

CHAPTER 4

THE NATURE AND RELIABILITY OF AUDIT REPORTS

4.1 This chapter deals with the nature and reliability of audit reports. It discusses some of the issues considered at the roundtable, including:

- whether audit reports should include a risk assessment;
- whether they should be prepared more frequently; and
- whether they should include a wider range of information, for example actuarial reports.

The nature of audit reports

4.2 As noted in Chapter 2, auditors of superannuation funds are required to prepare both a financial audit report and a report on compliance with the SIS Act requirements.

Emphasis of auditors' reports

4.3 Mr Chris Malkin from CPA Australia said much more emphasis was being put on the prudential controls related to administration of funds rather than the mere 'green ticking' of the financial statements and the assessment of compliance with the Act. He said that the profession was 'very conscious of raising the standards', and that the ICAA and CPA Australia were giving some attention to improving reporting 'that could be better attuned to fund members' needs and, in particular, the development of more explicit standards for explaining the risk management strategies adopted by the trustees'.¹

4.4 Ms Martin from the Institute of Actuaries of Australia agreed that auditors were identifying risk management issues 'in a number of instances now' in their annual audit reports.² However, there was no onus on the trustees to necessarily act on the risks that had been identified. She suggested that this might be an area of regulation that could be improved, explaining:

... ideally we would like to see some sort of process put in place, with a better risk management framework around the regulation of superannuation funds — something that requires superannuation trustees to have a proper risk management approach in place that identifies all the key risks that the

1 Committee Hansard, p. 1324-1325.

2 Committee Hansard, p. 1326.

funds face and that seeks advice on those key risks and how they can be mitigated ...³

4.5 She elaborated on the sorts of requirements that could be considered:

Rather than just saying that the trustee has to consider and formulate an investment policy, they need to more specifically require the trustee to identify particular investment risks and have in place a strategy that actually deals with those risks. Perhaps there even needs to be a requirement for the trustee to take professional advice on investment strategy and, if they choose not to follow that professional advice, to place some whistleblowing responsibility on the professional who provides that advice. So I think there is a need for some sort of forward looking risk management framework to try and deal with some of the issues that have emerged through the committee process.⁴

4.6 Like Mr Malkin, Ms Martin emphasised the need to be conscious about imposing additional costs on funds without any material benefit. She noted that actuarial reports are already required for certain types of superannuation funds, namely defined benefit funds.

4.7 Both Mr Brown and Mr Venkatramani from APRA supported the requirement for risk management statements to be made by trustees and in turn addressed in audit reports. Mr Venkatramani said:

I do believe that there is a good case for maybe making risk management statements not merely good practice but perhaps mandatory for trustees. Then auditors and others who are involved can express an opinion on the adequacy and effectiveness of those practices.⁵

4.8 ICAA representative Mr Rassi also suggested that a prudential review of superannuation funds could be made mandatory, in addition to the current audit requirements. Such a review could include an assessment of the fund's risk management approach, corporate governance structure and other related issues. Mr Rassi said a prudential review process would be 'an extremely healthy exercise', particularly for the larger funds.⁶ He added that such a review could be conducted by the same auditor as carries out the existing audits, as this would be cost effective and would help in that the auditor would already be aware of some of the fund's risks.⁷ However, later in the discussion Mr Rassi stated that the prudential reviews he had carried out of large funds' risk management systems cost between \$30,000 and

3 Committee Hansard, p. 1309.

4 Committee Hansard, p. 1309.

5 Committee Hansard, p. 1328.

6 Committee Hansard, p. 1327.

7 Committee Hansard, p. 1327.

\$50,000, compared with total audit fees of between \$20,000 and \$40,000.⁸ He noted, however, that for the large funds with substantial assets under management, such costs were ‘miniscule’.

Frequency of reporting

4.9 CPA Australia representative Mr Malkin did not support audit reports more frequently than once a year, due to the costs:

... every time a trustee spends money on administering a fund, it is reducing the amount of retirement benefit that the members are going to enjoy when they are able to get that retirement benefit.⁹

4.10 However, he noted that where an auditor had identified a possible breach of the Act and had given the trustee a defined time in which to rectify the situation, the auditor would go back to the fund to check on the progress rather than waiting until the next financial year’s annual audit. Consequently in those circumstances the auditor was looking at the fund ‘progressively during the year’.¹⁰

Reporting to fund members

4.11 The Committee was told that the auditor’s report was not required to be sent to the members of a superannuation fund, although the auditor would be named in the fund’s annual report and members did have a right of access to the auditor’s report.

The reliability of audit reports

4.12 A related issue raised for discussion at the roundtable was whether the regulators could rely on the current audit report format to provide them with early warning signals of fund failure.

4.13 Various views on the current audit report format were expressed. ANAO representative Mr McKean reiterated earlier comments that the auditing process was backward looking. He suggested that in order to be reliable in terms of picking up early warning signals, the process ought to be an ‘auditing at the moment’ process.¹¹

4.14 Mr Shanahan expressed concerns about the delay in the lodgement of audit reports, that is, up to nine months after the end of the financial year for the small self-managed funds. He argued that if 80 per cent of qualified reports were due to late lodgement, the audit process was so delayed that it was difficult to be of any use in terms of providing early warnings.¹²

8 Committee Hansard, p. 1333.

9 Committee Hansard, p. 1325.

10 Committee Hansard, p. 1325.

11 Committee Hansard, p. 1330.

12 Committee Hansard, p. 1329.

4.15 Mr Shanahan also compared the much more detailed audit reports on banks that were provided to the prudential regulator. Those reports ‘pick many more holes’. He noted, however, that the large number of superannuation funds may make similar requirements unworkable in the regulation of superannuation:

There are only a limited number of banks. I do not believe you could have a much more detailed report on prudential management issues. You [could] do it perhaps with the large or the medium super funds, but to look at this for the entire population of 220,000 I think would be fairly difficult.¹³

Revising the format of audit reports

4.16 Mr Shanahan said he was not persuaded that the present format of the audit report for superannuation funds would be useful unless ‘a particular prudential direction to the audit function’ was made clear:

Every auditor at the moment says, ‘APRA has set out what we will put in the audit report. We will all follow that. We cannot depart from that.’ I worry that our audit reports are so pro forma that you would all almost have to have a qualification in flashing neon lights and say, ‘Look in this additional paragraph. Something is wrong,’ before it gets noticed.¹⁴

4.17 Professor Harris suggested that APRA, as the basis for the audit report, prepare a set of specific questions to which they want specific answers.¹⁵ ICAA representative Mrs Orchard agreed:

... auditors would be willing to do a wider review of the risk management systems assessments of the fund but we would need some guidelines within which to work — for what is expected within that — so that an opinion could be formed. We cannot just say that the risk assessment is appropriate. That leaves the auditor quite wide open and does not give us a scope within which to work.¹⁶

4.18 Accordingly Mrs Orchard suggested that APRA develop appropriate guidelines for superannuation funds regarding audit report requirements. There was general support around the table for this suggestion, with APRA representative Mr Phelps saying such action would take a few months.¹⁷

13 Committee Hansard, p. 1329.

14 Committee Hansard, p. 1329.

15 Committee Hansard, p. 1329.

16 Committee Hansard, p. 1332. The ICAA in an earlier written submission also noted that ‘External auditors are more than happy to assist APRA in its prudential supervisory role, provided that the work requested is specific, rather than a vague general request to inform APRA of anything that APRA might need to be aware of’ (Submission No. 236, p. 2).

17 Committee Hansard, p. 1332.

The Committee's views

4.19 As the Committee noted in its First Report, it is essential that the regulator have effective risk management procedures in place in order to ensure that early warning signals of impending fund failure are detected.¹⁸ In addition, the Committee considers it essential for all funds to have a risk management strategy, as well as the investment strategy that is currently required under the SIS Act,¹⁹ and for auditors to review those strategies as part of the audit process. As part of the review of the risk management strategy, the Committee considers that it would also be appropriate for auditors to address issues associated with capital adequacy.

4.20 In order to assist auditors to assess and comment on funds' risk management and investment strategies, as well as capital adequacy issues, the Committee believes that APRA should prepare guidelines outlining the specific areas which should be addressed in the audit report. The results of the auditor's assessment should be included in a fund's annual report. The ATO should also give consideration to developing guidelines to assist auditors in preparing audits of small self-managed superannuation funds.

4.21 The Committee considers that where a qualified audit report has been issued (other than merely on a technical ground such as a late return), there should be a requirement to conduct another audit within a specified time prior to the next financial year's audit. The Committee notes the potential cost impact, particularly on the smaller funds, of more frequent audit processes, but considers that the rewards in terms of significant savings through improved fund security and early warning of potential problems outweigh those considerations.

4.22 The Committee also believes that auditors' reports should be sent to the members at the same time as the annual report, in order to improve communication to members on their fund's financial state. The Committee is mindful of the fact that not all members would necessarily understand or be interested in the details contained in such reports, but believes that the need for greater transparency and accountability in fund management justifies such a course.

4.23 The Committee considers it would be good practice, and part of an effective governance framework, for a prudential review to be carried out for superannuation funds regulated by APRA, particularly the larger funds. In order to avoid imposing an undue financial burden on the smaller funds, such a review need not be carried out annually, but should be required say every five years for the larger funds (as defined by APRA). It would not be necessary to make such reviews mandatory for the small self-managed superannuation funds regulated by the ATO, since all members of such funds are responsible for the management of their own money.

18 First Report, pp. 42, 45-46.

19 The fund's governing rules must include certain covenants by the trustees (s. 52(2)), including a covenant to formulate and give effect to an investment strategy.

4.24 Finally, the Committee notes that audit reports on banks are more detailed than those required for superannuation funds. The Committee considers that it would be impractical for the small and medium sized funds to move to this standard. However, the Committee considers that there may be merit in the longer term for consideration to be given to moving towards requiring the audit reports for large funds to ultimately be prepared to the same standard as that required for banks.

Recommendation 3

4.25 The Committee recommends that APRA prepare a set of guidelines outlining the specific areas which should be addressed in the audit report on assessments of risk management systems and investment strategies for superannuation funds.

Recommendation 4

4.26 The Committee recommends that where a qualified audit report has been issued (other than merely on a technical ground such as a late return), there should be a formal requirement for a follow-up audit to be conducted within a specified time.

Recommendation 5

4.27 The Committee recommends that the auditor's report on a superannuation fund be sent, as a matter of routine, to all fund members, in order to improve accountability and ensure transparency of the trustee's actions and communication about the fund's financial state.

Recommendation 6

4.28 The Committee recommends that the larger superannuation funds regulated by APRA be required to carry out a prudential review, at a minimum of once every five years.

4.29 The Committee also considered whether trustees should be required to provide more detailed information to auditors, in order to assist them in identifying particular issues of concern when conducting their audits. At present, the SIS Act²⁰ requires trustees each financial year to prepare a statement of financial position; an operating statement; a statement of cash flows; and such accounts and statements as are specified in the regulations.²¹ There is no requirement for trustees to alert the

20 SIS Act s. 112.

21 There is an additional requirement for superannuation funds which invest in derivatives (such as options, futures and warrants). A Risk Management Statement (RMS) must be prepared and the trustees or the directors of the fund's investment management company must certify in writing to the auditor that they have met their responsibilities with respect to the RMS (such as having it in a form that is appropriate and consistent with the guidelines set out in APRA's *Superannuation Circular No. II.D.7 Derivatives* and its 1998 addendum). The auditor must then report to the trustees or the directors of the investment management company his or her opinion as to whether those assertions are fairly stated.

auditors to any concerns about the fund's operation or to request the auditor to pay particular attention to an issue.

4.30 Nevertheless, there is opportunity for such concerns to be raised during the audit engagement process. The letter of engagement recommended for use by auditors²² clearly sets out the parameters for undertaking the audit. For example, when the audit is in progress, trustees may be required by the auditors to answer particular questions that arise.

4.31 The Committee has considered the possibility of requiring trustees to certify to the auditors, prior to the audit taking place, that the accounts are in good order and comply with the requirements of the SIS Act, and to indicate any systemic weaknesses or issues of concern in the fund's management or operations. The Committee acknowledges that this suggestion would have significant implications for the SIS Act regime. Matters to be determined would include specifying the types of information to be provided by trustees, the standard of evidence required to establish a contravention of this requirement, the consequences of any contravention (that is, whether civil or criminal) and the appropriate penalty. Consequently the Committee considers that this matter should be examined by APRA in consultation with the relevant professional and regulatory bodies.

Recommendation 7

4.32 The Committee recommends that APRA consult with the relevant professional and regulatory bodies with a view to developing a requirement for trustees to provide a statement to the auditor prior to the audit of a superannuation entity. The statement would certify that the accounts were believed to be in good order and to comply with the SIS Act, and would note any areas of weakness or concern in the fund's financial and management strategies.

22 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, Appendix C, p. 206. APRA's *Superannuation Circular No. IV.A.4 Responsibilities of the Approved Auditor*, para 14 notes that one of several issues about which APRA is concerned is that letters of engagement are issued, in order to ensure all parties are clear on the services being provided.

