

Auditing Standard

AUS 204
(June 2000)

Terms of Audit Engagements

Prepared by the **Auditing & Assurance Standards Board**
of the **Australian Accounting Research Foundation**

Issued by the
Australian Accounting Research Foundation
on behalf of **CPA Australia** and **The Institute of
Chartered Accountants in Australia**

The Australian Accounting Research Foundation was established by CPA Australia and The Institute of Chartered Accountants in Australia and undertakes a range of technical and research activities on behalf of the accounting profession as a whole. A major responsibility of the Foundation is the development of Australian Auditing Standards and Statements.

Auditing Standards contain the basic principles and essential procedures identified in bold-type (black lettering) which are mandatory, together with related guidance. For further information about the responsibility of members for compliance with AUSs refer Miscellaneous Professional Statement APS 1.1 "Conformity with Auditing Standards".

Copies of this Standard are available for purchase from the Australian Accounting Research Foundation by contacting:

Australian Accounting Research
Foundation
Level 10
600 Bourke Street
Melbourne Victoria 3000
AUSTRALIA

Phone: (03) 9641 7433
Fax: (03) 9602 2249
E-mail: standard@aarf.asn.au
Web site: www.aarf.asn.au

COPYRIGHT

© Australian Accounting Research Foundation. The text, graphics and layout of this Auditing Standard are protected by Australian copyright law and the comparable law of other countries. No part of this Auditing Standard may be reproduced stored or transmitted in any form or by any means without the prior written permission of the AARF except as permitted by law.

ISSN 1324-4183

AUDITING STANDARD

AUS 204 “TERMS OF AUDIT ENGAGEMENTS”

CONTENTS

	<i>Paragraphs</i>	
Main Features of the Standard		
Introduction.....	.01	
Agreeing and Documenting the Terms of the Audit		
Engagement02	
<i>Objective and Purpose</i>03	
<i>Engagements Subject to Legislative and Other Mandates</i>04	
Principal Matters to be Addressed when Agreeing and Documenting the Terms of the Audit Engagement.....		.05-.08
Recurring Audits.....	.09-.10	
Audits of Components11	
Acceptance of a Change in the Terms of the Engagement.....	.12-.18	
Operative Date and Transitional Arrangements.....	.19	
Compatibility with International Standards on Auditing20	
Appendix: Example of an Engagement Letter for a Financial Report Audit Engagement		
Background to Revision		

AUS 204 “TERMS OF AUDIT ENGAGEMENTS”

MAIN FEATURES OF THE STANDARD

This Auditing Standard (AUS) establishes standards and provides guidance for auditors on:

- (a) agreeing and documenting the terms of the audit engagement with the entity; and
- (b) the auditor’s response to a request by the entity to change the terms of the engagement to one that provides a lower level of assurance.

AUS 204 “TERMS OF AUDIT ENGAGEMENTS”

Introduction

- .01 The purpose of this Auditing Standard (AUS) is to establish standards and provide guidance on:
- (a) agreeing and documenting the terms of the audit engagement with the entity; and
 - (b) the auditor’s response to a request by the entity to change the terms of the engagement to one that provides a lower level of assurance.

Agreeing and Documenting the Terms of the Audit Engagement

- .02 *The auditor and the entity should agree the terms of the audit engagement, which are to be recorded in writing by the auditor and forwarded to the entity. When the engagement is undertaken pursuant to legislation, the minimum applicable terms are those contained in the legislation.*

Objective and Purpose

- .03 The terms of the audit engagement may be set out in an engagement letter or other written agreement. It is in the interests of both the entity and the auditor that the terms of the audit engagement are agreed and documented, preferably before the commencement of the audit, to help to avoid uncertainty and misunderstandings with respect to the engagement. An engagement letter (or other written agreement) documents and confirms the auditor’s acceptance of the appointment, the objective and scope of the audit, the extent of the auditor’s responsibilities to the entity and the form of any reports. When other services such as tax, accounting or management advisory services are to be provided by the auditor’s firm, separate engagement letters may be appropriate.

Engagements Subject to Legislative and Other Mandates

- .04 With some engagements, the objective and scope of the audit and the auditor’s resultant obligations are established by law. In certain jurisdictions, legislation may also give the auditor discretion to determine the activity to be audited and/or the scope of the audit. In such situations, the auditor advises the entity at the commencement of the audit of the objectives and scope of the audit, to clarify the auditor’s responsibilities and document any extensions in the scope of the audit beyond those established by law. However, an audit engagement letter (or other written agreement) cannot reduce obligations imposed by law.

AUS 204 “TERMS OF AUDIT ENGAGEMENTS”

Principal Matters to be Addressed when Agreeing and Documenting the Terms of the Audit Engagement

- .05 The principal matters to be addressed when agreeing and documenting the terms of the engagement may vary for each audit engagement, but generally include reference to:
- (a) the objective of the audit;
 - (b) management’s responsibility for the subject matter of the audit;
 - (c) the scope of the audit, including reference to applicable legislation, regulations and the pronouncements of CPA Australia and The Institute of Chartered Accountants in Australia;
 - (d) the form of any reports or other communication of results of the engagement;
 - (e) an explanation as to the extent to which an audit can be relied upon to detect material misstatements; and
 - (f) unrestricted access to whatever records, documentation and other information requested in connection with the audit.
- .06 The auditor also generally documents:
- (a) arrangements regarding the planning of the audit;
 - (b) expectation of receiving from management written confirmation concerning representations that may be made in connection with the audit;
 - (c) a request for the entity to confirm the terms of the engagement and acknowledge receipt of the documented terms by signing the engagement letter (or other written agreement);
 - (d) a description of any other letters or reports the auditor expects to issue to the entity; and
 - (e) the basis on which fees are computed and any billing arrangements.
- .07 When relevant, the following points may also be included:

AUS 204 “TERMS OF AUDIT ENGAGEMENTS”

- (a) arrangements concerning the involvement of other auditors and experts in some aspects of the audit;
- (b) arrangements concerning the involvement of the audit committee, internal auditors and other entity staff;
- (c) arrangements to be made with the predecessor auditor, if any, in the case of an initial audit;
- (d) any restriction of the auditor’s liability when such possibility exists, for example, where the auditor’s liability is limited under the *Professional Standards Act 1994* (NSW) or other relevant legislation;
- (e) that the auditor does not assume any responsibility for reliance on the audited financial report (or other audited subject matter) if it is used or disseminated other than for the stated purpose for which it was intended (for example, when the audited financial report is released to third parties without the auditor’s consent);
- (f) clarification of the entity’s responsibility for control issues relevant to the presentation of electronic information, where the entity’s audited financial report (or other audited subject matter) is presented on an internet web site;
- (g) a reference to any further agreements between the auditor and the entity; and

An example of an audit engagement letter is set out in the Appendix to this AUS.

- .08 The terms of the audit engagement may make reference to the intended form of the auditor’s communication with management, so that the auditor’s responsibilities are understood in their proper context. As recognised in Auditing Standard AUS 710 “Communicating with Management on Matters Arising from an Audit”, for engagements where there is a legislative or other specific mandate, the auditor may be required to produce a formal management letter at or near the conclusion of the audit. For example, in circumstances where there are no matters to report, the mandate may nevertheless require the auditor to report accordingly. For such engagements, the auditor includes a paragraph in the engagement letter (or other written agreement) that the auditor assumes no responsibility to design audit procedures which identify matters to report to the management of the entity, and that any matters so communicated to management do not preclude the

AUS 204 “TERMS OF AUDIT ENGAGEMENTS”

existence of additional matters of which management should be aware in meeting its responsibilities.

Recurring Audits

- .09 *On recurring audits, the auditor should consider whether circumstances require the terms of the engagement previously recorded in writing by the auditor to be revised, and whether there is a need to re-confirm in writing the existing terms of the engagement with the entity.*
- .10 The auditor may decide that the existing terms of the engagement need not be confirmed in writing with the entity each period. However, the following factors may make it appropriate to do so:
- (a) any indication that the entity misunderstands the objective and scope of the audit;
 - (b) any revised or special terms of the engagement;
 - (c) a recent change of senior management, including governing body, or ownership;
 - (d) a significant change in the nature or size of the entity’s business; and
 - (e) legal requirements.

Audits of Components

- .11 When the auditor of a parent entity is also the auditor of its subsidiary, branch or division (component), the factors that influence the auditor’s decision whether to separately agree and document the terms of the engagement for the component include:
- (a) who appoints the auditor of the component;
 - (b) whether a separate audit report is to be issued on the component;
 - (c) legal requirements;
 - (d) the extent of any work performed by other auditors;
 - (e) the degree of ownership by the parent entity; and
 - (f) the degree of independence of the component management.

AUS 204 “TERMS OF AUDIT ENGAGEMENTS”

Acceptance of a Change in the Terms of the Engagement

- .12 *The auditor who, before the completion of the engagement, is requested to change the terms of the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so and should only do so when there is reasonable justification.*
- .13 A request from the entity for the auditor to change the terms of the engagement may result from a change in circumstances affecting the need for the service, a misunderstanding as to the nature of the audit or related service originally requested or a restriction on the scope of the engagement, whether imposed by management or caused by circumstances. The auditor considers carefully the reason given for the request, particularly the implications of a restriction on the scope of the engagement.
- .14 A change in circumstances that affects the entity’s requirements, or a misunderstanding concerning the nature of the service originally requested, is ordinarily considered to be a reasonable basis for requesting a change in the engagement. In contrast, a change is not considered to be reasonable, if it appears that the change relates to information that is incorrect, incomplete or otherwise inadequate for the purpose of the audit. It is inappropriate to change the terms of the audit engagement in order to avoid the issue of a modified audit report.
- .15 Before agreeing to change the audit engagement to a related service, the auditor who was engaged to perform the audit in accordance with AUSs considers, in addition to the above matters, any legal or contractual implications of the change.
- .16 If the auditor concludes that there is reasonable justification to change the terms of the engagement, and if the audit work performed complies with the AUSs applicable to the changed terms of the engagement, the report issued is that appropriate for the revised terms of the engagement. In order to avoid confusing the user, the report is not to 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 perform agreed-upon procedures and thus reference to the procedures performed is a normal part of the report.

AUS 204 “TERMS OF AUDIT ENGAGEMENTS”

- .17 *Where the terms of the engagement are changed the auditor and the entity should agree on the new terms and confirm them in writing.*
- .18 *If the auditor is unable to agree to a change of the terms of the engagement and is not permitted to continue the original engagement, the auditor should withdraw from the engagement and consider whether there is any obligation, either contractual or otherwise, to report to other parties, such as the governing body or shareholders, the circumstances necessitating the withdrawal.*

Operative Date and Transitional Arrangements

- .19 This AUS is operative in relation to audit engagements commencing on or after 1 January 2001, although earlier application is encouraged. For recurring audit engagements not covered by an existing engagement letter or other written agreement, there is now a requirement for the terms of the engagement to be recorded in writing. This AUS supersedes AUS 204 “Terms of Audit Engagements” as issued in October 1995, and subsequently amended in April 1998.

Compatibility with International Standards on Auditing

- .20 The basic principles and essential procedures of this AUS and of International Standard on Auditing ISA 210 “Terms of Audit Engagements”, are consistent in all material respects, except that ISA 210 does not require the auditor to record the agreed terms of the audit engagement in writing and forward them to the entity.

AUS 204 “TERMS OF AUDIT ENGAGEMENTS”

APPENDIX

EXAMPLE OF AN ENGAGEMENT LETTER FOR A FINANCIAL REPORT AUDIT ENGAGEMENT

The following example audit engagement letter is for use as a guide only, in conjunction with the considerations outlined in AUS 204, and will need to be varied according to individual requirements and circumstances.

To [the governing body (e.g. the board of directors) or the appropriate representative of senior management]:

Scope

You have requested that we audit the financial report of [entity] as of and for the year ending [date]. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter. Our audit will be conducted pursuant to the [relevant statutory and other requirements]¹ with the objective of expressing an opinion on the financial report.

We will conduct our audit in accordance with Australian Auditing Standards to provide reasonable assurance as to whether the financial report is free of material misstatement. Our procedures will include examination, on a test basis, of evidence supporting the amounts and other disclosures in the financial report, and the evaluation of accounting policies and significant accounting estimates. These procedures will be undertaken to form an opinion whether, in all material respects, the financial report is presented fairly in accordance with Accounting Standards and other mandatory professional reporting requirements [and relevant statutory and other requirements]² so as to present a view which is consistent with our understanding of the [entity's] financial position, the results of its operations and its cash flows.

The work undertaken by us to form an opinion is permeated by judgement, in particular regarding the nature, timing and extent of the audit procedures for gathering of audit evidence and the drawing of conclusions based on the audit evidence gathered. In addition, there are inherent limitations in any audit, and these include the use of testing, the inherent limitations of any internal control structure, the possibility of collusion to commit fraud, and the fact that most audit evidence is persuasive rather than conclusive. As a result, our

¹ Cite relevant statutory and other requirements where appropriate.

² Cite relevant statutory and other requirements where appropriate.

AUS 204 “TERMS OF AUDIT ENGAGEMENTS”

audit can only provide reasonable – not absolute – assurance that the financial report is free of material misstatement.

In addition to our report on the financial report, we expect to provide you with a separate letter concerning any material weaknesses in the internal control structure that come to our notice.

Our audit procedures are designed to gather sufficient appropriate audit evidence to form an opinion on the financial report. Unless otherwise agreed with you, we assume no responsibility to design audit procedures to identify matters that may be appropriate to report to you. However, if we encounter matters during the course of our audit that we believe should be brought to your attention for consideration or further action, we will communicate these matters to you. If no such matters come to our attention, we will report accordingly.

You should not assume that any matters reported to you, or that a report that there are no matters to be communicated, indicates that there are no additional matters, or matters that you should be aware of in meeting your responsibilities.

We remind you that the responsibility for the preparation of the financial report, including adequate disclosure, is that of the governing body of the [entity]. This includes the maintenance of adequate accounting records and internal control structure, the selection and application of accounting policies, and the safeguarding of the assets of the [entity]. As part of our audit process, we will request from management written confirmation concerning representations made to us in connection with the audit.

Presentation of Audited Financial Report on the Internet³

It is our understanding that [the entity] intends to publish a hard copy of the audited financial report and audit report for members, and to electronically present the audited financial report and audit report on its internet web site. When information is presented electronically on a web site, the security and controls over information on the web site should be addressed by [the entity] to maintain the integrity of the data presented. The examination of the controls over the electronic presentation of audited financial information on the entity’s web site is beyond the scope of the audit of the financial report. Responsibility for the electronic presentation

³ For further guidance on this issue, refer AGS 1050 “Audit Issues Relating to the Electronic Presentation of Financial Reports”.

AUS 204 “TERMS OF AUDIT ENGAGEMENTS”

of the financial report on the entity’s web site is that of the governing body of [the entity].

Quality Control

The conduct of our audit in accordance with Australian Auditing Standards means that information acquired by us in the course of our audit is subject to strict confidentiality requirements. Information will not be disclosed by us to other parties except as required or allowed for by law or professional standards, or with your express consent. Our audit files may, however, be subject to review as part of the quality control review program of (*insert CPA Australia and/or The Institute of Chartered Accountants in Australia as appropriate*) which monitors compliance with professional standards by its members. We advise you that by signing this letter you acknowledge that, if requested, our audit files relating to this audit will be made available under this program. Should this occur, we will advise you. The same strict confidentiality requirements apply under this program as apply to us as your auditor.

Fees

We look forward to full co-operation with your staff and we trust that they will make available to us whatever records, documentation and other information are requested in connection with our audit. Our fees, which will be billed as work progresses, are based on the time required by the individuals assigned to the engagement plus out-of-pocket expenses. Individual hourly rates vary according to the degree of responsibility involved and the experience and skill required.

Other

This letter will be effective for future years unless we advise you of its amendment or replacement, or the engagement is terminated.

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our audit of the financial report.

AUS 204 “TERMS OF AUDIT ENGAGEMENTS”

Yours faithfully,

(signed)

.....

Name and Title

Date

Acknowledged on behalf of [entity] by

(signed)

.....

Name and Title

Date

AUS 204 “TERMS OF AUDIT ENGAGEMENTS”

BACKGROUND TO REVISION

As part of its ongoing program of maintaining the adequacy of existing Auditing Standards (AUSs), the Auditing & Assurance Standards Board (AuASB) has revised AUS 204 “Terms of Audit Engagements” to now require the auditor to record in writing, the terms of the audit engagement that are agreed to with the entity. In addition, AUS 204 now also requires the auditor to forward a copy of the terms of the engagement to the entity.

The documentation of the agreed terms of the audit engagement in an engagement letter or other written agreement, should assist the auditor to minimise any potential risk exposure which might arise as a result of any misunderstandings as to the auditor’s responsibilities, in the absence of an engagement letter or other form of written agreement. In the past, there has been a tendency for disputes to arise between auditors and their clients, in situations where the terms of the audit engagement have not been appropriately documented. In order to prevent such misunderstandings from arising, many auditing firms have adopted as a matter of course, the practice of establishing and confirming the agreed terms of the audit engagement in writing.

Current practice suggests that the terms of the audit engagement are best documented either through an engagement letter or some other form of written agreement. Consequently, the AuASB is of the view that from a risk management perspective, AUS 204 should adequately reflect current practice.

The revisions to AUS 204 have been made after consideration of Auditing Standards in other countries. For example, in the United Kingdom, the Auditing Practices Board through its Statement of Auditing Standards 140 “Engagement Letters”, requires that the auditor and the client should agree on the terms of the engagement, which should be recorded in writing.

The basic principles and essential procedures of AUS 204 and of International Standard on Auditing ISA 210 “Terms of Audit Engagements”, are consistent in all material respects, except that ISA 210 does not require the auditor to record the agreed terms of the audit engagement in writing, and forward them to the entity. It is the policy of the AuASB to implement, when and to the extent practicable under local circumstances, the requirements of ISAs. However, as has occurred in a number of cases, the AuASB believes that in order to establish appropriate Auditing Standards for Australia which reflect good auditing practice, it is sometimes necessary to impose different requirements to those found in the ISAs. Accordingly, the AuASB is of the view that the documentation and confirmation of the terms of the audit engagement by way of an engagement letter or other written agreement is a desirable audit practice, which should in future occur on all audit

AUS 204 “TERMS OF AUDIT ENGAGEMENTS”

engagements, as this would be in the best interests of both the auditor and the client.

The example engagement letter which is included in the Appendix to AUS 204 has also been updated to conform with the revised AUS 204 and other guidance issued by the AuASB.