CHAPTER 3: ENGAGEMENT PLANNING AND ASSESSING RISKS

TYPES OF AUDITS

There are three basic types of audits:

1. Compliance Audits – IRS audits, government audits, CPA's to determine compliance with bond/note provisions
2. Operational Audits – auditing for effectiveness and efficiency
3. Financial Statement Audits – objective opinion on financial statements

ACQUIRING A NEW CLIENT

Before acquiring a new client, an auditor should:

a) Communicate with predecessor auditor after getting permission from client. Ask questions about integrity of management and whether there were any disagreements with management about accounting principles or auditing procedures – what are the reasons for the auditor change?
b) New auditor should also ask whether the audit committee was ever informed of fraud, illegal acts or internal control problems
c) Obtain a general understanding of nature of organization/industry

ENGAGEMENTS REQUIRING INDEPENDENCE

Auditors must be independent for the following types of engagements:

1. Examinations/Audits
2. Reviews
3. Agreed-upon procedure engagements leading to findings
4. Special Reports

Auditors do NOT have to be independent for the following engagements:

1. Compilations
2. Taxes
3. Consultations

AUDIT ENGAGEMENT LETTER

Written communication is required when an engagement is accepted.

An engagement letter is recommended.

The Audit Engagement Letter will outline the nature of services and outline the responsibilities of both the client and the auditor.

The letter should include:

a) Objectives and Limitations of the engagement
b) Clear understanding of responsibilities of Management **and** Auditors
c) Scope of the audit – reasonable assurance

The letter will also indicate:

a) Compliance with laws
b) Establishment and Maintenance of Internal Control
c) Financial statements are responsibility of management
d) Letter of Representations

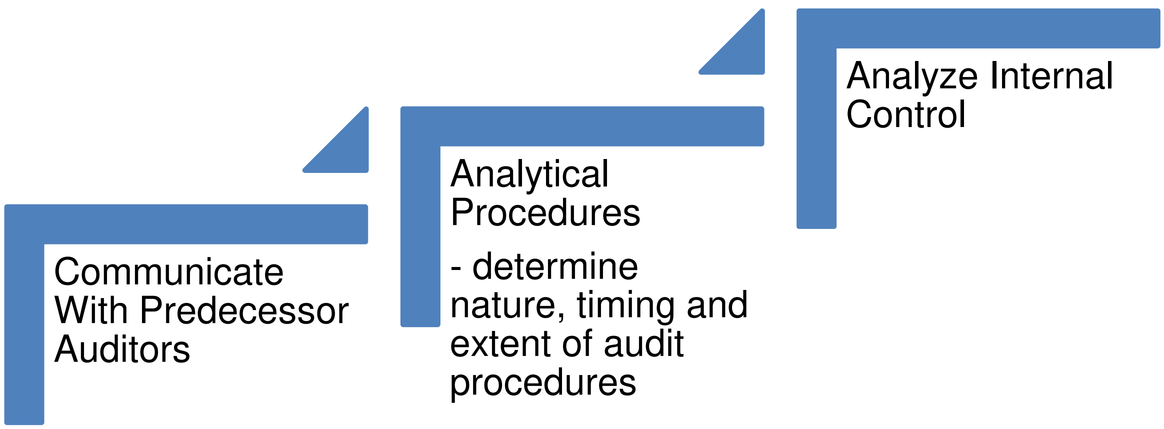
Other information in the audit letter:

a) When will work be completed
b) Will outside specialists be required
c) Fee arrangement

PLANNING THE AUDIT

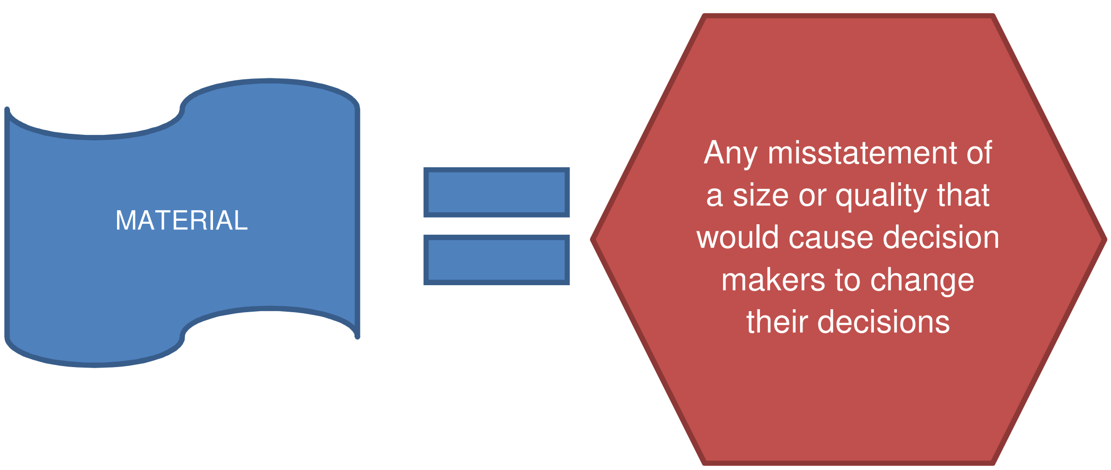
The auditor must understand the client's business and industry in order to plan the audit. Subsequently, the auditor will use risk assessment procedures in order to obtain specific evidence required for the audit.

The basic plan of the audit involves three steps which are discussed in other chapters.



MATERIAL MISSTATEMENT

In the planning stage, the auditor will perform an initial analysis about what shall be determined to be a "Material Misstatement." This analysis will change over the course of the audit.



MISSTATEMENTS ARE:

- ERRORS
- FRAUD
- DIRECT ILLEGAL ACTS

PURPOSE OF THE AUDIT

The auditor will provide reasonable assurance that the financial statements are free from material misstatement.

AUDIT RISK

The risk that material errors, fraud or direct illegal acts will result in audit where the auditor cannot provide reasonable assurance that the audit is accurate.

Audit risk consists of:

INHERENT RISK

- risk of a material misstateement

CONTROL RISK

- risk that a material misstatement would not be detected by the CLIENT’s internal control system

DETECTION RISK

- risk that a material misstatement that passed internal control system will not be detected by the auditor

Audit Risk = Inherent Risk X Control Risk X Detection Risk