Audit Engagement Letters
(Relevant to Paper 8 – Principles of Auditing and Management Information Systems)

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Background

Hong Kong Standard on Auditing 210 ("HKSA 210"), *Agreeing the Terms of Audit Engagements*, is within the scope of the syllabus of the HKIAAT examination. This article aims to explain the requirements set out in HKSA 210, with the exception of the requirements with respect to (a) financial reporting standards supplemented by law or regulation, and an (b) auditor's report prescribed by law or regulation.

(I) Preconditions for an audit

HKSA 210 states that the preconditions for an audit are that:
(a) The financial reporting framework to be applied in the preparation of the financial statements is acceptable; and
(b) The auditors obtain the agreement of the company's management that it acknowledges and understands its responsibilities.

It is important to establish the applicable financial reporting framework because such framework sets out the appropriate basis for the management in the preparation of the financial statements. Moreover, it provides the criteria that the auditor uses to audit the financial statements, including, where relevant, their fair presentation.

In determining the acceptability of the financial reporting framework to be applied in the preparation of the financial statements, auditors may consider:

(a) The nature of the entity (i.e. commercial entity, public sector entity);
(b) The purpose of the financial statements (i.e. for lenders, potential investors, or owners);
(c) The nature of the financial statements (e.g. accounting conventions, assumptions, and policy); and
(d) Whether law or regulation prescribes the applicable financial reporting framework (such as the Companies Ordinance, Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited, etc.).

As independent auditors, auditors are not supposed to be involved in or take any responsibility for the preparation of the financial statements or for the entity's related internal control process, and the auditors should have a reasonable expectation of obtaining any information necessary for the audit (including information obtained from outside the ledgers) from the management. To avoid any misunderstandings, auditors should reach an agreement that management acknowledges and understands that it has such responsibilities as part of agreeing on and recording the terms of the audit engagement. HKSA 580[1] requires the auditor to request management to provide written representations that it has fulfilled certain of its responsibilities. It may therefore be appropriate to inform the management of this expectation by including in the engagement letter that receipt of such written representations will be expected.

(II) Agreement on audit engagement terms

HKSA 210 requires auditors to agree on the terms of the audit engagement with management or those charged with governance, as appropriate, and that the agreed terms shall be recorded in an audit engagement letter, which must include:

(a) The objective and scope of the audit of the financial statements;
(b) The auditors' responsibilities;
(c) The management's responsibilities;
(d) Identification of the applicable financial reporting framework for the preparation of the financial statements;
(e) Reference to the expected form and content of any reports to be issued by the auditor; and
(f) A statement that there may be circumstances in which a report may differ from its expected form and content.

An audit engagement letter serves two purposes. The first purpose is to define clearly the extent of the auditors' responsibilities, and the second purpose is to provide a written confirmation of the auditors' acceptance of the appointment. In order to assist the auditors in fulfilling their responsibilities, items (a), and (d) to (f) are the basic terms to be agreed upon before the audit engagement, whereas items (b) and (c) are included to avoid any misunderstanding of the responsibilities of each party.

The form and content of the audit engagement letter may vary for each entity. In addition to including the above items (a) to (f), an audit engagement letter may make reference to other items relevant to the audit, which may state that due to the existence of the inherent limitations of both an audit and internal controls, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with the HKSAs.

(III) Recurring audits

HKSA 210 requires that on recurring audits, the auditor shall assess (i) whether circumstances require the terms of the audit engagement to be revised and (ii) whether there is a need to remind the entity of the existing terms of the audit engagement.

Normally it is not necessary to resend an audit engagement letter each period. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of the existing terms:

[1] HKSA 580 *Written Representations*

(i) Any indication that the entity misunderstands the objective and scope of the audit. (For example, the client misunderstands that it is the duty of the auditor to prepare the financial statements.)

(ii) Any revised or special terms of the audit engagement. (For example, the application of HKSA 701[2] on Communicating Key Audit Matters to audits of the financial statements of listed entities.)

(iii) A recent change of senior management. (For example, a new owner replaces all members of the board of directors.)

(iv) A significant change in ownership. (For example, the client has been acquired and is now part of a new group.)

(v) A significant change in nature or size of the entity's business. (For example, an inactive listed company has been acquired and becomes engaged in a new business.)

(vi) A change in legal or regulatory requirements. (For example, the disclosure of directors' remuneration is pursuant to Section 383 of the Hong Kong Companies Ordinance (Cap. 622) and the Companies (Disclosure of Information about Benefits of Directors) Regulation (Cap. 622G) and is no longer pursuant to Section 161 of the predecessor legislation Hong Kong Companies Ordinance (Cap. 32).)

(vii) A change in the financial reporting framework adopted in the preparation of the financial statements. (For example, the adoption of *HKFRS for Private Entities* as a reporting option, in lieu of the *HKFRS*s and *Small and Medium-sized Entity Financial Reporting Framework and Financial Reporting Standard*)

(viii) A change in other reporting requirements. (For example, a client becomes a subsidiary of a group and the auditor has to provide an audit clearance to the group auditor.)

(IV) Acceptance of a change in the terms of the audit engagement

Request to Change the Terms of the Audit Engagement

HKSA 210 states that the auditor shall not agree to a change in the terms of the audit engagement where there is no reasonable justification for doing so.

A request from the entity for the auditor to change the terms of the audit engagement may result from (i) a change in circumstances affecting the need for the service, (ii) a misunderstanding as to the nature of an audit as originally requested, or (iii) a restriction on the scope of the audit engagement, whether imposed by management or caused by other circumstances.

Each of the first two reasons may be considered a reasonable basis for requesting a change in the audit engagement. However, the third reason may not be considered reasonable if it appears that the change relates to information that is incorrect, incomplete or otherwise unsatisfactory. An example might be where the auditor is unable to obtain sufficient appropriate audit evidence regarding receivables and the

[2] HKSA 701 *Communicating Key Audit Matters in the Independent Auditor's Report*

entity asks for the audit engagement to be changed to a review engagement to avoid a qualified opinion or a disclaimer of opinion.

Request to Change from an Audit Engagement to a Review Service

HKSA 210 states that if the audit has commenced but, prior to completing the audit engagement, the auditor is requested to change the audit engagement to an engagement that conveys a lower level of assurance, the auditor shall determine whether there is reasonable justification for doing so.

Before agreeing to change an audit engagement to a review service, an auditor who was engaged to perform an audit in accordance with the HKSAs may need to assess the reasonableness of the justification to make the change, and also any legal or contractual implications of the change.

If the auditor concludes that the requested change is justifiable, the audit work performed before the changed engagement can be used to support the report to be issued. However, the report on the revised service would not include any reference to the original audit engagement and any procedures that may have been performed in the original audit engagement, unless these procedures are part of the agreed-upon procedures and a normal part of the report.

HKSA 210 requires the auditor and management to agree on and record the new terms of the audit engagement in an engagement letter. If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall withdraw from the audit engagement and determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

Reference:

HKSA 210, *Agreeing the Terms of Audit Engagements*
HKSA 580, *Written Representations*
HKSA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*