Parliamentary Joint Committee

Inquiry into the collapse of Trio Capital Limited

KPMG Submission

October 2011

This report contains 18 pages

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A. Introduction

1. KPMG makes this submission to assist the Parliamentary Joint Committee on Corporations and Financial Services (**PJC**) with its Inquiry into the collapse of Trio Capital Limited (**Trio**) and other related matters (**Inquiry**).

2. This submission sets out KPMG's observations from the perspective of an auditor operating in the managed investments (**MI**) sector of the financial services industry in relation to:

- Operational and business environment of Responsible Entities (REs) of MI schemes;
- Regulatory framework of MI schemes, including relevant standards and guidance made and formulated by the Auditing and Assurance Standards Board (AUASB);
- Functions of compliance plans and compliance plan auditor;
- Conclusions and regulatory alternatives.

3. The role of the financial statement auditor is well established and documented under the law and the relevant accounting standards, whilst the role of the compliance plan auditor is relatively new and less well defined. Therefore this submission has made only limited reference to the role of the financial statement auditor.

4. This submission is framed to address certain key issues raised by the Terms of Reference of the inquiry (**TOR**). It specifically includes comments on elements of TOR 1 (relevant regulatory regime), TOR 7 (fraud) and TOR 11 (other matters in further improving the sector).

5. Some incidental commentary included is relevant to TOR 6 (access to compensation and insurance).

6. Unless otherwise stated the content of this submission is primarily addressed towards the operation of registered MI schemes and is not intended to cover broader issues, for example, the following does not make observations related to the trusteeship of superannuation funds.

7. Reference is included to comments made in other publications about the MI industry and its regulatory framework where these are considered relevant to this submission.

8. In 2003 and 2005 Grant Moodie and Professor Ian Ramsay published two relevant research papers. The first was titled "Managed Investment Schemes: An Industry Report"[1]. The second was titled "Compliance committees under the Managed Investments Act 1998"[2]. The observations made by Moodie and Ramsay remain relevant.

[1] Moodie, Grant and Ramsay, Ian, *Managed Investment Schemes: An Industry Report*, Centre for Corporate Law and Securities Regulation The University of Melbourne 2003

[2] Moodie, Grant and Ramsay, Ian, *Compliance Committees under the Managed Investments Act 1998*. Australian Business Law Review, Vol. 33, No. 3, 2005

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B. Executive Summary

Operational and business environment of MI schemes

9. The operating model of MI schemes is based on three broad activities: attracting funds from investors, managing assets of the scheme, and servicing the scheme. It is common practice for the RE to outsource many of the functions associated with these operational activities to external service providers.

10. The risks arising from outsourcing these activities manifest in the disaggregation of the RE's functions, authority, accountability and oversight. Consequently, access to current and complete information by the parties who are required to independently monitor the RE's operation is inhibited.

11. It is essential that robust oversight and governance practices are deployed by the RE particularly the RE who makes extensive use of outsourcing.

Regulatory framework of MI schemes

12. Chapter 5C of the *Corporations Act 2001* (**Act**) provides the regulatory framework for MI schemes, including the requirement for schemes to be registered, operated by a licensed public company (the RE) and have a constitution and compliance plan. There are also certain financial requirements and compensation arrangements that an RE needs to have in place to operate a MI scheme.

13. The responsibility for the operation of MI schemes falls on the RE. In the previous regime before the enactment of the *Managed Investments Act 1998* (*Cth*) (**MIA**), schemes were run by a management company and monitored by an independent trustee.

14. The RE is required to act in the best interests of scheme members among other duties, and its governance is supported by the operation of an independent compliance committee where one is required.

Functions of compliance plans and compliance plan auditor

15. An RE is required to have a compliance plan for each scheme setting out measures to comply with the Act and the scheme's constitution. Some key requirements of the compliance plan include ensuring all scheme property is clearly identified and held separately from that of the RE and that the compliance committee, where required, functions properly.

16. An independent auditor is required to annually examine the compliance plan and audit the RE's compliance with the plan, as part of the oversight functions performed by various external parties. The compliance plan auditor cannot also be the auditor of the RE's financial statements.

17. As noted by the AUASB in its Guidance Statement GS 013 *Special Considerations in the Audit of Compliance Plans of Managed Investment Schemes* (**GS 013**), there are inherent limitations in auditing the RE's compliance with the compliance plan as there is no guarantee that it is free from deficiency or that all compliance breaches are detected.

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18. From observations including those of Moodie and Ramsay's 2003 report, some of the limitations may include:

- The requirements of the compliance plan are drafted at a sufficiently high level such that it enables the RE to provide evidence of compliance;
- The potential separation of parties to conduct the compliance plan audit and the financial statement audit increases the risk of disaggregating their oversight functions, and may limit access to complete information on the MI scheme;
- Limited effectiveness of intervening against instances of fraud or misconduct, because the compliance plan auditor uses historical information based on internal reporting provided by the RE, so that compliance checks are 'after the event' or 'revisionist' in nature;
- 'Revisionist' checks are based on internal reporting and are therefore, 'after the event'. That is, they do not support timely intervention.

19. There are also limitations in relation to the role of the financial statement auditor in detecting instances of fraud. As observed by the AUASB in its auditing standard ASA 240 *The Auditor's Responsibility to Consider Fraud in an Audit of a Financial Report* (**ASA 240**), the primary responsibility for its detection rests with those charged with governance of the entity and management. Auditors can only obtain reasonable assurance that a financial report is free from material misstatement, whether caused by fraud or error.

20. There appears to exist an 'expectation gap' between what is expected by stakeholders of financial statement auditors and compliance plan auditors, and the reality of an auditor's role as prescribed by law and regulation. The role of an auditor is subject to inherent and prescribed limitations. This 'expectation gap' will likely remain whilst stakeholders are unaware of the extent of these limitations or if appropriate regulatory alternatives are not able to reduce these limitations.

21. The expectation gap is not limited to expectations about detection of fraud. Importantly, there is a common misconception that the auditor 'signs off' on the business model. Flawed business models may provide an opportunity for fraud.

Conclusions and regulatory alternatives

22. In order to address the issues highlighted in this submission, a number of regulatory alternatives have been proposed in this document, which seek to increase the effectiveness of third party oversight on the RE, reinforce the fit and proper standards of REs, and provide stakeholders with increased guidance to minimise the expectation gap.

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C. Operational and business environment of MI schemes

Operating model of MI schemes

23. The key business focus of MI schemes is to provide a financial return to investors, whether they are retail investors, institutional investors, or high net worth individuals. The current MI business model encompasses three broad activities in dealing with investors' funds:

- Attracting funds to the MI scheme;
- Managing assets of the scheme;
- Servicing the scheme.

24. It is a common feature of the MI industry that many parties are involved in carrying out each of these activities. While the operation of an MI scheme is the sole responsibility of the RE, many of them outsource substantial functions. Examples include:

- The offer of interests in the MI scheme to investors through financial advisers;
- A custodian that holds the scheme assets on behalf of the RE;
- An investment manager that makes investment decisions on behalf of the RE;
- Registry services, processing applications, redemptions, paying distributions.

25. It is observed that some REs have outsourced compliance activities.

26. Furthermore, a compliance committee, where one is required, must contain a majority of members who are independent of the RE and the auditor; and the scheme's compliance plan auditor must not be the auditor of the RE's financial statements.

Risks of the current operating model

Disaggregation of functions, authority, accountability and oversight

27. The status of the current environment is such that key functions in the operation of MI schemes have become disaggregated between numerous parties other than the RE.

28. This disaggregation was observed by Moodie and Ramsay in their 2005 research paper. It commented that the trend towards use of external service providers was driven by the MI regulatory framework and commercial trends towards specialisation.

29. The Moodie and Ramsay paper identified two broad areas of an RE's functions: custody and administration; and investment management. These two areas cover six types of activities associated with managing a MI scheme, which are often conducted by external parties as agents of the RE:

- Investment management;
- Custody of scheme property;
- Valuation of scheme property;
- Record-keeping;
- Payment of fees from the scheme;
- Processing of applications, redemptions, distributions and investor reporting.

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30. Whilst the Act clearly points to the RE as the entity responsible for the MI scheme's operation, the law also allows the RE to appoint an agent to do anything that it is authorised or required to do in connection with the MI scheme[3]. In reality, this has permitted the business model to be defined by a disaggregation of functions, authority, accountability and oversight, giving rise to the potential for diminishing safeguards in the management of the scheme.

Accurate, complete and timely information

31. Information about the operations and transactions of a MI scheme to support robust oversight is generally dispersed across the RE and external third parties that are appointed by the RE. However, each party involved in the scheme's operation may have no relationship with others and so may have distinct boards, management, auditors and operating philosophies.

32. Consequently, ready access to current and complete information by these external parties, such as the compliance committee and compliance plan auditor, may be inhibited. This increases the potential of limiting the opportunity for timely detection of material errors and fraudulent activity. Timely detection may be further inhibited where an officer of an RE is motivated to take deliberate steps to conceal any errors or fraudulent activity.

[3] ss601FB(1) & (2) of the *Corporations Act 2001.*

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D. Regulatory framework of MIS

Background to the single RE system

33. The current regulatory framework for MI schemes and its RE is contained in Chapter 5C of the Act, which was introduced into law by the **MIA** on 1 July 1998. The RE also needs to hold an Australian Financial Services Licence (**AFSL**) in operating the scheme, as part of providing a financial service under Chapter 7 of the Act.

34. Under the previous regulatory framework (pre-MIA), schemes operated according to an approved trust deed approach. It provided for a management company to deal with the promotion and management of the scheme; and an external independent trustee responsible for ensuring the investors' interests were preserved.

35. The introduction of the current framework through the MIA was designed to create a single point of accountability in the RE, enhanced by the role of the compliance committee.

36. Some of the key requirements under Chapter 5C of the Act include the following:

- All MI schemes must be registered (except for 'private' or 'wholesale' schemes);
- All registered schemes must be operated by a licensed public company as the single RE, which is subject to certain statutory duties to scheme members;
- Each scheme must have a constitution, a compliance plan, engage an auditor to audit the RE's compliance with the compliance plan, and establish an external compliance committee if less than half of the RE's directors are external directors.

Financial requirements of the RE

37. REs must meet minimum financial requirements to operate an MI scheme, which relates to its statutory obligation as an AFSL holder to have adequate financial resources. These financial requirements are further detailed in Regulatory Guide 166: Licensing: Financial requirements (**RG166**) issued by the Australian Securities and Investments Commission (**ASIC**).

38. RG166 subjects all AFSL holders to base level financial requirements, including:

- Be solvent at all times;
- Have total assets that exceed total liabilities;
- Have sufficient cash resources to cover the next three months' expenses with adequate cover for contingencies;
- Provide an audit report for each financial year, including information about compliance with ASIC's financial requirements.

39. In addition for an RE, it must hold at all times minimum net tangible assets calculated on a sliding scale with a minimum requirement of $50,000 and a maximum of $5 million. This is dependent on the value of scheme assets.

40. The financial requirements were not intended to provide a source of compensation for scheme members as there are specific compensation arrangements under s912B of the Act. Rather they provide an indicator of the RE's capacity to operate schemes as stated in RG166.

41. The above financial requirements for an RE are different from those required for Registrable Superannuation Entities (**RSE**s).

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Compensation – Professional indemnity (PI) insurance

42. Section 912B of the Act "Compensation arrangements if financial services provided to persons as retail clients" provides that REs with retail clients must have compensation arrangements for clients' loss or damage through the RE's breaches of its obligations. Typically this means PI insurance must be maintained, which is adequate based on factors including relevant considerations in relation to the RE's business.

43. ASIC Regulatory Guide 126 Compensation and insurance arrangements for AFS licensees (**RG126**) provides information about ASIC's expectation concerning the adequacy of the RE's PI insurance.

44. Section B of RG126 states that licensees are responsible for determining what is adequate in their circumstances.

45. Section C states that a PI insurance policy must have a limit of at least $2 million for any one claim and in the aggregate for licensees with total revenue from financial services provided to retail clients of $2 million or less.

46. For licensees with total revenue from financial services provided to retail clients greater than $2 million, minimum cover should be approximately equal to actual or expected revenue from financial services provided to retail clients (up to a maximum limit of $20 million).

47. It states that the policy must be a contract of PI insurance, which must cover negligence, fraud and other misconduct (relating to retail clients) ordinarily covered by a contract of PI insurance. There is a minimum requirement for the scope of cover to include liability for loss or damage suffered by retail clients because of breaches of Chapter 7 of the Act by the licensee or its representatives. This includes liability for fraud or dishonesty by directors, employees and other representatives of the licensee.

48. It also states that the policy must not have the effect of excluding fraud and dishonesty by directors, employees and other representatives.

Overview of the different roles of the RE, compliance committee and compliance plan auditor

Duties of the RE

49. The MI regulatory framework under section 601FC of the Act places considerable emphasis on the responsibility of the RE to act in the best interest of scheme members. It also specifies other duties of the RE, including but not limited to:

- Act honestly;
- Exercise a high degree of care and diligence;
- Act in the best interests of members and, if there is a conflict between members' interests and the RE's, give priority to the members;
- Maintain a compliance plan with minimum content specified in Part 5C.4 of the Act;
- Comply with the scheme's compliance plan;
- Ensure that scheme property is: (a) clearly identified; and (b) held separately from property of the responsible entity and property of any other scheme;
- Value scheme property at regular intervals appropriate to the nature of the property;

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- Make all payments out of scheme property in accordance with the scheme's constitution and the Act.

50. Officers of the RE are subject to similar duties under section 601FD of the Act.

51. The RE is accountable for the actions or inactions of its agents even if they were acting fraudulently or outside the scope of their authority. Therefore the RE must obtain adequate ongoing information for oversight to satisfy itself that outsourced activities are conducted appropriately.

Role of the compliance committee in providing a check on the RE

52. The functions of a compliance committee as set out in section 601JC of the Act tend to place emphasis on the independence of its members. The functions are:

- Monitor the extent to which the RE complies with the plan and to report its findings to the RE;
- Report to the RE (a) any breach of the Act; or (b) any breach of the scheme's constitution; of which the committee becomes aware or suspects;
- Report to ASIC if the committee is of the view that the responsible entity has not taken, or does not propose to take, appropriate action to deal with a matter reported;
- Assess at regular intervals whether the compliance plan is adequate, to report to the responsible entity on the assessment and to make recommendations to the responsible entity about any changes that it considers should be made to the plan.

53. The fourth function applies a different standard on the compliance committee than the obligation on the auditor to opine on whether the compliance plan meets the narrow requirements of section 601HA of the Act.

54. Moodie and Ramsay's 2005 paper asserts that the purpose of a compliance committee is to independently monitor and report between the area performing the primary compliance function of the RE and the RE's board. However, it is the RE who must ensure the proper functioning of the compliance committee according to one of the content requirements in a compliance plan, including adequate arrangements relating to the membership of the committee and how often it meets. This may inhibit the independent operation of the compliance committee.

55. Under normal circumstances compliance committees for most schemes typically meet only four times a year. The RE's officers and employees have a greater opportunity to detect or suspect breaches on a day-to-day basis, whilst the compliance committee's opportunities to do so are intermittent and rely on the information that is provided to them by officers and employees.

56. Should the RE's officers or employees attempt to deliberately conceal any breach of the Act or of the scheme's constitution the compliance committee's ability to detect such an issue may be impaired.

57. The Act prescribes that the compliance committee may at the RE's expense, commission independent legal, accounting or other professional advice or assistance. Nevertheless the compliance committee is heavily dependent on the RE and its officers and employees for access to information about the day to day operation and transactions on behalf of the scheme. Hence, a compliance committee's monitoring activity becomes a retrospective review of material

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provided by the RE. It is intermittent and its value is constrained by the reliability, timeliness and completeness of materials provided by the RE.

Compliance plan

58. Part 5C.4 of the Act sets out the requirements concerning compliance plans. These include:

- Contents of the compliance plan;
- Directors must sign lodged copy of compliance plan;
- Audit of compliance plan;
- Removal and resignation of auditors.

Contents of the compliance plan

59. When applying to ASIC for registration of a MI scheme, the applicant must submit a statement by the RE's directors that the compliance plan has the minimum content requirements specified in section 601HA of the Act.

60. Section 601HA of the Act provides a scope for the contents of a compliance plan. It must set out adequate measures that the RE is to apply in operating the scheme to ensure compliance with the Act and the scheme's constitution, including the arrangements for ensuring:

- That all scheme property is clearly identified as scheme property and held separately from property of the responsible entity and property of any other scheme;
- If the scheme is required to have a compliance committee, that the compliance committee functions properly;
- That the scheme property is valued at regular intervals appropriate to the nature of the property;
- That compliance with the plan is audited;
- Adequate records of the scheme's operations are kept;
- Any other matter prescribed by the regulations.

61. The above content requirements do not provide detailed qualitative standards. This allows the compliance plan to be drafted at a high level. Therefore literal adherence to the compliance plan may not always result in the objectives of the Act being met.

62. Whilst ASIC may review compliance plans following their lodgement, ASIC is under no obligation to do so. It is possible that some REs believe that lodging a compliance plan with ASIC amounts to ASIC 'approving' the compliance plan, which is arguably not the case.

Compliance plan auditor

63. Section 601HG of the Act sets out the relevant provisions for the annual audit of the scheme's compliance plan. Key elements of the provisions include:

- The RE must ensure that at all times a registered company auditor, an audit firm or an authorised audit company is engaged to audit compliance with the compliance plan;
- A person is not eligible to be the compliance plan auditor if they are an associate of the RE, or an agent (or agent's associate) holding scheme property, or the auditor of the RE's financial statements;

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- Within 3 months after the end of the scheme financial year, the compliance plan auditor must carry out an audit of the RE's compliance with the compliance plan and report to the RE on whether (a) the RE complied with the scheme's compliance plan; and (b) the plan continues to meet the requirements of Part 5C.4;
- The compliance plan auditor has the right to reasonable access to records and the RE's officers.

64. Section 601HG(2) of the Act requires the auditor of a compliance plan to be a different person to the auditor of the RE's financial statements. Separation of these roles increases disaggregation in the oversight of the MI scheme. The safeguard is further reduced in the case where separate firms perform the compliance plan audit and the financial statement audit. Having one firm perform both roles provides a better opportunity for proper communication to occur. This is particularly relevant given the audit activity involved in fulfilling these audit responsibilities, including consideration of the RE's AFSL compliance, will often be required to take place in the same time frame. Combining the different roles of auditing the scheme's compliance plan and financial statements and the RE's financial statements would create more effective visibility of the scheme's operation and the RE's broader commercial activities. This may increase accountability and support outcomes which are more consistent with the intention of the Act.

65. It is noted APRA's prudential standards applicable to the operation of banks and life insurers (APS 520 and LPS 520 respectively), require amongst other people, that auditors must meet certain 'fit and proper' criteria. The criteria address appropriate levels of competence, character, diligence, honesty, integrity and judgement, and include 5 years of relevant industry experience. Although not determinative of the work undertaken, there is no commensurate requirement for auditors of REs or MI schemes despite REs having similar fiduciary responsibilities.

66. ASIC's Information Release in 2000 about the audit of compliance plans[4]states that, "The annual audit provides an additional and distinct protection for scheme members at set periods during the life of the scheme. Auditors will apply their independent professional judgement rather than relying on ASIC's initial review of the compliance plan at the time of registration."

67. Moodie and Ramsay state in their 2003 report: "Being an annual, 'after the event' test, the effectiveness of a compliance plan audit, as an intervention measure to protect against fraud or unauthorised investments, is limited."

68. The audit of compliance with compliance plans provides a simple 'pass or fail' opinion. The outcome of material, but not extreme, non-compliance is an exception report. This provides limited value to governance outcomes.

Inherent Limitations of Auditing Compliance with the Compliance Plan

69. Paragraph 3 of GS 013 requires the compliance plan auditor to adhere to the requirements contained in the Standards on Assurance Engagements, including ASAE 3100 *Compliance Engagements*.

70. GS 013 provides no direction on the consideration of fraud in the performance of an audit of a compliance plan. It provides two example forms of independent auditor's reports on MI

[4] ASIC Information Release IR00/012 – "Audit of Compliance Plans of Managed Investment Schemes" (6 April 2000).

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compliance plans. The wording in both examples at Appendix 2 notes the inherent limitations in such reports. It states: "Because of the inherent limitations of any compliance measures, as documented in the compliance plan, it is possible that fraud, error, or non-compliance with laws and regulations may occur and not be detected. An audit is not designed to detect all weaknesses in a compliance plan and the measures in the plan, as an audit is not performed continuously throughout the financial year and the audit procedures performed on the compliance plan and measures are undertaken on a test basis".

71. GS 013 notes there are certain limitations in auditing the RE's compliance according to the requirements of the compliance plan. The following two points from GS013 are relevant:

- Due to the nature of audit testing and other inherent limitations of an audit, together with the inherent limitations of a compliance plan and its related compliance measures, there is a possibility that a properly planned and executed audit will not detect all deficiencies in a scheme's compliance plan. Accordingly, the audit opinion under section 601HG(3) is expressed in terms of reasonable assurance and cannot constitute a guarantee that the compliance plan is completely free from any deficiency, or that all compliance breaches have been detected.
- There are also practical limitations in requiring an auditor to perform a continuous examination of the compliance plan, and form an opinion that the entity has complied at all times with the Act during the period covered by the compliance plan audit report. However, the auditor performs tests periodically throughout the financial year to obtain evidence and have reasonable assurance that the measures complied with the written descriptions and were adequate throughout the period under examination.

72. The 2003 paper by Moodie and Ramsay also makes statements consistent with the above position regarding the inherent limitations of the compliance function. Their paper concludes that the work performed by compliance plan auditors is "'revisionist' by nature, and provides relevant material for our submission in outlining the limitations of the regulatory regime that compliance plan auditors are working in".

73. The term 'revisionist' is described by Moodie and Ramsay as: "'after the event' checks, which are in turn based on internal reporting. The roles contemplated by the compliance committee and the compliance plan audit are not roles of intervention. If there is any 'interventionist' approach within the MIA, it lies within the compliance plan itself and those compliance managers whose day-to-day jobs revolve around it."

74. The paper states, "From an 'interventionist' perspective, the person or entity responsible for ensuring that the 'scheme operator meets high standards of competence, integrity and fair dealing' is the RE itself. In some respects, such an approach reflects the legitimate aim of internalising compliance functions and responsibilities. However, from a governance perspective, the effectiveness of having 'interventionist' mechanisms internal to the organisation but only 'revisionist' external supervisory mechanisms, particularly in circumstances where the RE is in a position of inherent conflict of interest, is highly questionable. While such an approach is consistent with the 'single responsible entity' framework, it is problematical. Superimposing 'after the event' checks and reviews by compliance committees (or independent board members) or compliance plan auditors may be of limited practical benefit in the event of fraud or misappropriation."

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E. Expectation gap

75. The 'expectation gap' is the difference between the public's expectation of the work a compliance plan auditor will undertake and what that work may disclose, and the compliance plan auditor's understanding of the work he or she is required to perform and the matters to be reported upon.

76. As outlined above, the scope of the work of a compliance plan auditor is defined by section 601HG of the Act. GS 013 provides further guidance to the compliance plan auditor. A stakeholder who is unfamiliar with the Corporations Act obligation and the content of GS 013 will not be well prepared to understand the limitations on the compliance plan auditor's obligation.

77. GS 013 specifically identifies the inherent limitation of the compliance plan auditor's work in relation to its ability to detect fraud.

78. Stakeholders often have erroneous expectations of an auditor's work. According to KordaMentha [5], members of the public, including investors and creditors, often expect that:

- Auditors are primarily responsible for the preparation and presentation of financial statements;
- A 'clean' audit opinion provides absolute assurance over the accuracy of the financial statements and guarantees the entity's future solvency;
- Auditors perform a 100% check over all items recorded in the accounts;
- Auditors are to provide early warning regarding the possibility of a corporate collapse;
- An auditor's role includes detecting all fraud.

79. This public expectation contrasts with the obligations of the auditing profession. For example, auditing standards require an auditor to plan and conduct an audit to obtain reasonable (as opposed to absolute) assurance that the financial statements are free from material error and fraud. Reasonable assurance does not certify or guarantee the accuracy of the financial statements or that the business model is sound.

80. Many of the submissions and the evidence to this Inquiry in relation to both audit and compliance plan audit activity have been premised upon expectations of auditors that are not consistent with the role undertaken by, or the law's expectations of, auditors. Such comments are non-specific in nature and appear to be founded upon the expectation gap.

81. There is a clear opportunity for education and improving the understanding of the public at large as to the nature and scope of the auditor's role.

82. Statistics from KPMG's 2011 global analysis of fraud[6] indicate that fraud takes longer to detect than four years ago. It now takes 3.4 years on average from inception of the fraud to detection, compared to an average of 2.9 years previously.

83. The report noted many of the frauds which have been investigated in the past few years have come to light due to formal or informal whistleblowing reports. By contrast, very few are discovered as a direct consequence of management, internal or external audit review.

[5] KordaMentha Forensics Matter report, "Audit negligence: Who is to blame when it all goes wrong" (Publication 11-04).
[6] KPMG Analysis of Global Patterns of Fraud, "Who is the typical fraudster", 2011.

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84. The report notes that even in a well-regulated market and with a good audit function, massive frauds can go undetected for a number of years.

Auditing Standards and Guidance

Auditor's Responsibility to Consider Fraud in an Audit of a Financial Report

85. Section 307A of the Act mandates the application of auditing standards in the conduct of an audit or review of a financial report.

86. ASA 240, as compiled by the AUASB in June 2011[7], does not comment on how fraud might be considered as part of a compliance plan audit and GS 013 mentions fraud only in the context of inherent limitations.

87. ASA 240 sets expectations for auditor's responsibilities relating to fraud in an audit of a financial report.

88. At paragraph 3, ASA 240 provides that, "the auditor is concerned with fraud that causes a material misstatement in the financial report. Two types of intentional misstatements are relevant to the auditor – misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. Although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred."

89. Paragraph 4 provides, "The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behaviour which can be reinforced by an active oversight by those charged with governance. Oversight by those charged with governance includes considering the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts as to the entity's performance and profitability."

90. Paragraph 5 sets out the auditor's responsibility to obtain reasonable assurance that the financial report taken as a whole is free from material misstatement, whether caused by fraud or error.

91. Paragraph 5 also points out the inherent limitations of an audit, which give rise to the 'unavoidable risk' that despite proper planning and conduct of the audit, some material misstatements may be undetected.

92. Paragraph 6 expands on the particular significance of the inherent limitations where material misstatement occurs as a result of fraud, rather than from error.

[7] ASA 240 takes into account amendments made by Auditing Standard ASA 2011-1 *Amendments to Australian Auditing Standards* (June 2011).

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93. ASA 240 also notes a range of factors which affect the ability of an auditor to detect fraud. These factors include deliberate steps by perpetrators to conceal fraud, the rank of those involved and the extent of collusion.

94. Paragraph 7 highlights the increased risk of not detecting material misstatements arising from fraud where the fraud is conducted by management rather than by an employee. This is stated as being because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees.

Audit guidance in relation to outsourced activities

95. The auditor of a compliance plan is directed by paragraph 37 of GS 013 to make use of Auditing Standard ASA 402 *Audit Considerations Relating to Entities Using Service Organisations* and Guidance Statement GS 007 *Audit Implications of the Use of Service Organisations for Investment Management Services* (**GS 007**).

96. GS 007 provides guidance to auditors whose MI clients make use of service organisations.

97. The scope of GS 007 specifically includes outsourcing of custody and asset management. In some cases, custodians (or other service providers) perform administration and reporting on behalf of their clients. This may include preparation of financial reports and arranging an audit of controls and balances included in such reports in accordance with GS 007. In substance, the GS 007 report may provide evidence in relation to significant components of the material subject to the audit of a scheme's financial statements or compliance plan.

98. An example where this may give rise to risks of disaggregation is as follows: The RE of a MI scheme appoints an external custodian. The custodian provides the RE with a report on its controls by the auditor it has appointed. The RE appoints a separate auditor with no relationship to the custodian's auditor. The RE's auditor must place reliance on the work performed by the custodian's auditor. Such a report may be based on sample evidence and conclusions may not be specific to the scheme in question.

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F. Conclusions and regulatory alternatives

Issues relating to regulation and oversight

99. From the discussions above, the following key issues emerge in relation to the regulation and oversight of MI schemes:

- Disaggregation of oversight functions in the operation of MI schemes;
- Auditor expectation gap;
- Fragmented access to timely, complete and accurate information by third party reviewers;
- High level compliance plan content and lack of qualitative standards for assessment;
- Limitations of the role of the compliance plan auditor.

Regulatory alternatives

100. There are a number of potential alternatives to address the above issues relating to the oversight of the scheme and the RE, and the conduct of audits.

101. As a measure to reduce the disaggregation of oversight, it may be beneficial to mandate a majority of truly independent directors of the RE thereby removing the need for a compliance committee, which has a limited view of the RE's operations. This would provide better alignment with APRA standard LPS 510 concerning life company governance.

102. A practicable alternative to mandating independent board supervision may be providing stronger legislative support for the operation of compliance committees. Measures may include holding management accountable for acting on recommendations of the compliance committee.

103. Safeguards provided by audit may be enhanced by combining the three audit roles associated with MI schemes. That is, the disaggregation risk may be reduced by requiring the same person to perform the audit of the RE's financial statements, the scheme financial statements and the compliance plan.

104. There is an opportunity to legislate more prescriptively about the drafting of the compliance plan as well as what outcomes it is intended to deliver.

105. In order to audit APRA regulated entities, one must normally demonstrate experience and skills under a 'fit and proper' process. A similar approach to auditors of REs and compliance plans may be appropriate.

106. The potential for an expectation gap between auditors and other stakeholders may be reduced through AUASB and ASIC working together to provide additional guidance. Greater guidance or prescription may be provided, for example, in the form of standards in relation to the requirements for the conduct of a compliance plan audit.

107. Adoption of a form of reporting similar to that used for GS 007 reports would give a much better insight into work done by the compliance plan auditor. This could include, for each compliance obligation, a description of the procedures performed and the findings from this work.

108. The alternative set out in the previous point might be strengthened by mandating a report by the RE's directors (or the compliance committee members if the concept is retained) along

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GS 007 lines whereby those charged with governance confirm the effective operation of the compliance framework as it relates to the scheme. This could provide the basis for additional review and reporting by the external auditor and may cause the directors to obtain enhanced reporting from service providers.

109. The measures in 9. and 10. might be enhanced by requiring that the auditor must report on the RE's compliance with the scheme's constitution and the Act, rather than the present requirement that they report on compliance with the compliance plan.

110. As a broader measure, consideration may be given to regulate for better facilitation of information sharing between parties involved in managing or oversighting the operation of a scheme.

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