

IAASB CAG PAPER



International Federation of Accountants

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Agenda Item

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Committee: IAASB Consultative Advisory Group

Meeting Location: Paris

Meeting Date: May 11-12, 2006

Written Representations

Objectives of Agenda Item

1. To report on the significant comments received from the IAASB in March 2006 on proposed ISA 580 (Revised and Redrafted), “Written Representations,” which was submitted for a “first read” (*see Agenda Item L.1*), and the task force’s responses thereto; and to obtain the views of the Representatives.

Background

2. The primary concern that gave rise to the project was that auditors may over rely on written representations from management. The task force proposed to:
 - Differentiate between general written representations relating to the financial statements as a whole, and specific written representations relating to specific financial statement elements.
 - Mandate general written representations relating to the financial statements as a whole. Specific written representations will be required when the auditor judged them necessary to obtain sufficient appropriate audit evidence related to a specific matter.
 - Clearly state that written representations alone are not sufficient audit evidence in general or with respect to a specific matter.

Overall Comments

3. A majority of the IAASB expressed general support for the requirements and guidance in the proposed ISA – two members, however, expressed reservations in relation to some requirements proposed by the task force. Their concerns and the counter points of IAASB members in support are summarized in the significant issues below.

Significant Issues

ISSUE 1: WHY THE AUDITOR NEEDS TO OBTAIN GENERAL WRITTEN REPRESENTATIONS

4. The proposed ISA describes representations as audit evidence. Certain general representations are necessary in order for the auditor to have obtained sufficient appropriate audit evidence. These representations relate to management’s acceptance of and accountability for performance of responsibilities for the financial statements and their preparation and the completeness of information made available to the auditor. Because of

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the fundamental nature of this evidence, failure to obtain such evidence results in either withdrawal from the engagement or a disclaimer of opinion.

5. The IAASB broadly supported this proposal. Two IAASB members, however, raised objections. Their arguments included the following:
 - (a) Responsibilities of relevant persons in relation to the financial statements are often set out in law, and management or those charged with governance publicly acknowledge their responsibility for the financial statements. Therefore, it is not necessary for the auditor to obtain general written representations.
 - (b) Even if such representations are necessary, failure to obtain them should not necessarily result in withdrawal or disclaimer. A qualified opinion for a scope limitation should also be a possible result.
 - (c) It was suggested at recent European Commission debates that enacting auditing standards into law imposes unintended responsibilities on management, and adopting the proposed ISA may do so.
6. The task force believes that the general representations relate not only to the acceptance of responsibilities related to the preparation and presentation of the financial statements but also to the acknowledgment of relevant persons' understanding and fulfillment of those responsibilities. Accordingly, the expression of those responsibilities in law and the submission of financial statements signed by the relevant parties do not expressly make such representations. It seems that matters of such fundamental importance should not be left to being implied by the issuance of signed financial statements. In addition, the general representations cover the completeness of information made available to the auditor. The task force sees no way to obtain sufficient audit evidence about the completeness of information without asking relevant parties whether all relevant information has been made available. Failure to provide such a representation should be a matter of highest significance to the auditor.
7. The task force believes that requesting representations about important matters is an effective auditing procedure in that refusal to provide the requested representations alerts the auditor to possibly significant issues. Further, the discipline of written representations rather than informal inquiries will likely draw greater attention to the matters by the relevant parties. Accordingly, the task force believes it is strongly in the public interest to require such representations.
8. The task force also believes that the responsibilities of relevant persons for the financial statements vary across jurisdictions. Certainly the degree of detail in laws and regulations varies considerably from jurisdiction to jurisdiction. Laws or regulations frequently contain only general references to responsibility for the financial statements which are open to varying interpretations. Therefore, reliance on the expression of these responsibilities under the law may be insufficient to satisfy the need to have sufficient appropriate audit evidence about relevant parties' acceptance and fulfillment of responsibilities and the completeness of information made available.

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9. To obtain a better understanding of requirements in various laws and regulations and of the issues raised by the IAASB members, staff selected a sample of jurisdictions and summarized their legal and regulatory regimes. The examination demonstrated that, in terms of responsibility for financial statements, a broad variety of legal requirements exists. For example:
 - (a) In the UK, the Companies Act requires directors to prepare the financial statements and holds the directors personally liable for failure to achieve true and fair presentation.
 - (b) In contrast, in the US in the state of Delaware, the General Corporation Law protects directors and officers who, in good faith, rely on the financial statements prepared by employees or officers of the company.
 - (c) In the Czech Republic, a statutory representative is required to sign the financial statements. However, there is no formal requirement that the statutory representative be either a director or officer of the company.
 - (d) At the European Union level, the Directorate General Internal Market has proposed amendments to the Fourth and Seventh Directive incorporating the directors' collective responsibility into the Directives. However, the ensuing public consultation demonstrated that: "There was no support for a definition of the term 'responsibility' at European level. Most substantiated contributions that it would be too difficult to reach a Community wide definition." Differing perspectives on responsibility were further exacerbated by a majority view, "that at EU-level it should only be confirmed that collective responsibility of board members applies towards the company whilst leaving it to the individual Member States to extend responsibility to other parties."
10. The task force's view is that varying legal requirements, including the inconsistent interpretation of the term "responsibility" in Europe, may give rise to inconsistent outcomes that in some cases may achieve the objective of the proposed ISA, while failing to achieve it in other cases. Therefore, it would not be appropriate to assume that a general requirement to obtain appropriate representations will accomplish a consistent application of the proposed ISA. The task force remains of the view that it is necessary to mandate obtaining of important general written representations.
11. Irrespective of the conclusion in the previous paragraph, the task force discussed specific examples of jurisdictions where relevant persons' responsibility for preparing and presenting the financial statements is set out in law. There are jurisdictions, such as UK, where such responsibility is set out in law and general written representations may be viewed as a duplication of effort. However, there also exist jurisdictions, such as Germany, where general written representations are required irrespective of the relevant persons' responsibility being set out in law. Therefore, the task force's view is that obtaining general written representation is not an excessive requirement even in these circumstances.

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12. Further, there is a need to clearly communicate that the auditor cannot assume responsibility for the audited financial statements. ISA 200, “Objective and General Principles Governing an Audit of Financial Statements” states (200.33):

While the auditor is responsible for forming and expressing an opinion on the financial statements, the responsibility for the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework is that of the management of the entity, with oversight from those charged with governance. The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

The task force is of the view that the process of obtaining general written representations further amplifies the principle that relevant persons are responsible for the financial statements and the auditor is responsible for an audit of the financial statements.

13. In this regard, one IAASB member noted that the list of required general written representations is important in the SME environment, where owners/managers may not always be aware of the responsibility imposed on them by legislation in relation to the financial statements preparation and presentation.

Matters for Consideration by the IAASB CAG:

1. The Representatives are asked for their views on the Task Force’s recommendations with regard to Issue 1.

ISSUE 2: WHY LACK OF GENERAL REPRESENTATIONS SHOULD RESULT IN WITHDRAWAL OR DISCLAIMER OF OPINION

14. The task force is of the view that where relevant persons refuse to provide general written representations, this always constitutes a scope limitation so pervasive and material that the auditor is unable to complete the audit and, accordingly, a disclaimer of opinion or withdrawal from the engagement is necessary. Where a relevant person refuses to provide a specific written representation, the consequence depends on the auditor’s judgment. An IAASB member expressed concern that the task force’s view in relation to relevant persons’ refusal to provide general written representations may not be an appropriate response by the auditor.
15. The task force discussed the implications of the relevant persons’ refusal to provide general written representations. The argument that refusal by relevant persons to provide general written representations may not constitute the grounds for a disclaimer or withdrawal is linked to the discussion of whether general written representations are necessary where relevant persons’ responsibility for the financial statements is set out in law. The task force remains of the view that general written representations are, for reasons discussed under Issue 1, a necessary prerequisite of audit completion. Without these representations sufficient appropriate audit evidence that relevant persons accepted and fulfilled their responsibility for the financial statements has not been obtained. The fact that law or

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regulation makes relevant persons responsible does not establish that relevant persons have accepted and fulfilled the responsibility. Therefore, the task force's conclusion that, where relevant persons refuse to provide general written representations, a disclaimer or withdrawal is necessary remains valid.

Matters for Consideration by the IAASB CAG:

2. The Representatives are asked for their views on the Task Force's recommendations with regard to Issue 2.

ISSUE 3: WHY SPECIFIC WRITTEN REPRESENTATIONS DO NOT CONSTITUTE SUFFICIENT APPROPRIATE AUDIT EVIDENCE ON THEIR OWN.

16. The task force recognizes that there are situations where sufficient audit evidence cannot be obtained without making inquiries of management. An example of such a situation is management's intent about a matter that is necessary for the purpose of making an accounting measurement. Other such situations may relate to completeness. In these situations the task force believes that the auditor may determine that a written representation is necessary in order to obtain sufficient appropriate audit evidence about a specific matter. When the auditor so determines, failure to obtain the written representation should result in at least a scope limitation. Recognition that written representations are not sufficient audit evidence is essential to address concerns about over reliance on such representations.
17. Some members of IAASB expressed views that there may not be any other evidence but management's representations about matters like intent. Accordingly, saying that representations are not sufficient in and of themselves is not appropriate. Likewise, some members raised concerns that some matters of this type may be documented in the records of the entity such as minutes of board meetings.
18. The task force does not believe that the principle that a specific written representation on its own is insufficient audit evidence is excessive. The task force is of the view that there is always some other information on which the relevant amount is based. This information may take the form of, for example: history of management realizing its intentions, the auditor's past experience with management representations, comparison with others in the industry, etc. Where management recorded an amount in the financial statements based on its expectations or intent and information relating to this amount, based, for example, on management history and responses to inquiries, does not provide sufficient appropriate audit evidence, the auditor may conclude that a specific written representation will provide the additional audit evidence needed. The issue therefore is not whether there is other information, but whether a specific written representation, when considered in conjunction with the other evidence or information, constitutes sufficient appropriate audit evidence.
19. The task force is of the view that the definition of "specific written representation" does not include documentary evidence prepared by the entity, such as board meeting minutes, because this evidence is not prepared for purposes of the audit. However, such

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documentary evidence may provide evidence or information, such as that discussed above, relevant for the audit. In these circumstances, the auditor considers whether the evidence, for example, minutes of a board meeting, provides sufficient appropriate audit evidence on its own. Where this is not the case, the auditors may conclude that the minutes, in conjunction with a specific written representation, will provide sufficient appropriate audit evidence. These considerations may be particularly important where the auditor evaluates relevant persons' intent.

Matters for Consideration by the IAASB CAG:

3. The Representatives are asked for their views on the Task Force's recommendations with regard to Issue 3.

Material Presented – FOR REFERENCE PURPOSES ONLY

Agenda Item L.1

Proposed ISA 580 (Revised and Redrafted), "Written Representations" (March 2006 Agenda Item 7-A)