

CHAPTER 3

EXPECTATION VS REALITY: DOES THE SIS ACT MEASURE UP?

3.1 This chapter considers the first two issues discussed at the roundtable, namely:

- community expectations of auditors; and
- the adequacy of current reporting requirements by auditors under the SIS Act.

Is there an ‘expectation gap’ about what auditors do?

3.2 A key issue discussed at the roundtable was the community’s expectations of auditors and whether there was a ‘gap’ between what users of financial reports expected of auditors and what auditors actually did.

3.3 Mr John Shanahan, an independent consultant, expressed concern about what he saw as very high expectations of auditors:

I think a lot of community expectation is that the auditor is not there just checking financial statements and compliance but that the auditor is somehow a broader type of insurance policy. That concerns me. The auditor will look at financial statements and does have obligations under the SIS legislation and APRA to report on compliance. My view is that a lot of compliance reporting is fairly mundane. Has a trustee been appointed properly? Has he kept minutes for 10 years? Are they properly filed? People are looking for more security on their investment decisions, which is not properly the function of the auditor.¹

3.4 Mr Shanahan said that nevertheless, he believed the requirements for auditing of superannuation funds needed to be improved, and that auditors should take a broader view of the status of a fund. He also supported the concept of a board of superannuation auditors to ensure that standards were rigorous.²

3.5 Professor Tony Harris agreed with the notion of an ‘expectation gap’:

There is indeed an expectation gap, and everyone around this table is aware that this is an issue which has concerned the accounting and auditing profession for some considerable time. The profession tries to address the expectation gap by telling the community the very limited role that auditors play today in the financial and superannuation services as well as in the broader commercial sector. I appreciate the concern that this committee has

1 Committee Hansard, p. 1308.

2 Committee Hansard, p. 1308.

that it may be that another solution is to expand the role of auditors to better meet a part of that expectation gap ... there is some scope for auditors to comment, for example, where there are systems failures within managers of superannuation funds.³

3.6 Professor Harris noted, however, that the accounting standards for superannuation were significantly better than those in the commercial area ‘which are characterised by ambiguity and flexibility, to put it mildly’.⁴

3.7 ICAA representative Mr Keith Reilly cautioned that there was no guarantee against the loss in value of any investments over time, even those of superannuation funds, despite community expectations that insurance companies, superannuation funds and banks ‘do not go broke’.⁵ He said there were ‘lessons to be learnt’ from two reports which he tabled: a 1994 research study commissioned by the ICAA and the Australian Society of Certified Practising Accountants to investigate the audit expectation gap,⁶ and a 1996 follow-up report.⁷

3.8 The 1994 research report differentiated between two components of the expectation gap:

- ‘unreasonable expectations’, that is, the difference between the expectations of users and the reasonable standards of auditing and financial reporting that could be expected of the auditing profession; and
- ‘inadequate performance’, that is, the difference between the reasonable standards that could be expected of auditors and what was actually being delivered by them. The Working Party concluded that the most serious concerns raised at that time related to this second issue, which became the focus of its report.⁸

3.9 The main theme of the report’s recommendations was that the auditing profession needed to be more proactive not only in relation to technical and ethical standards, but also in quality control and corporate governance.⁹ The report made many recommendations, including:

- improving quality control through a consistent quality assurance program with independent lay oversight, professional registration of principal accounting

3 Committee Hansard, p. 1312.

4 Committee Hansard, p. 1312.

5 Committee Hansard, p. 1313.

6 Australian Society of Certified Practising Accountants & ICAA *A Research Study on Financial Reporting and Auditing – Bridging the Expectation Gap: Executive Summary*, 1994.

7 Australian Society of Certified Practising Accountants & ICAA *Beyond the Gap*, 1996.

8 Ibid, p. 1.

9 The report emphasised (p. 2) that further proactivity was the “only answer” to performance issues concerning auditing and financial report preparation.

officers and auditors, and publication of a separate annual report of disciplinary findings;

- examining and improving the existing financial reporting scope and making appropriate changes. Some of the areas to be developed included:
 - reporting on bases other than that of ‘mere legal form’;
 - developing consistency in accounting policies adopted by different entities;
 - providing more frequent financial reports; and
 - improving the relevance and comparability of information;
- perfecting the existing auditing scope and making appropriate changes, including developing a conceptual framework for auditing as well as strict standards to govern ‘other services’ provided by auditors;
- improving the accounting and auditing environment by such means as reconstituting the Australian Accounting Standards Board with several full-time members, improving supervision and discipline standards, and the profession taking a leading role in setting and promoting corporate governance standards.

3.10 The follow-up report in 1996 outlined those priorities and the advances that had been made since 1994. Overall, the 1996 report endorsed the proactive approach and, in particular, supported initiatives in quality assurance and enhancement of the disciplinary process. The report also endorsed the need for external professional review and monitoring of accounting and audit standards, the importance of a high standard of corporate governance practices and the desirability of harmonising Australian accounting and audit standards with international standards as far as possible.

3.11 During the roundtable another representative from the ICAA, Mr Richard Rassi, commented that while auditors had been criticised recently, the relationships between key stakeholders, namely the trustees, fund administrators, investment managers, professional advisors and the regulators, needed to be considered. He also argued that the criticism of auditors needed to be kept in perspective:

There is no doubt that the auditing profession has been under attack in recent times, but it is really important that the politicians, the public and regulators do not generalise the findings of certain cases and apply those findings or concerns to the audit professional overall. If you have a look at the track record, it has not been that bad — considering the number of audit opinions that have been issued since the SIS legislation first came in. Very few auditors have been successfully accused and tried for negligence or indeed struck off as not being suitable to act as approved auditors.¹⁰

10 Committee Hansard, p. 1309.

3.12 Mr Rassi pointed out that the superannuation audit profession had been ‘doing a lot of positive things’ recently:

For example, at the moment a new accounting standard has been released in exposure draft form for comment which attempts to improve the quality of external financial reporting and at the same time get some balance between the cost and the benefit of financial reporting. The profession is in the process of updating the auditing guidance statements that are applicable to auditors of super funds. It continues to provide courses to practitioners and they are constantly under review and being improved upon. The profession has also been quite busy considering issues of independence, and this is an exercise that has been undertaken by the profession overall.¹¹

3.13 Representatives of other professional bodies also emphasised that most auditors were performing at a high standard.¹² APRA representative Mr Roger Brown also reminded the Committee that the primary responsibility for managing a superannuation fund lay with the trustees, and that it was important not to blur the line of responsibility between the trustees and the auditors.¹³

The Committee’s view

3.14 The Committee was somewhat disappointed that the roundtable did not ‘think outside the square’, despite the Committee’s exhortations to look beyond the current legislative provisions and the traditional functions of auditors of superannuation funds. The Committee noted that in some cases the participants seemed somewhat defensive of auditors’ current role and what they considered to be unrealistic community expectations.

3.15 The Committee also notes that despite what appear to be some important advances in the financial reporting environment following the 1994 research report on the audit expectation gap, that report’s broad approach to matters such as reporting on bases other than mere legal form, increasing the frequency of reporting, and improving the relevance and scope of information in financial reports appears to be somewhat diminished in the follow-up report in 1996. While clearly emphasising the need for quality, best practice, improvements in administration and accountability, the later report does so from a perspective of adjusting the present framework rather than re-examining the basis for that framework.

3.16 The Committee believes that auditors are not doing enough to address the expectation gap with the community, despite having made some efforts in the mid 1990s. As the community becomes better educated about their superannuation funds’ financial position and more aware of their responsibilities to check on trustees’

11 Committee Hansard, p. 1309. The accounting standard is AAS 25 *Financial Reporting by Superannuation Entities*.

12 Comments by Mr Edge of the AASB and Mr Reilly of the ICAA at Committee Hansard, pp. 1319, 1321.

13 Committee Hansard, p. 1315.

performance, the significance of this issue will only increase. The Committee also considers it essential that the professional bodies devote more resources to improve public education about their role.

3.17 Nevertheless, the Committee notes that discussion of other issues during the roundtable suggested that some expansion to auditors' roles might be possible and even acceptable to the professional bodies. Those issues are considered in the next chapter.

The adequacy of reporting requirements under the SIS Act

3.18 As noted in Chapter 2, under sections 129 and 130 of the SIS Act auditors must report to a fund's trustees if, during the course of the auditing, they identify a breach of the legislation or form the view that the fund is, or is about to be, in an unsatisfactory financial position. The auditors may also report to the regulators, although this is not mandatory unless the trustee fails to take appropriate action.

3.19 APRA representative Mr Roger Brown said that APRA needed to be able to rely on funds' accounts and audit reports on compliance.¹⁴ In its circulars on the responsibilities of approved auditors, APRA has stated that issues of principal concern include:

- that the auditor is independent and is seen to be free of any conflicts of interest;
- that there is a letter of engagement from the trustee to ensure that all parties are clear on the services being provided;
- that appropriate audit evidence is obtained;
- that sufficient documentation of the audit is maintained; and
- that management letters are issued to fund trustees as a matter of course, regardless of whether there are issues of concern.¹⁵

3.20 Mr Brown said that auditors' notification to APRA under section 129 (that is, compliance) was very rare, and that he had been able to identify only two such notifications in a brief review of APRA's files. However, he noted that approximately one in eight funds, excluding the small APRA funds, has a qualified audit report attached to its annual return. He estimated that 80 per cent of those qualified reports related solely to the late return of the report.¹⁶

14 Committee Hansard, p. 1314.

15 APRA *Superannuation Circular No. IV.A.4 Responsibilities of the Approved Auditor*, referred to in Committee Hansard pp. 1314-1315.

16 Committee Hansard, p. 1315.

3.21 Commenting on the very small number of auditors' notifications to the regulators, Mr Malkin from CPA Australia said that the current provisions were useful in that:

... [auditors] have the ability to negotiate with the trustees a way of rectifying either actual breaches or potential breaches. By so doing we can assist the trustees in repairing and making healthy the funds before they get to the stage of having to be reported to APRA or the ATO as being badly breaching funds, if you like ... In 90 per cent of cases — in fact, probably 99 per cent of cases — the trustees are very happy to listen to us and rectify the problems that they have got themselves into, perhaps inadvertently, before it even gets to the regulator. By so doing we are in fact the eyes of the regulator and we are taking a lot of pressure off the regulator by providing our competency in helping to rectify these funds.¹⁷

3.22 The roundtable discussed whether auditors should be compelled to report directly to the regulator where they had identified a compliance breach or possible unsatisfactory financial position. Mr Brown said that APRA would support such a requirement, noting that it would currently be open to the professional bodies to recommend such action by their members even though it was not mandatory under the SIS Act:

While in my experience the bulk of auditors are good auditors and would be happy to accede to such a request – particularly if it is promoted by their professional bodies – I see, like you, more funds at the bottom end of the market which are encountering difficulties, and frequently the auditors of those funds would be less willing to comply with a voluntary request.¹⁸

3.23 Mr Phelps concurred with Mr Brown's views, saying it would now be feasible for auditors to report all problems to APRA, following the transfer to the ATO of the responsibility for regulating most funds.¹⁹ Mr Shanahan also supported mandatory reporting requirements for auditors.²⁰

3.24 In relation to whether such requirements should also apply to the 220,000 self-managed superannuation funds regulated by the ATO, Assistant Commissioner Ms Lesley East said that the ATO was in a different position as it did not require audit reports for those funds to be lodged. If there were any qualifications, Ms East advised, these should be included in the fund's annual tax returns. Only if a problem was detected would the ATO pursue the matter further and ask to see the audit report.²¹

17 Committee Hansard, p. 1322.

18 Committee Hansard, pp. 1315-1316.

19 Committee Hansard, p. 1316.

20 Committee Hansard, p. 1318.

21 Committee Hansard, pp. 1317.

Alerting the regulators

3.25 The roundtable also discussed the adequacy of means by which issues of concern were drawn to the regulators' attention.

3.26 In response to a question from the ICAA, APRA representative Mr Brown said that APRA would not consider that submitting a qualified audit report was sufficient notification to satisfy the requirements of section 129.²²

3.27 Mr McKean representing the Australian National Audit Office agreed that the traditional audit model was backward looking and did not look at early warnings.²³ However, he noted that one of the dangers that needed to be considered was that an auditor's expression of concern about the solvency of a fund could in itself exacerbate the problem and create the failure itself. In order to avoid such a situation, he suggested consideration of a model that encompassed a 'gale warning type system where you may have a warning range from say, one to five', with one flagging a minor concern and five indicating a more serious breach. This would ensure that the regulator was alerted to any potential failure and was better prepared to step in when necessary.

Independence of auditors

3.28 Another issue discussed at the roundtable was auditors' independence. Mr Rassi from the ICAA commented that the profession 'has been quite busy considering issues of independence', although he did not elaborate.²⁴

3.29 Professor Harris suggested that there was ample evidence to suggest that audits were not always conducted at arm's length:

I would argue that the audit of Tricontinental and the audit by Deloitte of AWA were marred by lack of independence. I am sure that the SEC will say that the audit of Sunbeam was marred by lack of independence. I am sure that we will see with HIH that there will be problems with independence, as there will be with the audit of Harris Scarfe.²⁵

3.30 Professor Harris commented that the 1994 research report commissioned by the ICAA and Australian Society of Certified Practising Accountants to consider the audit expectation gap:

... was the first time I had ever seen the industry in Australia address this issue. They tentatively started discussing who should appoint the auditor and that it may not be in the best interests of auditors or society to have, in effect, managers appointing the auditors as occurs now in the corporate

22 Committee Hansard, p. 1322.

23 Committee Hansard, p. 1330.

24 Committee Hansard, p. 1309.

25 Committee Hansard, p. 1320; Submission No. 238.

world. The first time I saw that discussion was in 1993, and it has not been pursued since.²⁶

3.31 Professor Harris also commented that the United Kingdom equivalent of the Audit and Assurance Standards Board ‘is significantly much more outspoken about this problem in the United Kingdom than I see in Australia’.²⁷

3.32 APRA representative Mr Brown noted that APRA had raised the issue of auditor independence with the professional bodies in the past:

We have seen instances of severe lack of independence and we have on occasion disqualified auditors primarily for that reason. In a survey amongst our supervisory staff, they identified that as an issue in perhaps two to five per cent of the funds which we review. So it is not, in audit parlance, a material issue in terms of frequency, but certainly in those funds where it is an issue it does represent, in my view, a risk to members.²⁸

3.33 Mr Brown noted that it was frequently argued that one accounting firm could both prepare the accounts of an entity and audit them, and that ‘Chinese Walls’ within the firm could ensure independence. He said:

That position is certainly arguable, but perhaps particularly in smaller practices it can come under legitimate question. There is not, in our view, an easy answer to that. At the extreme you would say that no entity could simultaneously prepare the accounts of a body and also audit it. That would require, in our view, significant restructuring within the accounting and audit profession.²⁹

3.34 In its written submission, the ATO stated that the failure to maintain independence was ‘the greatest perceived risk we have identified to date’.³⁰ The ATO said that in view of both its research and anecdotal evidence, it was ‘supportive of any potential industry review on the issue of auditor independence’.³¹

3.35 However, there was no general agreement amongst the professional bodies as to whether a lack of auditors’ independence was a significant issue. Mr Reilly from the ICAA commented that the audit issues under discussion were similar to those being debated internationally. He argued that if there was evidence to suggest an auditor had become too close to the trustees and was not acting independently, there

26 Committee Hansard, p. 1320.

27 Committee Hansard, p. 1320.

28 Committee Hansard, p. 1316.

29 Committee Hansard, p. 1316.

30 Submission No. 240, p. 5.

31 Submission No. 240, p. 6.

were ‘more than adequate disciplinary processes’ to allow for ‘fairly immediate action’ by the professional bodies.³²

3.36 Mr Edge of the Auditing and Assurance Standards Board also queried whether there was any evidence of a systemic problem rather than isolated instances, pointing out that the regulators, like doctors, ‘only see the sick people’ and that generally speaking, Australia had ‘accounting and auditing standards of the highest quality’.³³ He said no examples put to him had indicated that the problem with a superannuation entity had been the lack of independence or the lack of a Chinese wall.³⁴

3.37 ICAA representative Mr Reilly argued that in general, the auditing profession adhered to requirements and standards, and estimated that 70 per cent of audit practices ‘are doing the right thing’ and presented ‘no problem whatsoever’. Another 10 to 12 per cent performed the work appropriately but did not document their work as required by the standard. He estimated that in about 8 per cent of cases reviews had to be done again due to ‘more serious problems’, and that in ‘a very small number of cases’ the ICAA had excluded members.³⁵

Committee view

3.38 The Committee notes that APRA regulates approximately 3,780 funds excluding the small APRA funds (that is, those with less than five members where not all of the members are trustees).³⁶ If one in eight of those funds has a qualified audit as Mr Brown suggested, and 20 per cent of those qualified audits concern breaches more serious than simply late returns, this equates to potentially serious breaches being noted in relation to about 90 funds. As Mr Brown did not offer any other details of the type of fund where serious breaches are reported, it is not clear to the Committee how many members this number of funds could involve, but it is potentially thousands.

3.39 As it has stated previously, the Committee believes that all funds that invest monies for the purpose of providing a retirement income stream must be fully protected. Accordingly it would seem that the problem of possible breaches of the Act is significant and that all possible steps should be taken to ensure that the regulator’s attention is drawn to those matters as quickly as possible.

3.40 Independence of the auditors of superannuation funds is also a crucial issue, as the Committee noted in its First Report.³⁷ The Committee recommended in that

32 Committee Hansard, p. 1317.

33 Committee Hansard, p. 1319.

34 Committee Hansard, p. 1319.

35 Committee Hansard, p. 1321.

36 According to figures supplied by APRA - see First Report, p. 19.

37 First Report, pp. 95-96.

report that APRA should work more closely with the peak professional bodies in order to identify ways to improve adherence by auditors to professional and ethical standards and ensure genuine auditor independence.³⁸ The Committee notes that the Minister for Financial Services and Regulation has recently announced the appointment of a corporate governance expert, Professor Ian Ramsay, to examine audit independence more generally.³⁹

3.41 Although a number of examples were cited, the Committee did not hear evidence of a major systemic problem concerning auditor independence in the area of superannuation. Nevertheless, the Committee considers that auditor independence would be enhanced by a mandatory requirement in the SIS Act that auditors report directly to the regulator any breach of the legislation or concerns about the fund's financial position, at the same time as they report such events to the trustee. Such notifications should include a clear indication of the auditor's opinion as to the seriousness of the identified problem, in order to assist the regulator in monitoring the situation.

3.42 Another way of assisting independence might be to introduce compulsory disclosure provisions for auditors in order to avoid any conflicts of interest. Although this issue was not specifically discussed during the roundtable, the Committee is especially concerned to ensure that the auditor of a company is not also the auditor of its superannuation fund. Arm's length auditing is essential to preserve independence.

3.43 The Committee notes that the SIS Act contains no specific requirement for auditor independence, although the lack of independence may obviously be a consideration in a regulator's decision to disqualify an auditor for unsatisfactory performance.⁴⁰ However, there are independence requirements in the relevant Code of Professional Conduct, particularly through Auditing Principle (AUP) 32 *Audit Independence* which provides guidance to auditors in applying legislation, professional ethics and auditing standards. Amongst other matters, AUP 32 emphasises the need for auditors to ensure that they are able to conduct the audit free from the governing body's intervention, that their independence is not impaired by becoming involved in management or decision-making and that undue influence does not arise through the level of fees derived from other services and the threat of loss of those fees.⁴¹

3.44 As auditor independence is becoming an increasingly important issue both nationally and internationally, the Committee considers that the solution should be

38 Recommendation 16.

39 Minister for Financial Services and Regulation *Press Release No. FSR/057* "Rebuilding Confidence in Australia's Audit Profession", 2 August 2001.

40 Under s. 131 of the SIS Act.

41 AUP 32 is discussed in Spencer, T for the Auditing and Assurance Standards Board and Australian Prudential Regulation Authority, *The Audit of Superannuation Funds*, Audit Guide No. 4, Australian Accounting Research Foundation, 1999, pp. 32-35.

stronger than a guiding principle. Accordingly the Committee recommends that the SIS Act be amended to reflect the need for auditor independence and in particular to provide that the auditor of a company is not also the auditor of its superannuation fund because of the problem of perceived or actual loss of independence.

Recommendation 1

3.45 The Committee recommends that Part 16 of the *Superannuation Industry (Supervision) Act 1993* (the SIS Act) be amended to require auditors to report to the regulator any breach of compliance with the Act or suspicion of a fund's unsatisfactory financial position, at the same time as they report such issues to the trustee.

Recommendation 2

3.46 The Committee recommends that the SIS Act be amended to require that auditors of superannuation funds be independent and that the auditor of a company is not also the auditor of its superannuation fund.

