



Financial Sustainability Program

Information Paper 24

Audit Management Letter

June 2009



Introduction

The Local Government Act provides that Councils must maintain correct and adequate accounting records; must ensure that appropriate policies, practices and procedures of internal control are implemented; must have an audit committee; must prepare annual financial statements and must have those financial statements audited. The Act also provides that an auditor must provide to Council an audit opinion with respect to the audited financial statements and a report on particular matters arising from the audit.

The Local Government (Financial Management) Regulations require the auditor of a Council to conduct the audit in accordance with auditing standards. These standards stipulate mandatory requirements to be followed by auditors and provide other guidance on the conduct of an audit, including reporting on the audit findings.

An auditor must provide a report (an Audit Management Letter) to a Council, at either the conclusion of an interim audit or the final audit, which sets out a range of matters that the auditor considers need to be drawn to the attention of the Council. This paper deals with the content of an Audit Management Letter and includes at Attachment 1 a Specification for an Audit Management Letter.

The Local Government Act also provides that the auditor must report to the Minister in specific circumstances (Section 129 (6) & (7)). This paper does not deal with such reports. It also does not deal with reports issued by auditors on special purpose audit engagements (Auditing Standard ASA 800).

This paper should be read in conjunction with Financial Sustainability Information Paper 4: 'Scope of External Audit – Audit Specification' which includes as an attachment a 'Draft Specification for Audits in Local Government'.

Other information papers have been, or will soon be, prepared on the following topics:

- Financial Sustainability
- An Overview of Audit Mechanisms
- Audit Committees
- Scope of External Audit - Audit Specification
- Efficiency and Economy Audits
- Infrastructure and Asset Management (Policy and Planning)
- Service Delivery Framework including the Role of Shared Services
- Long-term Financial Plans
- Local Government Financial Indicators
- Debt Management
- Governance in Local Government
- Targets for Local Government Financial Indicators
- Model Framework for Council Annual Business Plans
- Model Work Program for Council Audit Committees
- Treasury Management
- Long-term Financial Plan - A Model Format for Financial Information
- Depreciation and Related Issues
- Financial Policies
- Audit Committee Reporting
- Funding Policies and Strategies
- Internal Controls
- *Risk Management Framework (currently being prepared)*
- *A New Approach to State-Local Resourcing (currently being prepared)*

A number of manuals, guidelines, templates, technical definitions, codes, standards and similar documents supporting this series of information papers are also being prepared by the LGA to provide practical assistance to Councils.

For an update on which information papers have now been completed or information about other documents and activities, including briefing and training sessions, please visit our website at: www.lga.sa.gov.au/goto/fsp.

What do the Act and Australian Auditing Standards require?

The Local Government Act in Section 129 (Conduct of an annual audit) requires that the auditor must:

- Provide an audit opinion to the Council with respect to the audited financial statements [Section 129(3)]; and
- Provide to the Council a report on particular matters arising from the audit [Section 129(4)].

The relevant provisions of the Local Government Act 1999 are included at Attachment 2.

A proposal to amend the Local Government Act which was circulated by the Minister for State/Local Government Relations in December 2008 could result in a requirement for the auditor to provide an additional audit opinion on the adequacy of the Council's internal controls and whether those controls are sufficient to provide a reasonable assurance that the financial activities of the Council have been conducted properly and lawfully.

The Local Government (Financial Management) Regulations require the auditor of the Council to conduct the audit in accordance with auditing standards. Australian Auditing Standards are issued by the Auditing and Assurance Standards Board, a Commonwealth Government entity. They stipulate mandatory requirements to be followed by auditors and provide other guidance on the conduct of an audit, including reporting on the audit findings. For example, a key element of any audit is an assessment of the adequacy of the internal control environment of the organisation and ASA 315 (Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement) contains extensive requirements and guidance for auditors in the assessment of an organisation's internal control environment.

The form and content of reports from an auditor to the organisation being audited are set out in the following auditing standards:

ASA 260	Communication of Audit Matters with Those Charged With Governance
ASA 700	The Auditor's Report on a General Purpose Financial Report
ASA 701	Modifications to the Auditor's Report
ASA 800	The Auditor's Report on Special Purpose Audit Engagements

However, other auditing standards may include specific requirements on the reporting of relevant matters to those charged with governance. These matters will generally relate to the conduct of the audit and the audit findings. The inclusion of a specific reporting requirement in an auditing standard is to ensure that auditors report such matters.

Some definitions – for clarity

Different language is often used to describe the same thing and it is important that there is clarity in understanding the issues relating to the external audit of a Council. The following definitions are provided to assist.

'audit opinion' - the report issued by an auditor at the conclusion of the audit of a general purpose financial report (the financial statements) which provides an opinion on the truth and fairness of the financial report. The 'audit opinion' is issued in accordance with ASA's 700 and 701 and satisfies the requirements of Section 129(3) of the Local Government Act.

'management letter' – the report issued by an auditor at the conclusion of an interim audit or a final audit which sets out a range of matters that the auditor considers need to be drawn to the attention of the Council. The 'management letter' is issued in accordance with ASA 260 and satisfies the requirements of Section 129(4) of the Local Government Act.

'interim audit' – an audit of various aspects of a Council's operations, including the system of internal control, prior to the end of the financial year. This audit does not result in the issue of an audit opinion on the truth and fairness of the financial report nor an opinion on the adequacy of internal controls (if the latter becomes a new legislative requirement)

'final audit' – an audit which results in the issue of an audit opinion on the truth and fairness of the financial statements and, if it becomes a new legislative requirement, a separate opinion on the adequacy of internal controls.

'management representation letter' – Auditing Standard ASA 580 (Management Representations) requires auditors to obtain from management written representations in relation to the truth and fairness of the financial statements and on other related matters. Management representations may also be required as audit evidence. This paper does not deal with such representations.

'internal control' – is defined in ASA 315 (paragraph 54) as "...the process designed and effected by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations."

'internal financial controls' – are the internal controls that are specifically related to financial activities, management and reporting. Further information on internal financial controls is contained in LGA Financial Sustainability Information Paper 21 – '*Internal Financial Controls*'.

Specification for an Audit Management Letter

The Specification for an Audit Management Letter included at Attachment 1 provides model wording for inclusion in a Council's audit tender specification and audit contract documents. It is intended to provide Councils with the capacity to require auditors to report in sufficient depth for the CEO, the elected body and its audit committee to discharge their obligations under the Local Government Act. These include obligations in relation to the good governance and sound management of the Council's operations (with specific reference to internal control) financial management and the maintenance of accounting and financial records. It sets out the content that a Council should require an auditor to provide in a

management letter provided in accordance with ASA 260. In doing so, it does not limit the scope of reporting by an auditor.

To ensure that the Council, its audit committee and the Chief Executive Officer are provided with sufficient information to discharge their obligations under the Local Government Act for prudent financial management the management letter prepared by an auditor in accordance with ASA 260 must include comment on the following matters, where relevant.

1. Significant Adverse Trends in Financial Position or Financial Management Practice.
LGA Financial Sustainability Information Paper 4: '*Scope of External Audit – Audit Specification*' identifies the need for the auditor to report on significant adverse trends in the financial position or financial management practices of the Council and any material irregularities in the Council's accounting practices or in the management of the Council's financial affairs. This is broadly consistent with Section 129(5) of the Local Government Act which requires the auditor to report on such irregularities.
2. The appropriateness of the valuation and depreciation methodologies being used in respect of infrastructure assets.
Depreciation is a significant component of a Council's operating expenses and any errors in the way in which depreciation is calculated can have a material impact on the calculation of a Council's operating surplus or deficit. Information Paper 4 identifies the need for the auditor to report on the appropriateness of the depreciation charge. The auditor also needs to ensure that useful lives and residual values of infrastructure are realistic.
3. The Adequacy of the Internal Control Environment.
The auditor needs to clearly state the extent to which the internal control environment has been assessed. Where significant deficiencies exist in the internal control environment the auditor must set out what the deficiencies are and whether discussions with management have resolved a course of action to remedy such deficiencies.

Note. The proposal to amend the Local Government Act which was circulated by the Minister in December 2008 could result in a legislative change requiring the auditor to provide an opinion, to Council, on whether the internal controls exercised by the Council are sufficient to provide a reasonable assurance that the financial transactions of the Council have been conducted properly and lawfully. Such a requirement is likely to significantly change the scope of a Council audit. While auditors consider the effectiveness of internal controls over financial reporting when determining the nature and context of their audit procedures, audits are not currently designed to provide assurance on internal controls.

4. The Risk Management Framework.
Councils need to be regularly monitoring and updating their risk management framework to ensure that it is an effective element of a Council's processes and procedures to deliver services to its community. Councils and their Audit Committees need to be aware that while the external auditor may include some review of risk management in the audit plan (for more information see point 4 in Attachment 2 of LGA Financial Sustainability Information Paper 4) it will not necessarily be a thorough review of the adequacy or effectiveness of the risk management framework. However, the external auditor should, as a minimum, seek to check that a risk management plan is in place and that it is monitored and reported on regularly. In the absence of an active plan, a Council is not in a position to respond in a timely way to risks which may have an adverse effect on its operations. An effective Audit Committee can play a pivotal role in monitoring and assessing a Council's risk

management activities. This would be significantly enhanced by an internal audit function.

5. Specifically Requested Audit Examination.

It is not unusual for Councils to require that specific areas of a Council's operations are reviewed as part of the annual audit (e.g. the implementation of new taxation legislation). The auditor must report on the scope of the review, its findings and any recommendations in relation to the activity.

6. Specific Reporting Required by an Auditing Standard.

Some auditing standards require that consideration be given to the reporting of specific matters to those charged with governance. Auditors must comply with the auditing standards and report as necessary.

7. Review of the Adequacy of Response to Previous Management Letters.

The auditor must include in any management letter the outcome of any remedial action taken by the Council as a result of previous management letters. Specific attention must be drawn to situations where the remedial action is not adequate, including the failure to implement any remedial action.

In addition to the required tasks and outcomes the audit may result in additional findings that need to be communicated in an audit management letter.

8. Adherence to Council's Policies.

Councils develop policies to provide a framework for decision-making and to facilitate the day-to-day operations of the Council. Some of these policies form part of the internal control framework (e.g. delegations, tendering rules etc.) and deficiencies in this area will be communicated in relation to the adequacy of the internal control environment. Where other failures to implement or apply Council policies are discovered in the course of an audit the auditor must include in the management letter significant failures and the steps that management are taking to remedy such failures.

9. Compliance with Legislation.

Councils are required to comply with the Local Government Act and Regulations and a number of other Acts. Where failures to comply with legislation are discovered during the course of an audit the auditor must include in the management letter significant instances where the Council has failed to comply with legislation and the steps that management are taking to remedy such failures.

Timing of the Management Letter

ASA 260 requires auditors to provide 'timely' communication. It would be usual for the management letter to be provided at the conclusion of the annual audit and the auditor should discuss the contents of the management letter either at a meeting of the Council's Audit Committee or of the Council itself.

For larger Councils, it is likely that the audit will be conducted in two sessions – an interim audit during the financial year and a final audit when the financial statements are available. Where an auditor conducts an interim audit a management letter must be provided to the Council at the conclusion of the interim audit to enable any required remedial action arising from the audit to be implemented as soon as possible. This will ensure that any exposure to potential loss is minimised.

Delivery of the Management Letter

ASA 260 requires the auditor to determine 'the relevant persons who are charged with governance and with whom audit matters of governance interest are communicated'. Without limiting the ability of the auditor to exercise such judgment Councils should specify that management letters are to be sent to the Principal Member of the Council, the Council's Audit Committee and the Chief Executive Officer.

Response to the Management Letter

A Council needs to respond promptly to the management letter and where necessary, take adequate steps to remedy any deficiencies or shortcomings identified by the auditor. It is unlikely that the contents of the management letter will not already have been discussed with the CEO and following the discussion the CEO should take immediate action to clarify issues and correct errors, processes and procedures to ensure the soundness of the internal control framework and the appropriateness of policies and procedures.

What are the issues for Councils?

The Audit Management Letter is an important part of the reporting process associated with Councils' annual audits.

It is important that Councils ensure that their audit specifications, provided on the appointment of auditors, result in comprehensive, objective and independent audit reporting on the operations and the financial position of the Council. Councils should incorporate the Audit Management Letter specification set out in this paper as part of their overall specification for the conduct of annual audit.

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Attachment 1: Specification for an Audit Management Letter

Reporting on the Findings of an Audit

- A. Without limiting the scope and application of ASA260 – “Communication of Audit Matters with Those Charged With Governance” Council requires that the Auditor shall promptly after the conclusion of an interim audit or a final audit provide to the Principal Member of the Council, the Council’s Audit Committee and the Chief Executive Officer a management letter outlining the audit findings in relation to the following matters where such matters are material:
1. Any significant adverse trends in the financial position or financial management practices of the Council and any material irregularities in the Council’s accounting practices or in the management of the Council’s financial affairs identified during the course of the audit. Where management has taken steps to correct or improve the financial position, financial management practices, accounting practices or management of the Council’s financial affairs the auditor must comment on the efficacy of the correction or improvement.
 2. The appropriateness of the valuation and depreciation methodologies being used in respect of infrastructure assets. Depreciation is a significant component of a Council’s operating expenses and any errors in the way in which depreciation is calculated can have a material impact on the calculation of a Council’s operating surplus or deficit. The auditor also needs to ensure that useful lives and residual values of infrastructure are realistic.
 3. The extent to which the internal control environment has been assessed as set out in the audit plan and any material weaknesses in the control environment, based on the application of auditing standard ASA 315 *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* and other relevant auditing standards. Where weaknesses have been identified and management has proposed or adopted remedial action to rectify the weaknesses the auditor must comment on the efficacy of the proposed or adopted course of action. Where weaknesses have not been addressed the auditor must make recommendations for addressing the weaknesses.
 4. Whether the Council, through its Audit Committee, is regularly monitoring and assessing the adequacy and effectiveness of its risk management framework and activities.
 5. Where the Council or management have requested that a specific activity, function or operation of the Council be reviewed during an audit the auditor must report on the scope of the review, its findings and any recommendations in relation to the activity, function or operation of the Council.
 6. Where an auditing standard requires that the auditor must give consideration to the reporting of specific matters to those charged with governance the auditor must comply with the auditing standard and report as necessary.
 7. The auditor must report on the outcome of any remedial action taken by the Council as a result of previous reports. Specific attention must be drawn to situations where the remedial action is not adequate, including the failure to implement remedial action.

8. Where, during the course of an audit, it becomes apparent that the Council has failed to comply with relevant legislation, the auditor must report on significant failures and any remedial action proposed or adopted by management to rectify non-compliance.
9. Where, during the course of an audit, it becomes apparent that management have failed to comply with Council policies the auditor must report on significant non-compliance and any action proposed or adopted by management to rectify non-compliance with the Council's policies.
10. The requirements set out above do not limit the scope of the auditor's report and the auditor must report on any other matter that in the auditor's judgment may have an impact on good governance and the sound management of the Council's affairs.

Attachment 2: Local Government Act Provisions and Regulations Relating to External Audit

Local Government Act 1999

Chapter 8—Administrative and financial accountability

Part 3—Accounts, financial statements and audit

Division 4—Audit

129—Conduct of annual audit

- (1) The auditor of a council must undertake an audit of the council's financial statements within a reasonable time after the statements are referred to the auditor for the audit (and, in any event, unless there is good reason for a longer period, within two months after the referral).
- (2) An audit must be carried out in accordance with standards prescribed by the regulations.
- (3) The auditor must provide an audit opinion to the council with respect to the audited financial statements.
- (4) The auditor must also provide to the council a report on particular matters arising from the audit.
- (5) The auditor must specifically identify in the report under subsection (4) any irregularity in the council's accounting practices or the management of the council's financial affairs identified by the auditor during the course of an audit.
- (5a) The auditor will provide the reports under subsections (3) and (4)—
 - (a) to the principal member of the council (who must ensure that a copy is provided to the chief executive officer, and that copies are provided to the other members of the council before the next meeting of the council); and
 - (b) to the council's audit committee.
- (6) The auditor must report to the Minister—
 - (a) a failure by the council or the chief executive officer to rectify within a reasonable time or in a reasonable manner an irregularity identified by the auditor during the course of an audit; or
 - (b) a breach of this or another Act that comes to the attention of the auditor during the course of an audit; or
 - (c) evidence that, in the opinion of the auditor, indicates or suggests a serious financial irregularity.
- (7) An auditor is not required to report under this section on a minor irregularity or breach.
- (8) The Minister may, on the basis of a report under subsection (6), appoint an investigator or investigators to carry out an investigation under Chapter 13 Part 3 Division 1.

The investigator may be the Auditor-General.