Trustee Corporations Association of Australia

Submission to Joint Committee of Public Accounts and Audit

Review of Independent Auditing

May 2002

1. Introduction

The **Trustee Corporations Association of Australia** appreciates the opportunity to provide comments to the Committee in relation to its Review of Independent Auditing.

Background information on the Association and the trustee corporation industry is in the Attachment.

The Association strongly believes that appropriate independence is critical to good corporate governance and effective investor protection.

Independent "checks and balances" in a regulatory framework are needed to limit conflicts of interest arising, or at least prevent them from being exploited. This in turn assists in promoting confidence amongst investors. Public confidence is critical to the efficient operation of the financial system.

Recent events in Australia and overseas – HIH and Enron being prime examples – have clearly demonstrated that adequate investor protection requires a regulatory framework that incorporates an effective, independent financial auditing function.

The Association has expressed its general support for the recommendations of the recent Ramsay Report aimed at strengthening auditor independence. These include greater disclosure of non-audit services provided to audit clients and mandatory rotation of auditors.

More generally, we submit that genuine independence is also critical in the compliance monitoring function designed to protect superannuants and investors in managed funds, where about $700 billion is at stake. This oversight role should ensure that entities managing other people's money comply with relevant laws, regulations and operating standards.

The Association believes that investor protection in the important areas of superannuation and managed funds would be enhanced by:

- expanding the present role of the independent compliance auditor so that this function is performed on a more regular and timely basis,
- widening access to this role beyond financial auditors to other suitably qualified, independent entities, and

- ensuring adequate financial underpinnings for commercial entities involved in operating superannuation funds and managed investment schemes.

2. The role of financial auditors

The Association agrees that ultimate responsibility for the prudent management of a company rests with its board of directors, even though it necessarily delegates day-to-day managerial authority to senior executives. The board, preferably with a majority of independent directors, is meant to serve as the guardian of shareholders' interests, and provide objective oversight of managerial performance.

The board will also utilise outside professionals to assist in the proper governance of the company.

In the current regulatory framework, financial auditors have been given the important function of providing shareholders and other investors with independent assurance about the financial condition of the company, by confirming that its accounts comply with generally accepted reporting standards. Stakeholders have the reasonable expectation that financial auditors will carry out their role diligently and effectively.

Unfortunately, we have seen numerous instances, both in Australia and overseas, of companies collapsing soon after being given a clean bill of health by the auditors. Examples include Rothwells, Bond Corporation, Harris Scarfe, HIH Insurance, One.Tel and Enron.

In addition to causing direct losses for investors and creditors, these types of developments can seriously damage confidence in financial markets.

3. Features of an effective financial auditing function

The Association believes that effective financial auditing is based on two elements:

(i) competent practitioners - ie professionals with the ability to identify problems or potential problems in an increasingly complex financial system, and

(ii) the independent application of those technical skills and experience/judgment - ie auditors being prepared to take appropriate action when problems are identified.

The Association does not have particular concerns with the general level of professional competency in financial auditing.

Rather, the main issue is the extent to which lack of genuine independence may be undermining the effectiveness of financial audits.

The Association generally supports the recommendations of the Ramsay Report on the Independence of Australian Company Auditors, released in October last year, which are aimed at strengthening the independence of auditors.

Ramsay's main recommendations covered:

(i) Non-audit services

The Association supports the recommendation that there be greater disclosure of the nature and value of non-audit services provided by an audit firm to a client.

However, given that there can be cost efficiencies in such arrangements, and that there appears to be no solid correlation between serious shortcomings in financial audits and the provision of non-audit services, we do not believe that an outright ban is warranted. We understand that such a course of action was considered, but rejected, in the US.

We would also note that, in light of the recent attention given to this issue, audit firms are tending to "spin off" their consulting arms.

(ii) Audit Committees

The Association strongly supports the Report's recommendation that ASX Listing Rules should be changed to mandate that all listed companies must have an Audit Committee.

We see a properly structured and functioning Audit Committee as a fundamental element in ensuring auditor independence, and as an important part of an effective corporate governance framework.

We agree that a key function of the Audit Committee should be to ensure that the level of non-audit services provided to a client by the firm is not incompatible with being seen to maintain appropriate auditor independence.

However, the existence of an Audit Committee is not a panacea.

In this regard, we note that a recent survey by the Australian Securities and Investments Commission (ASIC) found that, while the vast majority of respondent companies have an Audit

Committee, most of those companies lack robust processes for ensuring that the independence of audit is not prejudiced by the provision of non-audit services. On average, fees for those other services represent almost 50% of the total fees paid to audit firms.

(iii) Appointment and removal of auditors

The Association agrees that the auditor should be appointed, and their remuneration determined, on the recommendation of the Audit Committee. We note that there is little support (and no international precedent among developed nations) for auditors to be appointed by a completely independent body such as ASIC.

We also support the recommendation that there be mandatory rotation of the audit partners responsible for the audit of listed companies. A maximum term of 7 years, together with a "cooling off" period of at least 2 years before a partner can again be involved in the audit of a particular client, does not seem unreasonable.

(iv) Auditor Independence Supervisory Board

The Association agrees that there needs to be appropriate oversight of the implementation of any changes to the present audit framework that the Government might endorse, and ongoing monitoring of the practical application of that framework.

The continual monitoring of international developments regarding auditor independence, and assessment of the adequacy of the Australian regime, will also be important.

However, we are unsure as to whether there is a need to establish a new body, in the form of the proposed Auditor Independence Supervisory Board, for this purpose. Careful consideration should be given to whether the role envisaged for the AISB could be carried out by an existing body, perhaps the Financial Reporting Council.

4. The balance between self-regulation and government controls

The Association believes that special attention needs to be given to audit/compliance arrangements in those industries that have access to vast amounts of other people's savings. In doing this, careful consideration needs to be given to the appropriate balance between self-regulation by those industries and Government controls.

Numerous commentators, both from inside and outside the accounting profession, have long been critical of the industry's disciplinary record. While appropriate ethics rules and auditing standards may be in place, there have been very few instances of industry-imposed sanctions for cases of serious professional misconduct.

Earlier this year, for example, ASIC's Chairman noted that "*action we take against auditors through the Companies Auditors and Liquidators Disciplinary Board carries very little support from the profession.*"

The debacle involving solicitors' and brokers' mortgage schemes also is a telling example of the dangers of over-reliance on self-regulation.

Losses estimated at hundreds of millions of dollars were experienced by thousands of investors in poorly managed solicitors' and brokers' mortgage schemes in recent years. These are mortgage schemes that were unable or unwilling to make the transition from the previous regulatory regime to the Managed Investments Act 1998 (MIA), generally referred to as "run-out" schemes.

ASIC has just released a report on this matter, following an investigation conducted by insolvency expert Tony Hodgson. That report identified several recurring shortcomings with run-out schemes:

- a chronic lack of management expertise,
- inadequate loan assessment and approval processes,
- poor default management practices,
- non-existent, inappropriate or fraudulent property valuations,
- conflicts of interest, with scheme operators acting for both the borrowers and the investors,
- inadequate or misleading disclosure to investors, and
- "totally inadequate" supervision by the relevant industry supervisory bodies (Law Societies or Brokers Institute in the respective States). The Report revealed a general failure by those bodies to act expeditiously, or at all in response to widespread loan defaults. Importantly, Hodgson found that the losses suffered would have been significantly reduced had the industry bodies enforced compliance in a more diligent and efficient manner.

The Hodgson report made a number of recommendations in relation to improving the ongoing corporate governance and regulation of registered mortgage schemes under the MIA, including:

- requiring that an independent registered valuer, engaged and paid by the lender, on rotation from a panel of valuers, conduct valuations in all circumstances, and
- where significant breaches by Responsible Entities (REs) who formerly operated, or still operate, a run-out scheme are exposed, ASIC should take into account the level of run-out defaults and the level of failure to comply with regulation in the past and give consideration to RE dealers licence revocation.

Further, the Hodgson Report noted that ASIC's supervision of REs has revealed:

- a lack of strong management within managed fund business, and
- extensive non-compliance with the legislation.

Hodgson suggests that the current Parliamentary review of the MIA should consider further law reform to better protect mortgage scheme investors from the systemic issues addressed in his Report.

The Association believes that Hodgson's findings support the case for generally strengthening the independent monitoring function of the compliance auditor under the MIA, not just for mortgage schemes – see below.

5. Independent compliance monitoring

The Association believes that the importance of independent checks and balances has relevance beyond ensuring effective financial audits.

Independence is also absolutely critical in protecting investors and savers by ensuring that entities managing other people's money comply with relevant regulations and operating standards.

In particular, we submit that investor protection requires clearly independent compliance monitoring for <u>managed investment schemes</u> (almost $200 billion involved) and <u>superannuation funds</u> (over $530 billion).

These issues currently are being considered, respectively, by:

- the Inquiry into the Review of the Managed Investments Act - being conducted by the Joint Committee on Corporations and Financial Services, and

- the Review of the Safety of Superannuation - being undertaken by the Superannuation Working Group (chaired by Don Mercer).

The Association has recommended to those reviews that the regulatory arrangements for superannuation and managed funds should be strengthened by:

(i) <u>expanding the independent compliance monitoring function</u>

We believe that, to ensure better investor protection, the independent compliance monitoring role should be expanded to entail:

- monitoring the adequacy of the fund/scheme's compliance plan,

- monitoring the operator's observance of its obligations under the fund/scheme's constitution and the relevant legislation, in order to minimise the potential for serious problems of maladministration, negligence and fraud to develop.

- reporting periodically, say quarterly, to the operator, and as necessary, but at least annually, to the regulator and fund/scheme investors on the operator's compliance procedures and the conduct of the fund/scheme, and

- acting as the investors' representative in pursuing remedies against the operator, and its directors and agents, for losses due to compliance breaches.

(ii) <u>opening up the compliance role to more competition</u>

While financial auditors may have a role to play in this area, we do not believe that they have a monopoly of skills in compliance work. Indeed, financial auditors may not necessarily be the most suitable persons to conduct compliance audits, given that these assessments involve a large component of operational matters.

Accordingly, we believe that access to the compliance monitoring/auditing role should be opened up to more competition by licensing other entities, provided they can demonstrate the necessary expertise and financial underpinnings.

It is relevant to note that in April the Government endorsed the Productivity Commission's recommendation that APRA should review the present arrangements for the oversight of superannuation funds, which confine the conduct of compliance audits to approved financial auditors. The Commission noted that, while specific skills and competencies are required to undertake compliance audits, financial auditors are not uniquely qualified to acquire them.

(iii) <u>ensuring adequate financial underpinnings for superannuation funds and managed investment schemes</u>

We also believe that the regulatory regime should mandate more meaningful levels of capital and insurance for operators of superannuation funds and managed investment schemes, having regard to the size of funds under management.

We believe that requiring more substance of operators and service providers would better ensure adequate provision of resources, and provide greater incentive for those parties to act appropriately.

It would also provide more substantial means of compensating investors, without drawing on the public purse, in the event of losses due to maladministration, negligence or fraud.

Conclusion

The Association believes that a genuinely independent financial auditing function is crucial to proper corporate governance and the provision to stakeholders of information that paints a fair picture of a company's performance.

However, history repeatedly indicates that self-regulation cannot be relied upon to satisfactorily address conflicts of interest, and that a degree of Government control is needed to ensure appropriate independence of financial auditors and adequate investor protection.

In order to ensure adequate protection for members of superannuation funds and managed investment schemes, the independent compliance monitoring role should be undertaken on a more timely and frequent basis than at present.

Further, in order to place downward pressure on costs, and tap a deeper and broader well of expertise, the compliance monitoring role should be opened up to competition from appropriately qualified and resourced entities other than financial auditors.

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Attachment

Trustee Corporations Association of Australia

The Association, formed in 1947, is the national body for the trustee corporation industry in Australia. It represents 17 organisations, comprising all 8 Public Trust Offices and all but 2 of the 11 private statutory trustee corporations.

The Association has a staff of 4 and operates out of premises in Sydney. The Association's National Council comprises the Chief Executive Officer of each member institution, and its Executive Committee is made up of 5 of those persons.

The Association's role is to:

- promote cooperation and a united industry position amongst members,
- advance and protect the interests of beneficiaries of trusts administered by trustee corporations,
- promote the cause of investor protection in the Australian financial system, especially the importance of independent review generally and compliance monitoring specifically,
- set professional standards of conduct for statutory trustee corporations in Australia, and
- provide professional education programs for staff of trustee corporations through the *Executor & Trustee Institute*.

The Trustee Corporation Industry

Traditionally, only a natural person could act as a trustee to take on the role of executor or administrator of an estate. In the 1870s, Governments first enacted legislation to extend this function to licensed trustee corporations. This was to benefit the public by providing greater expertise and resources than are available from an individual, together with perpetual succession to a client establishing a long-term trust. Within the next decade, most of the trustee corporations now authorised by law were established.

Trustees owe fiduciary duties to the beneficiaries of the assets they administer, and can be held personally liable for mismanagement. The directors of trustee corporations are also jointly and severally liable for the impartial, prudent and proper administration of assets entrusted to their institutions.

Today, trustee coorporations have expanded their trusted role to provide a wide range of financial services to individual, family and corporate clients. Services include:

- Personal wealth management, including: providing financial and estate planning; giving tax advice and preparing tax returns; acting as trustee or providing administrative services for small superannuation funds; setting up and managing personal trusts and guardianships; preparing wills and acting as executor to carry out the will-maker's instructions; and, preparing and administering powers of attorney.

- Charitable trusts and foundations, including for medical research, galleries, museums, and educational scholarships.

- Funds management, offering most types of unit trusts and common funds.

- Corporate activities, including: registry operations; custodial services; securitisation facilities; compliance monitoring; and acting as trustee or administrator for non-family superannuation funds.

In aggregate, trustee corporations have about $300 billion of assets under administration, and capital resources of about $600 million. They employ more than 3,500 staff in over 90 offices around Australia.

Almost 2 million Australians have wills recorded with trustee corporations.

Each year trustee corporations:

- write over 85,000 wills and powers of attorney.

- administer over 10,000 deceased estates.

- administer assets under agency arrangements or guardianships for over 10,000 people.

- prepare over 55,000 tax returns.

About half of trustee corporation revenue comes from funds management, and about a quarter each from corporate activities and from traditional personal and charity work.