A Handout on MANAGEMENT LETTER

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Introduction

It is sometimes observed that once the audit process is completed, the Auditors give their observations about the internal process of the organization in an informal manner. The weaknesses are brought to the notice of the management (but not formally) and thus the action taken by the management cannot be tracked. Therefore, to have a clear view on the auditors' observations it is recommended to issue a management letter. This is also a requirement of the International Standards on Auditing i.e. ISA 265 issued by International Auditing and Assurance Standards Board (IAASB) as well as Standard on Auditing i.e. SA 265 issued by ICAI- "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management". In ISA 265 point 9 it is specifically mentioned that "The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis." Therefore, a management letter is not just a recommendation but a requirement for all audits.

A management letter will be addressed to those charged with governance of the organization (in most circumstances it is the board) outlining the observations upon the system of accounting and internal controls, together with a detailed list of any significant findings that come to the auditors' attention during the course of the auditing. The letter will include recommendations as to how these weaknesses may be eliminated and how controls and records might be improved. The management in response to this letter needs to provide a written Action Taken Report (ATR) to the auditors' comments.

If a previously communicated significant deficiency remains, the auditor may ask management or, the board, those charged with governance, why the significant deficiency has not yet been remedied. A failure to act, in the absence of a rational explanation, may in itself represent a significant deficiency.

The Standard on Auditing (SA 265) provides the time limit to issue management letter, it provides *"As the auditor's written communication of significant deficiencies forms part of the final audit file, the written communication is subject to the overriding requirement for the auditor to complete the assembly of the final audit file on a timely basis. SA 230 (Revised) states that an appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report."*

Thus, it should be made a practice to issue the management letter before approval of the financial statements by the board and their comments be included in the management letter, then it would be much more effective since the entire board will also come to know of the observations.

1. Salient Features of a Management Letter

The main purpose of a management letter is to state the deficiencies in the internal control system and also cover certain essential points with respect to an audit. Some of the topics/issues a management letter should cover are listed below:

1.1. The letter should set out :

1.1.1. The weakness identified

1.1.2. The risk associated with that weakness

1.1.3. The possible consequences

1.1.4. Recommendations for improving the system

1.1.5. The likely outcome of implementing the recommendation

1.2. Comments as to whether recommendations made in the management letter for the previous audit were implemented and the implementation status.

A suggestive management letter is attached which can be used as a guideline/checklist for issuing a management letter (Annexure A).

2. Management Letter v/s Notes to Accounts

Management letter is not a letter to be issued in lieu of notes to accounts. There is a clear difference in purpose of both these documents. The notes to accounts forms part of the final audited accounts, it provides crucial narrative information on accounting policies and other explanations on the accounts. The notes to accounts can greatly change one's interpretation of the financial statements. It has the nature of influencing the decision of the stakeholders and persons associated/likely to be associated with the organisation. The notes to accounts are a mandatory requirement of financial reporting regulations/requirements. A management letter is also a mandatory requirement but is a tool for the management and is not a public document. It is issued with the objective of bringing to the notice of those charged with governance and management, the weaknesses in the internal control systems, accuracy of the financial statements, non- compliances or any other issue which needs to be taken an action. The purpose of issuing management letter is not only highlighting the weaknesses but also giving practical recommendations to overcome them.

3. Independence of Auditor

Independence is fundamental to the reliability of auditors' reports. Those reports would not be credible, and the donors and stakeholders would have little confidence in them, if auditors were not independent in both fact and appearance. To be credible, an auditor's opinion must be based on an objective and disinterested assessment of whether the financial statements are presented fairly in conformity with generally accepted accounting principles. The organization should select the auditor with due diligence and keeping in mind the independence of auditor and vice- versa.

Auditors' independence is also one of the requirements of SA 260, to be fulfilled by the auditor for communicating with those charged with governance.

4. Conclusion

It is very critical for the voluntary organisation to understand the value of audit. Audit must be used as a tool to promote accountability and transparency in the organisation. A strong and independent audit process generates confidence of stakeholders and enhances credibility of the organisation. It is also important to realize that audit should be seen as a continuous quality improvement process. In that context management letter by the auditor is a very critical component. It is necessary for the voluntary organisation to insist on obtaining a management letter from the auditor and to internally process it so that it serves as a good tool to improve the control systems and other financial management process in the organization.

Annexure-A

To,

The Governing Board/Chief Functionary of the Organisation

Name of the Organisation

Address

Sub: Management Letter for the year ending ________________

Dear Sir/ Madam

As part of our statutory/Project/others (specify) audit of ____________for the year ended _____, we evaluated the systems of internal controls to the extent we considered necessary under generally accepted auditing standards. This is done to establish a basis for reliance on systems and determining the nature, timing and extent of other auditing procedures necessary to express an opinion on the financial statements. This study was conducted to determine whether the system of internal controls is adequate and commensurate with the size of the organization and its activities.

Our audit identified areas where financial management and internal controls could be strengthened. The attached memorandum of observations and recommendations is enclosed for your information and consideration.

We would be pleased to discuss this document or to respond to any questions at your convenience.

Sincerely,

XYZ Chartered Accountants.

General areas covered during Audit Process	Weakness Identified	Risk Associated With That Weakness	Possible Consequences	Recommendations	Outcome Of Implementing The Recommendation	Management's Response
1. Accounting Policies Fixed Assets, Investments, Cash & Bank Management, Inventory, Any other.						
2. Accounting Record & Systems Books maintained, manuals						
3. Internal Controls Authority for approvals, Measures taken to ensure safety of cash , cheque books and other valuables						
4. Notional expenditure and Cost Allocation.						
5. Restricted fund, Unrestricted fund, Capital Fund etc						
6. Legal Compliances & registration under Income Tax, FCRA and any other applicable						

7. Budgetary Control Budget monitoring system, variance analysis, annual/half yearly/ quarterly operational budgets.						
8. Own means of contribution Cash and Non cash reporting to donor						
9. Documentation and processing of program expenses						
10. Assets Acquisition, Insurance, Sale and Depreciation.						
11. Investments Compliance with regulations and donor requirements.						
12. Contingent Liabilities Case/legal dispute						
13. Any other issue						