INSTITUTE OF PUBLIC ACCOUNTANTS®

Three- yearly audit cycle for some self-managed superannuation funds

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Three year audit cycle for some self-managed superannuation funds

We welcome the opportunity to provide this submission in response to the proposed change of the annual audit requirement to a to a three-yearly cycle for self-managed superannuation funds (SMSFs) with a history of good record-keeping and compliance. The policy intent behind this measure is to reduce red tape and compliance cost for those SMSFs that meet the eligibility criteria. The discussion paper has added an additional justification for the measure which is to incentivize good record-keeping and compliance by SMSFs whilst maintaining system oversight and integrity.

The IPA is supportive of measures that reduce compliance costs. Compliance costs have a detrimental impact on retirement savings. The Productivity Commission's (PC) draft landmark report on superannuation (*Superannuation: Assessing Efficiency and Competitiveness*) focused most of its recommendations on industry and retail funds; however, there were some findings specifically aimed at SMSF sector.

In particular the PC found that SMSFs with less than $1m in funds achieved lower returns than retail and industry funds which in part was due to administration costs associated with running the fund. SMSFs regardless of size, are required to undertake an annual audit which forms part of the administration costs.

The IPA has already held informal discussions with Treasury on this matter and has also provided a written submission on this proposal which is attached for your information as part of the appendix. The discussion paper acknowledges some of the stakeholder concerns expressed to date from consultations with stakeholders moving to a three-yearly audit cycle such as:

- there could be increased non-compliance with tax and regulatory obligations; and
- a reduction in audit frequency could alter the workflow of the SMSF audit industry, reducing profitability. This could lead to a reduction in the number of businesses specialising in SMSF audits and lower quality audits.

The discussion paper makes a statement that the concerns **will be** mitigated by appropriate eligibility criteria and, if necessary, transitional arrangements.

This assumption that the ATO can continue to manage the risk of tax and regulatory breaches by monitoring Superannuation Annual Returns) (SARs), thus maintaining appropriate oversight of SMSFs on a three-yearly audit cycle should be questioned. We question the ATO's ability to audit particular SMSFs in response to identified concerns.

Considering the number of concerns expressed by stakeholders, we find this statement **'of will be mitigated'** to be unhelpful and downplays the important role SMSF auditors perform in the regulatory oversight of trustees.

Whilst we appreciate some of the concerns can be mitigated, to categorically say they will be addressed through appropriate eligibility criteria, suggests that Treasury may not fully understand the SMSF audit procedures and the environment that SMSF's operate under.

There are risks that cannot be mitigated by limiting access to a three yearly audit by using appropriate eligibility criteria. One example to illustrate this point is ensuring assets are held on trust for the superannuation fund. If title is not in the name of the superfund, there is no safeguarding of assets held in trust to protect the assets from creditors or other claimants.

The lodgement of an SAR will not be able to verify this risk. There are many more examples of other risks that the ATO will not be able to effectively manage through monitoring of SARs as suggested.

What the good compliance history does not show is what happens behind the scene at the desk of the auditor. Not all breaches by trustees end up been reported as contraventions.

Also, many funds receive a management letter that outlines minor compliance issues, preventive advice, or education advice from the auditor. Without this check and balance, and delay in receiving this timely type of advice, we fear a spike in contraventions which could have been avoided.

Auditors spend a lot of time making sure breaches are rectified and all housekeeping tasks are in order as part of the audit process. The data on reported conventions is not a good metric to justify any changes as it does not reflect matters that are not reported.

Adding eligibility criteria will also increase complexity as trustees will need to self-assess eligibility to the three year audit cycle. Given the long lead time for the lodgement of SARs, this will be problematic if trustee's incorrectly self-assess.

The discussion paper already canvasses seven key events that may increase the risk of a breach under the SIS Act or SIS Regulations. If the list of key events becomes voluminous, it will add more complexity for unsophisticated trustees to navigate eligibility. Trustee with the help of their advisors will need to do a pre-emptive audit to determine eligibility. If this service is not going to be provided for free, will there will be hidden costs to factored into any perceived cost savings.

Lastly the proposal is at odds with the Super System Review Final Report which was chaired by Mr. Jeremy Cooper. The Super System Review found that an “annual audit provides a high level of assurance to members, regulators, government and the community more generally. Its current frequency of annual audits is appropriate and should not be reduced.

We now turn to the consultation questions in the discussion paper that you seek feedback on. We have asked our members to contribute towards these questions and the points raised reflect this contribution from members.

1. How are audit costs and fees expected to change for SMSF trustees that move to three-yearly audit cycles?

Most members responded by saying that audit costs are more likely to go up rather than down. Whilst a three year audit may seem more efficient, this is unlikely to translate into cost savings.

In fact, the measure can end up being a cost deferral at best which could end up costing trustees more in the long run especially if there are contraventions in the intervening years that need to be rectified retrospectively. Even the most compliant trustees may inadvertently do something that contravenes the SIS Act which is not hard to do, given the complex superannuation rules in place.

Reasons provided as follows:

- Difficulty finding documents and diligence maintaining records may wane. Diligent document keeping and ensuring three years’ worth of records are readily available and stored in a format and location where they can easily be accessed will be essential.

- If trustee changes accountants during the period and the new accountant does not use the same software or does not have information transferred, documents stored in the old accountant’s software will be lost, which means the original documents need to be found.
- The number of auditors may decline which could see fees increase over time
- Members raised the issue regarding ATO supervisory fee increases that are levied at SMSFs and justification for such charges as another option to reduce administration costs for SMSFs
- Cost to trustees of dealing with contraventions retrospectively including ATO penalties which can accumulate in a compound way
- Accountants fees for administration work my increase as SMSF administration providers will need to take more care with account preparation
- It is quite common for accounting practices to use lower paid staff to do a lot of the administration grunt work with the expectation that auditors will pick up any irregularities. This practice may result in more senior staff having to review SMSF accounts before returns are lodged, which can add costs to the annual return process.

- Compliant trustees who exhibit behavioural changes knowing that no one is looking over their shoulder and venture down a path intentionally breaking the rules to gain some personal advantage which may lead to more breaches and hence higher audit cost

2. Do you consider an alternative definition of 'clear audit reports' should be adopted? Why?

Most members maintain the point that clear audit reports do not infer that the auditor did not find any errors. Whilst the percentage of the SMSF population with auditor contravention reports (ACRs) is approximately less than 2% of all SMSFs each year, this does not reflect is what happens behind the scene at the desk of the auditor.

Not all breaches by trustees end up being reported as contraventions. Also, many funds receive a management letter that outlines minor compliance issues, preventive advice, or education advice from the auditor. Without this check and balance, and delay in receiving this timely type of advice, we fear a spike in contraventions.

Auditors spend a lot of time making sure breaches are rectified and all housekeeping tasks are in order as part of the audit process.

This proposal can only be viable under a self-assessment option which can be problematic due to lengthy lodgement cycle. SMS's are not required to lodge until May of the following year. The ATO can only assess whether the trustee has correctly assessed their eligibility for a three year audit cycle once a funds SAR is lodged. Whilst the lodgement of the SAR can detect events that make the SMSF fund ineligible for a three yearly audit, it will not be able to detect all non-compliance with tax and regulatory obligations.

3. What is the most appropriate definition of timely submission of a SAR? Why?

Most agree that the date the SAR is required to be lodged by, as the appropriate factor defining timely submission.

4. **What should be considered a key event for a SMSF that would trigger the need for an audit report in that year?**

Which events present the most significant compliance risks? Member feedback suggested the following events:

- Ceasing a pension
- Lump sum withdrawals to mitigate elder abuse
- Balances over $1.6m to ensure there are no non-concessional contributions
- Investments with related parties should be expanded to include investments in non-widely held/non-public entities as these rules are not well understood

- Illegal activities such as early payment of benefits where conditions of release have not been met.

Already there are a number of key events that would trigger a need for an annual event which will make self-assessment of entitlement a complex decision.

5. Should arrangements be put in place to manage transition to three-yearly audits for some SMSFs? If so, what metric should be used to stagger the introduction of the measure?

Most specialist auditors raised concerns about the lumpiness of audit work and the impact this would have on their business model. The issue around ASIC requiring minimum number of audits to be performed to maintain SMSF auditor registration was also a concern. Other issues identified included:

- Loss of auditing skills
- Professional development skills still need to be maintained
- Cost of continued education
- Time taken to review each audit and delays that this can create with scheduling work and meeting lodgement requirements
- There is already consolidation happening within the SMSF audit space, with fewer and fewer auditors in existence. Already 95 per cent of auditors do less than 250 fund audits. If this proposal proceeds, we expect more concentration in the market place which can have implications on the level of independence in the sector.

ASIC fees for new SMSF auditors are also about to be increased substantially creating more barriers to entry for aspiring SMSF auditors.

6. Are there any other issues that should be considered in policy development?

If the objective driving this proposal is to reduce compliance costs and incentivise good record-keeping, then other options should be considered which better maintain integrity and oversight. Whilst the proposal specifically looks at a three year audit cycle, there are other ways to reduce the audit burden and therefore the cost associated with this compliance obligation which should also be explored.

Some of the other options that should be explored are detailed in our previous submission which is attached in the appendix. The policy objective for this proposal is to reduce red tape and compliance cost for SMSF's with good record-keeping and compliance. This objective can be achieved in other ways with less impact on oversight and integrity.

We welcome the opportunity to discuss the proposed changes in greater detail.

Yours sincerely

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Appendix – Previously lodged submission prior to release of discussion paper

The Treasury
Retirement Income Policy Division
Langton Crescent
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By email: Superannuation@Treasury.Gov.Au

Dear Sir/Madam

Review of annual audit requirement for some SMSFs

We welcome the opportunity to provide this submission in response to the proposed change of the annual audit requirement to a to a three-yearly cycle for self-managed superannuation funds (SMSFs) with a history of good record-keeping and compliance. The policy intent behind this measure is to reduce red tape and compliance cost for those SMSFs that meet the eligibility criteria.

The IPA is supportive of measures that reduce compliance costs. Compliance costs have a detrimental impact on retirement savings. The Productivity Commission's (PC) draft landmark report on superannuation (*Superannuation: Assessing Efficiency and Competitiveness*) focused most of its recommendations on industry and retail funds; however, there were some findings specifically aimed at SMSF sector. In particular the PC found that SMSFs with less than $1m in funds achieved lower returns than retail and industry funds which in part was due to administration costs associated with running the fund. SMSFs regardless of size, are required to undertake an annual audit which forms part of the administration costs.

The Government may see this as something that it can do to lessen the compliance burden on trustees who are in the main respectful of the rules, regulations and requirements for running their own SMSF. It is in this light, that we should assess merits of this proposal.

The measure will apply to funds with a good history of compliance, which is loosely defined as three consecutive years of unblemished audit reports and timely lodgement of annual returns.

When the policy was first announced, it was unclear whether an audit would be conducted for one year, every three years or an audit covering all three years would be conducted every three year cycle. Now that it has been confirmed that the auditor needs to effectively audit three years, our submission is based on this premise.

At first glance, it is difficult to apprehend the assertion that trustees will be better off from a compliance cost perspective in the long run. In fact, the measure can end up being a cost deferral at best which could end up costing trustees more in the long run especially if there are contraventions in the intervening years that need to be rectified retrospectively. Even the most compliant trustees may inadvertently do something that contravenes the SIS Act which is not hard to do given the complex superannuation rules in place.

Then there are the compliant trustees who exhibit behavioral changes knowing that no one is looking over their shoulder and venture down a path intentionally breaking the rules to gain some personal advantage.

A well-functioning SMSF sector is a by-product of good regulation. The annual independent audit requirement provides the regulator with assurances that SMSF trustees are operating within the rules. History tells us that leaving trustees to their own devices invites trouble which ultimately leads to more regulation for all trustees in the long run.

According to the ATO, the percentage of the SMSF population with auditor contravention reports (ACRs) is approximately 2% of all SMSFs each year. In the year ended 30 June 2016, there were 7,600 SMSFs that had ACRs lodged with 14,800 contraventions, with just under half (48%) of these contraventions reported as rectified.

What the good compliance history does not show is what happens behind the scene at the desk of the auditor. Not all breaches by trustees end up been reported as contraventions. Also, many funds receive a management letter that outlines minor compliance issues, preventive advice, or education advice from the auditor. Without this check and balance, and delay in receiving this timely type of advice, we fear a spike in contraventions which could have been avoided. Auditors spend a lot of time making sure breaches are rectified and all housekeeping tasks are in order as part of the audit process.

Not been able to work with trustees in the unsupervised years has the potential to see an increase in contraventions if this measure proceeds. The annual audit cost whilst it is a grudge outlay, most trustees see it as a form of insurance as the penalties that can be imposed by the ATO for contraventions can be substantial. The consequences of a fund being rendered non-complying is 45 per cent of the gross value of the fund’s assets, so trustees need to be constantly reminded to say within the confines of the rules and regulations. It is the trustee’s responsibility to ensure the funds acts within the rules and laws of the superannuation system. Auditors provide a strong influence on trustees which maintains the health and integrity of the SMSF sector.

Types of contraventions reported to the ATO (up to 30 June 2017)

Contravention types	Number (%)	Value (%)
Loan to member/financial assistance	21.4%	14.9%
In-house assets	19.1%	28.2%
Administrative-type contraventions	10.3%	2.2%
Separation of assets	12.8%	24.5%
Operating standard-type contraventions	7.5%	6.2%
Borrowings	8.0%	8.6%
Sole purpose	8.3%	4.4%
Investment at arm’s length	7.6%	7.8%
Other	3.7%	1.0%
Acquisition of assets from related parties	1.2%	2.3%
Total	**100%**	**100%**

Policy Rationale – reduction in compliance costs

As a starting point, the Government has not provided any evidence to substantiate its policy rationale that the measure will reduce compliance on trustees. The annual audit cost forms part of the administration costs, that trustees incur in running an SMSF fund. Lowering annual compliance can contribute to significant retirement benefits over time. Certainly for some SMSFs with relatively straight forward circumstances, there may be some merit in assuming that the three yearly audit cost will reflect some efficiencies and will be less than the sum of three years of annual audit outlays.

As soon as you move away from SMSFs with relatively simple affairs, you start to wonder how well the policy rationale holds up, even for funds with good compliance history and timely lodgement performance. Loss of documents, poor record keeping leading to not remembering certain transactions, change in service provider and accessing records, compliance breaches etc. are some examples of where the three year audit could easily become more time consuming and expensive, particularly if any breaches have occurred early in the intervening years as the cost will grow exponentially. Catching them early is the key to an easier and cheaper rectification.

Diligent document keeping and ensuring three years' worth of records are readily available and stored in a format and location where they can easily be accessed will be essential. It is quite common for accounting practices to use lower paid staff to do a lot of the administration grunt work with the expectation that auditors will pick up any irregularities. This practice may result in more senior staff having to review SMSF accounts before returns are lodged, which can add costs to the annual return process.

Concerns if regulatory oversight reduced

Even if the policy rationale holds up, we are more concerned about the risks it introduces into the SMSF regulatory environment. SMSF audits are required to ensure that trustees play by the rules which entitles the fund to valuable tax concessions. The ATO relies heavily on SMSF auditors to undertake the heavy lifting in ensuring trustees comply with their onerous trustee obligations. Allowing three years between audits creates opportunities to abuse the system for a period of time and then get back in line at audit time.

Will the annual return for funds that meet eligibility criteria for a 3-year audit cycle be expanded to flag possible irregularities in the intervening unaudited years? As stated earlier, there is a lot of cleaning-up and education that is undertaken by auditors that may not be appreciated or factored into the policy proposal.

Some preliminary concerns that will need to be addressed:

1) Related party acquisitions, particularly in-specie contributions for unlisted assets to manipulate contribution caps

2) Related party non-arm's length transactions
3) Loans to members
4) Fraud risk from unscrupulous spruikers targeting unsupervised SMSFs
5) Elder abuse which is on the rise and could potentially be amplified where an audit is delayed
6) Safeguarding of assets to ensure held on trust for the superannuation fund
7) Pension balance and asset value manipulations
8) Auditor education role provided to trustees that catch inadvertent mistakes and contraventions early in the piece that contribute to the overall high levels of compliance in the SMSF sector.

There are many more concerns that SMSF auditors can add to the above so by no means is the list exhaustive. This begs the question whether the small savings to be had are worth the loss in integrity of the SMSF system. The timing of the policy announcement to reduce regulatory oversight is interesting given the Royal Commission Banking Inquiry revelations around the financial sector integrity.

There are also impacts on our members who provide specialist SMSF audits. Depending on the number of funds that meet the eligibility criteria for three yearly audits, there will be a direct loss of revenue which can have adverse implications for a lot of our members. Workflow management and having sufficient work to maintain practice overheads to ensure continuing professional development are also areas of concern.

There is already consolidation happening within the SMSF audit space, with fewer and fewer auditors in existence. Already 95 per cent of auditors do less than 250 fund audits. If this proposal proceeds, we expect more concentration in the market place which can have implications on the level of independence in the sector. ASIC fees for new SMSF auditors are also about to be increased substantially creating more barriers to entry for aspiring SMSF auditors. ASIC also requires auditors to do a minimum number of audits to maintain their registration which may need to be revisited if this proposal proceeds. ASIC only recently increased the education and experience requirements for SMSF auditors.

Other policy options – reduce audit

Whilst the proposal specifically looks at a three year audit cycle, there are other ways to reduce the audit burden and therefore the cost associated with this compliance obligation which could also be explored.

1. Removing the need to report certain minor contraventions to the ATO, thereby saving audit time and ATO resources;

2. Removing the need for the auditor to review certain documentation and its retention, thereby saving audit time;

3. Consultation with stakeholders and standard setters to design more relevant and efficient mandatory auditing standards applicable to SMSF's audits.

If the overall aim is to reduce red tape and costs for trustees, these other options should also be evaluated and benchmarked against the change in audit cycle proposal.

As stated earlier, a well-functioning SMSF sector is a by-product of good regulation. Given the growing size of the SMSF sector which represents one-third of all superannuation in Australia, it seems prudent to have timely independent regulatory oversight to avoid problems from happening as they occur.

Without this oversight we are fearful that the low rate of contraventions may start to reverse for the sake of a small reduction in costs which over time may lead to a loss of integrity in the SMSF sector.

We welcome the opportunity to discuss the proposed changes in greater detail.

Yours sincerely

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