

AICPA ISSUES NEW STANDARD ON ENGAGEMENT LETTERS

By Gary A. Porter, CPA

Statement on Auditing Standards (SAS) No. 83, *Establishing an Understanding with the Client*, establishes new standards for the auditor in documenting the agreement with the client for the performance of professional services. This new SAS, issued by the American Institute of Certified Public Accountants (AICPA), modifies section 310 of SAS No. 1, "Relationship Between the Auditor's Appointment and Planning." Section 310 is renamed by the new SAS to *Appointment of the Independent Auditor*.

When the auditor establishes and understanding with the client, it reduces the risk that either the auditor or the client may misinterpret the needs or expectations of the other party. As an example, it reduces the risk that the client may inappropriately rely on the auditor to protect the entity (association) against certain risks or to perform functions that are the client's responsibility.

The understanding that is reached should include:

- C the objectives of the engagement
- C management's responsibilities
- C the auditor's responsibilities
- C the limitations of the engagement.

The auditor should document the understanding in the working papers, preferably in writing. If an auditor believes that an understanding has not been reached, the auditor should decline the engagement. For this reason, it is most preferable to have an agreement that is signed by both parties.

Matters that would generally be included in an understanding with the client regarding an audit of financial statements are:

- C The objective of the audit is the expression of an opinion on the financial statements
- C Management is responsible for the association's

Executive Summary

"SAS No. 83, Establishing an Understanding with the Client, amends SAS No. 1 by requiring auditors to establish an understanding with the client that includes the objective of the engagement, the responsibilities of the client and the auditors, and the limitations on the engagement. At a minimum, auditors are required to document their understanding in the workpapers. Use of a written engagement letter is not required, although it is encouraged. SAS No. 83 is effective for years ending on or after, June 15, 1998, with earlier application encouraged."

financial statements --It is important to note here that the term "management" means the board of directors of an association, because they have the ultimate responsibility for the association. While the board of directors may delegate authority to either staff or a management company, they cannot delegate responsibility. Because the nature of many associations, particularly those with a relatively passive board who have delegated total management to an outside management company, is to not be involved in the creation of the financial records of the association, many board members feel uncomfortable in signing an engagement letter or representation letter containing this assertion. While this issue has been discussed many times, SAS No. 83 makes it clear that this is a requirement in establishing an understanding with the client. If the client [board] refuses to accept responsibility for the financial statements, it will probably constitute a scope limitation that is so unacceptable to the auditor, that the auditor must decline the



AICPA Issues New Standard on Engagement Letters (continued)

- engagement.
 - C Management is responsible for establishing and maintaining effective internal control over financial reporting
 - C Management is responsible for identifying and making sure that the association complies with laws and regulations applicable to its activities
 - C Management is responsible for making all financial and related information available to the auditor
 - C At the conclusion of the audit, management will confirm in writing certain representations made during the audit
 - C The auditor is responsible for conducting the audit in accordance with Generally Accepted Auditing Standards (GAAS). These standards require that the auditor obtain reasonable (rather than absolute) assurance whether the financial statements are free from material misstatement, whether caused by error or by fraud. Consequently, a material error may remain undetected. Also, an audit is not designed to detect error or fraud. If the auditor is unable to complete the engagement or reach an opinion, the auditor may decline to issue an opinion (a disclaimer of opinion), or may decline to issue a report.
 - C An audit includes obtaining an understanding of internal control sufficient to plan the audit and to determine the nature, timing, and extent of audit procedures to be performed. While an audit is not designed to provide assurance on internal control, the auditor does have the responsibility to communicate any reportable conditions that come to his or her attention.
- audit
 - C Arrangement regarding the use of specialists (This might include the use of an engineer to compile the required disclosures on reserves required by the AICPA as supplementary information to be attached to, but not be a part of the basic financial statements of the association.)
 - C Arrangements regarding a predecessor auditor
 - C Arrangements regarding fees
 - C Conditions under which access to the auditor's working papers may be granted to others
 - C Any limitations regarding the liability of the auditor or the association arising from knowing misrepresentations by the auditor or management
 - C Additional services to be provided regarding regulatory requirements
 - C Arrangements for other services to be provided in connection with the audit.

The statement is effective for audit engagements for periods ending on or after June 15, 1998. However, earlier application is both permitted and encouraged.

SAS no. 83 will likely require that all CPAs modify their standard engagement letter to include the required components listed above. While virtually all audit engagement letters are drafted by the auditor, associations should also be aware of the new requirements to make sure that (1) their CPA is current on new standards, and (2) that they have the opportunity to insert any protective language of their own into the agreement.

The Statement also identifies certain additional matters which may be included in an understanding with the client:

- C Arrangements regarding timing, availability of documents, and client preparation of schedules to be used by the auditor in the conduct of the

Note: A modified version of this article was published in CAI's "Ledger Quarterly," Winter 1998 Issue

