SMART AUDITORS

Whether they like it not, auditors are set to play a vital role in the prudential supervision of collective investments.* Evelyn McWilliams *reports.

In the course of its examination of superannuation schemes the Review concluded that auditors could play a greater role in keeping superannuation schemes honest. It could be up to them to check that the trustees are keeping a proper watch on their fund managers and administrators. To help clarify the role of the auditor, the regulator should, in conjunction with the profession, develop guidelines outlining exactly which features of schemes need to be checked. Auditors would therefore be looking at things like whether contributions have been properly paid into accounts; whether fees have been charged and expenses allocated in accordance with deeds; whether superannuation payouts have been calculated in accordance with the deed; whether valuation procedures have been followed and whether the restriction on in-house investment has been breached. The Attorney tabled that report on 28 April this year and the Treasurer, Mr John Dawkins, announced on 21 October that most of the key recommendations in that report have been adopted by the government and will be implemented in legislation to be introduced shortly. In the same speech the Treasurer concurred with the Review's recommendations about the role of auditors in superannuation schemes.

The Government plans to use auditors of funds to keep trustees and managers on the straight and narrow. Auditors will be required, by force of law, to report breaches they encounter to the ISC. This is a new development in regulation generally.

To equip auditors for this enhanced reporting task, the Review recommends that the regulator should establish standards to be met by auditors before they could be registered as an auditor for a superannuation scheme and that the standard of auditors should be subject to regulatory supervision. Auditors for life insurance companies are presently required to be specially approved by the Insurance and Superannuation Commission. The ISC is investigating various options for regulating superannuation scheme auditors. One option might be to license them, although this could prove complex since there are more than 50 thousand scheme auditors. Another option would be for the ISC to monitor auditors' participation in various training programs to ensure their professional competence.

Knowing where 'the buck' stops allows you to ensure that schemes fulfill certain duties and statutory obligations to their members.

Other collective investments

Having dealt with superannuation schemes, the Review went on to examine other collective investment schemes. It defined them as any type of fund raising vehicle other than those which are both capital guaranteed and subject to prudential supervision by the Reserve Bank of Australia, the Insurance and Superannuation Commission (ISC) or the Australian Financial Institutions Commission (AFIC). These are essentially deposits and traditional life insurance policies. Investment linked policies of life insurance which have soft guarantees come within the Review's definition of collective investment schemes. Collective investments may take any legal form, such as trust, contract or partnership and includes unit trusts currently subject to a buy-back obligation, investment linked life insurance funds, some portion of trustee common funds and some limited partnerships. The range of assets they may invest in is quite broad, ranging from equities and cash to racehorses and property.

The 'responsible entity'

Discussion of how to regulate collective investment schemes begins with a truism: Supervision implies delegating responsibility. The Review proposes that the operation of a collective investment scheme must be the responsibility of a single entity (the responsibility entity). Knowing where 'the buck stops', allows you to ensure that schemes fulfill certain duties and statutory obligations to their members. The Review also recognises that, merely establishing high standards of regulation for collective investment schemes is not enough. You also have to ensure

that schemes comply with those standards. So the audit function becomes vital.

Proactive auditors

Effective regulation means that the regulator has to have the powers as well as the human resources necessary to conduct an effective random audit and compliance program. But even with significant resources, the regulator will not always be able to supervise regularly the activities of superannuation schemes. The Review therefore proposes that auditors of superannuation and other collective investment schemes should become more proactive in ensuring that schemes comply with the standards set out in the Review's reports.

Auditors should be required to report to the regulator any instances of non-compliance with legislative standards when they become aware of them; that is, auditors should face obligations similar to those that the Reserve Bank imposes on auditors of banks. Under Reserve Bank obligations, auditors do more than check whether the accounts are true and fair. There are other rules to ensure that the regime will work. They must report on the bank's compliance with its prudential requirements. As with banks, the Review proposes that the auditors of collective investment schemes should do more than just check the accounts because there are other requirements that must be enforced if the appropriate level of investor protection is to be achieved. The Review proposes a regime to ensure that these other requirements have been complied with and auditing would seem to be the most cost effective way of implementing this system of checking.

Auditors could be obliged to report to the regulator breaches or suspected breaches of standards or deeds. Auditors could also have to check that borrowing limits on collective investment schemes are not breached and, if the scheme offers redemption 'at call', that the untraded assets do not exceed the prescribed percentage and that the proposed prescribed cash balances are met or lines of credit are in place.

Reactions to the proposals

These proposals have drawn a mostly positive response. But a number of respondants suggested that the auditor should have to discuss any anomalous features with the scheme's responsible entity before involving the regulator. According to this argument, the person or persons responsible for the scheme should have an opportunity to sort out any problems first, and that reporting directly to the regulator creates an unnecessary workload for the regulator. Other respondents argued that auditors should not have to report to the regulator at all because it is not their responsibility.

On the other hand, the Corporations Law already obliges company auditors to draw possible irregularities to the attention of the Australian Securities Commission and it gives auditors civil liability protection to do so. The Review considers that this is the way to go for collective investment schemes. To require the auditor to discuss the matter with the responsible entity first may impede the regulator's ability to respond quickly. The Review therefore considers that the auditor should be the one to decide whether to approach the responsible entity first. It should not be compulsory.

Qualifications for auditors

To equip auditors for this enhanced reporting task, the Review proposes to protect them from possible intimidation (such as threats of defamation) by a defence of qualified privilege. Their standards of competence would also need to be beyond question.

The Review believes that legislation making it an offence for an unqualified person to act as auditor without the permission of the regulator can achieve the same objectives as a licensing scheme without incurring its administrative costs. The regulator would special the qualifications by *Gazette* notice. The legislation would also empower the regulator to step in and restrain an otherwise qualified auditor from auditing one or more specified schemes, based on the regulator's assessment of the risk of contravention of a relevant law. The regulator's decision would be reviewable by the Administrative Appeals Tribunal.

In discussing the appropriate role of the auditor in collective investment schemes, the Review has called into question the role of the trustee and even its *raison d'etre*. Some submissions have suggested that a beefed up auditor, combined with a more powerful regulator and increased obligations on scheme operators, provides better regulation. Others see a need for both muscular auditors and trustees. The debate also gives rise to the question of whether the auditing profession, if given a choice, would be prepared to take on the extra responsibility of monitoring collective investment schemes. At first glance it might be considered that greater fees would offer sufficient enticement. But members of the auditing profession have, in the past, expressed reservations about what they describe as the 'audit expectations gap' — the gap between what investors think they are getting and what in fact auditors deliver. No doubt auditors, who by law have unlimited liability, will also need to make careful assessments of their potential exposures in indertaking such activities. But whichever conclusion the Review reaches on the role of trustees the auditors are assured of a more important role than they have traditionally held.

Members of the auditing profession have, in the past, expressed reservations about what they describe as the 'audit expectations gap'.