LETTERS

1. Letter Of Engagement—From auditor to directors
2. Letter of Weakness (Management Letter)—From auditor to CEO
3. Management Representation Letter—From CEO to auditor

1. Letter of Engagement (ISA 210)

A LOE is sent by the new auditors to their client at the beginning of any new audit to set out the terms and basis of the contract in order to avoid any misunderstandings between the client and auditors as to what the audit involves and the extent of auditors responsibility.

The basic auditing principle involved is that the client and the auditor should AGREE on the terms of the engagement and such agreement is in form of the engagement letter.

Such letter is written by the auditor to the BOD of the company and sent BEFORE commencement of the engagement in order to avoid misunderstandings about the scope of the auditor work and form of his report.

Contents of the Letter

- Introduction paragraph
- Directors legal responsibilities
- Auditors’ legal and professional responsibilities
- Degree of cooperation expected from client
- Responsibility for the prevention and detection of fraud rests with management
- Other services
- Fees& other Matters
- Agreement of terms

When to send a L.O.E?

- To all new clients before the start of the audit.
- To all existing clients who have not previously had such a letter.
- Change of circumstances.

Change in Engagement letter

- The auditors should agree an engagement letter with new clients. Thereafter the auditors should regularly review the terms of engagement and if appropriate agree an updated engagement letter.
- 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.-PAR 10 ISA 210

Situations favouring a change in L.O.E?

- 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, BOD or ownership.
- A significant change in nature or size of the client’s business.
- Legal requirements.
2. **Letter of Weakness**

It is addressed to the directors of a company and is written by the auditors of that company at a time towards the end of the audit. The letter contains information on weakness in the company’s control systems, identified by the auditor, e.g. of errors that could occur because of each weakness and recommendations on how to mitigate those weaknesses.

It is also known as Management Letter or Internal Control Letter.

**Purposes**

- To enable the auditor to give his comments on the accounting records, systems and controls.
- To enable the auditor to bring the attention of management areas of weaknesses that might lead to material errors.
- To provide management with constructive advice.
- A potential defence in cases of litigation.
- To improve the quality of the evidence gathering process in future years.

**Contents**

- List of weaknesses identified.
- Areas where controls are not being applied.
- Errors identified.
- Unsuitable accounting policies and practices.
- Non compliance with accounting standards or legislation.

**Format**

- Opening paragraph explaining the purpose of the letter.
- A note that it contains only those matters which came to the auditor’s attention during the audit and cannot be relied upon as a comprehensive list of all weaknesses.
- For each weakness give an explanation together with its effect and recommendation
- Concluding paragraph
Example of a management letter

Bloggs & Co
Certified Accountants & Registered Auditors
100 City, Rd London

The Directors,
Upper plc,
Lower Court,
London
15 May 20X8

Dear Sirs,

Upper plc
Audit for the year ended 31 December 20X7

In accordance with our normal practice, we are writing to you with regard to matters arising out of our audit for the year ended 31 December 20X7 which we consider should be brought to your attention.

Our responsibilities as auditors are governed by the Companies Act and principally require us to report on the accounts laid before the company in general meeting.

This report has been prepared for the sole use of the directors of Upper plc. None of its contents may be disclosed to third parties without our written consent. Bloggs & Co assumes no liability to any other persons.

The matters detailed in this report reflect matters coming to our attention during the course of our audit. They are not intended to be a comprehensive statement of all weaknesses that may exist or of all improvements that could be made.

Sales system - credit control

I. Present System
Credit checks are not performed for new or existing customers when orders are received.

II. Implications
Goods could be despatched to a bad credit risk.

III. Recommendations
Customer orders are subject to the following checks:

- Credit limits are imposed for all customers.

We would be pleased to discuss three points with you at your convenience.

Yours Faithfully,

Bloggs & Co

Important points
Management letter should:

- Not include language that has the effect of being in conflict with the opinion expressed in the audit report.
- Include a statement that the communication is provided for use only by management (or another specific named party).
- State that it discusses only weaknesses in internal control which have come to the auditor’s attention as a result of the audit and that other weaknesses in internal control may exist.
State that the accounting and internal control systems were considered only to the extent necessary to determine the auditing procedures to report on the financial statements and not to determine the adequacy of internal control for management purposes or to provide assurances on the WHOLE accounting and internal control systems.

Management Representations

It is a piece of audit evidence from management to auditors on matters material to the FS when those representations are critical to form an opinion.

Form of representation

- Letter from management to auditor.
- Letter from auditors outlining their understanding of management’s representations duly acknowledge and confirmed in writing by management.
- Minutes of board meeting at which such representations are approved.

Purposes

- Reduce the possibility of misunderstanding where oral representation have been made.
- To ensure that the auditors have been informed of all facts relevant to the company.
- To remind management of its legal responsibility.
- To provide written evidence on matters material to the FS.

Reliability of LOR

- Do not rely on LOR where other evidence ought to exist: Auditors should not place reliance on representations where reliable evidence is expected to exist i.e. Mgt Representations are not a substitute for other audit evidence that should be available. E.g. all sales are accounted in the system- this should be verifiable through substantive testing.
- Audit opinion is based on testing and not on LOR: the auditor would rely on the substantive testing as an audit evidence to form an opinion rather than relying on the LOR on this issue.(to form an opinion)
- LOR is not a substitute for corroboratory evidence: the absence of corroboratory evidence would in itself be suspicious and should lead to further inquiry. The auditor should not accept representations as audit evidence on issues or areas where reliable and verifiable evidence is expected to be available.

Sufficiency of Letter of representations

- LOR may constitute evidence: written representations do NOT necessarily constitute sufficient evidence i.e. it may constitute audit evidence.
- Final decision to rely on LOR is with auditors: the final decision whether to rely on the letter of representations rest with the auditors.
- Auditor may qualify audit report despite the LOR: while forming his audit opinion, he will consider all evidence available and the reliability constitutes sufficient evidence, he may decide that despite the LOR, there is insufficient evidence to form an opinion.
Further considerations:

• **Not seeking LOR is negligence:** where independent corroboratory evidence is not available, failure by the auditors to confirm such representations in writing would constitute negligence.

• **Signed by high officials:** it should be signed by persons with high level of authority in the entity (e.g. CEO and financial Director) on behalf of the board.

• **Modify audit report if client refuse to sign:** where a client refuses to give written representations, this would constitute a limitation in the scope of the audit work. Here the auditor may issue a modified audit opinion in the form of a:
  - Qualified opinion with “except for” or
  - Disclaimer of opinion.

• **Always dated before audit report date:** the LOR should never be dated after the audit report.
Preamble:

Legal rights of auditor

- Right of access to books and records
- Right to receive information and explanation during audit

Information received during audit.

2 types

(i) General information (ie general representation)

- Oral + written information in response to auditor's direct enquiries eg acting from implicit information eg all tax have double

(ii) Critical information (ie critical representation)

- Knowledge / facts confined to mgmt only
  - eg subsequent events, contingent liabilities, banks ye, stock held, legal cases, R & T
  - matter is one of judgement and opinion
    - eg depth rate, assumption used in preparing F. accounting policies, valuation of antiques, assumption used for not making provisions

Confirmation of representations (ie information rec'd)

- General information will be confirmed during audit
  - Substantive testing, TOC, EC0, EAP, assertions
- Critical information will not be confirmed during audit because no corroboratory evidence is available

How to obtain critical information from management

- Through a formal letter from management - LOI
- Confirming critical information for which no corroboratory evidence is available

Letter is received by auditor prior to completion of audit and before audit report is issued.
2 (a) Explain the purpose of a management representation letter. (5 marks)

- Is a form of audit evidence.
- Letter written by directors and sent to the auditors.
- Directors acknowledge their responsibility towards the preparation of financial statements.
- To confirm matters which are material to the financial statements where representations are necessary.
- Where other form of audit evidence is unavailable and a letter of representation is important.
- Auditors still need to collect evidence to support their opinion.
- Any contradiction between letter of representations and other evidence must be investigated.

(b) You are the manager in charge of the audit of Crighton-Ward, a public limited liability company which manufactures specialist cars and other motor vehicles for use in films. Audited turnover is $140 million with profit before tax of $7.5 million. All audit work up to, but not including, the obtaining of management representations has been completed. A review of the audit file has disclosed the following outstanding points:

**Lion’s Roar**
The company is facing a potential legal claim from the Lion’s Roar company in respect of a defective vehicle that was supplied for one of their films. Lion’s Roar maintains that the vehicle was not built strongly enough while the directors of Crighton-Ward argue that the specification was not sufficiently detailed. Dropping a vehicle 50 metres into a river and expecting it to continue to remain in working condition would be unusual, but this is what Lion’s Roar expected. Solicitors are unable to determine liability at the present time. A claim for $4 million being the cost of a replacement vehicle and lost production time has been received by Crighton-Ward from Lion’s Roar. The director’s opinion is that the claim is not justified.

**Depreciation**
Depreciation of specialist production equipment has been included in the financial statements at the amount of 10% pa based on reducing balance. However the treatment is consistent with prior accounting periods (which received an unmodified auditor’s report) and other companies in the same industry and sales of old equipment show negligible profit or loss on sale. The audit senior, who is new to the audit, feels that depreciation is being undercharged in the financial statements.

**Required:**
For each of the above matters:
(i) discuss whether or not a paragraph is required in the representation letter; and
(ii) if appropriate, draft the paragraph for inclusion in the representation letter. (10 marks)

**Solution:**
**Calculate Materiality Level.**
The amount of the claim is material being (4/7.5) 50% of profit before taxation. There is also a lack of definitive supporting evidence for the claim. The two main pieces of evidence available are the claim from Lion’s Roar itself and the legal advice from Crighton Ward’s solicitors. However, any claim amount cannot be accurately determined because the
dispute has not been settled. The directors have stated that they believe the claim not to be justified, which is one possible outcome of the dispute. However, in order to obtain sufficient evidence to show how the treatment of the potential claim was decided for the financial statements, the auditor must obtain this opinion in writing. Reference must therefore be made to the claim in the representation letter.

**Paragraph for inclusion in representation letter.**

‘A legal claim from Lion”s Roar has been obtained within an estimated value of $4m. We are of the view that the claim is not justified as we believe that we are not in breach of the product specification. The matter is considered to be possible rather than probable thus no provision has been made but has been disclosed by way of notes. We also confirm that no other such claims has been received or expected to be received.

(c) A suggested format for the letter of representation has been sent by the auditors to the directors of Crighton-Ward. The directors have stated that they will not sign the letter of representation this year on the grounds that they believe the additional evidence that it provides is not required by the auditor.

**Required:**

**Discuss the actions the auditor may take as a result of the decision made by the directors not to sign the letter of representation.** (5 marks)

**Solution:**

- Discuss matter with directors and if necessary amend letter.
- Auditor should explain directors the importance of a management representation letter.
- Auditor should explain that failure to provide a representation letter could amount to a qualification on the audit report.
- If auditor does not obtain representation letter the modified ‘except for’ opinion on the grounds of limitations on scope would be required.
- If matter is pervasive then ‘a disclaimer of opinion’ would be appropriate.
- If directors provide a representation letter and the auditor later obtains evidence that a qualification is required then the letter provides no reliable evidence.