

Management Representation Letter (Relevant to AAT Examination Paper 8 - Principles of Auditing and Management Information Systems)

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This article discusses the management representation letter. We go through the reasons for auditors obtaining a management representation letter, the representations usually requested from the management, the persons signing the letter, the date of the letter, and the consequence of requested written representations not being provided or being unreliable.

What is a management representation letter?

Candidates often confuse a management representation letter with a management letter.

A **management representation letter** is issued by the directors of the company near the completion of an audit, and is addressed to the auditors of that company. The letter contains information from management¹ confirming matters on which the auditor may not have been able to obtain sufficient evidence from other sources, such as estimates for bad debt provisions, as well as confirming management's responsibilities for the financial statements.

On the other hand, a **management letter** is issued by the auditors of the company near the completion of the audit and is addressed to the board of directors of that company. The letter contains information on the company's internal control weaknesses identified by the auditors, their implications, and recommendations thereon.

Reasons for obtaining a management representation letter

Written representations are an important source of audit evidence. During the course of an audit, auditors may have made many inquiries of management. However, the replies may be in oral form, which is not a reliable form of audit evidence. Although a management representation letter is in written form, it does not provide sufficient appropriate audit evidence on its own. For instance, a director may estimate that a 5% provision on doubtful debt is considered sufficient. Without providing further audit evidence, the written representation would by itself not enhance the quality of the audit evidence.

If a written representation does not automatically improve both the quality and quantity of the audit evidence, then why do we need the management to provide such a representation?

¹ In this article, references to "management" should be read as "management and, where appropriate, those charged with governance."

Firstly, written management representation aims to document the responses from management to inquiries (oral representations) about various aspects of the audit. Secondly, written management representation reinforces management's acknowledgement of their appropriate responsibilities for the financial statements and knowledge of the matters concerned. Thirdly, if management modifies or does not provide the requested written representations, it may alert the auditor to the existence of certain issues. Fourthly, a request for written representations may prompt management to consider such matters more rigorously, thereby enhancing the quality of the representations.

Requested representations on preparation of financial statements

Auditors are not able to judge solely on other audit evidence whether management has prepared and presented the financial statements and provided information to the auditors on the basis of the agreed acknowledgement and understanding of its responsibilities²; therefore auditors require confirmation from management that it has fulfilled those responsibilities.

Auditors may also ask management to reconfirm its acknowledgement and understanding of those responsibilities in written representations, especially when:

- (a) Those who signed the audit engagement letter no longer have the relevant responsibilities;
- (b) The terms of the audit engagement were prepared in a previous year;
- (c) There is an indication that management misunderstands those responsibilities;
- or
- (d) Changes in circumstances make it appropriate to do so.

Requested representations about the financial statements

Auditors also require representations from the management about the financial statements on:

- (a) whether the accounting policies are appropriately selected and applied; and
- (b) whether the following matters have been recognized, measured, presented or disclosed in accordance with applicable financial reporting framework:
 - (i) Plans or intentions that may affect the carrying value or classification of assets and liabilities;
 - (ii) Liabilities, both actual and contingent;
 - (iii) Title to, or control over, assets, the liens or encumbrances on assets, and assets pledged as collateral; and
 - (iv) Aspects of laws, regulations and contractual agreements that may affect the financial statements, including non-compliance.

² In the case of a fair presentation framework, management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework; or the preparation of financial statements that give a true and fair view in accordance with the applicable financial reporting framework.

For example, if the intent of the management is important to the valuation basis for investments, it may not be possible to obtain sufficient appropriate audit evidence without a written representation from management about its intentions. The valuation of bond securities with fixed maturities may be carried at cost if the management intends to hold the bond securities until they mature; otherwise, the bond securities have to be marked-to-market.

Requested representations on information provided to auditors

Auditors shall request management to provide a written representation that it has provided the auditors with all relevant information and access as agreed in the terms of the audit engagement. Such information may include deficiencies in internal control of which management is aware.

Requested representations on completeness of transactions

Auditors shall request management to provide a written representation that all transactions have been recorded and are reflected in the financial statements.

Other Requested Representations

Auditors shall also obtain written representations from management that:

- (a) They acknowledge their responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud;
- (b) They have disclosed the internal assessment on risk of material misstatements to the auditors;
- (c) They have disclosed their knowledge of fraud or suspected fraud to the auditors;
- (d) They have disclosed all known instances of non-compliance or suspected non-compliance with laws and regulations to the auditors;
- (e) They believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole;
- (f) They have disclosed all known actual or possible litigation and claims to the auditors;
- (g) They believe significant assumptions used in making accounting estimates are reasonable;
- (h) They have disclosed to the auditor the identity of the entity's related parties and all the related party relationships and transactions of which they are aware;
- (i) All events occurring subsequent to the date of the financial statements have been properly adjusted or disclosed; and
- (j) They have disclosed to the auditors any restatement made to correct a material misstatement in prior period financial statements that affect the comparative information.
- (k) They confirm that the entity has the ability to continue as a going concern, their plans for future action and the feasibility of these plans.

Persons signing the management representation letter

Written representations should normally be signed by management responsible for the preparation of the financial statements, such as chief executive officer and chief financial officer. Due to its responsibility for the preparation of the financial statements, and its responsibilities for the conduct of the entity's business, management is expected to have sufficient knowledge of the process followed by the entity in preparing the financial statements.

In some cases, management may include in the management representation letter qualifying language, such as "to the best of our knowledge and belief". It is reasonable for the auditor to accept such wording if the auditor is satisfied that the representations are being made by those with appropriate responsibilities and knowledge of the matters included in the representations.

In order to increase the usefulness of management representations as audit evidence and to ensure that the management understands the matters they are being asked to confirm, the auditor may request that management includes the phrase "having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves" in the management representation letter.

The management should be aware that it is a criminal offence under the new Companies Ordinance for any person, not just a company officer, to knowingly or recklessly make a statement to an auditor conveying or purporting to convey any such information or explanation that is misleading, false or deceptive in a material particular.

Date of management representation letter

Since the management representation letter is an important source of audit evidence, the auditor should obtain the management representation letter before expressing the audit opinion. Furthermore, the auditor is concerned with events occurring up to the date of the auditor's report that may require adjustment to or disclosure in the financial statements, and thus the written representations are dated as near as practicable to, but not after, the date of the auditor's report on the financial statements.

Requested representations are unreliable or not provided

If management does not provide one or more of the requested written representations, the auditor shall:

- (a) Discuss the matter with the management;
- (b) Re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and
- (c) Take appropriate actions, including determining the possible effect of the opinion in the auditor's report.

If the auditor concludes that the written representations about the requested matters are unreliable, or if management does not provide those written representations, the auditor is unable to obtain sufficient appropriate audit evidence. The possible effects on the financial statements of such inability are not confined to specific elements, accounts or items of the financial statements and are hence pervasive. In accordance with HKSA 705, the auditor shall issue a disclaimer of opinion on the financial statements in such circumstances.

References:

HKSA 580 “Written Representations”, issued July 2009, revised July 2010 by Hong Kong Institute of Certified Public Accountants

HKSA 240 “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”, issued July 2009, revised July 2010, May 2013, Hong Kong Institute of Certified Public Accountants

HKSA 450 “Evaluation of Misstatements Identified during the Audit”, issued July 2009, revised July 2010, Hong Kong Institute of Certified Public Accountants

HKSA 501 “Audit Evidence – Specific Considerations for Selected Items”, issued July 2009, revised July 2010, Hong Kong Institute of Certified Public Accountants

HKSA 540 “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures”, issued July 2009, revised July 2010, Hong Kong Institute of Certified Public Accountants

HKSA 550 “Related Parties”, issued July 2009, revised July 2010, May 2013, Hong Kong Institute of Certified Public Accountants

HKSA 560 “Subsequent Events”, issued July 2009, revised July 2010, Hong Kong Institute of Certified Public Accountants

HKSA 710 “Comparative Information – Corresponding Figures and Comparative Financial Statements”, issued July 2009, revised July 2010, Hong Kong Institute of Certified Public Accountants

HKSA 705 “Modification to the Opinion in the Independent Auditor’s Report”, issued September 2009, revised July 2010, Hong Kong Institute of Certified Public Accountants