

Revision of ISA 580 “Management Representations” – Issues Paper

I INTRODUCTION

1. Extant ISA 580 was issued in October 1985 and codified in November 1993. ISA 580 has five black letter requirements:
 - **The auditor should obtain appropriate representations from management.**
 - **The auditor should obtain evidence that management acknowledges its responsibility for the fair presentation of the financial statements in accordance with the relevant financial reporting framework, and has approved the financial statements.**
 - **The auditor should obtain written representations from management on matters material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist.**
 - **If a representation by management is contradicted by other audit evidence, the auditor should investigate the circumstances and, when necessary, reconsider the reliability of other representations made by management.**
 - **If management refuses to provide a representation that the auditor considers necessary, this constitutes a scope limitation and the auditor should express a qualified opinion or a disclaimer of opinion.**
2. In April 2004, the IAASB approved a project proposal to revise ISA 580. The main purpose of the revision was to:
 - Address the issue of undue reliance on management representations by auditors;
 - Introduce greater rigor in the use of management representations;
 - Consider the nature of representations as audit evidence; and,
 - Establish who should provide what representations.

Executive Summary

3. Management representations differ from other audit evidence in that they may involve transactions or events that have a significant impact on the financial statements and yet corroborative evidence may not always be available. The Task Force noted that the scope of representations has been steadily increasing in recent years. This trend has affected the content, length and complexity of national standards and of management representations letters.
4. The Task Force concluded that certain representations, specifically those relating to the financial statements, are different and decided to adopt a distinct approach to management representations. The Task Force members believe that it is critical to understand the issues of the definition and nature of management representations. The Task Force proposes a new definition of management representations in the context of ISA 580. The Task Force also proposes to separate assertion-specific representations from general representations and

introduce them as internal confirmations. The term may be new but an internal confirmation in this sense is a response to inquiry as discussed in ISA 500. The focus of ISA 580 would be primarily on management responsibility and accountability for the financial statements. Understanding of the critical issues and delineating management representations from internal confirmations should result in a more rigorous standard and reduced possibility of an auditor's overreliance on representations. In addition, the focus on critical issues should facilitate an easier application of ISA 580 by SMP/SMEs.

5. The delineation of internal confirmations, if approved by the IAASB, will give rise to another issue. The IAASB will be asked to determine, whether the use of internal confirmations as audit evidence should be addressed in ISA 580, or whether ISA 500 should be revised to provide relevant standards and guidance. There is a third option, to establish standards and guidance for the use of internal confirmations in a separate standard. If the second or third option is selected, the IAASB should determine whether the project should be completed by this Task Force.

II ISSUES

6. The Task Force has identified the following issues that need to be addressed:
 - (a) Representations;
 - (b) Internal confirmations;
 - (c) Other matters.

A. Representations

A1. DEFINITION OF REPRESENTATIONS

7. All historical financial records and other internal records are, essentially, management representations. However, this is not the definition of management representations in the context of ISA 580. In the context of ISA 580, management representations are currently defined as, "Representations made by management to the auditor during the course of an audit, either unsolicited or in response to specific inquiries."¹ The broad definition has led in some countries to an increasing number of mandatory representations and lengthy representation letters. Issues arise as to whether the scope of representations in the context of this definition is too broad, and whether it is appropriate for the purposes of ISA 580. To address these issues, it is useful to analyze the definition of management representations and to compare it with the intent of ISA 580.
8. The general nature of the definition covers both oral and written representations made by management during an audit of financial statements. The inclusion of unsolicited representations further expands the scope of the definition. The two stated reasons for auditors to obtain representations are: (i) to obtain acknowledgement by management of its responsibility for the financial statements; and, (ii) to obtain audit evidence where other

¹ Extracted from IFAC Handbook of International Auditing, Assurance, and Ethics Pronouncements, 2004, Glossary of Terms.

evidence cannot reasonably be expected to exist. They result in two “types” of representations: (i) “general” representations obtained from management, in which management acknowledges its responsibility and accountability for the financial statements; and, (ii) “specific” representations, which may provide audit evidence on certain assertions.

9. It is the second type, “specific” representations, that is problematic, as it can be continually expanded. As stated in ISA 200, “Objective and General Principles Governing an Audit of Financial Statements,” and ISA 500, “Audit Evidence,” sufficient appropriate evidence gathered by the auditor is persuasive but not conclusive. Therefore, additional evidence, even if weak, can always be obtained by a written representation. In many countries, this has led to an ever-increasing number of written representations. More representations, however, may result in an auditor’s use of and possible reliance on representations in circumstances where other audit evidence should have been obtained. In addition, when other evidence exists and has been obtained, obtaining a representation may result in a perception that the representation was necessary for sufficient appropriate audit evidence, even though this was not the case.
10. To address this issue and to define management representations in the context of ISA 580, one additional question should be asked – why do we need them? The Task Force is of the view that auditors need management representations primarily to obtain evidence of management’s acceptance of responsibility and accountability for the financial statements as a whole. The Task Force has concluded that these “general” representations are the driver behind ISA 580. Therefore, the definition of management representations in the context of ISA 580 should concern primarily with them.
11. When representations are used as audit evidence for certain specific assertions, the issue arises whether these representations should be included in ISA 580, or whether ISA 500, “Audit Evidence,” provides standards and guidance in this context. In this case, management representations are written responses to an inquiry. ISA 500 discusses the use of inquiry and its validity as audit evidence. The discussion addresses some of the issues relevant for this project, in particular the use of uncorroborated information obtained as the result of an inquiry. It provides guidance that is useful for ISA 580, including the guidance for obtaining written representations. This does not mean that “specific” representations are outside the scope of ISA 580. An auditor should have the flexibility to include “specific” representations in his or her management representation letter if such inclusion is important in the auditor’s view. Therefore, there is a need to provide standards and guidance in ISA 580 for the auditor who wishes to obtain “specific” written representations. However, the “specific” representations should be viewed as other audit evidence and, thus, the standards and guidance provided in ISA 500 should always be applied.
12. The Task Force has also considered whether the delineation should also include terminological distinction. The significance of the two types in the context of ISA 580 suggests that such distinction would assist auditors in applying the Standard. Therefore, the Task Force believes that “general” representation should be “management representation” in the context of ISA 580, while “specific” representation should be “internal confirmation.” Management representations defined in this way would be mandatory representations for the purposes of management

representation letter. It would be up to the auditor to decide whether written internal confirmations will be included in the representation letter or in the audit file. The decision should be based on the importance of the item in the context of a specific audit engagement.

13. This restriction on the use of the term management representations will have the following implications:

- The auditor will be able to decide whether an internal confirmation should be obtained for the purposes of audit evidence and whether it should be included in the management representation letter or in the audit file;
- The increasing length and complexity of the management representation letter would be avoided;
- Application of ISA 580 to small and medium-sized enterprises may become easier.

14. The proposed terminology is used throughout the remainder of this paper.

The Task Force proposes that the existing definition of management representations be reconsidered. Under the proposed definition, management representations would include those representations confirming acceptance by management of its responsibility and accountability for the preparation and presentation of financial statements. Assertion-related representations would be denoted as internal confirmations and addressed separately from management representations.

Action Requested: Does the IAASB agree that management representations relating to the financial statements should be delineated from assertion-related internal confirmations? If so, should internal confirmations be addressed in ISA 580, ISA 500, or a new standard? If the IAASB determines that ISA 500 be updated or a new standard developed: is there a need to set up another task force?

A2. REPRESENTATIONS AS AUDIT EVIDENCE

What Audit Evidence Does a Representation Provide?

15. As explained in the previous section, management representations provide evidence of management’s acceptance of responsibility and accountability for the preparation of the financial statements. For these representations to provide suitable evidence, however, they must be reliable. In the context of management representations, reliability depends on three ethical factors:

- Management competence;
- Management integrity;
- Due care.

Competence

16. Some academics suggest that in discussing the assessment of management competence, it is helpful to distinguish between capability evidence and performance evidence.² To illustrate this, an otherwise capable management may perform its tasks with a lack of due care, resulting in poor performance and, possibly, misstatements. Similarly, a capable management may perform its tasks with due care but ill intent. Further, the researchers propose five kinds of assessment methods from which to choose when assessing competence. The methods are:

- Questioning techniques;
- Simulations;
- Skills tests;
- Direct observation; and
- Evidence of prior learning.

17. Although it is not within an auditor's ambit to perform tests specifically designed at the assessment of management competence, the nature of the auditor's work is such that it includes some of the above techniques. An auditor performs procedures relevant for this purpose as part of his or her risk assessment, particularly during obtaining an understanding of the control environment. The auditor's assessment may be aided by his or her past experience. The auditor's approach to the assessment is that of professional skepticism and he or she is alert to evidence indicating that management competence is not equal to the task. If the auditor concludes that management competence is not commensurate with its role and level of responsibility, the reliability of management representations may be undermined. A real-life example of this scenario is included in footnote 5.

Integrity

18. The assessment of management integrity is part of the procedures to obtain an understanding of the control environment, as well as the engagement continuation procedures. The knowledge obtained in the course of these procedures should be utilized when obtaining management representations. Deficiencies noted and their impact should be considered when the auditor evaluates the suitability of management representations.

Due Care

19. The fact that even a capable management may perform poorly if the tasks are not performed with due care has been included as a requirement into corporate governance codes in some countries. For example, the German Corporate Governance Code states, "The Management Board and Supervisory Board comply with the rules of proper corporate management. If they violate the due care and diligence of a prudent and conscientious Managing Director or Supervisory Board member, they are liable to the company for damages."³

² The Challenge of Assessing Management Competence: A Case Study. Paul Hager and Tony Holland, University of Technology, Sydney

³ Government Commission of the German Corporate Governance Code, par 3.8

20. Due care may not be easy to measure. Legal texts often cite the following description: “It is well settled that in measuring due care you must balance the risk against the measures necessary to eliminate the risk. To that proposition there ought to be added this: you must balance the risk against the end to be achieved.”⁴ The auditor, due to his or her professional background, should be in position to evaluate whether or not the management performs its tasks with due care. The auditor ordinarily obtains the knowledge by communication with management members and from past experience.
21. Throughout the engagement, an auditor maintains the attitude of professional skepticism. To obtain reliable management representations providing suitable evidence of management’s acceptance of responsibility and accountability for the financial statements, all three factors should be considered.
22. The Task Force believes the reliability of management representations in the context of ISA 580 should be based on conclusions the auditor has reached during risk assessment procedures, in particular those relating to the control environment.

Action Requested: Does the IAASB agree that the reliability of management representations as defined in this paper should be based on management competence, integrity and due care?

A3. GUIDANCE WHEN EVIDENCE UNDERMINING RELIABILITY OF REPRESENTATIONS EXISTS

23. During an audit, the auditor may detect circumstances or conditions which raise doubts about management competence, integrity or due care. In such case, the auditor should consider the impact of the circumstances or conditions on the reliability of management representations.
24. When such doubts are raised, the auditor should consider not only the level of effort to address risk, but also whether the doubts are so pervasive as to undermine the reliability of management representations. The auditor needs to consider whether the circumstances constitute a scope limitation and what impact this conclusion has on the auditor’s report.
25. In determining whether the doubts about management competence, integrity and due care have undermined the reliability of management representations, the auditor should consider:
 - His or her past experience with the management;
 - The incidence of changes in the management team;
 - External influences on the management behavior;
 - Nature of the entity’s business;
 - The diversity and complexity of the entity’s operations;
 - Past regulatory or legal actions against the entity; and
 - The auditor’s assessment of the entity’s control environment.

⁴ Denning LJ: Watt v Hertfordshire County Council

The Task Force believes that guidance as to the actions the auditor should take when doubts have been raised about management competence, integrity and due care, should be provided in ISA 580.

Action Requested: Does the IAASB agree that additional guidance should be provided when doubts have been raised about management competence, integrity and due care?

A4. MANAGEMENT REFUSAL TO PROVIDE REPRESENTATIONS

26. ISA 580 states that when management refuses to provide necessary representations, the auditor should qualify or disclaim his or her opinion. The refusal to provide written representations implies management’s unwillingness to accept responsibility and accountability for the financial statements. The Task Force believes that qualification is not appropriate and therefore recommends that the appropriate action for an auditor in these circumstances to take is to disclaim an opinion or to withdraw from the engagement.

Action Requested: Does the IAASB agree with the Task Force recommendation to strengthen ISA 580 guidance when management refuses to provide required representations?

A5. WHO SHOULD PROVIDE REPRESENTATIONS?

27. ISA 580, as well as certain other national standards, offers guidance for representations provided by management but not by others within the entity. The issue is that this scope may be too narrow, as the consequences of some representations provided by management prior to some corporate failures demonstrated.⁵ The argument in favor of the scope expansion to include management as well as others in obtaining representations is based on the following rationale: To obtain audit evidence, representations should be provided by those individuals who not only bear responsibility for the matter, but also who can be expected to have sufficient knowledge about the matter. To obtain such representations would suggest to expand the scope to include representations from those charged with governance and from those within the entity in possession of specialized knowledge. This change may not have many counterparts among national standards, although the proposed ISA 580 (UK and Ireland) does recognize the role of those charged with governance⁶ and the US standard (AU 333.11, “Management Representations”), as well as the recent CICA exposure draft (“Management Representations”) mention representations “from other individuals.”
28. The Task Force proposal to delineate management representations and internal confirmations would have an important impact on this issue. Management representations would be defined as “general representations” demonstrating the acceptance of responsibility and accountability for the financial statements by management. The auditor needs merely to determine who is

⁵ For example, in the Barings case, the FD who had not supervised Mr Leeson’s operational activities was found not guilty of signing the representations deceitfully and the auditor’s defense based on this claim was unsuccessful. This verdict raises the question who should sign what representations.

⁶ ISA 580 (UK and Ireland) 3.1, 3.2

responsible and accountable for the preparation and presentation of the financial statements and the form of management’s demonstration of its acceptance of responsibility and accountability.

29. A practical solution may exist in the proposed revised ISA 260, “Communication of Audit Matters with Those Charged with Governance.” The proposed revised Standard includes the concept of “relevant persons:” “The auditor should determine the relevant persons who are charged with governance and with whom audit matters of governance interest are communicated.”⁷ This concept may also be suitable for ISA 580 as it would provide the auditor with the flexibility needed to establish who should provide what representations. This is important, as the auditor needs to convey the message to relevant persons that they are responsible and accountable for the financial statements. Therefore, the auditor determines who these persons are.

The Task Force recommends that the concept of “relevant persons” adopted in the proposed revised ISA 260 be considered for ISA 580.

Action Requested: Does the IAASB agree that the concept of “relevant persons” be adopted in ISA 580 for the purposes of management representations?

A6. EXPANDING MANDATORY REPRESENTATIONS

30. In addition to management’s acknowledgement of its responsibility for the preparation and presentation of financial statements,⁸ a large part of practice includes standard representations on some basic elements. The example representation letter in the appendix includes some of these representations, such as full access to all books, records and minutes, before addressing representations (internal confirmations) required by other ISAs. In seeking to introduce a greater rigor and to enhance a consistent application of ISA 580, the Task Force considered the question of whether there should be an expansion of mandatory written representations.
31. The benefits of expanding the list of mandatory representations include:
- Enhancing the consistency and uniformity of application of the Standard across jurisdictions;
 - Introducing greater rigor and improved guidance for auditors;
 - Aligning with other ISAs which include required representations in the Standard.
32. The result is more prescriptive nature of the Standard which will lead to more detailed requirements and may restrict professional judgment.
33. The following table provides a possible list of mandatory representations premised on their relationship with principles embodied in these representations (to avoid duplication, these principles are discussed in B1 only, although they are relevant for both representations and internal confirmations):

⁷ ISA 260.5

⁸ ISA 580.3

Representation	Responsibility and accountability	Completeness	Responsibility for compliance with FRF
Management responsibility and accountability for financial statements	X	X	X
All records made available		X	
No unrecorded transactions		X	
Statements free of misstatements	X		X
Responsibility for effectiveness of internal control	X		
Plans or intentions that may alter value of assets or liabilities			X
Claims and possible claims disclosed		X	X
Contingent liabilities and similar items, including guarantees		X	X
Title to assets, liens, encumbrances collaterals disclosed			X
Compliance with aspects of contractual agreements that may affect the financial statements			X
Subsequent events		X	X
No significant matters that would require a restatement of the comparative financial statements	X	X	X

The Task Force believes that the expansion of mandatory representations would enhance the ISA's rigor and is consistent with other ISAs' approach to representations.

Action Requested: Does the IAASB believe that mandatory representations should be expanded? If so, does the IAASB agree that the list above contains the items that should be included in mandatory representations?

A7. REPRESENTATION LETTER

34. There is intrinsic value in the act of consideration by management of certain matters. Signing a written letter of representation brings to the attention of (and reinforces) management's responsibilities for matters related to the financial statements and often elicits thoughtful

consideration of specific matters. Some regulators recognize this proposition, and now require a written representation by senior management on specific matters. In addition, in some instances, management may not believe it is in a position to sign a letter of representation on some or all of the matters addressed. Such circumstance may further highlight areas where additional effort by management and the auditor may be warranted.

35. ISA 580.11 states, “A written representation is better audit evidence than an oral representation and can take the form of: (a) a representation letter from management; (b) a letter from the auditor outlining the auditor's understanding of management's representations, duly acknowledged and confirmed by management; or (c) relevant minutes of meetings of the board of directors or similar body or a signed copy of the financial statements.”
36. On condition that management representations are defined as statements of responsibility and accountability for the financial statements, the importance of a written management letter takes on a new dimension. Management acceptance of responsibility and accountability for the financial statements becomes the focus of the letter. The act of signing the mandatory representations lends credence to management’s assertion of the fairly presented financial statements. Therefore, there does not seem to be compelling evidence to permit alternatives to the requirement of a written management representation letter.
37. Another issue is that the representation letter, if required, may represent a change in some jurisdictions where the management letter is either unknown or optional. Therefore, the management letter requirement might cause difficulties for the auditor if management does not expect it. To avoid misunderstanding, it may be useful for the auditor to include in the terms of engagement the list of mandatory representations expected from management.

The Task Force recommends that the revised ISA should require the auditor to obtain a written representation letter. The letter should be signed by those within the audited entity directly responsible for the preparation and presentation of the financial statements (relevant persons). In addition, the auditor should advise management in the terms of engagement that representations and internal confirmations will be used as audit evidence and that they are required in writing.

Action Requested: Does the IAASB agree that a written representation letter should be mandatory? Does the IAASB agree that the terms of engagement should include an article stating written representations and internal confirmations will be required?

A8. WHO SHOULD SIGN THE MANAGEMENT REPRESENTATION LETTER?

38. Extant ISA 580 states that the management representation letter is “ordinarily” signed by those members of management who have primary responsibility for the entity and its financial aspects based on the best of their knowledge and belief.⁹ The proposed change to the definition of management representations in the context of ISA 580 and its delineation from internal confirmations presents an issue whether this guidance is appropriate.

⁹ ISA 580.14

39. This paper proposes that the auditor identify “relevant persons” bearing responsibility and accountability for the preparation and fair presentation of the financial statements. Since the “relevant persons” may differ from country to country, it is important that this concept be upheld also in this section. In other words, the management representation letter should be signed by those persons, who are responsible and accountable for the preparation and fair presentation of the financial statements. In addition, if the auditor determines that the terms of engagement should include reference to management representations, he or she should consider whether the terms of engagement should be signed by relevant persons who are expected to provide the representations.

The Task Force believes that the management representation letter should be signed by relevant persons who are responsible and accountable for the financial statements preparation and presentation.

Action requested: Does the IAASB agree that the management representation letter should be signed by relevant persons who are responsible and accountable for the preparation and presentation of the financial statements?

A9. WHAT SHOULD BE THE DATE OF THE MANAGEMENT REPRESENTATION LETTER?

40. ISA 580 states that the representations letter would “ordinarily” be dated as of the date of the auditor’s report. For some representations relating to “specific transactions,” ISA 580 permits other dates. The issue is that management representations, as defined in this paper, do not include specific transactions. Since management representations are circumscribed to management acceptance of responsibility and accountability for the financial statements, the acceptance of different dates is not appropriate. Management representations letter, in the context of ISA 580, should be dated as of the date of the auditor’s report.
41. The revised ISA 700 discusses national differences relating to the dating and approval of the financial statements. While this discussion may have an effect on the date of the auditor’s report in various countries, the principle of dating the representation letter as of the date of the report remains unaffected.

Action requested: Does the IAASB agree that the management representation letter should be dated as of the date of the auditor’s report?

B Internal confirmations

B1. INTERNAL CONFIRMATIONS AS AUDIT EVIDENCE

42. As explained, the proposed purpose of management representations is to demonstrate the acceptance by management of its responsibility and accountability for the financial statements. The purpose of internal confirmations is to provide audit evidence relating to assertions at the level of account balances and transactions where other audit evidence cannot reasonably be expected to exist.

43. In the absence of other audit evidence, however, the issue arises about the value and nature of internal confirmations as evidence. Since representations related to assertions (internal confirmations) have been recently in the centre of some well-publicized scandals, one might conclude that their value is low. The purpose of the following discussion is to establish whether this conclusion is, indeed, appropriate.
44. While other audit evidence may be readily available for some assertions, it may be more difficult to obtain for other assertions. For some assertions, the only audit evidence available may be management’s response to the auditor’s inquiry. In this context, a written internal confirmation is an acknowledgement by management that they accept responsibility and accountability for the assertion. This acknowledgement represents an important principle comprising two “subprinciples:”
- Management’s confirmation of completeness of information provided in the internal confirmation; and
 - Management’s responsibility for compliance with the relevant financial reporting framework’s requirements relating to the assertion.

Management’s acceptance of responsibility and accountability for the assertion

45. It is difficult to establish what evidence internal confirmations provide when no other evidence can reasonably be expected. Evidence generated internally is weaker than external evidence (although this assumption has been challenged).¹⁰ In addition, management members providing confirmations may find themselves in the position of conflict of interest. It may not be reasonable to expect management to provide information leading to a downward adjustment of the net income figure when the management has a vested interest in higher net income. The question that needs to be addressed is whether in such circumstances a confirmation can provide a form of audit evidence.
46. The broadest theoretical definition considers evidence “all influences on the mind of the auditor.”¹¹ Other definitions describe evidence as any information supporting or undermining an assertion.¹² A definition circumscribed to information is also used in ISA 500.¹³ The first definition implies that evidence is broader than information. However, the prevailing view is that for assurance purposes, evidence is information.

¹⁰ FEE Issues Paper – Principles of Assurance, pg 248, FEE 2003 – “Rather than being more reliable than internally generated evidence, third party confirmations may represent either independent corroborating evidence or independent evidence that undermines the evidence internally generated. In this sense, stating that evidence from external sources is more reliable than that internally generated does not appear to be an appropriate generalization.”

¹¹ The Philosophy of Auditing, Mautz and Sharaf

¹² Principles of Assurance Engagement, p. 232

¹³ ISA 500.3: “Audit evidence” is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based, and includes the information contained in the accounting records underlying the financial statements and other information.

47. Internal confirmations would meet the first definition – their purpose is to influence the mind of the auditor. But do they meet the second (and relevant for assurance purposes) definition, i.e. can internal confirmations constitute sufficient appropriate audit evidence on their own?
48. Recent events have caused some to believe that representations related to assertions (internal confirmations) provide evidence of low value. Some business scandals involved reliance by the auditor on misleading representations related to assertions (internal confirmations). Unless a business failure occurs, it is difficult to determine whether an internal confirmation is true or not. The question is, what is it that separates the misleading and true representations? A possible answer is – the three ethical factors discussed in A2 (competence, integrity, due care). In other words, some managements provide representations that are suitable evidence and take responsibility and accountability for them, while others do not. Numerous lawsuits against managements involved in the scandals lend some credence to this conclusion.

Management’s confirmation of completeness of information provided in the representation

49. Completeness is described as, “all transactions and events that should have been recorded have been recorded.”¹⁴ Only when all transactions, other events and conditions are recorded, the relevant balance or class of transactions achieved representational faithfulness. This is important, as representational faithfulness is an essential ingredient of reliable financial statements. Therefore, there is a direct link between completeness and reliable financial statements. The issue with completeness is that, unlike other assertions, it deals with transactions, events and conditions that may not be necessarily in the audit population. This characteristics has a bearing on the extent, nature and timing of auditing procedures.
50. Representations related to assertions (internal confirmations) of completeness often constitute a significant element of audit evidence pertaining to an account or class of transactions. This is due to the nature of the completeness assertion – it may be impossible for an auditor to obtain sufficient appropriate audit evidence of completeness when no underlying records exist (for example, unrecorded liabilities or potential and likely claims). A written internal confirmation may be the only evidence available. The evidential value of such internal confirmation, however, will not be identical on every audit. As explained in the preceding discussion, the quality will vary based on management’s integrity, competence and due care.

Management’s responsibility for compliance with financial reporting framework

51. Compliance with IAS/IFRS “requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Framework.”¹⁵ The IAS definition of fair presentation requires that the financial statements assertions go beyond record of transactions. “Other events and conditions” should be considered when the financial statements are prepared. Knowledge of some of these events and conditions may be confined to management. Although the responsibility for compliance with financial reporting framework rests with management, there is a need for the auditor to obtain evidence that management is cognizant of and accepts

¹⁴ ISA 500.17

¹⁵ IAS 1.13

the responsibility. A written internal confirmation is a practical way of obtaining the evidence. Once again, the value of the evidence obtained by management representations is linked to the three ethical factors discussed in A2 (competence, integrity, due care).

The Task Force proposes that the ISA should link the use of internal confirmations as audit evidence to the evidence of management competence, integrity and due care, as determined during risk assessment.

Action Requested: Does the IAASB agree that ISA 580 should link the use of internal confirmations as audit evidence to the evidence of management competence, integrity and due care, as determined during risk assessment?

B2. CAN UNCORROBORATED INTERNAL CONFIRMATIONS PROVIDE SUFFICIENT APPROPRIATE EVIDENCE ON THEIR OWN?

52. ISA 580.4 states that the auditor should obtain written representations (internal confirmations) in circumstances where other sufficient appropriate evidence cannot reasonably be expected to exist. The guidance paragraphs explain that these representations (internal confirmations) cannot be a substitute for evidence that might reasonably be expected to be available.¹⁶ However, in certain circumstances representations (internal confirmations) may be the only evidence that can be expected to be available.¹⁷ This prima facie appears to permit the use of internal confirmations without corroboration in certain circumstances. The interpretation, however, may be adding to the actual or perceived undue or over-reliance by auditors on internal confirmations. The issue is, then, whether internal confirmations not corroborated by other evidence can be used as audit evidence and if so, whether there are additional criteria to be met.

53. The Task Force has considered three options addressing this issue:

- To require that all internal confirmations used as audit evidence be corroborated by other audit evidence;
- To permit the use of internal confirmations as audit evidence where no other audit evidence can reasonably be expected only in “rare circumstances;” and,
- To restrict the use of internal confirmations without corroboration to specifically identified circumstances.

Should corroborative evidence always be required?

54. The PCAOB has recently indicated that it might consider management representations (internal confirmations) “an extremely weak form of evidence” which should always be corroborated, and a new standard superseding AU 333 may be drafted.¹⁸ To corroborate all internal confirmations by other audit procedures, however, may not be a realistic requirement. For example, if a confirmation relates to the intent of management to hold investments for

¹⁶ ISA 580.7

¹⁷ ISA 580.8

¹⁸ PCAOB Standing Advisory Group Meeting , June 21-22, 2004

appreciation, corroborative evidence is not likely to exist. In such situation, an internal confirmation provides weak but often important evidence which would not be available if there were a corroboration requirement.

55. A related issue arises when corroborative evidence exists but its quality is low. Such corroborative evidence may not add to the level of assurance on the audited transaction or assertion. In such case, the auditor has to address the same issues as if no corroborative evidence existed.

Should uncorroborated internal confirmations be permitted in “rare circumstances?”

56. It is almost inevitable that some internal confirmations cannot be corroborated. However, there is merit in an explicit circumscription of such situations. One form is a general circumscription. The general form might permit uncorroborated representations in “rare circumstances,” or even “extremely rare circumstances.” “Rare circumstances” has been included in the recent CICA Exposure Draft, “Management Representations” (September 2004). “Extremely rare circumstances” is used in IAS 1.17 in connection with a departure from Standards and imposes additional disclosures on the entity that concluded its circumstances justified the departure. “Extremely rare circumstances” is also addressed in ISA 700.15, “The Independent Auditor’s Report on a Complete Set of General Purpose Financial Statements.” The advantage of this approach is that it restricts the use of uncorroborated confirmations but does not fully eliminate the option. Guidance needs to be provided to determine when “rare circumstances” exist. The issue that may render this option difficult is that some “rare” or “extremely rare” circumstances may, in fact, be common (for example, management intentions). If the IAASB accepts the recommendation linking the use of confirmations and management integrity, competence, and due care, uncorroborated internal confirmations should not be permitted if the auditor identified weaknesses in the entity’s control environment, particularly in management’s commitment to integrity and ethical values.

Should uncorroborated internal confirmations be permitted in specifically identified circumstances?

57. The Task Force is of the view that for uncorroborated internal confirmations to be suitable audit evidence, the auditor should be able to conclude that the information is consistent with other information the auditor received during an audit. The auditor should be alert to inconsistencies in management responses to inquiries and should draw upon his or her past experience with the entity.
58. If these general conditions are met, this form of circumscription would permit the use of uncorroborated internal confirmations as audit evidence in specific circumstances, such as:
- Management’s intent;
 - Management’s judgment; and
 - Facts or knowledge confined to management.

There are two issues with this approach. First, the prescriptive nature implicitly acknowledges that the auditor may obtain uncorroborated internal confirmations in the identified circumstances. This may not go far enough in reducing undue reliance. Second, drafting a complete list of all specific circumstances where representations do not have to be corroborated may be fraught with difficulties. However, this method provides a specific guidance to auditors on the use of uncorroborated confirmations.

The Task Force concluded that the ISA should explicitly restrict the use of uncorroborated internal confirmations as audit evidence to circumstances involving management’s intent, management’s judgment; and facts or knowledge confined to management. If the IAASB accepts the recommendation linking the use of internal confirmations to management integrity as explained in paragraphs 48, 50 and 51, the use of uncorroborated internal confirmations as audit evidence would also be linked to management competence, integrity and due care.

Action Requested: Does the IAASB agree that the use of uncorroborated internal confirmations as audit evidence should be permitted only in specifically identified circumstances and linked to management competence, integrity and due care?

B3. WHAT ACTIONS SHOULD THE AUDITOR TAKE WHEN NO OTHER EVIDENCE IS AVAILABLE AND INTERNAL CONFIRMATIONS FORM SIGNIFICANT BASIS OF THE OPINION?

59. Assuming that uncorroborated internal confirmations are permitted in specifically identified circumstances (see 57-58 above), an auditor may conclude that no other evidence is available for an assertion that forms a significant basis of the opinion. At least one national standard considers this situation in an expansion to its equivalent management representations standard. The expansion states, “in some exceptional cases, the matter may be of such significance the auditors refer to the representations in their report as being relevant to a proper understanding of the basis of their opinion.”¹⁹

60. The Task Force is of the view that when no other evidence is available for an assertion not specifically identified in B.2 above and internal confirmations should form a significant basis of the opinion, this constitutes a scope limitation and the auditor should follow the standards and guidance provided in ISA 701.

Action Requested: Does the IAASB agree that ISA 701 should be followed when internal confirmations form a significant basis of the opinion and other evidence is not available?

B4. GUIDANCE WHEN EVIDENCE UNDERMINING RELIABILITY OF INTERNAL CONFIRMATIONS EXISTS

61. Extant ISA 580.9 states: “**If a representation by management is contradicted by other audit evidence, the auditor should investigate the circumstances and, when necessary, reconsider the reliability of other representations made by management.**” Extant ISA 580 does not provide any further guidance in support of this principle.

¹⁹ ISA 580 (UK and Ireland) 8.1

62. Additional guidance that may be relevant is included in the proposed ISA 580.9.1 (UK and Ireland):

“The investigation of apparently contradictory audit evidence regarding a representation received usually begins with further enquiries of management, to ascertain whether the representation has been misunderstood or whether the audit evidence has been misinterpreted, followed by corroboration of management responses. If management is unable to provide an explanation, or if the explanation is not considered adequate, further audit procedures may be required to resolve the matter.” The inclusion of this or similar guidance would enhance the uniformity of application of the ISA.

The Task Force believes that additional guidance as to the actions the auditor should take when inconsistencies are not explained should be added to the ISA. If, following further audit procedures, the auditor is not able to form a conclusion on the matter, this constitutes a scope limitation and the auditor should consider the impact of the matter on the auditor’s report.

Action Requested: Does the IAASB agree that additional guidance should be provided on evidence undermining the reliability of internal confirmations?

B5. MANAGEMENT REFUSAL TO PROVIDE INTERNAL CONFIRMATIONS

63. ISA 580 states that when management refuses to provide necessary representations (internal confirmations), the auditor should qualify or disclaim his or her opinion. Almost no further guidance is provided. If the principle that internal confirmation demonstrates the acceptance by management of responsibility and accountability for the assertion is valid, the refusal to provide written confirmations implies management’s unwillingness to accept responsibility and accountability for specific assertions. In such circumstances, the auditor’s confidence in management trustworthiness may be undermined to such an extent that a qualified opinion may not be a defensible alternative. The Task Force is of the view that, ordinarily, the disclaimer or withdrawal from the engagement should be the options when management refuses to provide internal confirmations. However, there may be circumstances when the auditor determines that the nature of confirmations not obtained does not undermine his or her conclusions, or identifies circumstances that justify the management’s refusal to provide internal confirmations. Consequently, the auditor may conclude that a qualified opinion is appropriate. Some national standard setters have also adopted this approach (e.g., US AU 333, “Management Representations”).

The Task Force recommends that a disclaimed opinion or withdrawal from engagement be the optional courses of action when management refuses to provide written internal confirmations. A qualified opinion should be permitted only if the nature of confirmations not obtained does not undermine the auditor’s conclusions, or circumstances exist that justify management’s refusal to provide internal confirmations.

Action Requested: Does the IAASB agree that with the Task Force recommendation to strengthen ISA 580 guidance when management refuses to provide requested internal confirmations?

B6. WHO SHOULD PROVIDE INTERNAL CONFIRMATIONS?

64. Internal confirmations should be provided by those individuals within the entity who are not only responsible for but also knowledgeable of the assertion. In addition to management, there may be others who are identified as potential providers of internal confirmations. This gives rise to the issue as to whether internal confirmations should be obtained not only from management but also from “others.” Since the individuals responsible for the relevant assertions will vary, a general approach may be appropriate to capture all those individuals responsible for all relevant assertions, including those with specialized knowledge.
65. The Task Force recommends that, similarly to management representations, the concept of relevant persons be adopted for internal confirmations.

Action Requested: Does the IAASB agree that the concept of ‘relevant persons’ be adopted in ISA 580 for the purposes of internal confirmations?

B7. WHAT SHOULD BE THE FORM AND DATE OF INTERNAL CONFIRMATIONS?

66. As explained above, internal confirmations are responses to oral or written inquiries. Some of the confirmations may be required by ISAs, other may be the result of an auditor’s need to obtain additional audit evidence during the audit. An internal confirmation should be signed by the person responsible for and knowledgeable of the assertion. This should prevent the situation cited above (Nick Leeson), where a financial executive formally responsible for an assertion signed a representation of which, in fact, he was not knowledgeable and, according to the court verdict, nor responsible for.
67. The date of an internal confirmation is an issue. If the required date would be the date of the report, this may impose an unreasonable burden on the auditor who would have to collect possibly numerous confirmations prior to the report issuance. The Task Force believes that the date depends on the nature of the confirmed assertion. However, the latest possible date should be the date of the auditor’s report.

Action requested: Does the IAASB agree that internal confirmations should be treated as responses to oral or written inquiries? Further, does the IAASB agree that internal confirmations should be dated based on the nature of the confirmed assertion, up to the date of the auditor’s report?

Other Matters

C.1 INTERRELATIONSHIP OF ISA 580 WITH OTHER ISAS

68. ISA 580 is considered an “overarching ISA” in that it specifies the basic principles governing management representations and internal confirmations, with specific representations and internal confirmation requirements identified in other topic-specific ISAs. The IAASB has generally agreed to use an appendix for certain “overarching ISAs” to list relevant ISAs containing specific requirements to improve the link between these ISAs. This approach is being applied to the revision of ISA 230 and ISA 260.

69. If the IAASB adopts the proposed delineation of management representations and internal confirmations, the ISAs including representation requirements will be reviewed and amended to separate representations and internal confirmations.

The Task Force recommends that the revision of ISA 580 should adopt a similar approach and provide an appendix listing relevant ISAs that contain representation or internal confirmation requirements.

Action Requested: Does the IAASB agree that the list of ISAs requiring written representations should be attached to ISA 580 as appendix?

C2. EXAMPLE LETTER

70. The example representation letter in the ISA is obsolete and needs to be updated as part of the revision of ISA 580.
71. Due to continual development of the ISAs and changing representation requirements, the question arises whether the letter should cover all the existing representation requirements, or whether it should continue to be an example only, including some, but not all, required representations.
72. While there is merit in providing the auditor with a template representation letter, there will always be differences across jurisdictions due to varying national auditing standards or legislation which may impose additional required representations.

The Task Force discussed the issue and agreed that the example letter should be updated and retained in Appendix to the Standard.

Action Requested: Does the IAASB agree that the example letter should be updated and retained in Appendix to the Standard?

C3. WHAT SHOULD AN AUDITOR DO WHEN REPORTING ON COMPARATIVES?

73. ISA 580 does not address the issue of comparatives. The issue is that in many countries the auditor reports on comparatives and currently no standards and guidance are available for management representations. Since management representations in the context of ISA 580 demonstrate the acceptance by management of responsibility and accountability for the financial statements as a whole, there is a need to provide guidance and standards for comparatives.
74. ISA 710, “Comparatives,” makes the distinction between “corresponding figures” and “comparative financial statements.” An auditor’s responsibilities differ in relation to each. For corresponding figures, the auditor’s report refers only to the current period financial statements. For comparative financial statements, however, the auditor’s report refers to each period. While it is clear that management representation letter should cover all periods for comparative financial statements, the issue is, whether this requirement is valid also for corresponding figures.

75. The auditor's responsibilities for corresponding figures do not include an audit of the figures. However, management responsibility and accountability relates to both audited and corresponding figures. Therefore, it seems appropriate that management should demonstrate acceptance of its responsibility and accountability for both audited and corresponding figures.

Based on the management responsibility and accountability for the financial statements, the Task Force believes that the management representation letter should cover all periods for comparative financial statements and all periods for which audited and corresponding figures are presented.

Action requested: Does the IAASB agree that the management representation letter should cover all periods for comparative financial statements and all periods for which audited and corresponding figures are presented?