

STATEMENT 3.233
AUDITING GUIDELINE
REPRESENTATIONS BY MANAGEMENT

Introduction

1. Paragraph 7 of the Statement of Auditing Standard No. 3.101 "Audit approach" states that:

"The auditor should obtain relevant and reliable audit evidence sufficient to enable him to draw reasonable conclusions therefrom".

This evidence will be obtained from many different sources. Representations by management are one such source.

2. This auditing guideline, which gives guidance on how that paragraph may be applied, should be read in conjunction with the Explanatory Foreword to Auditing Standards and Guidelines including the Glossary of Terms, and, where applicable, legislation relating to the disclosure of information to auditors. In this context, section 134 of the Companies Ordinance provides that an officer of a company will be guilty of an offence where he knowingly or recklessly makes a statement (orally or in writing) to the company's auditor which is misleading, false or deceptive in a material particular.

Background

3. Oral representations will be made throughout the audit in response to specific enquiries. Whilst representations by management constitute audit evidence, the auditor should not rely solely on the unsupported oral representations of management as being sufficient reliable evidence when they relate to matters which are material to the financial statements.
4. In most cases, oral representations can be corroborated by checking with sources independent of the enterprise or by checking with other evidence obtained by the auditor, and therefore do not need to be confirmed in writing.
5. However, in certain cases, such as where knowledge of the facts is confined to management or where the matter is principally one of judgement and opinion, the auditor may not be able to obtain independent corroborative evidence and could not reasonably expect it to be available. In such cases, the auditor should ensure that there is no other evidence which conflicts with the representations by management and he should obtain written confirmation of the representations.

6. Where written representations are obtained, the auditor will still need to decide whether in the circumstances these representations, together with such other audit evidence as he has obtained, are sufficient to enable him to form an unqualified opinion on the financial statements.
7. In circumstances where the auditor prepares the financial statements for the company it may be appropriate for the directors to acknowledge their responsibility for the financial statements when confirming their representations in writing. This is because the directors have the ultimate responsibility for ensuring the completeness and accuracy of the enterprise's accounting records and for the view shown by the financial statements.

Procedures

8. Where oral representations by management are uncorroborated by sufficient other audit evidence and where they relate to matters which are material to the financial statements, they should be summarised in the auditor's working papers. The auditor should ensure that these representations are either formally minuted as being approved by the board of directors or included in a signed letter, addressed to the auditor, known as a "letter of representation".
9. Because the representations are those of management, standard letters of representation may not be appropriate. In any event, management should be encouraged to participate in drafting any letter of representation or, after review and discussion, to make appropriate amendments to the auditor's draft, provided that the value of the audit evidence obtained is not thereby diminished.
10. A letter of representation should be signed by persons whose level of authority is appropriate to the significance of the representations made — normally by one or more of the executive directors (for example by the chief executive and the chief financial officer), on behalf of the whole board. The signatories of the letter should be fully conversant with the matters contained in it. The auditor should request that the consideration of the letter and its approval by the board for signature be minuted. He may request that he be allowed to attend the meeting at which the board is due to approve the letter. Such attendance may also be desirable where the representations are to be formally minuted, rather than included in a letter.

11. Procedures regarding written representations should be agreed at an early stage in order to reduce the possibility of the auditor being faced with a refusal by management to co-operate in providing such representations. However, management may at the outset indicate that it is not willing to sign letters of representation or to pass minutes requested by the auditor. If it does so indicate, the auditor should inform management that he will himself prepare a statement in writing setting out his understanding of the principal representations that have been made to him during the course of the audit, and he should send this statement to management with a request for confirmation that his understanding of the representations is correct.
12. If management disagrees with the auditor's statement of representations, discussions should be held to clarify the matters in doubt and, if necessary, a revised statement prepared and agreed. Should management fail to reply, the auditor should follow the matter up to try to ensure that his understanding of the position, as set out in his statement, is correct.
13. There may, however, be circumstances where the auditor is unable to obtain the written representations which he requires. This may be because of a refusal by management to co-operate, or because management properly declines to give the representations required on the grounds of its own uncertainty regarding the particular matter. In either case, if the auditor is unable to satisfy himself, he may have to conclude that he has not received all the information and explanations that he requires, and consequently may need to consider qualifying his audit report.

Groups

14. Because the directors and auditors of holding companies have responsibilities to prepare and audit respectively group financial statements, auditors should, where appropriate, obtain written representations for those financial statements as well as for the financial statements of the holding companies themselves. The way in which the auditor of a holding company obtains these representations will depend upon the pattern of delegation of managerial control and authority which can vary both between and within different groups of companies. For instance, the auditor of a holding company may be able to obtain the written representations that he requires, regarding the group financial statements, from the directors of the holding company by virtue of their involvement

in the management of the subsidiaries. Alternatively, there will be circumstances where the management structure of a group dictates that the auditor of the holding company will wish to have sight of appropriate written representations made by the directors of subsidiary companies to the auditors of those subsidiaries.

Dating

15. The formal record of representations by management should be approved on a date as close as possible to the date of the audit report and after all other work, including the review of events after the balance sheet date, has been completed. It should never be approved after the audit report since it is part of the evidence on which the auditor's opinion, expressed in his report, is based.
16. If there is a substantial delay between the approval of the formal record of representations by management and the date of the audit report, the auditor should consider whether to obtain further representations in respect of the intervening period and also whether any additional audit procedures need to be carried out, as described in the draft Auditing Guideline "Events after the balance sheet date".

Contents and wording

17. The precise scope of the formal record of representations should be appropriate to the circumstances of each particular audit. The representations will be necessary where there are matters which are material to the financial statements, in respect of which the auditor cannot obtain independent corroborative evidence and could not reasonably expect it to be available, as indicated in paragraph 5 above.

Frequently, representations by management will not be necessary and they should not be requested as a matter of course. Set out in the appendix is an example of a letter of representation together with examples of additional paragraphs which may be appropriate for inclusion in a letter of representation or in board minutes.

Appendix

EXAMPLES OF REPRESENTATIONS BY MANAGEMENT

Set out below is an example of a letter of representation which relates to matters which are material to financial statements prepared by an auditor for the company, and to circumstances where the auditor cannot obtain independent corroborative evidence and could not reasonably expect it to be available (see paragraph 5 of the guideline above). It is not intended to be a standard letter because representations by management can be expected to vary not only from one enterprise to another, but also from one year to another in the case of the same audit client.

Dear Sirs,

We confirm to the best of our knowledge and belief, and having made appropriate enquiries of other directors and officials of the company, the following representations given to you in connection with your audit of the company's financial statements for the year ended 31 December

1. We acknowledge as directors our responsibility for the financial statements of the company. All the accounting records have been made available to you for the purpose of your audit and all the transactions undertaken by the company have been properly reflected and recorded in the accounting records. All other records and related information, including minutes of all management and shareholders' meetings, have been made available to you.
2. The legal claim by Mr. G. H. has been settled out of court by the company paying him HK\$380,000. No further amounts are expected to be paid, and no similar claims by employees or former employees have been received or are expected to be received.
3. The company has had at no time during the year any arrangement, transaction or agreement to provide credit facilities (including loans, quasi-loans or credit transactions) for directors nor to guarantee or provide security for such matters, except as disclosed in note 14 to the financial statements.

4. Other than the fire damage and related insurance claim described in note 19 to the financial statements, there have been no events since the balance sheet date which necessitate revision of the figures included in the financial statements or inclusion of a note thereto. Should further material events occur, which may necessitate revision of the figures included in the financial statements or inclusion of a note thereto, we will advise you accordingly.

Yours faithfully,

Financial Director

Managing Director

Signed on behalf of the board of directors.

The paragraphs included in the example letter relate to a specific set of circumstances. Set out below are some examples of additional paragraphs which, depending on the circumstances, may be appropriate for inclusion in a letter of representation or in board minutes. It is not expected that the auditor will obtain all these written representations as a matter of routine.

- With the exception of the penalties described in note 17, we are not aware of any circumstances which could produce losses on long-term contracts.
- DEF Ltd., an associated company, is about to launch a new product which has received excellent test results. As a result, the amount of HK\$1,550,000 outstanding since 6 January, is expected to be fully recoverable.
- The company has guaranteed the bank overdraft of its subsidiary A Ltd. but has not entered into guarantees, warranties or other financial commitments relating to its other subsidiary or associated companies.
- The transaction shown in the profit and loss account as extraordinary is outside the course of the company's normal business and is not expected to recur frequently or regularly.

- Since the balance sheet date, the company has negotiated a continuation of its bank overdraft facilities with a limit of HK\$2,000,000. There have been no other events which are likely to affect the adequacy of working capital to meet foreseeable requirements in the year following the adoption of the financial statements.
- The company plans to sell the sports division to a third party. It is anticipated that the loss will not exceed HK\$800,000 and the effect to the company will not be significant.
- The short-term loan of HK\$1,000,000 which will be due on 30 September 19...., has been excluded from current liabilities because the company intends to refinance on a long term basis and has the ability to do so.