



**International Federation of Accountants**

545 Fifth Avenue, 14th Floor, New York, NY 10017 USA

Tel +1 (212) 286-9344 Fax +1 (212) 286-9570 www.ifac.org

## Agenda Item

# 6

**Committee:** IAASB  
**Meeting Location:** Toronto  
**Meeting Date:** April 19–22, 2004

### IAASB Project Proposal — Representations

#### 1. Subject

Revision of ISA 580, *Management Representations* (“MRs”).

#### 2. Reasons the Subject Should Be Studied Now

##### THE SHIFT TOWARDS GREATER ACCOUNTABILITY

As a result of the recent corporate failures, there has been a distinct shift in public expectation towards greater responsibility and accountability from management and those charged with governance (and of course, auditors). The United States has already enacted legislation<sup>1</sup> to require management and those charged with governance to effectively bear responsibility for the fairness and veracity of their companies’ financial statements. In the wake of the Ahold and Parmalat fraud cases, the European Commission is also taking steps for legislation to be drafted to bring about greater accountability on the part of management and those charged with governance.

In light of this shift towards greater accountability, the question arises as to whether the auditor should limit obtaining representations from only management during the audit. It could be argued that while those charged with the entity’s governance are independent of management, if they fulfill their supervisory responsibilities adequately, they should be knowledgeable about all the significant issues affecting the entity. Consequently, a legitimate question that this project will examine is whether it would be appropriate for the auditor to also obtain representations from those charged with governance.

A related question that also needs to be considered is whether, in the context of representations, “management” includes only the entity’s Chief Executive Officer and Chief Financial Officer (or equivalent). The trend towards greater accountability from those within the entity bearing key responsibilities would indicate that the auditor should not have to limit the prime source of representations from the entity to only the CEO/CFO but also consider others with key responsibilities and/or knowledge. A move away from a narrow definition of “management” to the broader inclusion of individuals in key positions and/or having specialized knowledge should benefit the overall quality of the audit since the auditor would avoid placing over-reliance on the CEO/CFO.

<sup>1</sup> The Sarbanes-Oxley Act of 2002.

In addition, the project will also explore whether, for purposes of audit standards, representations should be limited to information provided by those within an entity or whether similar information provided by third parties should also be considered. This issue may be particularly difficult for matters that involve the expressions of intention or opinion, or use of judgment. This might entail defining what is meant by “representation” to distinguish this from the concept of an external confirmation.

#### DEVELOPMENTS IN PRACTICE

Firms’ practice on MRs tends to vary widely. Some firm policies require that a comprehensive list of written representations be obtained from management, whilst others require only minimum representations as they determine appropriate. Compounding this, liability laws regarding the validity of management representations as evidence are unclear and potentially vary widely amongst jurisdictions. Consequently, this project will consider how to bring about greater consistency of application amongst audit firms. The approach might take the form of requiring the auditor to obtain a minimum set of mandatory representations and providing additional guidance for the auditor to determine when and what additional representations should be obtained.

A recurring theme from quality control inspections conducted by the firms and independent external parties<sup>2</sup> is that auditors often place excessive or undue reliance on representations, without appropriately obtaining corroborating evidence. Thus, the project will discuss the types of matters on which representations might be obtained, and also consider strengthening the requirement and guidance on corroborative procedures.

#### DEVELOPMENTS IN ISAS AND IAPSS

Given the succession of new ISAs and IAPSS<sup>3</sup> that have been released since the original issue of ISA 580 in 1985 that address specific MR issues, there is a need to consider whether ISA 580 continues to provide an appropriate overarching framework for representations or whether the basic principles in ISA 580 need to be strengthened and expanded in light of these developments. Additionally, the positioning of an example MR letter in the appendix to the existing Standard continues to create an updating issue as and when new ISAs and IAPSS are issued. Consequently, this project needs to address how best to restructure ISA 580.

#### EXTERNAL INPUTS

IOSCO completed a review of five ISAs and provided comments to the IAASB in a letter dated October 15, 2002 that touched upon a number of MR issues. This project will consider the issues raised by IOSCO.

Commentators have also written to the IAASB to urge that the example letter in the appendix to the extant ISA 580 be updated so that auditors do not continue to rely on outdated guidance.

<sup>2</sup> See, for example, “*Lessons from Fraud-Related SEC cases: Top 10 Audit Deficiencies*” – Beasley, Carcello and Hermanson, *Journal of Accountancy*, April 2001.

<sup>3</sup> For example, ISAs 240, 250, 545, 550 and 570, and IAPSS 1005, 1006, 1010 and 1012.

### 3. Scope of Project

#### (a) LIST THE MAJOR PROBLEMS AND ISSUES THAT SHOULD BE ADDRESSED

The issues that the project will consider are addressed in the following four sections:

- I. Defining the scope of representations;
- II. Representations from within the entity;
- III. Nature and extent of MRs;
- IV. The construct of ISA 580; and
- V. Nature and extent of additional guidance considered appropriate.

#### I) DEFINING THE SCOPE OF REPRESENTATIONS

A critical decision that the project needs to make is to clearly identify the criteria that differentiate a representation from a confirmation. This will determine whether assertions made to the auditor by parties within or outside the entity fall within the scope of ISA 580 or ISA 505, "External Confirmations."

If such criteria could indeed be established, a related question would be to consider whether there is such a concept as an "external representation," and if so, how it should be defined. In practice, there may be significant barriers that may prevent third parties from readily giving representations to the auditor, especially in writing. The issues that arise relate principally to (a) legal liability considerations for the parties giving the representations, including data privacy laws; (b) potential disclosure of competitive information by the third parties; and (c) the requirement to maintain business confidentiality in transacting with the entity.

Notwithstanding these potential limitations, the question of whether third parties can provide appropriate representations to the auditor is worth further investigation. Other than the issue of whether an external representation is inherently a confirmation, issues that could be considered include:

- Determining the nature and type of appropriate representations the auditor could obtain from third parties.
- Determining what criteria should be specified to identify the external parties that could provide reliable and relevant representations to the auditor. For example, does the party need to be independent of management? Or what level of authority or competence does the party need to have?
- While the existing ISA 580 mandates either qualification or disclaimer of the auditor's report on scope limitation ground if management refuses to provide a representation the auditor considers necessary, would there be a scope limitation similarly if the external parties refuse to give the representations the auditor considers necessary? And what would be the impact of such a limitation of scope on the auditor's report? (See also "Impact on auditor's report if representations considered necessary are not obtained" in Section III below).

## II) REPRESENTATIONS FROM WITHIN THE ENTITY

As discussed above, this project will consider whether representations from within the entity should be limited primarily to the entity's CEO and CFO, or whether representations should also be obtained from (i) those charged with governance, and (ii) broadly, other individuals within the entity having key responsibilities and/or knowledge.

### *i) Representations from those charged with governance*

Those charged with governance fulfill key supervisory responsibilities and are expected to be knowledgeable about the key issues the entity's faces and how it is dealing with them. Consequently, the question arises as to whether the auditor should obtain representations from those charged with governance that they have discussed these key issues with management and understand and agree with management's plan of action to address these issues.

There might be some merit in at least having those charged with governance review the representations given by management and confirm that they understand and have appropriately discussed with management the key issues for which management is providing the representations. Such a procedure would help the auditor not only in confirming the completeness of the list of issues for which representations are being sought but also in obtaining a formal record of consensus reached on key representation issues discussed with those charged with governance. The responsibilities of those charged with governance vary in different jurisdictions and the project will need to consider whether the concept is generally workable.

If the project Task Force were to conclude that representations should be obtained from those charged with governance, the project would need to consider defining the nature and characteristics of such representations (e.g. whether they are given independently of management, whether they add credibility to management's representations, etc), and whether there are circumstances in which such representations need not be obtained.

### *ii) Representations from other "senior personnel"*

The project will also consider whether representations should be broadened to cover "senior personnel" other than the CEO/CFO of the entity. Individuals who comprise this group include personnel within the entity with key responsibilities and/or specialized knowledge, for example, internal auditors, in-house counsel, engineers, etc.

A main benefit from broadening representations in that way would be to obtain representations from individuals who are closer to the subject matter than the CEO/CFO, and thus improve the quality of the evidence that representations provide. Therefore, the focus of guidance in the revised ISA would shift from viewing the CEO/CFO as the primary source of representations to encompassing all relevant senior personnel with key responsibilities and/or knowledge.

If the project Task Force were to conclude that such representations should be obtained, the project would consider whether to place the basic principles and guidance in the revised ISA 580 or whether to position them more appropriately in ISA 620, "Using the Work of an Expert."

## III) NATURE AND EXTENT OF REPRESENTATIONS

Without excluding other issues that the project Task Force might consider, the project will address

the following matters regarding the nature and extent of representations:

#### Minimum mandatory written representations

Determining whether there should be a set of minimum representations that the auditor should always obtain from management, for example, whether management has made all the books and records available to the auditor, and whether there have been any irregularities involving management or employees who have a significant role in the accounting and internal control systems or that could have a material effect on the financial statements. There might be a need for criteria to be developed for such mandatory representations, such as whether they are sufficiently broad to apply to all audits, whether they address all financial statement assertions, and whether they are appropriate for management to provide.

#### Other situations when representations should be obtained

In addition to the above, consideration should be given to providing guidance in relation to circumstances where evidence cannot reasonably be expected to exist and, therefore, when representations should be obtained, for example, when knowledge of the facts is confined to management, or when the matter is principally one of intention, judgment or opinion.

#### Representations that should not be obtained

Consideration needs to be given to whether there are specific representations that should not be obtained if the auditor has performed a quality audit in accordance with professional standards and regulatory and legal requirements, and expects to issue an unqualified opinion. For example, if the auditor expects to issue an unqualified report, it could be argued that a representation from management that “the financial statements are free of material misstatements, including omissions” actually undermines the audit opinion instead of supporting it, since a properly conducted audit would arrive at that conclusion on the basis of sufficient appropriate evidence obtained independently of management.

Consequently, there might be a need to provide guidance for the auditor to evaluate whether a given representation is superfluous on the basis that the auditor has already obtained other sufficient appropriate evidence to support the underlying financial statement assertion. Consideration should also be given to whether there would be any legal liability implications for the auditor from obtaining (or not obtaining) representations that could be considered superfluous.

#### Representations as “supplementary” evidence for “gray” or difficult areas

The auditor may also encounter areas for which he or she might be unsure about whether the evidence obtained is sufficient and appropriate, for example, in situations where the subject matter is complex or where completeness is in question. Consideration needs to be given to whether to provide guidance to the auditor in such cases to determine whether management should provide representations to supplement the audit evidence already obtained. For example, even if the auditor has performed tests for unrecorded liabilities, should written representation be obtained as supplemental evidence that management has no knowledge of any liabilities that have not been recorded?

### Corroboration

Given the importance of corroboration and how often auditors are cited in file inspections as not having properly corroborated representations when they should have done so, there is a need to determine whether corroboration should be elevated from the status of guidance in the existing ISA 580 to a more presumptive action in the revised ISA 580. Additionally, consideration needs to be given to providing guidance regarding the circumstances under which corroboration might be difficult, for example, in relation to matters of intention, opinion or judgment, and whether the representation alone would provide sufficient appropriate audit evidence.

### Impact on auditor's report if representations considered necessary are not obtained

The existing ISA 580 mandates the auditor to either qualify or disclaim the audit opinion if management refuses to provide a representation the auditor considers necessary. Consideration should be given to whether qualification is the appropriate response or whether this requirement should be strengthened to require the auditor to disclaim the audit opinion or withdraw from the engagement.

### Subsequent events

Determining whether the auditor should obtain written representations from management regarding the existence (or not) of material subsequent events.

### Going concern

Determining whether the auditor should obtain written representations from management and/or those charged with governance regarding management's future plans and the adequacy of any disclosures in relation to matters critical to the going concern basis. The issue of corroborative evidence may also apply here.

### Changes in management

When there is a change in management of the entity, consideration needs to be given to whether the new management should provide representations to the auditor for the whole period covered by the audit, even though new management might not have been part of the entity during that period. In the event that new management refuses to provide the necessary representations to the auditor, would the auditor consider this a scope limitation that would trigger an audit qualification?

## IV) CONSTRUCT OF ISA 580

The IAASB agreed at its February 2004 meeting in New York that the proposed revised ISA 230 on Audit Documentation should be constructed as an "overarching" standard that contains all the basic principles, instead of as an all-in-one Standard that groups the documentation requirements and guidance in all other standards.

It is recommended that the same approach be adopted for the revised ISA 580. In taking this approach, consideration needs to be given to whether ISA 580 is appropriately constructed as an overarching Standard that establishes the basic principles on representations. An appropriately constructed overarching Standard would guide the establishment of specific MR requirements

and guidance in other ISAs/IAPSs.

Consideration also needs to be given to whether to provide an appendix to ISA 580 listing all the ISAs and IAPSs that contain specific requirements and guidance on representations. As with the ISA 230 project, such an appendix would be updated by IAASB staff as and when necessary without the need for specific Board review and approval.

In terms of structure, some thought also needs to be given to whether to move the guidance and the example MR letter in the existing ISA 580 into an IAPS, which would then be updated as necessary. This might render the task of updating the guidance and example letter easier since the Standard itself would not have to be revised each time.

#### V) ADDITIONAL EXPLANATORY OR OTHER GUIDANCE

Based on the decision the Task Force will take regarding the construct of ISA 580, there may be a need to evaluate whether requirements for representations in other ISAs are complete and consistent with the principles to be adopted in the revised ISA 580. In addition to these potential conforming changes, consideration should be given to whether to provide guidance on the following specific issues:

- Determining whether to cross-refer to Paragraph 7 of ISA 210, “Terms of Audit Engagements”, which states that the auditor may wish to include in the letter of engagement an expectation of receiving from management written confirmation concerning representations made in connection with the audit.
- Determining whether management should provide an updated MR letter if there is a long delay in issuing the auditor’s report (Subsequent Events).
- Determining whether management should communicate its understanding of materiality in the MR letter, either in qualitative or quantitative terms, in order to minimize the risk of misunderstanding between management and the auditor. The Materiality Task Force has recommended that this issue be addressed in this project.
- When management asks the auditor not to obtain a particular external confirmation and the auditor agrees, should the auditor obtain written representations from management as to the reasons for the request, even though the auditor might have performed alternative procedures to obtain sufficient appropriate evidence? Consideration needs to be given to whether to provide guidance on this issue (External Confirmations).
- Determining whether to emphasize that when the auditor is reporting on consolidated financial statements, acknowledgement by management of its responsibility for the “financial statements” applies to both the consolidated financial statements and the financial statements of the parent entity (Group Audits).
- Determining whether a component auditor should appropriately obtain representations, subject to confidentiality rules, from the group management or group auditor concerning matters that may affect the component, such as related-party transactions or the parent entity’s intention to provide continuing financial support to the component (Group Audits).
- Clarifying that representations should be tailored to comply with local professional, legal or

regulatory requirements.

**(b) DESCRIBE IMPLICATIONS FOR ANY SPECIFIC PERSONS OR GROUPS**

- CAG and IOSCO, due to stakeholder and regulatory interest in representations as a form of audit evidence.
- National standard setters, due to the potential effect any revised international standard on representations would have on corresponding national standards, particularly from the perspective of convergence.
- INTOSAI, due to the expected future use of ISAs in public sector audits.
- SMP Task Force, particularly with regards to (a) the importance of obtaining representations on relevant matters from small- and medium-sized enterprises (“SMEs”) since many do not have formal procedures documenting how decisions have been taken on important accounting issues; and (b) the need to give appropriate consideration to the informal organizational structure of SMEs, which often do not have audit committees.

**(c) CONSIDER WHETHER IT REQUIRES PARTICULAR CONSIDERATION**

There are no specific IT considerations.

**4. Indicate the Type of Material to Be Published**

Revision of the existing ISA 580.

Proposed timeline:

- Issues paper – December 2004 (or September 2004, as the IAASB schedule permits)
- First read – March 2005
- Exposure draft – June 2005
- Approved – March 2006

**5. Resources Required**

- An IAASB task force, including an INTOSAI representative.
- IAASB technical staff (one).

**6. List Important Sources of Information That Address the Matter Being Proposed**

- ISA 210: Terms of Audit Engagements (Mar 1994).
- ISA 240, The Auditor’s Responsibility to Consider Fraud in an Audit of Financial Statements (Feb 2004).
- ISA 250, Consideration of Laws and Regulations in an Audit of Financial Statements (July 1993).
- ISA 545, Auditing Fair Value Measurements and Disclosures (Aug 2002).
- ISA 550, Related Parties (Oct 1984).
- ISA 570, Going Concern (Jun 1999).
- ISA 810, The Examination of Prospective Financial Information (Feb 1989).



- ISA 910, Engagements to Review Financial Statements (Jul 1988).
- ISA 930, Engagements to Compile Financial Data (Oct 1990).
- IAPS 1005, Particular Considerations in the Audit of Small Businesses (Mar 1999).
- IAPS 1006, The Audit of International Commercial Banks (Dec 2001).
- IAPS 1010, The Consideration of Environmental Matters in the Audit of Financial statements (Mar 1998).
- IAPS 1012, Auditing Derivative Financial Instruments (Jun 2000).
- IOSCO Standing Committee No. 1, Comment Letter on ISAs 230, 260, 505, 560 and 570 (Oct 2002).
- AICPA AU 333, Management Representations (Dec 1999).
- US SAS 99, Consideration of Fraud in a Financial Statement Audit (Oct 2002).
- UK SAS 440, Management Representations (Jan 1995).
- ICAEW Audit and Assurance Faculty Technical Release 4/02, Management Representation Letters (Nov 2002).
- JICPA Auditing Standards Committee Report No. 3, Management Representation Letter (May 2002).
- French Auditing Standard CNCC 2103.1, Les Déclarations de la Direction.
- Australian Auditing Standard AUS 520, Management Representations (July 1999).
- CICA AuG-8, Auditor's Report on Comparative Financial Statements (Oct 1990).
- US Panel on Audit Effectiveness – Report and Recommendations, Appendix F: Analysis of SEC Accounting and Auditing Enforcement Releases (Aug 2000).
- Fraud-Related SEC Enforcement Actions against Auditors: 1987-1997 (Aug 2000).
- US SEC – 2000 Audit Risk Alert (Oct 2000).
- Firms' policies and internal guidance.

## **7. Factors That May Add To Complexity or Length of Project**

- Consideration of issues for which there is no consensus among national standard setters.

Prepared by Ken Siong Date March 19, 2004

**Comments by Technical Managers/Committee Secretaries**

The comments and sign-off of *each* Technical Manager are required before this Project Proposal is considered by the IAASB.

**Professional Accountants in Business**

**[Pending response – IAASB to be advised in April]**

CLASSIFICATION

*Class:* A      B1      B2      C

SUGGESTED PRIORITY

OTHER COMMENTS

Signed \_\_\_\_\_ Date \_\_\_\_\_

**Education Committee**

CLASSIFICATION

*Class:* A

SUGGESTED PRIORITY

N/A

OTHER COMMENTS

Signed Claire Egan Date March 19, 2004

**Ethics Committee**

CLASSIFICATION

*Class:* A

SUGGESTED PRIORITY

N/A

OTHER COMMENTS

Signed Jan Munro Date March 4, 2004

**Compliance Committee**

## CLASSIFICATION

*Class:* A

## SUGGESTED PRIORITY

N/A

## OTHER COMMENTS

It is important to study / revise this area because there seems to be divergent practices internationally and because there is a lack of clarity as to the scope of requirements for management representations and the extent management representations represent a form of audit evidence. Compliance recognizes that there may be barriers to implementation. It appears one barrier or cause of divergent practice in this area may be differing legal frameworks or customs which may increase the challenge some countries may have in converging existing practice.

Signed Sylvia BarrettDate March 29, 2004**Public Sector Committee****[Pending response – IAASB to be advised in April]**

## CLASSIFICATION

*Class:* A    B1    B2    C

## SUGGESTED PRIORITY

## OTHER COMMENTS

Signed \_\_\_\_\_ Date \_\_\_\_\_

**Trans-National Auditors' Committee**

## CLASSIFICATION

*Class: A*

## SUGGESTED PRIORITY

The TAC felt this project should be given priority, but not to the extent it would inhibit the work plan for obtaining EU endorsement of ISAs. The TAC noted that the issue of representations is important to the profession.

## OTHER COMMENTS

The TAC expressed some concerns regarding the merging of internal (management) and external (third party) representations. Those identified as third parties need to be those with the proper position to provide a representation. It was noted that the large firms are working on a project on confirmations and it may be possible for the IAASB to leverage off of the work done by them. The difference between third party representations and confirmations should be clear.

The TAC was supportive of broadening the definition of management to include individuals in key positions to avoid placing over-reliance on CEO/CFO.

Signed Victoria RandDate March 22, 2004**SMP Committee**

## CLASSIFICATION

*Class: B1*

## SUGGESTED PRIORITY

High.

## OTHER COMMENTS

Corporate governance may not be an audit project but nonetheless the value of management representations can only be assessed by reference to the corporate governance practices upheld within an entity.

Signed Robin MathiesonDate March 18, 2004

## Project Classifications

All activities of IFAC have the same overall objectives. When a project involving more than one committee is approved, there must be close co-ordination to minimize schedule disruptions and to avoid inconsistent conclusions. The following procedures are designed to try to ensure the smooth co-ordination of joint projects.

### Standards and Guidelines

A project is put forward for approval only when a Project Proposal has been completed; each Project Proposal includes space for the recommendation of each committee secretary on the proposed nature of a project under one of the following classifications:

*Class A Project:* entirely the responsibility of only one committee.

*Class B Project:* mainly the responsibility of one committee but with important implications to at least one other committee.

*Class C Project:* a joint project—the priority, work and conclusions are of importance to two or more committees.

Approval of the classification of a project lies with the responsible committee(s).

#### 1. CLASS A PROJECTS

Full details of a Class A project will be sent only to the committee responsible for its development and approval but the committee secretaries of the other committees will be kept informed by the responsible committee secretary, at all significant points, of the project's progress by distribution of committee agenda papers.

#### 2. CLASS B PROJECTS

Since the degree of “jointness” can vary substantially in a Class B project (from being almost a Class A to almost a Class C project), the Project Proposal form should indicate which of the two following routes is proposed for handling the project:

B1: The work will be handled entirely by a subcommittee of the “primary” committee but at significant points in the development of the project (statement of principles, exposure draft, final recommendations) the “primary” committee will ascertain from the other committee(s) whether the proposals would create significant difficulties for the other committee(s) before the “primary” committee approves the material.

B2: The subcommittee of the “primary” committee responsible for the project will have added to it one or two representatives of the other committee(s).

Whichever route is approved, comments by the other committee(s) will be considered by the “primary” subcommittee and the “primary” committee.

#### 3. CLASS C PROJECTS

[Process under discussion]

#### 4. SIGNIFICANT DIFFICULTY

To avoid the possibility of inconsistencies in Recommendations between standard-setting committees, on any project on which one of the standard-setting committees has indicated to another that the project would create a significant difficulty,\* the difficulty must be cleared up to the satisfaction of both committees before the project proceeds.

If an irreconcilable difference occurs between committees, the matter can be referred, by either or both of the committees concerned, to the Board for an opinion but in no case will amendments or additions be made to the IFAC Handbook or to other official pronouncements as long as there remains a significant difficulty between committees.

#### **Discussion Papers and Other Information Documents**

The same procedures as for Standards and Guidelines (including the classification of a project) will be followed in the preparation and approval of these publications.

\* A significant difficulty is considered to have been created when a proposed Recommendation from one committee will, in the opinion of the other committee, undermine or contradict a Recommendation of another committee.