

AUDIT ENGAGEMENT LETTER

The audit engagement letter confirms the auditor's acceptance of the audit and includes the responsibilities' objective, scope, and extent of the audit.

The audit engagement letter 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 client, and the form of any reports.

Issuance of the engagement letter is one of the procedures to be followed before the commencement of an audit and is in response to the appointment for a new audit assignment.

An engagement letter is sent by an auditor to his client after the receipt of the communication regarding his appointment, but preferably before the commencement of the engagement, spelling out the extent of his responsibilities to avoid any misunderstanding concerning his engagement and documents and confirming the acceptance of appointment, the objectives, and scope of the audit, the extent of responsibilities and the form of reports to be made to the client.

Objectives of Engagement Letter

The main objectives of an engagement letter are as follows:

1. It clearly defines the extent of the auditor's responsibilities and minimizes the possibility of any misunderstanding between the client and the auditor.
2. It provides written confirmation of the auditor's acceptance of his appointment, the scope of an audit, and the form of his report.
3. The client becomes aware of the directors' statutory responsibilities, which in no way are diminished by the appointment of an auditor.
4. It clearly defines the extent of the auditor's responsibilities and minimizes the possibility of any misunderstanding between the client and the auditor.
5. It provides written confirmation of the auditor's acceptance of his appointment, the scope of an audit, and the form of his report.
6. The client becomes aware of the directors' statutory responsibilities, which in no way are diminished by the appointment of an auditor can provide
7. The client is briefed that the discovery of fraud is not the main aim of the audit.
8. The scope of special or additional work is also determined.
9. The basis of the computation of fees is brought to the client's knowledge.

The contents of an engagement letter will be decided in the light of the requirements of each client, but every such letter would normally cover the following matters:

1. Auditor's Responsibilities
2. Management's Responsibilities
3. Scope of Audit
4. Management's Representations
5. Irregularities and Fraud
6. Other services
7. Fees
8. Client's Confirmation



1. Auditor's Responsibilities

The engagement letter should explain the statutory and professional duties and reporting responsibilities.

2. Management's Responsibilities

The engagement letter should point out the management's statutory responsibilities for maintaining proper accounting preparation of financial statements, an institution of internal control, selection and application of accounting policies, and safeguard of assets.

3. Scope of Audit

It should be indicated that the audit will be conducted following the international auditing standards and regarding relevant international statements on auditing. It should be pointed out that the auditor would satisfy himself:

- by conducting adequately necessary tests and procedures;
- the extent of substantive tests will depend upon an assessment of the accounting system and proper evaluation of internal control;
- he will expect relevant and reliable evidence from the management in matters where independent audit evidence is unavailable.

4. Management's Representations

It should indicate that the auditor, before finalization of the audit, may seek written representation from the management in respect of matters having a material effect on financial statements

5. Irregularities and Fraud

The engagement letter should clarify that management is responsible for preventing and detecting irregularities and fraud. It should be made clear that an audit's main purpose is not to discover fraud and defalcations.

6. Other services

The engagement letter should adequately describe the nature and scope of services that an auditor may carry out in addition to his responsibilities as an auditor.

7. Fees

The fees and the basis on which the same is computed.

8. Client's Confirmation

The engagement letter should include a request to management that they confirm in writing an agreement to the terms of an engagement letter.

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AUDIT EVIDENCE

Audit evidence refers to all the information obtained by the auditor by the conduct of compliance and substantive procedures from which he draws conclusions on which he bases his opinion on the financial statements. The auditors operational standard requires the auditor to obtain relevant, reliable and sufficient evidence.

The quantum of audit evidence needed to achieve the required level of assurance necessary to form an opinion is a question for the auditor to determine by exercising his judgement in the light of the opinion called for under the terms of his engagement. Generally, the judgement as to what constitutes sufficient audit evidence will be influenced by:

- * The nature and materiality of the items in the financial statements;
- * The auditors experience as to the reliability of management and staff of the enterprises and of its records.
- * The financial position of the enterprise
- * The persuasiveness of the evidence; and
- * The consistency of evidence.

The relevant of audit evidence is influenced by the audit objectives. Accordingly, audit evidence is considered relevant where it enables the auditor to draw conclusions about some characteristics of the items tested. In relation to compliance procedures relevant audit evidence are those which enable the auditor to decide whether or not:

- a. Controls exist;
- b. Controls are operating effectively, and
- c. Controls have operated effectively throughout the period of intended reliance.

In relation to substantive procedures relevant audit evidence are those which enable the auditor to decide:

- Whether an asset or a liability exists at a given date.
- Whether an asset is owned by the enterprise or a liability is owed by the enterprise.
- Whether a transaction or an event which pertains to the enterprise took place during the period.
- Whether an asset or a liability or a transaction has been omitted from the records.
- Whether an asset or a liability is recorded at an appropriate value.
- Whether a transaction has been recorded at an appropriate amount and revenue or expense is allocated to the proper period.
- Whether an item is disclosed, classified and described in accordance with acceptable accounting policies, and where applicable, legal requirements.

The reliability of audit evidence is influenced by its source-internal and external and by its nature - visual, documentary or oral.

While being dependent on the circumstances under which it is obtained, the following generalisations are used in assessing the reliability of audit evidence:

- External evidence, for example confirmation received from a third party, is more reliable than internal evidence.
- Internal evidence is more reliable when related internal control is satisfactory.
- Evidence obtained by the auditor himself is more reliable than that obtained from the enterprise.
- Evidence in the form of document and written representation is more reliable than oral representation.

The distinction between compliance and substantive tests derive from their objectives. Compliance tests are those audit tests which seek to provide audit evidence as to whether controls are being applied as prescribed. Substantive tests, on the other hand, are those audit tests, including analytical review procedures, which seek to provide audit evidence regarding the completeness, accuracy and the validity of transactions and balances included in the accounts and financial statements.

Five methods of obtaining audit evidence include the following:

- **Inspection** - This refers to the review or the examination of records, documents or tangible assets. Inspection of records and documents provides evidence of varying degrees of reliability depending upon their nature and source. The inspection of tangible assets provides the auditor with reliable audit evidence as to the existence of those assets, but not necessarily as to their ownership, cost or value.
- **Observation** - This means looking at an operation or procedure being performed by others with a view to determining the manner of its performance. Observation provides the auditor with reliable audit evidence as to the manner of the performance of the process or procedure at the time of observation but not at any other time.
- **Enquiry** - This means seeking relevant information from knowledgeable persons inside or outside the enterprise, whether formally or informally, orally or in writing. The degree of reliability that the auditor attaches to evidence obtained in this manner is dependent on his opinion regarding the competence, experience, independence and integrity of the respondent.

- Computation - This means checking the arithmetical accuracy of accounting records or performing independent calculations of accounting procedures - These include the study of significant ratios, trends and other statistics and investigating any unusual or unexpected variations. The auditor obtains reliable audit evidence regarding the reasonableness of transactions and balances through the performance of these procedures.

The auditors use third party evidence for various reasons:

- To confirm information obtained from within the enterprise.
- To seek expert's opinion in relation to certain aspects of the enterprise's business.
- To seek complementary audit evidence, which in addition to the audit evidence obtained from within the enterprise, will provide the audit with a reasonable basis for drawing conclusions.

It is important for the auditor to obtain third party evidence in addition to that obtained entirely from within the enterprise because such audit evidence tend to be more objective than that which is obtained solely from within the company alone. In certain circumstances, third party audit evidence may be more authoritative than evidence obtained from within the enterprise. For example, the valuation of liabilities on outstanding life policies by an actuary.

The reliability of the valuation of assets carried out by specialist valuers is dependent on the skills and experience of the valuers, their independence and objectivity as well as their integrity. The reliability will also be influenced by the objective of the valuation and the quality of data used for carrying out the valuation.

The auditor, will also consider the assumptions made by the valuer for consistency with other information available to him and reasonableness. He should also check the computation carried out by the valuer in arriving at his valuation to ensure that they are accurate.

Other audit procedures that should be conducted include:

- The physical verification of the land and buildings to ascertain their existence.
- The examination of title deeds and certificate of occupancy to ascertain the ownership of the land and industrial building.
- The auditor on should review depreciation policies on the building to ensure that the depreciation charge is reasonable and correct.
- The auditor should ascertain whether the land and buildings are free of third party lien.
- Check the treatment of surpluses or deficiencies on revaluation.
- Review the presentation of land and buildings in the financial statements.

Replies to debtors circularisation provides reliable evidence in relation to the existence of the debtors and the amount owing the company by the debtor, and necessarily the collectibility of the debts. The auditor must ensure that the replies are not intercepted by the enterprise's staff.

The additional audit work needs to be performed in order to verify the amount of trade debtors shown in the balance sheet include:

- Agreeing the opening balances of trade debtors to prior year audit working papers and published financial statements.

- Agreeing closing balances included in debtors schedule prepared by the client staff to the debtors control account and the individual debtors ledger balances
- Vouching a sample of payments by debtors to the cash book and bank statements to ensure authenticity
- Vouching discounts and amounts written off during the year to ensure that they were authorised and are in accordance with the enterprise's policy
- Vouching return inwards to stock records to ensure that they are authentic
- Reviewing the aged analysis of debtors to determine the collectibility of the amounts and the adequacy of the provision for doubtful debts
- Comparing the current year trade debtors balances with those for prior years and in the light of current trading circumstances investigating any unusual variation
- Obtaining a written representation from management regarding debtors balances
- Ensuring that trade debtors are properly presented and relevant information disclosed in the financial statements
- Evidence obtained by way of confirmation from banks regarding cash at bank or bank overdraft are often very reliable. The additional audit work to be carried out include:
 - A review of bank reconciliation statements to identify unusual transactions for further investigation
 - As regards bank overdraft reviewing for compliance with terms
 - Obtaining written representation from management

i To determine whether internal controls were being applied as prescribed by management throughout the period during which the transactions occurred. This type of audit test is referred to as compliance test.

ii To determine whether transactions and balances included in the accounts and the financial statements are complete, accurate and valid. This type of audit test is known as substantive test.

An example of audit test which not only assist the auditor in determining the reliability of controls, but also the completeness and accuracy of transactions and balances is the test counting of stock items when the auditor attends the client's stocktake. Such test counts will enable the auditor:

- To determine the extent to which the stocktake procedures can generate reliable stock quantities for incorporation in the financial statements, and
- To ascertain the accuracy of the counted stock items. By tracing a single transaction of each type through all stages of the accounting system, the auditor is able to confirm the correctness of his understanding of the accounting and internal control systems which exist in the client's enterprise. This type of test is referred to as walk-through test or walk-through check or walk-through procedure.

The two audit objectives normally associated with tests executed on a sample of transactions selected from a large-volume population are: