

GS 014
(August 2009)

Guidance Statement GS 014 *Auditing Mortgage Schemes*

Issued by the **Auditing and Assurance Standards Board**



Australian Government

Auditing and Assurance Standards Board

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AUTHORITY STATEMENT

The Auditing and Assurance Standards Board (AUASB) issues Guidance Statement GS 014 *Auditing Mortgage Schemes* pursuant to section 227B of the *Australian Securities and Investments Commission Act 2001*, for the purposes of providing guidance on auditing and assurance matters.

This Guidance Statement is the re-issuance of AGS 1058 *Auditing Mortgage Investment Schemes* (July 2002), with updated references to the *Corporations Act 2001* and relevant *ASIC Regulatory Guides* to reflect subsequent regulatory changes affecting mortgage schemes. Further consideration of these changes will be undertaken by the AUASB as part of the future revision of this Guidance Statement.

This Guidance Statement provides guidance to assist the auditor to fulfil the objectives of the audit or assurance engagement. It includes explanatory material on specific matters for the purposes of understanding and complying with AUASB Standards. The auditor exercises professional judgement when using this Guidance Statement and needs to refer to the *ASIC Regulatory Guides* where relevant.

The Guidance Statement does not prescribe or create new mandatory Requirements.

Dated 12 August 2009

M H Kelsall
Chairman - AUASB

GUIDANCE STATEMENT GS 014

Auditing Mortgage Schemes

Application

- 1 This Guidance Statement has been formulated by the Auditing and Assurance Standards Board (AUASB) to provide guidance to auditors of mortgage schemes which are regulated by the Australian Securities and Investments Commission (ASIC) and are subject to Chapter 5C of the *Corporations Act 2001* (the “Act”).

Issuance Date

- 2 This Guidance Statement is issued on 12 August 2009 by the AUASB and replaces AGS 1058 *Auditing Mortgage Investment Schemes* which was issued in July 2002.

Introduction

- 3 The guidance in this Guidance Statement is to be read in conjunction with that contained in GS 013 *Special Considerations in the Audit of Compliance Plans of Managed Investment Schemes* for audits of mortgage schemes’ compliance plans undertaken pursuant to section 601HG of the Act.
- 4 Auditors of mortgage schemes are required to adhere to the mandatory requirements contained in Auditing Standards (ASAs) when undertaking financial report audits and the requirements contained in Standards on Assurance Engagements (SAEs) when undertaking audits of compliance plans. This Guidance Statement has been developed to clarify auditors’ responsibilities in respect of such engagements, and to provide guidance to the auditors on additional considerations which may be taken into account when undertaking financial report and compliance plan audits of mortgage schemes.
- 5 It is important to note that this Guidance Statement does not impose any responsibilities on the auditor beyond those which are imposed by ASAs, SAEs and the requirements of the Act. The provisions of the Act in this area are supported by ASIC Regulatory Guide 144 *Mortgage investment schemes* (RG 144), Regulatory Guide 45 *Mortgage schemes - improving disclosure for retail investors*

(RG 45) and other ASIC regulatory guides, including those applicable to managed investment schemes, as well as modifications to the Act made by individual orders or class orders issued by ASIC.

Regulatory Background

- 6 ASIC's regulatory framework for mortgage schemes principally consists of:
- (a) a requirement for operators of mortgage schemes, that meet the criteria for registration as a managed investment scheme, to comply with Chapter 5C of the Act;
 - (b) application of RG 144 and RG 45, as well as other relevant ASIC regulatory guides applicable to managed investment schemes generally; and
 - (c) relief to mortgage scheme operators in certain cases, such as operators of small, low risk schemes e.g. solicitors' mortgage practices, may be permitted to comply with an approved industry body's rules (for example, those of the relevant State or Territory professional law bodies) rather than all of Chapter 5C, if the body can demonstrate effective supervision over such participants.¹
- 7 RG 144 indicates that a mortgage scheme is likely to be regarded as being a managed investment scheme if:
- (a) the legal or commercial character of the investment is determined by the nature of the business operations of the promoter e.g. where money contributed by different investors is lent under one mortgage; and
 - (b) commercial decisions are taken by the operator or the promoter of the scheme and not by investors.
- 8 RG 144 recognises that subsection 601ED(1) must also be satisfied for a mortgage scheme to be required to be registered as a managed investment scheme under Chapter 5C. In particular registration may be required under subsection 601ED(1) if:

¹ For schemes of this kind with no more than 20 investors and no more than \$7.5 million in total loan capital, ASIC allows such operators to participate in an industry-based compliance structure approved by ASIC. However, ASIC has indicated that it will impose various conditions on such schemes, including the application of the disclosure and anti-hawking provisions of the Act.

- (a) the scheme has more than 20 members (investors); or
- (b) the scheme was promoted by a person, or an associate of a person, who was, when the scheme was promoted, in the business of promoting managed investment schemes; or
- (c) ASIC has determined that the scheme is one of a number of schemes that are closely related and the total number of members is greater than 20.²

Responsibilities of Management and Auditors

Management's Responsibilities

- 9 Section 285 of the Act imposes a responsibility on registered schemes, which includes mortgage schemes, to comply with the requirements of Chapter 2M of the Act dealing with financial reports and audit requirements. Furthermore, section 285(3) deems a scheme's responsible entity responsible for the performance of the financial reporting obligations in that Chapter in respect of the scheme.
- 10 In addition to the above obligations, the responsible entity of a scheme is required to comply with Part 5C.4 of the Act and expected to apply ASIC Regulatory Guide 132 *Managed investments: Compliance plans*. The requirements of the Act impose obligations on the responsible entity to ensure that compliance plans are in place which set out adequate measures that the responsible entity is to apply in operating the scheme to ensure compliance with the Act and the scheme's constitution.
- 11 As with managed investment schemes generally, the responsible entity of a mortgage scheme which is registered under section 601ED, operates the scheme on behalf of the members of the scheme. To this end, the responsible entity and the directors of that entity, are responsible to the members of the scheme for the operation of the scheme, including for meeting its statutory and other legal obligations. The responsible entity will need to establish and maintain an adequate system of internal control to protect the interests of members who have invested in the scheme.

² Auditors of smaller schemes not directly regulated by ASIC but administered as part of an industry-based compliance structure may also be required to report on various compliance matters as part of the auditing arrangements which are agreed to with the individual State or Territory industry supervisory bodies.

- 12 A scheme's internal control structure is to provide its management, i.e. the responsible entity, with reasonable, but not absolute assurance, that the operations of the scheme are orderly and efficient, and that irregularities are prevented as far as possible and detected should they occur. An adequate internal control system will also provide management with reasonable assurance that assets are safeguarded from unauthorised use or disposal, and that the financial and other records of the scheme reflect the entire operational activities of the scheme and permit the timely preparation of financial reports required by the Act.

Auditors' Responsibilities

- 13 The auditor of a scheme's financial report ordinarily obtains a preliminary understanding of the scheme and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial report whether due to fraud or error, and sufficient to design and perform further audit procedures, which may include, where appropriate, tests of the operating effectiveness of controls and other compliance measures in the context of the scope of the scheme's financial report audit, in order to be able to form an opinion on it as required by Chapter 2M.³
- 14 Similarly, the compliance plan auditor⁴ who conducts the audit of a scheme's compliance plan under section 601HG, is required under ASAE 3100 *Compliance Audits* to obtain an understanding of the scheme's compliance plan (the subject matter) and other engagement circumstances sufficient to identify and assess the risks of non-compliance, either of the responsible entity with the compliance plan or of the compliance plan with the Act, and be mindful of the compliance related expectations set out in RG 144, RG 45 and the other relevant ASIC regulatory guides, including those regulatory guides applicable to managed investment schemes generally.

Agreeing on the Terms of the Audit Engagements

- 15 Under section 331AAA, the scheme's responsible entity is responsible for the appointment of the scheme's financial report auditor. This is also the case for the scheme's compliance plan

³ See ASA 315 *Understanding the Entity and its Environment and Assessing the Risk of Material Misstatements*.

⁴ Under section 601HG(2) the compliance plan auditor and the financial report auditor of the responsible entity must be different persons, notwithstanding that they may be from the same firm. See also GS 013 *Special Considerations in the Audit of Managed Investment Schemes*.

auditor who is appointed by the responsible entity under section 601HG. It is therefore essential that the auditors and the scheme's responsible entity separately agree on the terms of the respective audit engagements, which are to be recorded in writing. Such terms are normally outlined in separate audit engagement letters⁵ which are forwarded to the responsible entity.

- 16 The auditors may use the engagement letters to clarify the respective roles of the responsible entity's directors, the financial report auditor and the compliance plan auditor, by contrasting the respective statutory responsibilities of the responsible entity and the auditors under the Act. Both the financial report auditor and compliance plan auditor obtain acknowledgment of management's responsibilities from the directors of the scheme's responsible entity when obtaining agreement on the terms of the audit engagements.

Issues for Auditors to Consider

- 17 In addition to the issues normally considered when undertaking financial report audits and compliance plan audits, auditors of mortgage schemes will need to consider several matters that are particularly important to the operation of such schemes. These matters include whether:
- (a) appropriate documentation is available in respect of all deposits or receipts to the scheme and its bank accounts, and in relation to payments and withdrawals from the scheme and its bank accounts;
 - (b) appropriate documentation is available in respect of all loans made by the scheme, including detailed loan agreements, securities held, guarantees, terms of repayments and external independent valuations;
 - (c) the mortgage scheme's circumstances are consistent with the basis of reporting, that is whether it is a going concern for the relevant period; and
 - (d) the compliance plan adequately addresses the expectations about disclosure and advertising specified by ASIC in RG 45 and the relevant measures are complied with to ensure disclosure against the benchmarks provided in RG 45.

⁵ Or other suitable form of audit contract. See ASA 210 *Terms of Audit Engagements* and ASAE 3100.

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- 18 The auditors of mortgage schemes may also take into account other specific compliance related considerations relevant to such schemes. These considerations include whether:
- (a) investor funds have been placed in the mortgage scheme on the basis of the written approval of the investor;
 - (b) specific disbursements of investor funds are supported by written authorities from investors;
 - (c) investor funds are capable of being remitted back to the investor within the time period agreed by the investor and that the net monies loaned (after agent's commission or loan establishment fees) are sufficient to enable payment of the amount that has been agreed to be paid to the investor;
 - (d) investor funds have been appropriately secured e.g. first mortgage or other charges or liens are taken out over the assets and undertakings of the investee or borrower;
 - (e) commissions or loan establishment fees paid to agents are in accordance with legally binding agreements between the parties;
 - (f) interest and principal payments from the investee or borrower are being received in accordance with loan agreements;
 - (g) interest paid to the investors is financed from receipt of investee or borrowers funds and not from the commissions or other monies due to solicitors or agents;
 - (h) periodic statements are provided to investors in respect of the disbursement of their funds until the funds are fully utilised in the mortgage scheme; and
 - (i) that monthly bank reconciliations have been prepared in respect of each "trust" account.
- 19 It is important that auditors take the above considerations into account when planning and undertaking both financial report audits and compliance plan audits of mortgage schemes. While not purporting to be an exhaustive list of compliance matters to be considered by auditors, they represent areas in which there should be appropriate controls in place, so as to adequately mitigate the risk of a material misstatement in a scheme's financial report and/or material non-compliance with a scheme's compliance plan.

Conformity with International Pronouncements

- 20 There is no equivalent International Auditing Practice Statement (IAPS) to this Guidance Statement.