CHAPTER 5

COMPLIANCE PLAN AUDITING

External compliance monitoring

5.1 When applying for registration, a scheme must lodge a copy of the scheme's compliance plan with ASIC.[1] The compliance plan must set out adequate measures which the RE is to apply to ensure compliance with the Act and the scheme's constitution when operating the scheme. The plan must specify arrangements for the holding and valuation of scheme property, the proper constitution and functioning of the compliance committee, the auditing of compliance with the plan and the maintenance of adequate records.[2]

5.2 In addition to the requirements already mentioned, all the directors of the RE must sign the copy of the compliance plan (or the amended or new compliance plan) lodged with ASIC.[3] ASIC is empowered to require additional information about a compliance plan and may direct the RE to modify the compliance plan to ensure consistency with legislative requirements.[4]

5.3 These provisions all highlight the importance of the compliance plan in the MIA framework.

The compliance plan audit

5.4 Under the MIA, a registered company auditor must conduct an annual audit of compliance with the scheme's compliance plan.[5]

5.5 The compliance plan audit is intended to provide an independent check on the in-house monitoring of a scheme's compliance plan. This explains why the compliance plan auditor must be independent of the RE's scheme and also why the same auditor cannot be the auditor of the RE's financial statements (although both auditors may work for the same firm of auditors).[6]

5.6 The spate of high-profile corporate collapses overseas and in Australia over the past two years has highlighted the importance of good corporate governance and the need for reporting to be transparent and reliable. As mentioned earlier, the United

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1 Section 601EA.

2 Section 601HA.

3 Sections 601HC and 601HE.

4 Sections 601HD and 601HE.

5 Subsection 601HG(1).

6 Subsection 601HG(2).

States has recently introduced the *Sarbanes-Oxley Act of 2002*, which aims to increase the accountability of directors, ensure the independence and quality of financial auditing, and improve disclosure so it is more reliable.

5.7 Closer to home, the Government recently released its CLERP 9 issues paper. This presages legislative amendments to strengthen auditor independence, enhance the transparency of on-going disclosure and encourage shareholder participation.

5.8 Although the discussion in this report concerns performance-based, qualitative auditing as opposed to financial auditing, the principles regarding independence are considered to be the same. The Committee has consequently been able to draw on overseas legislative initiatives and numerous commentaries and reports dealing with governance issues.[7]

5.9 The Committee did not hear a great deal of evidence on the independence of external compliance monitoring per se. Of the evidence presented, however, the major issue was whether merely prohibiting the same auditor from auditing both the scheme's financial statements and the compliance plan was a sufficient guarantee of independence.

5.10 The possibility of allowing professionals other than accountants to undertake compliance plan auditing was also raised.

5.11 The MIA requires the compliance plan auditor to report to the RE on whether the scheme complied with its compliance plan during the year under examination and whether the plan meets the requirements of the Act.[8] If there are deficiencies, then the audit must be qualified, and contraventions of the Act reported as soon as possible to ASIC.[9]

5.12 At the Committee's hearing on 7 August 2002, ASIC provided the Committee with results of a survey it had conducted on qualified audits for the year ended 30 June 2001. It advised that, of just over 2,000 compliance plan audits lodged for the year, 12.9 per cent had been qualified. Of these qualifications, ASIC reported that the top five deficiencies were more administrative in nature and included late lodgement of returns, breaches of net tangible asset (NTA) requirements, ineffectiveness of the

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7 For commentaries and studies, see for example: Professor Ian Ramsay, *Independence of Australian Company Auditors: Review of Current Australian Requirements and Proposals for Reform*, October 2001; Joint Committee of Public Accounts and Audit, *Review of Independent Auditing by Registered Company Auditors, Report 391*, August 2002; Ernst & Young, *Survey of Top 200 Companies' Compliance with NYSE Listing Rules, Corporate Governance Series*, September 2002. See also ASIC's survey of auditor independence concluded in December 2001 (ASIC Media and information release 02/13 *ASIC announces findings of auditor independence survey*, 16 January 2002.

8 Subsection 601HG(3).

9 Subsection 601HG(4): ASIC must be notified if the auditor has reasonable grounds to suspect that a contravention of the Act has occurred and believes that the contravention has not or will not be adequately dealt with by commenting on it in the auditor's report.

compliance plan (i.e. failure to comply with the provisions of the plan), poor monitoring and reporting processes.[10]

5.13 ASIC proposed several legislative amendments to upgrade the integrity of compliance plan audits and said they would be best introduced as a package.[11] These had been submitted to the Turnbull Review which suggested development through industry consultation.[12] These were that:

- the auditor of the compliance plan should be required to report to scheme members and not just to the RE;
- the auditor's opinion should relate to the performance of the scheme throughout the whole year, and not just at certain times or at the end of the financial year (section 601HG is unclear, and a majority of auditors reported only that the plan was adequate as at the end of the financial year);
- the first compliance plan audit for a new scheme should be completed and lodged within nine months of the scheme's registration (and not up to 21 months later);
- an auditor's opinion on the adequacy of a new scheme's compliance plan should be lodged with other documents when the scheme applies for registration; and
- the legislation should specify that the compliance plan audit should focus on 'material' issues.[13]

5.14 In relation to the last point about materiality, Mr Johnston, Executive Director, Financial Services Regulation, ASIC, suggested that the development of a 'materiality' test would promote efficiencies by avoiding qualification of audits for trivial, immaterial matters.[14]

5.15 The Trustee Corporations Association of Australia (TCAA) shared ASIC's view that compliance plan auditors should not only report to ASIC but also to scheme members. In addition it proposed a more extensive role for the compliance plan auditor which would include:

- more frequent and timely monitoring of scheme operations;
- monitoring of related party dealings;
- acting as the 'investor champion' if action against the RE was required; and

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10 Mr Sean Hughes, *Committee Hansard*, 7 August 2002, p. 92.

11 *Committee Hansard*, 7 August 2002, p. 99.

12 Turnbull Review, p. 71; Treasury consultation pp. 29–31.

13 See ASIC's submission to the Turnbull Review, Part 2, pp. 12–15; Turnbull Review p. 71.

14 *Committee Hansard*, 7 August 2002, p. 97.

- more frequent reporting—say, quarterly—to ASIC and, as referred to before, to scheme members. [15]

5.16 In a joint submission, CPA Australia and the Institute of Chartered Accountants in Australia thought compliance plan audits should be more frequent.[16]

5.17 The TCAL asserted in its submission that potential conflicts of interest arising with the compliance plan audit had not been properly dealt with by the MIA.

5.18 On this point, Mr Jonathan Sweeney, Managing Director, TCAL, commented at the hearing on 11 July 2002 that:

> Under the Managed Investments Act, basically, we now have self-regulation by a single responsible entity subject to after-the-event, semiannual financial audit, a compliance plan operation, a periodic review and an annual compliance plan audit. That is typically conducted by a partner of the auditor of that entity's finances. So you have the auditor of the company on the finance side with another partner auditing on the compliance side. Again, with the spotlight put on the role of auditors and the expansion of these roles, you can see there could be some issues there.
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> The operational nature of the compliance plan audit and the potential for consulting work further adds to the potential for conflict…[17]

5.19 The TCAA envisaged other ways in which the independence of compliance monitors could be safeguarded. In evidence to the Committee, Mr Michael Shreeve, National Director, suggested opening up the field:

> We believe access to this compliance monitoring role should be widened. Allowing qualified professionals other than accountants to take on this work would introduce more competition into the area. It would also improve options to avoid conflicts of interest between financial audit and other work. We understand that this is being considered for superannuation. It is also relevant that the compliance monitoring role involves operational and other risk management issues that a financial auditor is not necessarily equipped to review.We see positive influences from this arrangement in placing downward pressure on costs. Increased competition in the compliance monitoring role and the monitoring of related party dealings should better ensure arms-length pricing. We see a stronger compliance monitor reducing the need for compliance committees and external board members.[18]

5.20 Asked whether the MIA had sufficient protections to ensure that compliance plan auditors would not be unfairly or unduly influenced by the RE, the Department of the Treasury responded that the Department:

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15 Mr Michael Shreeve, *Committee Hansard*, 12 July 2002, p. 49.

16 Supplementary submission no. 4A, p. 2.

17 *Committee Hansard*, 11 July 2002, p. 2.

18 *Committee Hansard*, 12 July 2002, pp. 49–50.

> …[was] not aware that the new regime [had] put any more pressures on auditors or…diminished their independence…There are various issues…about whether the auditor of the responsible entity as a company should be different from the auditor who does the audit of the compliance plan for the various schemes. In the [Turnbull Review] there were some people who said that they should be separate firms—that you should never let the same firm do the two audits. At the other extreme there were people who said that the same person in the same firm should be able to do both audits. The legislation now has what everyone acknowledges to be a compromise—it can be the same firm, but different people within the firm should do the two audits. …we did not think there was enough justification to change that…[19]

The Committee's views

5.21 The Committee notes the findings of several reports and surveys on auditor independence which indicate unequivocally that there is a need for reform to strengthen auditor independence in Australia.

5.22 Professor Ian Ramsay's report, *Independence of Australian Company Auditors: Review of Current Australian Requirements and Proposals for Reform*, commissioned by the Government and released in October 2001, commented that the growth of large accounting firms and an increase in non-audit services provided by these firms increased scope for conflicts of interest. The report also noted that Australia lagged behind other parts of the world, particularly the United States and Europe, in the development of measures to improve audit independence.[20]

5.23 The findings of an auditor independence survey conducted by ASIC and concluded in December 2001, were consistent with those of Professor Ramsay's report. ASIC's survey indicated practices in the use of audit services that would appear to militate against auditor independence. The respondents' use of non-audit services was widespread and accounted for about 50 per cent of the total fees paid to auditing firms. Although most respondents had audit committees, it was found that better mechanisms to deal with potential conflicts of interest were needed. Partner rotation was inconsistent and rotation of firms was almost non-existent.[21]

5.24 An Ernst & Young study into Australia's top 200 companies, indicated that more than 25 per cent would not meet the basic requirements for audit committees

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19 Mr Dave Maher, *Committee Hansard*, 7 August 2002, p. 88.

20 The *Sarbanes-Oxley Act of 2002* passed by the United States Congress on 30 July 2002 requires all members of the audit committee to be fully independent and at least one to be appropriately qualified. The committee is responsible for the appointment and supervision of the independent auditor.

21 See ASIC Media and information release 02/12 *ASIC announces findings of auditor independence survey*, 16 January 2002 with attachment. The findings were based on answers to questionnaires sent to 100 of Australia's largest companies, of which 67 provided comprehensive replies.

under United States law, namely, that all members must be fully independent and at least one a 'financial expert'.[22]

5.25 The Committee is satisfied on the basis of evidence presented to it during the inquiry and also taking into account the numerous studies on the subject, that additional measures are needed to ensure the independence of external auditing.

5.26 The Committee notes that the Joint Committee of Public Accounts and Audit (JCPAA) proposed several measures to enhance auditor independence. These included:

- the establishment of an independent audit committee in all publicly listed companies with the statutory prescription of minimum requirements for the role, responsibilities and composition of the committee;
- a clear statement in the *Corporations Act 2001* requiring an auditor to be independent when undertaking his or her functions (which can be assessed by reference to a Code of Professional Conduct of the professional accounting bodies);
- requirements for auditors of publicly listed companies to report annually to ASIC regarding the management of independence issues according to benchmarks developed by ASIC, with ASIC having the relevant investigatory and enforcement powers;
- the imposition of greater accountability on directors of companies being audited;
- to cater for an expansion in the role of auditors, the principle of joint and several liability should be replaced with proportional liability, and audit firms should be permitted to operate within limited liability structures and a cap should apply to professional liability claims; and
- the provision in the *Corporations Act 2001* of 'whistleblower' protection for those raising concerns about corporate fraud and other irregularities.

5.27 The Government's CLERP 9 paper, in common with the JCPAA's recommendations, proposed the inclusion in the *Corporations Act 2001* of a general statement of principle requiring the independence of auditors. It also proposed the establishment of an audit committee but, diverging from the JCPAA's recommendation, for the top 500 listed companies only.

5.28 Some of the other proposals in CLERP 9 which are relevant to the Committee's inquiry included the amendment of the *Corporations Act 2001* to require:

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22 Ernst & Young News Release, *Ernst & Young study reveals Australian corporate lag behind in board independence* and *Survey of Top 200 Companies' Compliance with new NYSE Listing Rules, Corporate Governance Series*, 24 September 2002. (See Chapter 4 for commentary on the *Sarbanes-Oxley Act of 2002*, regarding 'financial experts'.)

- auditors to make an annual declaration to the company's board that they have maintained their independence according to the Act and the rules of their professional accounting bodies;
- the application of the Joint Code of Professional Conduct of the Institute of Chartered Accountants in Australia (ICAA) and CPA Australia dealing with professional independence;
- the rotation of audit partners every five years;
- auditors to attend AGMs of listed companies to answer reasonable questions about the audit;
- auditors to report to ASIC any attempts to influence, coerce, manipulate or mislead the auditor; and
- the application of qualified privilege and 'whistleblower' protection to company employees reporting to ASIC in good faith and with reasonable cause, any suspected breach of the law.

5.29 The Committee further notes the ICAA and CPA Australia's new Australian standard for audit independence which bans the provision of non-audit services such as material asset valuations where, in also conducting the audit, a firm could be required to check their own work.[23]

5.30 The Committee believes there is substantial merit in the proposals made in the JCPAA report, CLERP 9's issues paper, and the ICAA and CPA Australia's new audit standard outlined above. The Committee's recommendations consequently draw on several of these proposals.

Recommendation 9

The Committee recommends that the *Corporations Act 2001* should be amended to strengthen the independence of compliance plan auditors to include:

- **a general statement of principle requiring the independence of compliance plan auditors;**
- **a requirement for compliance plan auditors to report to ASIC annually about their management of independence issues according to benchmarks developed by ASIC; and**
- **a requirement for compliance plan auditors to report to ASIC any attempts to corrupt the integrity of the audit.**

5.31 The Committee considers that the overall integrity of compliance monitoring would benefit from the extension of qualified privilege and whistleblower protection to employees of REs and, where the application of the legislation may be uncertain, to employees of compliance plan auditors.

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23 ICAA and CPA Australia Media release, *New Australian standard for audit independence,* 23 May 2002.

Recommendation 10

The Committee recommends the application of qualified privilege and whistleblower protection to employees of the RE and, if not already covered by subsection 601HG(8) of the *Corporations Act 2001* to employees of, and, the compliance plan auditor reporting any suspected breaches of the law to ASIC in good faith and with reasonable cause.

5.32 The Committee considers the suggestion that eligibility to conduct a compliance plan audit be opened up to persons other than registered company auditors has sufficient merit to justify further investigation. It is possible that persons with other qualifications and experience could be eminently suitable to conduct compliance plan audits for certain schemes. There would be the added benefit of increasing the pool from which compliance plan auditors could be drawn. This could play a part in reducing scope for conflicts of interest.

Recommendation 11

The Committee recommends that the Department of the Treasury, in consultation with ASIC and relevant industry stakeholders, look into the feasibility of opening up the field for compliance plan auditors where it is considered that persons other than registered company auditors as defined under the *Corporations Act 2001* could effectively carry out the requirements of a compliance plan auditor.

5.33 In making the above recommendations, the Committee assumes that legislative amendments will be made under CLERP 9 resulting in better governance of managed investment schemes by making directors more accountable, strengthening the independence of financial auditors and improving the continuous disclosure regime, largely through more extensive enforcement.

5.34 The Committee has not made recommendations regarding audit partner or audit firm rotation but awaits with interest CLERP 9's conclusions in this regard. In the meantime, the Committee would encourage initiatives in the private sector to develop best practice audit standards for performance audits.

5.35 The Committee notes that the proposals submitted by ASIC to improve the integrity of the compliance plan audit have been included in the Department of the Treasury's consultation regarding issues raised in the Turnbull Review. Of these proposals, the Department has commented in its consultation paper that:

> While they may impact on the costs faced by a RE, [the proposals] have the potential to substantially enhance investor protection. However, they also affect the liability and duties of auditors of compliance plans, and it is important that auditors be given adequate opportunity to comment on the proposals. It is therefore suggested that these matters be progressed through

> consultation involving the Treasury, ASIC, the auditing profession and other interested parties.[24]

5.36 The Committee notes the proposals in the JCPAA report and CLERP 9's paper to limit the liability of auditors in response to increases in their exposure entailed in other proposed reforms. Assuming these proposals are adopted, the Committee believes that ASIC's proposals will improve regulation under the MIA by:

- clarifying the legislation;
- providing for more timely lodgments of audits for newly registered schemes;
- bringing additional expertise to the formulation of a scheme's compliance plan;
- imposing greater accountability on the compliance plan auditor and increasing transparency.

5.37 The Committee supports ASIC's proposals for the improvement of compliance plan audits and notes that the Department of the Treasury has sought the views of the public on these.

The Committee strongly believes that greater transparency in reporting should be encouraged and therefore makes the following recommendation:

Recommendation 12

The Committee recommends that the Corporations Act 2001 be amended to accommodate ASIC's proposals to:

- **require the compliance plan auditor to report to scheme members;**
- **clarify that the auditor's opinion relates to a scheme's performance for the entire year being audited;**
- **require a compliance plan audit of a newly registered scheme within the first year of its registration;**
- **require an auditor's opinion on the adequacy of the compliance plan to be included with a scheme's application for registration; and**
- **clarify that the compliance plan audit need only focus on material issues.**

The Committee further recommends that the Department of the Treasury and ASIC should develop a test of materiality.

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24 *Review of the Managed Investments Act 1998 Report*, Department of the Treasury Discussion Paper, Chapter 3.