;
2. the objective and scope of the audit;
3. the extent of the auditor's responsibilities to the client; and
4. the form of any reports.

Principal Contents

The form and content of audit engagement letters may vary for each client, but they would *generally* include reference to:

- The objective of the audit of financial statements.
- Management's responsibility for the financial statements.
- The scope of the audit, including reference to applicable legislation, regulations, or pronouncements of professional bodies to which the auditor adheres.
- The form of any reports or other communication of results of the engagement.
- The fact that because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatement may remain undiscovered.
- Unrestricted access to whatever records, documentation and other information requested in connection with the audit.

The auditor *may also* wish to include in the letter:

- Arrangements regarding the planning of the audit.
- Expectation of receiving from management written confirmation concerning representations made in connection with the audit.
- Request for the client to confirm the terms of the engagement by acknowledging receipt of the engagement letter.
- Description of any other letters or reports the auditor expects to issue to the client.
- Basis on which fees are computed and any billing arrangements.

When relevant, the following points could also be made:

- Arrangements concerning the involvement of other auditors and experts in some aspects of the audit.
- Arrangements concerning the involvement of internal auditors and other client staff.
- Arrangements to be made with the predecessor auditor, if any, in the case of an initial audit.
- Any restriction of the auditor's liability when such possibility exists.
- A reference to any further agreements between the auditor and the client.

Audits of Components

When the auditor of a parent entity is also the auditor of its subsidiary, branch or division (component), the factors that influence the decision whether to send a separate engagement letter to the component include:

- Who appoints the auditor of the component.
- Whether a separate audit report is to be issued on the component.
- Legal requirements.

- The extent of any work performed by other auditors.
- Degree of ownership by parent.
- Degree of independence of the component's management.

Recurring Audits

On recurring audits, the auditor should consider whether circumstances require the terms of the engagement to be revised and whether there is a need to remind the client of the existing terms of the engagement.

The auditor may decide not to send a new engagement letter each period. However, the following factors may make it appropriate to send a new letter:

- Any indication that the client misunderstands the objective and scope of the audit.
- Any revised or special terms of the engagement.
- A recent change of senior management, board of directors or ownership.
- A significant change in nature or size of the client's business.
- Legal requirements.

Acceptance of a Change in Engagement

A request from the client for the auditor to change the engagement may result from:

1. a change in circumstances affecting the need for the service;
2. a misunderstanding as to the nature of an audit or related service originally requested; or
3. a restriction on the scope of the engagement, whether imposed by management or caused by circumstances.

Items 1 and 2 would ordinarily be considered a reasonable basis for requesting a change in the engagement. In contrast a change would not be considered reasonable if it appeared that the change relates to information that is incorrect, incomplete or otherwise unsatisfactory.

If the auditor agreed to a change of the engagement:

- the auditor and the client should agree on the new terms;
- the report issued would be that appropriate for the revised terms of engagement; and
- in order to avoid confusing the reader, the report would **not** include reference to:
 - (a) The original engagement; or
 - (b) Any procedures that may have been performed in the original engagement, except where the engagement is changed to an engagement to undertake agreed-upon procedures and thus reference to the procedures performed is a normal part of the report.

If the auditor is unable to agree to a change of engagement and is not permitted to continue the original agreement:

- the auditor should withdraw; and
- consider whether there is any obligation, either contractual or otherwise, to report to other parties, such as the board of directors or shareholders, the circumstances necessitating the withdrawal.

MULTIPLE CHOICE QUESTIONS

1. Prior to the acceptance of an audit engagement with a client who has terminated the services of the predecessor auditor, the CPA should
 - a. Contact the predecessor auditor without advising the prospective client and request a complete report of the circumstance leading to the termination with the understanding that all information disclosed will be kept confidential.
 - b. Accept the engagement without contacting the predecessor auditor since the CPA can include audit procedures to verify the reason given by the client for the termination.
 - c. Not communicate with the predecessor auditor because this would in effect be asking the auditor to violate the confidential relationship between auditor and client.
 - d. Advise the client of the intention to contact the predecessor auditor and request permission for the contact.

2. Before accepting an audit engagement, a successor auditor should make specific inquiries of the predecessor auditor regarding the predecessor's
 - a. Opinion of any subsequent events occurring since the predecessor's audit report was issued.
 - b. **Understanding as to the reasons for the change of auditors.**
 - c. Awareness of the consistency in the application of GAAP between periods.
 - d. Evaluation of all matters of continuing accounting significance.
3. A successor auditor most likely would make specific inquiries of the predecessor auditor regarding
 - a. Specialized accounting principles of the client's industry.
 - b. The competency of the client's internal audit staff.
 - c. The uncertainty inherent in applying sampling procedures.
 - d. **Disagreements with management as to auditing procedures.**
4. Which of the following should an auditor obtain from the predecessor auditor prior to accepting an audit engagement?
 - a. Analysis of balance sheet accounts
 - b. Analysis of income statement accounts
 - c. All matters of continuing accounting significance
 - d. **Facts that might bear on the integrity of management**
5. When an independent auditor is approached to perform an audit for the first time, he or she should make inquiries of the predecessor auditor. Inquiries are necessary because the predecessor may be able to provide the successor with information that will assist the successor in determining whether
 - a. The predecessor's work should be used.
 - b. The company rotates auditors.
 - c. In the predecessor's opinion, control risk is low.
 - d. **The engagement should be accepted.**
6. If permission from client to discuss its affairs with the proposed auditor is denied by the client, the predecessor auditor should:
 - a. Keep silent of the denial.
 - b. **Disclose the fact that the permission to disclose is denied by the client.**
 - c. Disclose adequately to proposed auditor all noncompliance made by the client.
 - d. Seek legal advice before responding to the proposed auditor
7. The objective and scope of the audit and the extent of the auditor's responsibilities to the client are best documented in

a. Independent auditor's report	c. Client's representation letter
b. Audit engagement letter	d. Audit program
8. The following are valid reasons why an auditor sends to his client an engagement letter:

	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>
a. Avoid misunderstanding with respect to engagement	Yes	Yes	No	Yes
b. Confirms the auditor's acceptance of the appointment	Yes	Yes	Yes	No
c. Objective and scope of the audit	Yes	Yes	Yes	Yes
d. Assures CPA's compliance to GAAS	Yes	No	No	Yes
9. Which of the following is appropriately included in an audit engagement letter?
 - I. Because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatements may remain undiscovered.
 - II. The audit will be made with the objective of expressing an opinion on the financial statements.
 - III. An audit also includes assessing the accounting procedures used and significant estimates made by management.

a. I and II	c. II and III
b. I and III	d. I, II and III

10. Which of the following is least likely included in an audit engagement letter?
 - a. **The objective of financial reporting.**
 - b. Management responsibility for the financial statements.
 - c. The form of any reports or other communication of the results of the engagement.
 - d. Arrangement concerning the involvement of other auditors or experts in some aspects of the audit.
11. An audit engagement letter least likely includes
 - a. A reference to the inherent limitation of an audit that some material misstatements may remain undiscovered.
 - b. **Identification of specific audit procedures that the auditor needs to undertake.**
 - c. Description of any letters or reports that the auditor expects to submit to the client.
 - d. Arrangements concerning the involvement of internal auditors and other client's staff.
12. Which of the following least likely requires the auditor to send a new engagement letter?
 - a. An indication that the client misunderstands the objective and scope of the audit.
 - b. Any revised or special terms of the engagement.
 - c. **A recent change in the audit firm's management.**
 - d. Legal requirements and other government agencies' pronouncements.
13. Which of the following least likely influence the auditor's decision to send a separate engagement letter to a component of parent entity client?
 - a. Legal requirements
 - b. Degree of ownership over a component entity by parent company
 - c. **Location of the principal place of business of the component entity**
 - d. Who appoints the auditor of the component
14. According to PSA 210, which of the following statements is correct?
 - a. The auditor and the client need not agree on the terms of the engagement.
 - b. Where the terms of the engagement are changed, the auditor and the client need not agree on the new terms if they already agreed on the old terms.
 - c. The engagement letter assists in the supervision and review of the audit work.
 - d. **The auditor may agree to a change of engagement where there is reasonable justification for doing so.**
15. Which of the following is a NOT valid reason for a change of the engagement to a lower "level of assurance"?
 - a. Change in circumstances affecting the need for the service.
 - b. **Restriction on the scope of the engagement.**
 - c. Misunderstanding as to the nature of the engagement originally requested.
 - d. The client's need is satisfied by an engagement that provides lower level of assurance.
16. When a change in the type of engagement from higher to lower level of assurance is reasonably justified, the report based on the revised engagement
 - a. Should contain a separate paragraph that refers to the original engagement.
 - b. Should always refer to any procedures that may have been performed in the original engagement.
 - c. Should qualify the opinion due to scope limitation.
 - d. **Omits reference to the original engagement.**
17. Which of the following actions may be appropriate if the auditor is unable to agree to a change of the engagement and is not permitted to continue the original engagement
 - I. Issue a qualified opinion due to a significant scope limitation.
 - II. Auditor should withdraw from the engagement.
 - III. Consider whether there is any obligation to report to the board of directors or shareholders the circumstances necessitating withdrawal
 - a. I only
 - b. I and II
 - c. **II and III**
 - d. I, II and III

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