STATEMENT 3.254

AUDITING GUIDELINE

REPORTS TO MANAGEMENT

Introduction

1. Paragraphs 21 and 22 of Statement 3.240 "Internal controls" state:

   "It is important that the auditor should report, as soon as practicable, significant weaknesses in internal controls which come to his attention during the course of an audit to an appropriately senior level of management of the entity. Any such report should indicate that the weaknesses notified are only those which have come to the attention of the auditor during the course of his normal audit work and are not necessarily, therefore, all the weaknesses which may exist.

   The fact that the auditor reports weaknesses in internal controls to management does not absolve:

   (a) management from its responsibility for the maintenance of an adequate internal control system; or

   (b) the auditor from the need to consider the effect of such weaknesses on the extent of his audit work and on his audit opinion."

2. A report to management arising out of an audit assignment is also a suitable medium for providing constructive advice on improvements to the financial and accounting efficiency of the client's business.

3. Reports to management should not be confused with specific responsibilities which may be imposed on the auditor in some sectors (by statute, regulation, or agreement), to report to a third party on the adequacy of a client's internal control arrangements.

4. The purpose of this guideline is to provide guidance on the procedures involved in making a report to management on matters arising out of an audit assignment.

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Background and purpose

5. Reports to management are known by various names, for example management letters, post audit letters and letters of weaknesses. The report should preferably be communicated in writing to the client, but may take the form of a record of a discussion held with management, to be included in the auditor's working papers. In smaller companies, for example, it may be more cost-effective to discuss with management the various matters to be reported and after such a meeting to provide a note of the observations and action which the client intends to take. The principles outlined in this guideline should be followed whatever method is used to report to management on matters which have arisen during the audit.

6. The auditor's statutory duty is to express an opinion on the financial statements and this responsibility is not reduced by any report made to management. A report to management is additional to, and is not a substitute for, the exercise of the auditor's statutory duties.

7. Principal purposes of a report to management are:

   (a) to enable the auditor to give the comments he wishes on the accounting records, systems and controls that he has examined during the course of his audit. Areas of weakness in systems and controls that have come to his attention and might lead to material errors should be highlighted and brought to management's attention, together with any advice for their improvement;

   (b) to provide management with other constructive advice. The auditor might, for example, be able to suggest areas where economies could be made or where resources could be used more efficiently; and

   (c) to communicate matters that have come to the auditor's attention during the audit that might have an impact on future audits.

8. The auditor would not normally make a report to management where there are no significant matters to bring to management's attention. In such a case the auditor may wish, solely as a matter of courtesy, to inform management that no report will be forthcoming.

Planning

9. A report to management will normally be a natural by-product of the audit, and the auditor should incorporate the need to report in the planning of the audit.

10. In addition to advising the client in an engagement letter that the auditor will report to the client's management any weaknesses in the client's systems which he thinks should be brought to its attention, the auditor should add that he may also comment on other matters.

11. The auditor should also refer in the engagement letter to any arrangements agreed with the client for submitting to, or requesting from, other group companies any reports to management which might arise (see further at paragraph 29 et seq).

12. To be effective, a report to management should be made as soon as possible after completion of the audit procedures giving rise to comment. Where the audit work is performed on more than one visit, it will often be appropriate to report to management after interim audit work has been completed as well as after the final visit. If there are procedures that need to be improved before the financial year end the auditor should raise them in a letter or in discussion at an interim stage. As soon as an accounting breakdown is identified or serious weaknesses are apparent, senior management should be informed without delay.

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13. Generally, where the following matters arise out of the audit, they should be included in a report to management:

    (a) weaknesses in the structure of accounting systems and internal controls;

    (b) deficiencies in the operation of accounting systems and internal controls;

    (c) inappropriate accounting policies and practices; and

    (d) non-compliance with legislation, accounting standards, or other regulations.

    An auditor may have specific reporting duties imposed on him by statute or regulation. For example, the auditor of a company incorporated under the Companies Ordinance has a specific duty to report where, in his opinion, proper accounting records have not been kept. Where a qualified audit report is required to discharge such a duty, a report to management cannot be regarded as a substitute.

14. The auditor may also wish to include in the report comments on potential economies, improvements in efficiency, or other constructive advice which might be of assistance to the client organisation.

15. Reports to management should explain clearly the implications of any matters raised. The use of specific examples identified during the audit to illustrate these matters helps readers to understand the nature of the problems which require action.

16. It is normally helpful for the auditor to make recommendations for improvements on the matters raised. This should not however delay the issuing of any report to management. It should be borne in mind that determination of appropriate improvements in systems and the assessment of the cost-effectiveness of additional controls may be complex issues that in any event are management's responsibility.

17. Points made in previous years' reports should be reviewed. Where they have not been dealt with effectively the auditor should enquire why appropriate action has not been taken. If the auditor considers the points still to be significant, they should be included again in his current report, otherwise there is a risk that the auditor may give an impression that he is satisfied that the weakness has been corrected.

18. Where the work of internal audit reveals weaknesses in internal controls, the external auditor should consider whether it is enough to draw management's attention to a report of internal audit or whether he should also report to management himself, particularly where he considers management response to internal audit reports is inadequate or where the weaknesses are significant.

Format and presentation

19. The report should be clear, constructive and concise. Careful presentation will help the recipient to understand the significance of the comments and devise corrective actions.

20. It is important that matters of concern should be discussed and recorded as they arise to ensure that the auditor has properly understood the situation. Those discussions should take place with appropriate members of the client's staff at an operating level and should not necessarily be limited to executives concerned solely with finance and accounting. When the points in the report are drafted they should be cleared for factual accuracy with the client's staff concerned.

21. The auditor should explain that his report to management only includes those matters which have come to his attention as a result of the audit procedures, and that it should not be regarded as a comprehensive statement of all weaknesses that exist or of all improvements that might be made.

22. The report may contain matters of varying levels of significance and the inclusion of detail may make it difficult for senior management to identify points of significance. The auditor can deal with this by giving the report a "tiered" structure so that senior management can consider any major points, and other points can be brought to the attention of less senior personnel. Alternatively, by agreement with the client, this objective might best be achieved by preparing separate reports for different levels of management, and reporting that this has been done.

23. Where different members of management are responsible for different regions, branches or functions, the report may have separate sections relating to the various areas of responsibility.

24. When submitting his report the auditor should use his best endeavours to ensure that its contents reach those members of management who have the power to act on the findings. It is usually appropriate to address the report, or that part of the report containing the major points, to the Board of Directors or equivalent body even if the receipt of a report of less important point is delegated by the Board. The auditor may agree with the client to address his report to the client's audit committee.

25. The auditor should preferably communicate his report in writing to the client, but the volume or nature of his comments may be such that a written report is unnecessary, inappropriate or not cost-effective. In these circumstances the report should consist of a record of a discussion with management which should be minuted or otherwise recorded in writing. Management should be provided with a copy of this note to ensure the discussion has been fairly reflected. The written record of any such discussions should preferably form part of the audit working papers.

Management response

26. The auditor should request a reply to all the points raised, indicating what action management intends to take as a result of the comments made in the report. It should be made clear in the report that the auditor expects at least an acknowledgement of its receipt or, where he considers it appropriate, the directors' discussion of the report to be recorded in the board minutes.

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27. Where matters have been discussed with client staff as and when they arise, the auditor should consider whether to incorporate responses made by staff in the final form of a report. This will be particularly useful where, say, senior management receive the report and need to be informed of the action taken by their staff.

28. Where the report to management takes the form of a record of the auditor's discussions with management, this record should preferably include management's response and any intended action.

Groups of companies

29. The management of a holding company may wish to be informed of significant points arising in the reports to the managements of its subsidiaries. Where the auditor is responsible for the audit of all the companies in the group, the management of the holding company may request that an additional report be addressed to the holding company summarising points of significance to the group that were made in the individual reports to the managements of the subsidiaries. The auditor may agree to this request. However, as a report to management is a confidential matter between the auditor and the management of the company concerned, he should first obtain permission from the managements of the subsidiary companies to disclose the contents to the holding company.

30. Where other auditors are involved, the auditor of the holding company will usually request that he should receive copies of reports sent to the managements of subsidiary companies, so that he is aware of any significant internal control weaknesses or accounting weaknesses in those companies. The request should normally be made through the holding company to the management of the subsidiary companies concerned. Should such a request be received by the auditor of a subsidiary company he should obtain permission from the management of the subsidiary before complying.

31. If the auditor of a holding company wishes to report to the management of the holding company on matters contained in the reports to the managements of subsidiaries whether or not their financial statements are audited by him, he should first ensure that the managements of the subsidiary companies concerned and their auditors both agree to this procedure, and that no breach of confidence takes place.

32. All these arrangements for groups should be established at the planning stage, and should be recorded in the engagement letters.

Third parties interested in reports to management

33. Any report made to management should be regarded as a confidential communication. The auditor should therefore not reveal the contents of the report to any third party without the prior consent of the management of the organisation.

34. In practice the auditor has little control over what happens to the report once it has been despatched. Occasionally management may provide third parties with copies of the report, for example, their banks or certain regulatory authorities. Therefore care should be taken to protect the auditor's position from exposure to liability in negligence to any third parties who may seek to rely on the report.

35. As a general rule a liability in negligence could arise where an auditor carries out work for a client in circumstances where the auditor knows or ought to foresee that:

    (a) his work is liable to be relied upon by a third party;

    (b) and the third party may suffer financial loss as a result.

    An express disclaimer of liability will normally provide a high degree of protection against unforeseen liability to third parties who may choose to rely on the report to management. To achieve this, the auditor should state clearly in his report that:

    (i) the report has been prepared for the private use of his client;

    (ii) it must not be disclosed to a third party without the written consent of the auditor; and

    (iii) no responsibility is assumed by the auditor to any other person.

36. Use of disclaimer paragraphs may not however give full protection from liability where the auditor knows or ought reasonably to know that a report to management may be passed on to a third party who would rely upon it. Thus the auditor should recognise that, for example, his client's bankers may occasionally request a copy of the report to management and may make use of it on the assumption that the auditor has performed his duties to the client to an acceptable standard. The auditor should therefore clarify with the client whether his report to management is likely to be submitted by the client to any regulatory body or other interested parties.

37. The auditor should ensure that his comments are factually accurate, his opinions reasonably held and stated, and that remarks of a personal nature are carefully considered. This is particularly necessary when his report contains comments which are critical of members of the client's management or other staff and could lay the auditor open to a charge of defamation.