audit Able

17. Management Letter (SA 265) Oct '19

In this Issue

What is a Management Letter?	1
Relevance for NGOs	1
Importance for Auditors	1
Matters to be Included	1
Communicating the Findings	2

Statutory Audit Reports are focused mainly on whether the financial statements give a true and fair view or not. However, during the audit, auditors also notice weaknesses or deficiencies in internal controls. These are shared with the management through a letter called Management Letter or Letter of Weaknesses.

This issue of AuditAble explains the audit standards related to Management Letter, and why these are as important for NGO audits as for corporate audits.

What is a Management Letter?

A Management Letter is a by-product of the statutory audit (or an independent audit).

A statutory audit is one that is mandated under a law — for example, the Income Tax Act or Companies Act. Statutory audits are conducted by independent auditors, who fulfill a critical public attest function. Huge amounts of funds (bank loans, investments, grants) exchange hands between strangers partly because an independent auditor has said that the accounts are good.

The statutory audit itself is conducted with one primary objective: Do the financial statements present a true and fair picture of the organisation's activities and financial position? The audit tests, time and fees are structured accordingly. If this was not so, statutory audits would become prohibitively expensive — and painful.

During the statutory audit, auditors also sometimes notice weaknesses or deficiencies in the internal controls. Sometimes this means that the auditors would have to perform additional tests to give a true and fair report. Once the main audit report is issued, auditors may consider whether they should talk to the management about the weaknesses in internal control. This would help the management fix these — and hopefully the next audit would not be as troublesome.

Relevance for NGOs

Most NGOs are strapped for funds, especially when it comes to segregation of duties or introducing internal audit. They are also not able to recruit or retain highly paid finance professionals. In these conditions, a Management Letter helps NGOs fix some of the problems in their internal control systems. A Management Letter also helps donor agencies assess the quality of statutory audit and get a peek into the internal controls of the NGO.

Importance for Auditors

A Management Letter is helpful for the auditors in two ways. Firstly, improved internal controls reduce audit risk for future audits. Secondly, it protects the auditor against charges of negligence in audits.

Issuing management letters was an optional good practice before Standards on Auditing became formalised. Now this is a professional requirement mandated through Standards on Auditing, which apply to all independent audits, including financial statement audits of NGOs.

Matters to be Included

The Management Letter is a by-product of the audit. Therefore, matters to be included in the Management Letter depend largely on the audit coverage itself. These can be:

Deficiencies in Internal Controls

According to SA 265[1], the auditor should figure out whether any internal control deficiencies (weaknesses) have been discovered during audit. If no weaknesses are discovered, no further action is needed.

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[1] Standard on Auditing 265: Communication of Deficiencies in Internal Controls to Those Charged with Governance or Management; Issued by Auditing Standards Board of Institute of Chartered Accountants of India.

If significant weaknesses have been found, these must be communicated in writing to the Board or Executive Management. Other weaknesses may be shared during meetings or verbally. If the auditor wishes, these also may be shared in writing.

Identified or Suspected Non-compliance with Laws & Regulations (NOCLAR)
The ICAI Code of Ethics (2019) is applicable in case of listed entities (w.e.f. 1-April-2020) only, and not in case of NPOs. However, it offers a window into what auditors are expected to do in case of compliance defaults. Requirements are relevant for members in service (para 260) and those in public practice (para 360). The Code of Ethics and SA 250 categorise legal compliance and auditor's responsibilities into two:

1. Laws (such as Income Tax Act, Payment of Gratuity Act, EPF Act, Bombay Public Trust Act, Companies Act), which directly affect financial statements. Auditors look for positive evidence to check compliance, and assess the impact on 'True and Fair' view.

2. Laws relating to operations (such as FCRA, FEMA, PMLA), which don't directly affect financial statements. Non-compliance with the latter could result in suspension of operations, or in penalties. Auditors try to discover non-compliance with these and assess whether there may be a material impact on true and fair view. During audit tests as above, the auditor may come across compliance issues which don't affect financial statements. In such cases also, the auditor may bring these to the attention of the management through the management letter. Reporting non-compliance to regulators through a separate letter is not required unless the relevant law places this responsibility on the auditors.

Identified or Suspected Fraud
SA 240[2] deals with auditor's responsibilities in this matter. The auditors are expected to offer reasonable assurance that true and fair view is not affected by fraud.
If fraud is identified or suspected, the auditors are expected to share the findings with the management, unless the management itself is suspected of being involved in the fraud. In such cases, the auditors are expected to report the matter to Governing Board. Reporting fraud to regulators through a separate letter is not required unless the relevant law places this responsibility on the auditors.

> "If you think compliance is expensive, try non-compliance"
>
> **Former U.S. Deputy Attorney General Paul McNulty**

Other Matters
Sometimes, the statutory audit may also cover additional matters. For example, the audit report in form 10B includes an Annexure. This covers questions such as whether key persons received any benefits from the NGO. Similarly, the audit report issued under Bombay Public Trust Act must include comments on specific matters. Audit report of a sec. 8 company also includes comments on other matters. Audit certificate issued under FCRA talks about records and utilisation of funds as per FCRA.
Sometimes the letter of engagement with the client or the donor may specify additional areas to be covered in audit (e.g., under SRS 4400). In such cases, the auditors findings may also include other topics (e.g., budgeting, financial management practices, utilisation of funds, program activities, governance aspects).The Management Letter may also include findings incidental to these areas.

Communicating the Findings

Not all findings may merit inclusion in the formal Management Letter. What should be included and what should be left out is governed by SA 260, as well as by the auditor's professional judgment. Some findings may be communicated verbally (and a record kept). Others may be included in the Management Letter. In the sample given below, LMN society is an NGO which has received a grant from ABC donor agency. The project is called XYZ. The auditors have written a Management Letter to the NGO, with a copy to the donor agency ABC (optional). The Management Letter may also contain description of methodology (optional) and scope:

[2] The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements.

To,
Secretary,
LMN Society,
[Address]
Dear _______

Sub: Management Letter from Auditor (2018)
During the recent review of records for expressing an opinion on ABC-supported Project called "XYZ," a two-member team visited the organisation.

Methodology: The audit commenced with an opening meeting with the key project holders to get an overview of the organisations background and project activities. As part of our audit method, we examined 100% of the vouchers for ABC-supported project from the period 1st January'18 to 31st December'18. Where necessary, the vouchers were co-related with the programme records (attendance sheets, photographs, etc.) to verify the programme events. Project costs for the period under the review that had insufficient supporting document were tabulated. A closing meeting was held with key project holders and the accountant. The audit was performed in accordance with ISA 805 and Upstream Donor's audit instructions.

Scope: Our audit was restricted to examination of the books of account, vouchers, supports, and records (programs and financial) in order to review, assess and report on compliance with terms of the agreement with ABC and applicable legislation and ordinances. We were required to report on the financial statements for ABC/Upstream Donor's grant to the Organisation, along with a report on factual findings in accordance with ISRS 4400.

We were also required to issue a management letter and comment on the action taken by the organisation in response to auditor's comments in previous year's management letters. We have been informed that a management letter was not issued during previous year's audit.

During the audit, we have made the following incidental observations, which you may wish to consider for further improving the effectiveness of your accounting, record-keeping, controls and financial reporting of ABC funds and of the Organisation as a whole. Please note that this does not constitute an overall assessment of the Organisation's systems or financial/compliance risks:

Sl.	Observation	Implication	Suggested Mitigation
A. Legal Compliance			
1.	Provisions of The Payment of Gratuity Act 1972 are applicable to the Society. No provision has been made in the accounts.	Difficulty in meeting gratuity liability	Make a provision for gratuity in the accounts as per the requirements of The Payment of Gratuity Act, 1972.
2.	Rule 13(a) of Foreign Contribution Regulation Rules, 2011 (FCRR 2011) requires organisations registered under FCRA 2010, to upload annual audited statements for FC funds on Organisation's Website. Organisation maintains a website, but this is not being done.	Non compliance with FCRA provisions	Consider uploading FC audited financial statements on organisation's website.
3.	Schedule K of Form ITR-7 (annual return of income), requires particulars of Founders, governing body members, large donors and their relatives, etc. This is not being provided.	Inadequate disclosure of information in Income Tax Return	Consider including details of such persons in Form ITR 7.
4.	Section 40A(3) of Income Tax Act 1961, prohibits cash payment exceeding INR 10,000 to an individual or organisation during a particular year. Some payments over Rs. 10,000 in cash were noticed.	Payments in excess of INR 10,000 may be disallowed and result in tax.	Consider ensuring payments exceeding Rs. 10,000 made to an individual or organisation are through crossed account payee cheques or bank transfer only.
B. Accounting and Audit			
5.	Project expenses are booked in donor accounts using accrual basis of accounting. These are reported to ABC using cash basis of accounting i.e. when expenses are actually paid.	Mismatch between account books and donor reports	Consider using the same accounting method for booking expenses in accounts and reporting expenses in financial reports submitted to ABC.
6.	Quotations from three vendors are compared before purchase of supplies, etc. In one case, two out of three vendors were under same management.	Purchases may not be cost-effective.	Consider inviting quotations from independent vendors only.

Sl.	Observation	Implication	Suggested Mitigation
7.	Program advances are disbursed to employees through bank transfer, who then pay the participants and vendors in cash.	Weak control over vendor payments	Minimise cash payments through staff and pay directly whenever possible.
8.	In some cases, overwriting of amount or date on a bill was not authenticated by the vendor.	Supports may be unreliable and rejected in audit.	Consider discouraging the practice of over-writing/making corrections to bill amount or date. The person making the correction may be asked to sign against the same.
C. Record-Keeping			
9.	LMN Society is maintaining project wise HR file. A single consolidated HR file for ABC employees is maintained. These include photocopies of documents like educational certificates, identity proof (PAN Card, Voter ID, Driving Licence etc).	Documents may not be authentic.	Copies of documents should be self attested by respective employee and verified by an officer, and then filed. Employee bank details should be taken on record.
D. Compliance with Donor Terms and Conditions			
10.	In some cases, supports do not carry ABC fund stamp.	Supports may be mixed up or re-used.	Mark 'ABC Funds' and 'PAID' stamp on the supports rather than on plain paper (on which these are pasted).
E. Internal Controls			
11.	For Needs Based workshops, cash payment of INR 1,000 is made to the resource person as honorarium. Similarly, expenses are incurred on hire of hall for various meetings. These payments are supported by a plain paper receipt signed by the receiver.	Difficulty in verifying the payments	Consider noting name, address, phone number of the receiver apart from ensuring the date and venue is always mentioned. Payment receipt may be countersigned by the LMN Society employee who hands over the cash. Option of bank transfer for such honorarium payments may be examined.
12.	Appointment letters are in two parts: one (on letterhead) mentions the name and the duration of the job. This is signed by both the employer and the employee. The second part, on a separate sheet of plain paper mentions the JD, the amount of salary and various other general conditions. This part is signed only by the employer. Both documents are prepared each year in the same manner.	Appointment letters may be substituted or treated as defective during audit.	Consider integrating the appointment letter and job description in one document, and adding with a running footer containing period, name of employee and page number, to prevent mixup of pages. All pages should be signed and dated by both parties.

We trust the above is to your satisfaction and will be glad to provide any information or explanations you may desire. We also take this opportunity to thank you for the courtesy and cooperation extended to our team during the review.

For [Name of Firm], Chartered Accountants (FRN ______)
[Name of Member], Partner/Proprietor (Membership No. _____)
UDIN: ________

Copy, for information to:
The President,
ABC Foundation
[Address]

What is AuditAble:
Each issue of 'AuditAble' covers a different topic related to NGO auditing and is mailed to about 800 NGO auditors and grant-makers in India. AccountAid encourages reproduction or re-distribution of 'AuditAble' in professional circles for non-commercial use, provided the source is acknowledged.

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You can send your questions by e-mail (query@accountaid.net) or letter. You can also discuss these over the phone.

Comments: AccountAid India, 55-B, Pocket C, Siddharth Extension, New Delhi-110 014; Phone: 011-2634 3128; Phone/Fax: 011-2634 3852; e-mail: info@accountaid.net

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Content: Shri Sanjay Agarwal, with inputs from Shri Aditya Agarwal, Delhi

Design: Ms. Moushumi De