Consider the Management Letter to Identify Potential Lending Risk

Internal Controls

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It is no surprise to hear lenders and investors tell us that in the "post-great-recession-era," many have tightened their credit evaluation process before approving lending to new customers or making adjustments to existing loans. Some banks stopped offering certain credit facilities or stopped lending to certain segments of the market. In the new world of lending, bankers are looking for more information about the viability of their existing or prospective clients.

Are you overlooking important risk information in your investments?

There is one valuable resource of important risk information which is often overlooked – the management letter issued by an organization's CPA firm to the owners and senior management in connection with an annual audit of privately held companies.

What is the management letter?

The management letter is a document issued by the organization's CPA firm that communicates internal control related matters. The letter is generally issued during a financial audit of a non-public organization.

Although the CPA firm is not required to perform procedures to identify deficiencies in internal control or to express an opinion on the effectiveness of the organization's internal control, during the course of an audit, the auditor may become aware of control deficiencies.

The American Institute of CPAs (AICPA), which provides professional guidance to CPA firms, requires the issuance of a management letter to those charged with governance of the organization, in the event material weaknesses or significant deficiencies are identified.

A ***material weakness*** is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the organization's financial statements will not be prevented or detected and corrected on a timely basis.

A ***significant deficiency*** is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

In general, the AICPA appears to follow similar definitions used in the various Sarbanes Oxley rules in connection with internal control reporting for public companies.

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What is the Value of the Management Letter in Due Diligence?

If a management letter is issued, the disclosed control deficiencies in the financial internal control system might represent risks to lenders and investors. These risks could relate to collateral reporting, interim financial reporting or possibly fraud, such as asset misappropriation.

Key Considerations When Reviewing the Management Letter

1. **Request the management letter.** Don't wait for an organization to give you their management letter. Be sure to request the most recent management letter along with financial statements normally gathered during due diligence.

2. **Read all the comments**. Although a CPA firm is required to disclose material weaknesses and significant deficiencies, due to the subjectively involved in the classification process itself, you should consider all comments included in the management letter. You can find many of these comments under "Process Enhancements."

3. **Know the types of deficiencies that present the greatest risk to lenders.** Consider control deficiencies which appear to have a pervasive impact on the organization, such as: a) occurrence of fraud; b) insufficient or incompetent accounting personnel; c) insufficient monitoring of management overriding existing controls; d) poor monitoring over system access, fraud, and risk management; and e) ineffective accounting software systems.

4. **Compare management letters over several years.** Pay close attention to those control deficiencies that appear to repeat themselves from year to year – this may be a sign that problems are not being fixed and may get bigger.

5. **Look for management remediation plans.** Remediation plans can help determine if senior management is dedicated to addressing and fixing the disclosed control deficiencies. These plans may be included as an Appendix to the management letter.

6. **Discuss disclosed deficiencies.** If any of the disclosed control deficiencies raise concerns regarding the viability of the organization or the integrity of the financial reporting process, you may consider having further discussions with management, and possibly with the CPA firm. Such discussions should be conducted with the overall goal of working in partnership with all parties involved to enhance the internal control system of the organization. If necessary, consider consulting with an internal control expert.

7. **Review. Trust. Verify.** Once you are satisfied with management's plans to address the identified control deficiencies, you should follow up to confirm that management's plans have been implemented.

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