Representations by Management[1]

Introduction

1. The financial statements prepared and presented by the management contain seven important assertions of the management as to the information contained therein namely, existence, rights and obligations, occurrence, completeness, valuation and presentation and disclosure. Whereas the preparation and presentation of these financial statements, as we all know, is the responsibility of the management of the entity, the responsibility of the auditor is to express an opinion on such financial statements. The auditor's work involves performing audit procedures and obtaining sufficient appropriate audit evidence to support these assertions in the financial statements. The auditor forms his opinion on the basis of the results of the procedures performed and the audit evidence gathered during the course of audit. The auditor gathers audit evidence normally by means of audit procedures of inspection, observation, inquiry and confirmation, computation and analytical review. It is also important to note that the timing of these means and procedures for obtaining audit evidence depends to certain extent upon the periods of time during which audit evidence sought is available. Management representations are one such means which assist the auditor in expressing an opinion on the financial statements. This write up is meant to assist the readers in gaining an insight into the various critical aspects of management representations, such as meaning of management representations, need, use of management representation *vis a vis* audit evidence, deciding on matters on which to obtain management representations, and the effect of management representations on the auditor's report, authority to issue management representations, documentation etc.

What are Management Representations[2]

2. In simplest terms, management representations are the various submissions made, information or explanations given by the management, either on a specific request or inquiry by the auditor or on its own, to the auditor during the course of his audit. For example, the policy adopted by the entity for accounting for its fixed assets, the amount of provision required to adequately cover damaged, obsolete and slow moving stocks. Whereas some management representations find their way in the financial statements explicitly as in case of quantity and existence of inventories, some of them appear implicitly in the financial statements such as going concern. The auditor also uses a management representation to obtain acknowledgement from/ inform the management as to its responsibility for the preparation and presentation of financial statements. Such explicit management representation are especially valuable for small practitioners whose clients have a greater need for reiteration for such responsibility of the management. In fact, an engagement letter from the auditor, outlining, among other things, the responsibility of the management for:

- preparation and presentation of the financial statements
- selection and consistent application of accounting policies
- implementation of applicable accounting standards, etc.
- reasonable and prudent judgments and estimates necessary to give a true and fair view of the affairs of the entity as the financial year end
- maintenance of adequate accounting records
- maintenance of internal controls for safeguarding

[1] Contributed by Puja Wadhera, Sr. Technical Officer, a staff of the Secretariat of the Auditing and Assurance Standards Board. The views expressed herein are the personal views of the author and do not in any way, purport to be the views of either the Auditing and Assurance Standards Board or the Council or any other Committee/ Board of the Institute. This article also does not also claim to be any interpretation of the Auditing and Assurance Standard (AAS) 11, Representations by Management, issued by the Institute of Chartered Accountants of India.

[2] Auditing and Assurance Standard (AAS) 11, Representations by Management, was issued by the Institute of Chartered Accountants of India in February 1996 to establish standards on the use of management representations as audit evidence, the procedures to be applied in evaluating and documenting management representations and the duties and responsibilities of the auditor if the management refuses to provide appropriate representations. A gist of the requirements of AAS 11 is given at the end of this article.

assets and preventing and detecting frauds or other irregularities

when duly acknowledged by an officer of the management authorised in this regard, would constitute a management representation to that extent.

3. In a way, then, even the financial statements are the representations made by the management as to the economic activity undertaken by the entity and its results during the period covered by those financial statements. Therefore, the assertions in the financial statements too are representations of management with regard to the existence, rights and obligations, occurrence, completeness, valuation and presentation and disclosure of those economic activities and their results. The so called management representations, therefore, supplement the information given in the financial statements to enable better understanding of the various management assertions in those financial statements and express an opinion on matters related to assertions attached to the underlying items of financial statements. That gives rise to a fundamental question whether management representations really are audit evidence by themselves.

Duties of the Auditor *vis a vis* Management Representations

4. As discussed in paragraph 3 above, it is debatable whether a management representation is an audit evidence by itself. This question is significant in the light of the fact that management representation(s) would, on most occasions, be with respect to matters material to financial statements. It may be noted that though much of the contemporary auditing literature describes management representation as an audit evidence, a debate as to its catagorisation as audit evidence *per se* is raging at important forums. However, even if an auditor, keeping in line with the current thinking in auditing, considers a management representation as an audit evidence, he has to understand that a management representation is an evidence generated internally and that too by parties capable of wielding direct and considerable influence thereon. Thus, a management representation as, an evidence, is not as reliable as an external evidence. Another important issue related to management representations is of management representations *vis a vis* other corroborating audit evidence. The auditor needs to note two important interrelated yet exclusive issues in this regard:

(a) that a management representation is not a substitute for the other audit evidence that an auditor can reasonably expect to exist; and
(b) that obtaining a management representation does not exonerate the auditor from obtaining corroborative audit evidence to support the management representation.

To elaborate point (a), a management representation w.r.t. existence, quantum and value of inventory of raw material as on balance sheet date does not in any way, say, preclude the auditor to expect that the client has a proper inventory accounting system in place. From this it also follows that [as described in point (b) above], the auditor's responsibilities as illustrated for point (a) w.r.t. inventory of raw material on the balance sheet date do not come to an end at receiving a management representation w.r.t. existence, quantity and value of inventory as on the balance sheet date. The auditor still has to apply appropriate audit procedures required for carrying out an audit of inventories[3]. The auditor, therefore, normally seeks to obtain corroborative evidence to support the management representations and evaluate whether the management representations are consistent with the other audit evidence obtained by him. In fact, if the auditor is unable to obtain sufficient appropriate audit evidence corroborating the management representation(s), which can otherwise reasonably be expected to exist, that would give rise to a scope limitation on audit. In such cases, the auditor would, among other things, also need to assess the reliability of any other representation(s) made by the management as well as the effect on his audit report.

5. An auditor, therefore, needs to be wary of over reliance on management representations. In fact, from an analysis[4] of a publication of the American Institute of Certified Public Accountants, "Fraud Related SEC Enforcement Actions Again Auditors: 1987-1997", it was found that in almost 80% of the cases, the action

3 Readers may, incidentally, note that the Council of the Institute had, in September 1999, issued a Clarification, "Auditor's Duties where Inventories are Stated to be "As Valued and Certified by the Management" in Financial Statements". The said Clarification also reiterates the point that has been made above w.r.t. auditor's duties *vis a vis* management representations. The Institute has also issued AAS 34, "Audit Evidence – Additional Considerations for Specific Items". This AAS establishes standards on auditors responsibilities, audit procedures and provides additional guidance in addition to that contained in AAS 5, "Audit Evidence", with respect certain specific financial statement amounts and other disclosures, including, attendance at physical inventory counting.

4 Data taken from an article titled, "Top Ten Audit Deficiencies", by Mark S Beasley, Joseph V Carcello and Dana R Hermanson, published in the April 2001 issued of the Journal of Accountancy, American Institute of Certified Public Accountants.

against auditors was due to deficiency in gathering sufficient audit evidence in 71% cases, the action had been due to deficiency with respect to exercising due professional care, in 60% of the cases, due to lack of demonstrating appropriate level of professional scepticism; and in another staggering 40%, the action against the auditors arose due to over reliance on inquiry as a form of evidence. A major problem with the auditors, as found by the said Publication, was failure to corroborate management response to the inquiries of the auditors. It is important for the auditors to understand that a contradiction between the management representations *vis a vis* corroborative audit evidence obtained by the auditor on the concerned issue may arise due to:

(i) problems in the management information system on which the management has based its representations, requiring the auditor to consider its affects on his assessment of the reliability of the accounting and other internal controls of the entity and the financial reporting system on the whole; or

(ii) problem regarding integrity of the management, requiring the auditor to reconsider the reliability of other management representations and the financial statements themselves; or

(iii) problem with the audit evidence itself, requiring the auditor to reconsider the reliability the source of the audit evidence, appropriateness of the nature, timing and extent of audit procedures employed by him in obtaining that evidence.

Deciding on Matters on which to Obtain Representation(s)

6. An auditor uses his professional judgment in deciding the matters on which he wishes to obtain a representation from management and again on matters wherein a written management representation would be appropriate. Normally, the auditor seeks management representations for such matters wherefor other sufficient appropriate audit evidence cannot reasonably be expected to exist. Such matters are, ordinarily, those on which no clear cut supportings or evidence are available, say, because of factors such as the time when such evidence is being sought by the auditor. For example, management representation with respect to physical verification of inventory by management held before the appointment of the auditor. Management representations are also useful in respect of matters, which are typically matters involving judgment of the management. For example, matters like, guarantees, contingent liabilities, subsequent events etc. It is obvious that in such cases management obviously possesses better information and is in a position to confirm it. Thus, the auditor would normally obtain written representations from management in respect of such matters:

(i) which are material either individually or collectively to the financial statements under audit

(ii) in respect of which sufficient appropriate audit evidence cannot reasonably be expected to exist

(iii) in respect of which only the management can provide any confirmation or information

It would be more appropriate if the auditors do not seek management representations for amounts and figures already appearing in the financial statements but for the assumptions and estimates used by the management in reaching those figures/ disclosures. From the above, it may also be drawn that management representations would prove to be immensely useful to the auditor especially in cases of initial engagements, i.e., where either the financial statements are being audited for the first time or where the auditor is auditing the financial statements of the client for the first time.

7. An auditor may either request the management to give in writing the representations made by it during the course of the audit or himself prepare a letter setting out his understanding of the representations made to him during the auditor and request the management to acknowledge the same, thereby confirming that his understanding is correct. The management, however, cannot refuse to provide a management representation to the auditor on a matter he considers material to the financial statements on the grounds that it (management) feels that sufficient appropriate audit evidence supporting that matter exists. It may be noted that what constitutes a sufficient appropriate audit evidence depends upon the professional judgment of the auditor. Thus, management's refusal to sign such a letter or to provide a representation on any matter that the auditor considers necessary, would constitute a limitation on the scope of the audit. In such cases, the auditor has to examine whether such a refusal to sign the letter or provide the necessary representation raises any doubts as to the integrity and intention of the management. He would also, therefore, need to consider the effect of such refusals on the reliance placed by him on any other representations by the management as also the effect on his audit report.

Authority to Issue Management Representations

8. Authority to issue management representations is another important issue associated with management representations. While obtaining management representations, the auditor first needs to evaluate whether the individual making the representation can be expected to be well informed on the matter on which

representation is being sought. For example, a Corporate communications manager cannot reasonably be expected to give representation as to the quantity of damaged inventory returned to the supplier. Further, however, the auditor also needs to understand that a management representation letter should ordinarily be signed by the members of management who have primary responsibility for the entity and its financial aspects, for example, the managing director or the finance director. However, an important aspect related to authority to issue is the authority of those charged with governance *vis a vis* management to issue representation(s).

9. Further, an auditor might seek a management representation during the audit or at the end of the audit, depending on the facts and needs of each case. Thus, a management representation letter is normally, of the same date as the auditor's report or a date prior thereto.

Documentation

10. Finally, it is equally essential that the auditor documents the evidence of management representations in his audit working papers. Though it is not necessary that all the management representations should be in writing but when the representations relate to a matter which is material to financial statements whether individually or collectively given the fact that other audit evidence cannot reasonably be expected to exist, it would be appropriate for the auditor to obtain a management representation in writing. Further, in view of what has been discussed in paragraph 2 above, it is also necessary that the auditor documents the audit engagement letter which has been duly acknowledged by the management since such a letter would also constitute a management representation as to its duties and responsibilities, *inter alia*, preparation and presentation of financial statements and their audit, its understanding of the duties of the auditors as well as the scope of the audit.

Auditing and Assurance Standard (AAS) 11: Representations by Management: *A Gist*

1. Effective from April 1, 1995.
2. Obtain management representations where considered appropriate
3. Use professional judgment for deciding on such matters as:
   - matters on which management representation is required
   - matters on which written representation is required
4. Obtain written representations in respect of material matters and for which no other audit evidence can be expected to exist
5. For representations w.r.t. material matters:
   - seek corroborative evidence to support those representations
   - evaluate reasonableness of management representations *vis a vis* corroborative evidence
   - evaluate the knowedgeability of the individual on the matter in question
6. Reconsider reliability of other management representations where contradictory evidence exists
7. Document evidence of management representations in working papers
8. Salient features of management representation letter:
   - addressed to the auditor
   - contains relevant information
   - dated as of the date of auditor's report or an earlier date
   - signed by the members of management having primary responsibility of the entity and its financial aspects
9. Scope limitation in case:
   - auditor unable to obtain sufficient appropriate audit evidence that can reasonably be expected to exist w.r.t. a management representation on a material matter
   - management refuses to provide representation on a matter considered essential by auditor
   - management refuses to sign a letter from auditor documenting his understanding of management representations made to him during audit