CHAPTER 38 MANAGEMENT LETTERS INTRODUCTION

In planning and performing our audit we consider the entity's internal control over financial reporting as a basis for designing our audit procedures. We do this for the purpose of expressing our opinion on the financial statements and not for expressing an opinion on the operating effectiveness of internal controls. During our risk assessment process and throughout the audit engagement we may become aware of deficiencies or other matters of governance interest that require, or are appropriate for, us to communicate with those charged with governance or management.

This chapter contains guidance on the use of management letters to communicate deficiencies or other matters including their:

- form;
- objectives;
- content; and
- timing.

This chapter also sets out where we may draw management's attention to matters of judgment, in particular with respect to the accounting policies.

Consideration is also given to the adequacy of information systems and deficiencies in both these systems and internal control.

General considerations for communicating with management and those charged with governance can be found in chapter 5 - Communication with those Charged with Governance.

We can use the management letter to comment constructively in a timely manner on wider aspects of the client's operations and the way they are managed.

DEFICIENCIES IN INTERNAL CONTROL

On the basis of our work performed, we determine if we have identified one or more deficiencies in internal control and whether, individually or in combination, they constitute significant deficiencies. For further guidance see chapter 15 - Understand and Assess Cycles.

Significant deficiencies in internal control identified during the audit shall be communicated in writing to those charged with governance on a timely basis.

We shall also communicate with management at an appropriate level of responsibility and on a timely basis:

- in writing, significant deficiencies in internal control that we have communicated or intend to communicate with those charged with governance, unless it would be inappropriate to do so in the circumstances; and
- other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that in our professional judgment, are of sufficient importance to merit their attention.

APPLICATION GUIDANCE - ADDITIONAL CONTEXT FOR OUR COMMUNICATION

When the identified significant deficiencies in internal control call into question the integrity or competence of management, it may not be appropriate to communicate directly with management. For example, when the following conditions exist:

evidence of fraud or intentional non-compliance with laws and regulations by management; and

an inability of management to oversee the preparation of adequate financial statements that raises doubt about management's competence.

Our written communication of significant deficiencies shall include:

a description of the deficiencies and an explanation of their potential effects; and

sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, we shall explain that:

the purpose of the audit was to express an opinion on the financial statements;

the audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that were appropriate in the circumstances, but not for the purpose of expressing an opinion on the operating effectiveness of internal control; and

the matters being reported are limited to those deficiencies that we have identified during the audit and that we have concluded are of sufficient importance to merit being reported to those charged with governance.

APPLICATION GUIDANCE - LEVEL OF DETAIL TO COMMUNICATE

In communicating significant deficiencies, the level of detail required is a matter of professional judgment. Factors to consider include:

the nature of the entity (public interest entity or a non-public interest entity);

the size and complexity of the entity;

the nature of the deficiency that we have identified;

the persons comprising the entity's governance structure (industry experience or knowledge in affected areas);

legal or regulatory requirements regarding specific types of deficiencies (regulator imposed controls such as capital adequacy ratios in banking clients, or public sector imposed reporting requirements); and

whether the significant deficiencies had previously been reported either by us or by internal audit functions.

MANAGEMENT LETTERS - GENERAL

A management letter is one way we may communicate with those charged with governance. We may consider it more appropriate to communicate matters and recommendations by discussion, with minutes prepared afterwards. Significant deficiencies, however, shall always be communicated in writing.

In those cases where the engagement partner decides that possible points for discussion with those charged with governance, or for inclusion in a management letter, are not of sufficient importance to justify discussion or a letter, an explanation is documented stating the reasons why no discussion has occurred and no letter has been issued.

OBJECTIVE

Our aim is to make sure that clients derive the greatest possible benefit from the independent audit. The management letter is often a key visible sign to senior management of the quality of the service we provide.

When we are communicating using a management letter, we address it to management at the appropriate level of responsibility and, where we have identified significant deficiencies in internal control, also to those charged with governance. To communicate successfully at that level, it is important that the management letter is consistent with management's overall responsibilities for the financial statements and for the direction of the business.

Our management letters are to be structured in a positive, constructive style. Wherever possible, we concentrate on offering a solution to a problem rather than on the problem itself, suggesting a strengthening of the control or improvement to management procedures.

Our letters are to be clear, concise and factually accurate. This can be achieved by giving a draft to the client to review and agree to the facts prior to sending the final letter.

CONTENT OF THE MANAGEMENT LETTER

The content of the management letter can be considered under the following headings:

- financial information.

  This may include the following matters:

  - matters affecting the current financial statements. This may include:
    - the AYA Audit Approach;
    - violations of laws and regulations/fraud;
    - significant issues in the financial statements;
    - the accounting policies; and
    - emerging accounting issues.
  - information systems. This may include:
    - the adequacy of information systems; and
    - deficiencies in information systems and internal control that may affect the quality of management information.

- other client service matters. These vary from client to client depending on the nature of the client and our relationship with the client. We use mature judgment to determine the best way to make a constructive comment to the client on such wider matters; such as operational matters, tax planning, and management techniques. Accordingly senior members of the engagement team are to be involved.

Certain of the above headings are considered in further detail below.

FINANCIAL INFORMATION

Significant Issues in the Financial Statements

Senior management are to be made aware of the key decisions that have been taken by management and others within the entity in preparing the financial statements and the significant auditing and accounting judgments that have been made by us in forming our opinion on the financial statements. In particular, senior management is to be made aware of matters that lead to an opinion other than an unmodified opinion and whether or not this is adequately disclosed in the financial statements.

The preparation of financial statements necessarily involves the exercise of judgment by management that tends to be more significant for certain areas, (e.g. asset lives, inventory valuation and the provision for deferred taxation) than for others. In forming our opinion, we want to satisfy ourselves whether or not such judgments are appropriate in the light of available information. Senior management is to be made aware of these matters and the basis on which we have formed our opinion. It may be appropriate here to refer specifically to any matters on which we wish to obtain written representations from the client see chapter 35 - Written Representations.

The Accounting Policies

As discussed in chapter 37 - Forming an Opinion we consider:

whether the accounting policies selected and applied conform to the requirements of [AYA Member Firms to refer here to the authoritative professional bodies or statutes] or otherwise have general acceptance; and

the appropriateness of the selected accounting policy.

In some areas this may involve the exercise of significant judgment where accounting standards permit more than one accounting treatment or where accounting practice is developing.

In some cases, we may draw attention to:

those accounting policies which we consider inappropriate and which are the subject of a qualification of our audit opinion. This provides an opportunity to explain our position in greater depth to senior management. When the accounting policies used to develop the financial statements are not appropriate we also consider whether this represents a significant deficiency in internal control surrounding the preparation of accurate financial statements;

those accounting policies which we consider inappropriate but which do not result in a qualified opinion because the misstatement involved is not material. However, we need to make senior management aware of such matters if the policy could result in a material misstatement at a future date or may result in management decisions based on misleading information; and

those accounting policies adopted which are acceptable but in place of which other accounting policies might be applied. In cases where other accounting policies might be applied because accounting practice is developing, it may also be appropriate to deal here, rather than separately under emerging accounting issues, with developments in this area since these may result in a new policy being applied in the future.

Emerging Accounting Issues

We may draw the attention of senior management to possible or known developments in law or accounting practice which could impact on future reported results or on the form of the financial statements. We may also consider deviations from accounting rules or other laws that could have a material impact on the financial statements.

INFORMATION SYSTEMS

Adequacy of Information Systems

In planning and conducting the audit, we gain an understanding of the information systems that management use to control and monitor the performance of the business. Senior management would ordinarily have an expectation that, where such systems are inadequate, including the information that senior management itself receives, we would draw this to their attention.

Information systems may be inadequate for a number of reasons:

- the information is incomplete or inaccurate;
- the information is not sufficiently disaggregated, e.g. by product;
- the information does not explain the assumptions on which it is based or consider the sensitivity to changes in those assumptions;
- the information is not received by those who need it;
- the information is not received promptly; and
- the information is disregarded.

Many of the risk conditions that we identify when understanding the entity and its environment, including internal control, see chapter 13 - Understand the Entity, may be caused by management action or inaction in relation to information used in the business.

APPLICATION GUIDANCE - INFORMATION REGARDING INFORMATION SYSTEMS

If budgets are set at unrealistically high levels so that staff may be led into erroneous reporting, this not only carries the risk that the financial statements may be misstated but also that the information used by management may be inaccurate.

In addition, our evaluation of the entity's system of internal control involves a consideration of the reports that represent information used by management to monitor and control the business. We may draw on these assessments as appropriate.

DEFICIENCIES IN INFORMATION SYSTEMS AND INTERNAL CONTROL

A deficiency in internal control exists when a control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statement on a timely basis; or when a control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

All significant deficiencies in internal control that become apparent during the course of our audit are to be drawn to the attention of senior management and those charged with governance. Such deficiencies may have implications not only for the financial statements but also for the quality of the information used by management to plan and monitor the performance of the business.

Communicating deficiencies in internal control, particularly in writing, emphasizes the importance of these matters. It assists management and those charged with governance in fulfilling their oversight responsibilities and in taking actions to minimize the risk of material misstatement in the financial statements. Management letters are a tool for fulfilling our responsibility to communicate any significant deficiencies noted during our audit and our review of the client's internal control. They also represent an opportunity to serve our clients by helping them improve not only their internal control, but also accounting policies, operating procedures, tax planning and management techniques.

Significant Deficiencies

A significant deficiency in internal control is defined as a deficiency or combination of deficiencies in internal control that, in our professional judgment, is of sufficient importance to merit the attention of those charged with governance.

In determining whether a particular deficiency is a significant deficiency, we consider not only whether a material misstatement has actually occurred, but also the likelihood that a misstatement could occur and the potential magnitude of the misstatement. Significant deficiencies may exist even though we have not identified misstatements during the audit.

Where other deficiencies in the entity's system of internal control become apparent that are of sufficient importance to merit management's attention, they are still brought to the attention of the client but this may be done in writing to a more appropriate level of management or in the context of a discussion with the client.

Sources of Deficiencies in Internal Control

Observations on deficiencies in internal control come primarily from the following:

> review of the information system, including the accounting system; as discussed in chapter 14 - Understand Internal Control, for each engagement, we develop an understanding of the controls operating within the information system. Deficiencies may become apparent at this stage from:
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> > observations of client operations and discussions with client personnel; and
> >
> > our experience with clients in similar situations, industries or sectors;

evaluation of controls; where we intend to obtain audit evidence from tests of controls, the detailed evaluation of the design of the controls, as discussed in chapter 23 - Tests of Controls, may reveal deficiencies. However, we would not ordinarily carry out a study and evaluation of controls solely for the purpose of identifying and reporting such deficiencies unless the client specifically requests us to do so as an additional service or we are otherwise required to do so by regulatory provisions;

performance of tests of controls; the performance of tests of controls provide evidence of the extent of adherence to the designed procedures;

performance of substantive procedures; even when, in deciding the nature and extent of our audit procedures, we have decided to perform primarily substantive procedures, such procedures may still bring deficiencies to our attention;

previous years' management letters; we review the points made in previous management letters and the action taken by the client in respect of our recommendations. Where such points have not been dealt with effectively, we may inquire with management or, where appropriate, those charged with governance as to why appropriate action has not been taken. We consider whether the failure to act is in itself a significant deficiency requiring communication with those charged with governance. If a previously communicated significant deficiency remains, we may either repeat the description or make reference to the previous communication in our current year management letter. To do otherwise may give the impression that we are satisfied that the deficiency has been corrected. If the point related to deficiencies other than significant deficiencies that were communicated by us or other parties, such as internal auditors or regulators, we are not required to repeat the communication in the current period. We may, however, choose to do so if there has been a change in management or new information has come to our attention. It may be useful to emphasize these repeated comments by including them under a separate heading (i.e. recommendations previously reported); and

review of adjusting journal entries; the nature and effect of adjusting journal entries are reviewed to determine whether they are indicative of a significant deficiency and to consider if a management letter comment is required.

Reporting

Our description of deficiencies indicates whether the deficiency relates to the design of the related control or to the entity's implementation of that control. We also make it clear whether or not the deficiency has any implications for the current financial statements.

The letter includes recommendations for improvements, comments concerning corrective action taken or in process, or other comments appropriate in the circumstances. The basis for any comments concerning subsequent corrective action is indicated, including the scope of any review and tests we have undertaken.

A significant deficiency is communicated to those charged with governance or, where appropriate, management, regardless of whether or not we are able to make a recommendation for cost effective corrective action. The determination of appropriate improvements in control activities and an assessment of the cost effectiveness of additional controls may be complex issues that in any event are management's responsibility. Where management believes corrective action is not practical, this is indicated in our letter.

FORMAT

Our letters normally reflect the following principles:

> the introduction to the letter varies from client to client but it normally refers to the following matters:
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> > the reason for submitting the letter;
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> > the action taken by the client concerning recommendations in previous letters. It is important, where previous management letters have noted deficiencies in some aspect of a client's system or its operation and the client's staff have made progress to correct the situation, that we recognize such progress; and
> >
> > caveats on the extent of audit procedures.

where practical, the points to be made are set out as recommendations, in logical subdivisions, and listed in order of importance within each subdivision. Each recommendation may be structured in terms of the problem (for example, purchase invoices are not matched with receiving reports prior to payment of the invoice), its effect (for example, payments may be made for items which have not been received) and our recommendation (for example, the accounting department need to match purchase invoices and receiving reports prior to payment). In particular, we:

quantify the implications of what we say, where possible; and

explain the impact, if any, on the current financial statements.

any comments by the client's officials on the recommendations or proposed remedial action, either before the letter is sent or in response to the letter, is documented either in a meeting report (or memorandum) or in a letter from them. If the letter is to be given to third parties, it may be advisable to include management's reaction to our comments; and

the letter may conclude with an expression of willingness to discuss our recommendations further and, where appropriate, of gratitude for the assistance of the client's officers and staff in the course of the audit.

TIMING

General

Management letters are submitted on a timely basis. These communications form part of our final audit file which would ordinarily be completed within 60 days after the date of our report, see chapter 39 – Close Down Procedures for further guidance. Laws and regulations for listed entities may have further requirements to consider in determining when to issue our management letter.

Interim Letters

When we have identified significant deficiencies in the course of our audit, the client is promptly informed and we may issue our management letter as soon as is practical. Since these deficiencies are often identified while carrying out audit procedures before the year end, this may involve issuing an interim management letter. In general, our comments at this stage may be detailed in nature and may be addressed to the client's financial management. Where the deficiency is fundamental and impacts on our opinion on the financial statements, it may be necessary to alert not only financial management but also those charged with governance.

At any stage of an audit, if a fundamental issue concerning the client's information system, including the accounting systems or the financial statements comes to our attention or we are aware of a strong recommendation of a business advisory nature, we alert the appropriate level of senior management as soon as possible.

Review

Appropriate consideration as to the involvement of other experts, e.g. tax, IS audit or consultancy, in contributing to and reviewing management letters may be included in the engagement planning to avoid unnecessary delays in issuing the management letter.

When our management letter identifies significant deficiencies, we discuss the deficiencies with the appropriate members of management and obtain their reaction to our recommendations, stating either that they agree with the recommendations and are going to adopt them (or take other appropriate action) or that they do not believe it is necessary to change their existing procedures and the reason for such a decision (e.g. because of cost/benefit considerations). To ensure the accuracy of our management letter, we would ordinarily discuss a draft of the letter, before finalizing it, with the appropriate level of management and the client's staff (e.g. the information systems department manager regarding information systems comments).

FOLLOW UP

Prompt follow up with the client is essential to the success of our management letter procedures and gaining an understanding of whether our recommendations are to be implemented and, if so, how this is to be done. As soon as practical following the mailing of the management letter, the engagement partner or manager would ordinarily telephone the recipient of the letter and request a luncheon date, conference, or other appropriate method of personal communication. This follow-up is to be documented by a memorandum that also includes the client's reaction to our comments.

POLICY REGARDING MANAGEMENT LETTERS GIVEN TO THIRD PARTIES

The management letter may state that the communication is intended solely for the information and the use of management and those charged with governance. However, there are times when a copy of our management letter is requested, either directly from the client or from us, by parties outside the client entity. Since the letter is issued to the client, we cannot prevent the client from furnishing a copy to a third party if the client desires to do so. Accordingly, management letters will contain a disclaimer of responsibility to third parties. If we are aware that the management letter is to be given to third parties, we may modify the letter to identify the third parties to whom the letter is to be given.

APPLICATION GUIDANCE – THIRD PARTY DISCLAIMER

The following is example wording regarding a disclaimer of responsibility to third parties that may be included in a management letter:

'This communication is intended solely for the information and use of management, [identify the body or individuals charged with governance] and [identify any other specific individuals] and is not intended to be, and is not to be, used by anyone other than these specified parties. This communication is not to be relied upon by third parties. We do not accept responsibility for this report to any other person and we hereby disclaim any and all such liability.'

In no case do we give a copy of the letter to a third party unless prior written authorization is obtained from the client.

GROUPS

For groups, the management letter to the senior management of the parent entity communicates all matters that we consider affect their group responsibilities arising out of our audit of components. However, local management has the opportunity to review the comments relating to their entity before it is included in the consolidated letter. More detailed matters may be dealt with in a letter to an appropriate level of management and we may address separate management letters to each component.

However, the organizational structure of individual groups and client expectations sometimes mean that it is either appropriate or necessary to prepare separate management letters for all components. The arrangements in each case, therefore, are addressed at the planning stage.

For referred engagements, as discussed in chapter 42 - Audits of Group Financial Statements, the referring engagement partner instructs the receiving office as to the arrangements to be adopted in respect of management letters. Where the receiving office is to send a management letter to local management, as well as providing contributions to a consolidated management letter, the referring engagement partner may provide instructions as to the desired format (particularly opening and closing paragraphs) and the types of matters to be included.

SMALL ENGAGEMENTS

The above principles apply to any engagement regardless of size. However, for audits of smaller entities we may communicate with management and those charged with governance in a less structured way. It may be better to communicate matters and recommendations by discussion with the client. As with any engagement, we document such discussions and send a copy to the client where we have identified significant deficiencies in internal control.