

Preparing for an audit

UNIT SUMMARY

- Engagement letter
- Preparing for an audit

INTRODUCTION TO READING 1

Before an audit engagement is accepted, the auditor must make sure that the integrity of his prospective client is beyond question. Once this has been established, the terms of engagement can be agreed. The written document that defines the terms of engagement and other aspects of the audit assignment is called the engagement letter. Reading 1 analyses the content and the purpose of this document.

TOPIC PREVIEW

Answer the following questions with a partner:

1. What is an engagement letter?
2. What is the purpose of an engagement letter?
3. What is meant by the term 'auditor's liability'?

VOCABULARY PREVIEW

Match the words to their definitions

1. engagement letter	A. is something that must be obeyed by law
2. legally binding	B. is the quality of information whose omission could lead users of financial statements to make wrong decisions
3. negligence	C. is a written agreement between the audit firm and a new client
4. duty of care	D. is when the auditor does not perform an audit according to standards
5. materiality	E. is the auditor's responsibility to provide quality professional services

1: ____; 2: ____; 3: ____; 4: ____; 5: ____;

READING 1: Audit engagement letter

1. Petra, now I'd like to find out more about the actual audit engagement. How does it all start? What matters should be considered before accepting a new engagement?

The first step in the audit process is the preparation of an **engagement letter**. This letter defines the relationship between the auditor and its client. It stipulates the **terms of engagement**, outlines the **timeframe** of the audit and explains what the audit can and cannot do.

When both parties come to an agreement, the client officially confirms the **appointment** of the auditor. As the final step in this process, the auditor prepares and sends the engagement letter to the client.

2. Do auditors have to evaluate a potential client before accepting an engagement?

Yes, they do. This process is called a **pre-engagement assessment**. This is an investigation of a potential client, its owners and its business activities. Its purpose is to evaluate whether there are any questions concerning the integrity of a potential client. This procedure is necessary because accepting a suspicious client might damage the audit firm's reputation.

3. Can you tell us more about the engagement letter and its content?

It is a document that confirms the auditor's acceptance of the appointment, states the objective and the **scope** of the audit, the **extent** of the auditor's responsibilities to the client and the form of report issued by the auditor.

In simple terms, the engagement letter is a document prepared to prevent any **misunderstandings** between the client and the auditor concerning the engagement.

4. It sounds very much like a written contract.

Although it contains many of the same elements as a written contract, the audit engagement letter is less formal. It is written in an easily understandable style without the **legal jargon** of a contract. However, it is still considered **legally binding** and can be used as evidence in a court of law.

5. You've mentioned that the engagement letter defines the extent of the auditor's responsibility. Why is the auditor's responsibility sometimes called the auditor's liability?

These two terms are very similar, and both refer to the auditor's responsibility to intended users of audit findings. However, the word *liability* indicates a legal obligation, which means that auditors can be sued in case of **negligence**. This is because the auditor owes a **duty of care** to the client. Simply speaking, the auditor promises to carry out his work according to certain professional standards.

6. So what exactly is the auditor's liability with regard to the client and what are its limits?

The auditor is responsible for reporting on whether the financial statements as a whole are true and fair. Contrary to a widespread belief, auditors do not have a responsibility to prevent fraud. This is the obligation of the management.

In terms of detecting fraud, auditor's responsibility does not go beyond the concepts of **materiality** and **reasonable assurance**. In simple words, auditors can only say that they are pretty sure that financial statements are ok, but they cannot absolutely guarantee that this is the case.

7. What is the management's liability in this respect?

The management is responsible for preparation of information that is accurate and in compliance with the relevant regulations.

COMPREHENSION CHECK

Decide whether the following sentences are true or false.

1. An engagement letter specifies the conditions for performance of an audit.
2. An engagement letter has no legal relevance in case of a dispute between the auditor and the client.
3. The auditor is responsible for the accuracy of all information contained in financial statements.

SPEAKING 1

Interview your partner about his or her involvement in preparation of an engagement letter. Present your findings to the class.

FOCUS ON VOCABULARY: Collocations

Choose the right collocation to complete the sentences.

1. After completing the pre-acceptance procedure, the audit firm _____ the engagement letter.
A. prepares B. makes
2. The new contract should clearly _____ the terms of engagement.
A. dictate B. stipulate
3. The auditor's duty to _____ fraud relates to fraudulent financial reporting and misappropriation of company funds.
A. determine B. detect
4. The court found that the auditor _____ duty of care to shareholders and was held responsible for the loss.
A. owed B. carried out
5. The document defines the _____ of the auditor's liability to third parties for negligent work.
A. extent B. volume
6. A new version of the letter was written because it did not clearly _____ the objective of the engagement.
A. cite B. state

LANGUAGE TASK: Establishing audit strategy

Match the pairs. The sentences below will help you talk about audit strategy. The first one has been done for you.

1. The auditor establishes the overall	A. the scope, timing and direction of the audit.
2. The audit strategy outlines	B. the resources to the audit team.
3. The auditor develops	C. of the engagement that define its scope.
4. The auditor identifies the characteristics	D. gained on other engagements.
5. The auditor ascertains the reporting	E. engagement activities.
6. The auditor considers the results of preliminary	F. objectives of the engagement.
7. The auditor effectively allocates	G. strategy for the engagement.
8. The auditor considers the knowledge	H. an audit plan.

1: **G**; 2: ____; 3: ____; 4: ____; 5: ____; 6: ____; 7: ____; 8: ____;

GRAMMAR IN ACTION: Present Continuous Tense for activities in progress around the time of speaking

The Present Continuous Tense can be used to talk about current activities in progress around the time of speaking. However, this does not mean that those activities are happening precisely at the moment of speaking. You can use this structure to ask someone about their current professional engagements.

ACTIVITY

Use the prompts below and your own ideas to interview your partner about his or her current professional situation and industry trends. Present your findings to the class.

Example:

What are your current professional engagements?

I am currently working on an audit of a new client.

- current professional engagements
- current professional goals
- current professional projects
- current professional challenges
- current developments in the company
- current trends in the local and global audit market

INTRODUCTION TO READING 2

An audit is performed in several phases. The first one is the audit planning. It is in this phase that the auditor establishes the audit strategy and develops the audit plan. Reading 2 explores the content and the purpose of these two documents.

TOPIC PREVIEW

Answer the following questions with a partner:

1. What are the different stages of the audit process?
2. What is the difference between the audit strategy and the audit plan?
3. What matters are considered by the auditor when establishing the audit strategy?

VOCABULARY PREVIEW

Match the words to their definitions

1. preliminary engagement activities	A. is a general approach adopted by an auditor to a specific audit engagement
2. approach	B. are the activities the auditor undertakes at the beginning of an engagement to prevent possible problems in future
3. audit strategy	C. is a list of specific procedures carried out to implement the audit strategy
4. audit plan	D. is a standard accounting practice that uses financial statements to disclose a company's financial information and performance over a particular period
5. financial reporting	E. is a method used in dealing with something

1: ____; 2: ____; 3: ____; 4: ____; 5: ____;

READING 2: Preparing for an audit

1. In the previous session you have told us about the purpose and the content of an engagement letter. What is the next stage in the audit process?

Audit engagements are performed in three general phases: planning, **fieldwork** and reporting. However, before embarking on the actual audit, the auditor must stop and think what might go wrong with the audit. This forward-thinking process is known as **preliminary engagement activities**.

Generally, preliminary engagement activities include performing procedures regarding the continuance of the client relationship; evaluating the compliance with relevant **ethical requirements** and establishing an understanding of the terms of engagement. Having completed this step, the auditor must establish the overall **audit strategy** for the engagement and develop the **audit plan**.

2. What is the difference between the audit strategy and the audit plan?

The audit strategy is simply a general **approach** adopted by an auditor to a specific **audit assignment**. It defines in general terms how the audit is to be conducted. The type of approach taken by the auditor depends on the nature of a client. For instance, an audit of a multinational company will require a different strategy than an audit of a small, owner-managed company.

This strategy is then used as the basis for preparing and developing an audit plan. The audit plan outlines specific procedures carried out to implement the strategy and complete the audit. Naturally, planning for the audit of a new client is more extensive than planning for the audit of an **existing client**.

3. Could you tell us why this is the case?

An effective audit cannot be conducted without a complete understanding of the client and its business. Before the actual audit, the auditor should obtain a **preliminary knowledge** of the industry, ownership, management and operations of the entity to be audited.

In addition to a thorough understanding of the entity and its **regulatory environment**, the auditor should evaluate the **effectiveness** of his client's **internal controls**. This understanding enables the auditor to identify events and transactions that are likely to have a significant effect on financial statements.

4. What specific issues are considered by the auditor when establishing the audit strategy?

First of all, the auditor must identify the characteristics of the engagement that define its scope. As I have said earlier, an audit of a multinational company will have a broader scope than an audit of a small company.

Another thing to be considered is reporting requirements, since they are not always the same. Some entities have additional **reporting requirements** because they need to comply with specific regulatory obligations.

In addition, the auditor must identify – or ascertain as auditors say – the nature, timing and extent of resources necessary to perform the audit. In other words, the audit strategy must ensure that a sufficient number of staff is allocated to the audit team.

And finally, the auditor must take into account the results of preliminary engagement activities. As mentioned earlier, these activities should help the auditor anticipate any possible problems that might affect the audit.

COMPREHENSION CHECK

Decide whether the following sentences are true or false.

1. Preliminary engagement activities help auditors prevent possible problems in performance of an audit.
2. Auditors should always adopt the same audit approach.
3. The audit plan is developed before the audit strategy is established.

SPEAKING 2

Ask your partner how the audit strategy is designed and developed in his or her company. Present your findings to the class.

WRITING TASK: An engagement letter

Write a sample engagement letter. Make sure to include the following items:

- the objective and the scope of audit
- the timeframe
- the applicable financial reporting framework
- the auditor's responsibilities
- the management's responsibilities
- the form and content of the report
- the professional fee