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31 August 2018

Mr Robert Jeremenko
Retirement Income Policy Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: Superannuation@treasury.gov.au

Dear Mr Jeremenko

Submission on Treasury Discussion Paper: Three-yearly audit cycle for some self-managed superannuation funds

ASF Audits is a leading independent self-managed superannuation fund (“SMSF”) audit firm with a team of over 35 highly skilled and specialised SMSF auditors.

ASF Audits is one of the largest SMSF audit firms in Australia and undertake more than 12,000 SMSF audits each year from over 150 accounting and administration firms, representing 2% of all SMSFs.

ASF Audits has a long-standing reputation as an advocate for upholding the integrity of the superannuation system and plays a fundamental role in the SMSF regulatory framework.

Against this background, ASF Audits welcomes the opportunity to comment on the issues and questions raised in the abovementioned discussion paper.

If you have any queries regarding any aspects of the attached submission, please contact Richard Smith on [redacted] or via email at [redacted].

Yours faithfully,

Richard Smith
Managing Director

Submission by ASF Audits in response to Treasury Discussion Paper "Three yearly audit cycle for some self-managed superannuation funds"

Executive Summary

- We do not anticipate there being any material savings for SMSFs by the implementation of a three-year audit cycle
- The proposal will impose a complex and significant administrative burden on the SMSF industry
- Current high rate of compliance in the sector, resulting in a low rate of ACRs, is a direct result of the annual audit

Consultation Questions

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

We do not anticipate there being any material change in audit costs and fees for SMSFs that move to a three-year audit cycle.

1.1 Additional One-Off Costs

Many Trust Deeds explicitly require an annual audit to be completed. Therefore, SMSFs would be required to amend their deed if they wished to change to a three-yearly audit cycle, incurring additional legal expenses.

1.2 Minimal Potential Cost Savings

Where an SMSF is eligible for a three-yearly audit, we anticipate there would be some savings with respect to auditing the SMSF's compliance with the requirements regarding the ongoing operation of the SMSF, for example reviewing Permanent Records of the SMSF such as the Trust Deed, Investment Strategy and Trustee Minutes.

With respect to the financial and compliance audit, each year is a separate engagement and auditors are required to audit them independently of the other years, irrespective of whether multiple years of audits are completed at the same time. As a result, there would be no saving in costs for the financial and compliance audit.

Combining all elements of an SMSF audit, we estimate a maximum potential saving of around 3-4% of the annual audit fee[1].

[1] Source: ASF Audits, analysis of fund completion times

1.3 Potential Cost Increases

Based on an analysis of FY2017 audits completed[2], an average of 18% of funds had queries (with a range between 4% and 65%) raised with the fund accountant or administrator during the audit. This excludes requests for signed documents, including Permanent Records required to sign-off on the audit.

Documentation requests represent the largest number of queries we raise during our audits. Where an SMSF is audited every three years, we anticipate that documentation will be harder to obtain or no longer available due to the extended timeframe. This will increase the number of queries raised and potentially Auditor Contravention Reports ("ACR"), both of which will result in additional costs to the SMSF.

Where errors requiring amendments to the financial statements are found, the financial statements and Annual Return will need to be amended, re-signed by the Trustees and re-lodged with the ATO, incurring significant additional costs to the SMSF. In the case of a 3-yearly audit cycle, this risk is magnified as multiple years may need to be amended and re-lodged. Additionally, if there are errors, it will mean that incorrect data is being reported to the ATO.

Anecdotally, a large number of our accounting and administration clients have stated that they rely on the annual audit as a part of their quality review process

1.4 Potential savings may be overstated

Annual audit fees are reported as ranging from *less than $500 to over $2,000 … with an average auditor fee of $694 and a median fee of $550 for audit of 2016 financial year*[3]

We believe this data may not be representative of the underlying audit fees charged by auditors and, therefore, any modelling of estimated savings will be overstated.

- The data reported excludes SMSFs that did not report an audit fee greater than $0 in their SMSF Annual Return
    - It is common practice for a combined administration and audit fee to be charged to SMSFs, with the audit fee being invoiced to the SMSF administrator directly. The audit fee is therefore not always reported on the annual return. In our experience, audit fees for combined administration and audit services are significantly less than the median fee reported.

- The data reported by the ATO shows no change in the median audit fee from 2013-2016.
    - Over the past five years, our average audit fees have reduced as a result of investments in technology, increased efficiencies and economies of scale.
    - We believe the median audit fee will reduce in the future as other auditors make similar investments in their businesses and market forces bring about a reduction in fees.

[2] Source: ASF Audits, sample size 10,400 funds
[3] ATO, Self-managed superannuation funds: A statistical overview 2015-2016, 18 January 2018

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

The discussion paper defines a clear audit report as an SMSF without any financial or compliance contraventions issued in an ACR in the previous three years.

This definition is too narrow as it does not give a true reflection of issues which auditors address as a part of their audit.

2.1 Background to Reporting of ACRs

Section 129 of the Superannuation Industry (Supervision) Act 1993 obliges the auditor to inform the trustee and the Regulator in writing if they form an opinion that a contravention may have occurred, may be occurring or may occur in relation to the fund.

Lodgement of an ACR requires certain threshold tests to be met, including timeframes and minimum values of reportable contraventions.

While the overall rate of ACRs is currently low at 2.4%; this omits the much larger number of audit reports which are qualified and/or have compliance breaches identified in the audit management letter, but which do not meet the ACR reporting thresholds.

SMSF auditors play an integral role in educating trustees about fund compliance. In FY2014[4] 79% of funds had compliance breaches reported in the audit report or management letter and 5% had ACRs lodged.

Through ongoing education, by FY2016 this had improved to 55% of funds having compliance breaches reported in the audit report or management letter, along with a reduction in ACRs lodged to 2.4%. However, this still represents a significant proportion of funds with compliance issues which are not captured by an ACR.

By using ACR lodgement as the “clean audit” criteria, funds with identified contraventions that have not been lodged through an ACR for FY2017, FY2018 and FY2019 would qualify for a three-yearly audit cycle. Left unaddressed such minor contraventions would be more likely to escalate into a reportable contravention in subsequent years, thereby increasing the number of contraventions in general and putting the system integrity at risk.

2.2 Alternative Definition

SMSF auditors play a key role in ensuring SMSF compliance with regulatory obligations and the annual audit enables trustees to engage with their superannuation.

It is therefore recommended that any compliance breach act as a trigger for an annual audit to provide a level of assurance that a compliance-based regulatory framework demand.

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[4] Source: ASF Audits Fund Database - sample of 600 funds

Definition

1. An SMSF should only be eligible for a three-yearly audit cycle if it has a Clear Compliance History.
2. A Clear Compliance History should be defined as an SMSF who has not had any of the events below occur for three consecutive years:

    - if an SMSF has an ACR lodged;
    - if an SMSF is issued with a qualified audit report; or
    - if an SMSF has breached any of the listed sections or regulations as defined in the annual audit report[5], irrespective of whether the breach results in a qualified audit report being issued

[5] The ATO publish annually an approved form "Self-managed superannuation fund independent auditor's report" which includes sections and regulations of the SIS Act and SIS Regulations which an auditor is required to form an opinion on with respect to compliance by the fund

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

3.1 Definition of Timely Submission

We believe an SMSF that has not submitted a late SAR in the last three years would be an appropriate definition. “Late” would be deemed to be lodgement of the SAR after the lodgement due date published by the ATO.

We believe that the definition of a timely submission should not include any extensions provided by the ATO to individual taxpayers or tax agents. On-time lodgement of returns is key to the regulation of SMSFs by the ATO, and this will provide an additional incentive to trustees to ensure timely lodgement of their SAR.

A fund will continue to be eligible for a three-year audit cycle by submitting their annual SAR prior to the lodgement due date set by the ATO.

By way of explanation, a fund would be eligible for a three-yearly audit cycle as at 1 July 2019 if they had lodged three (3) years of SARs before the ATO lodgement deadline for the 2017, 2018 and 2019 financial years.

A SAR lodged after the ATO lodgement due date in any year will cause the fund to revert to annual audits until a total of three (3) years of consecutive SARs have been submitted before the lodgement deadline.

4. What should be considered a key event for an SMSF that would trigger the need for an audit report in that year? Which events present the most significant compliance risks?

4.1 Introduction

While trustees are not expected to be superannuation experts, they are required to be responsible for the operation of their fund and, ultimately, assessing their actions in relation to key events to qualify for a three-yearly audit cycle.

Self-assessment provides the grounds for a conflict of interest for trustees between their duties as a trustee and their own private interests, which could improperly influence the performance of their official duties and responsibilities.

A trustee's ability to understand what constitutes a key event will be critical to the ongoing integrity of the superannuation system. Ensuring the key events are written in plain English will be fundamental to empowering trustees in self-assessing correctly.

A three-yearly audit cycle provides an opportunity for a higher risk of non-compliance. Key events, therefore, need to foster transparency and confidence in the superannuation system.

A delay in identifying compliance breaches means they will be more difficult to rectify and lead to increased costs and compliance burden.

4.2 What Is a Key Event?

We recommend that key events be classified into three categories:

- Fund Status
- Investment
- Compliance

4.2.1 Fund Status Events

We consider that the following key events in relation to fund status will help trustees mitigate risk and ensure ongoing compliance:

- Establishment of a fund
- Winding up a fund
- Funds with the following status on SuperFund Lookup:
  - Non-complying
  - Regulation Details Withheld
  - Regulation Details Removed
- Change of fund name

4.2.2 Investment Events

A fund with more complex investments can lead to a higher rate of compliance issues, especially with respect to market valuations. We recommend a “white-list” of eligible asset classes.

To be eligible for a three-yearly audit, a fund should only hold the following assets for the entire financial year:

- Cash and term deposits
- Listed shares
- Listed trusts
- ASIC registered managed investments

Where a fund holds assets not listed above at any point during the financial year, it should be regarded as a Key Event and accordingly require an annual audit.

4.2.3 Compliance Events

There are many SIS compliance events that may not be identified during a three-year audit cycle which poses a significant risk of material non-compliance. We believe the following SIS compliance events should act as a trigger for an annual audit during any financial year:

- Addition or removal of a member, including the death of a member
- Change of trustee
- Commencement of a superannuation income stream by a member
- Commuting a superannuation income stream by a member
- Payment of benefits or lump sum
- Payment of a death benefit
- Benefits held in a reserve
- Commencement of a limited recourse borrowing arrangement
- Acquisition of an asset from a related party
- Investments, loans or leases with a related party
- Receipt of non-arm’s length income

Lastly, trustees who do not use the services of an SMSF professional to prepare the financial statements and lodge the SAR would be at a higher risk of breaching the SIS rules due to the complex nature of the legislation.

4.2 Reporting of Key Events

We recommend that the trustee – or the SMSF’s tax agent – be required to advise the ATO of their eligibility to continue in a three-yearly audit cycle through the SAR. We believe the key events should be listed in the SAR and the trustee should state whether any of them have occurred. If they have, then an annual audit will be required prior to lodgement of the SAR.

The reporting of this information would provide the ATO with the confidence that the trustee had fully considered their eligibility for a three-yearly audit cycle.

It would enable the ATO to keep track of how many intervening years the fund has without an audit and provide notification to auditors and tax agents of the fund's status in relation to three yearly audits.

If the questions are not answered correctly, the ATO would have the discretion to apply penalties relating to incorrect reporting.

If a key event falls in a year when an SMSF is not otherwise required to be audited, the fund will be required to have all financial years audited since the last audit before submitting that year's SAR.

Where the audit does not result in any compliance breaches in accordance with the definition of a clear audit report outlined in question 2, the SMSF may then continue to be eligible for a three-yearly audit cycle.

If no other key events occur in the next three years and the SMSF continues to meet good record keeping criteria, the SMSF will next require an audit three years after the 'key event' audit.

4.3 Which events present the most significant compliance risks?

4.3.1 Timing Risk

The biggest issue is the risk of a compliance breach being ignored or identified. Under these circumstances, it may be too late for a fund to remain compliant depending on the length of time passed since the previous audit as well as the extent of the breach.

The Super System Review identified that while the fear of being made non-compliant for taxation purposes acts as a deterrent to significant non-compliance, this diminishes as the level of non-compliance reduces.

Under a three-year audit regime, the time lag to manage non-compliance will significantly contribute to increasing the non-compliance gap without an annual audit.

As a result, we may see extended periods of non-lodgement as the three-year timeframe provides trustees with an excuse to "switch off" and ignore the compliance aspects of their funds on an annual basis. Trustees may also genuinely miscalculate the time between the fund's three-year audit and end up inadvertently triggering an annual audit, despite their best intentions.

Even longer periods of non-lodgement may occur where a trustee does not use a tax agent or SMSF professional to oversee their actions and running of their fund. To this end, the proposed three-year audit cycle policy is effectively underwriting the risk of SMSF failure via the social security system.

4.3.2 Significant Key Events

Based on our experience conducting tens of thousands of SMSF audits, we consider the following events to present the most significant compliance risks.

Related Party Investments and Transactions

There is a propensity for several compliance issues to arise when a related party is involved in an investment or transaction. It can be easy to 'abuse' the system when it comes to related party transactions because the trustee does not distinguish between their role as a trustee and their role as a private individual.

A breach of this nature which is not identified or rectified over a three year period may be impossible to correct. It does not provide transparency, it is inherently risky and will trigger an ATO audit resulting in higher costs, taxes and penalties for the fund.

Market Value of Assets

There are certain times where trustee compliance with the ATO market valuation guidelines does not constitute sufficient and appropriate audit evidence. This provides the ability to artificially set the market value of assets to circumvent the legislation in areas such as pension establishment, payment of contributions, disposal and acquisition of related party investments and Super Reform.

Verifying the market value of assets through an annual audit will enhance the integrity of the SMSF system and provide a safeguard to illegal practices.

Establishing a Retirement Income Stream

The cashing restrictions in SIS detail the conditions of release a member must meet to access retirement benefits. As the proportion of members receiving pension payments from an SMSF continue to trend upwards, the propensity for trustee mistakes in paying the minimum pension, starting a pension and claiming exempt current pension income will increase.

While the annual audit checks compliance after the fact, there is still merit in consistently reviewing funds and maintaining standards on an annual basis to ensure regulatory compliance.

Payment of a Death Benefit

There is a high risk of benefits not being paid to the beneficiary to whom they were intended. The distribution of death benefits and the documentation required will depend on a case by case basis.

Whether incorrect payment is a deliberate action or not, death and the payment of death benefits incur specific legal and compliance obligations that can only be mitigated through an annual audit.

It is a highly litigious and complex area that requires maximum protection for the beneficiaries to preserve the integrity of the superannuation system.

Change of Trustee

The process, steps and documents needed to effect a change of trustee is risky and complex. It can occur quickly due to factors such as divorce or death, so it is critical to note that any deficiencies in the appointment of a new trustee may render any subsequent deed amendments to be invalid.

As a change of trustee requires several considerations to be addressed, the maximum amount of protection must be afforded to members to ensure they do not incur adverse outcomes.

The retention of an annual audit when there is a change of trustee will provide for a more robust SMSF system and the ability of the ATO to regulate the sector.

Absence of an SMSF Professional

The amount of information available on the internet means that more SMSF trustees are not engaging with an SMSF professional such as a financial adviser, accountant or administrator.

These SMSFs will have no external oversight or compliance assistance for three years. The main potential contraventions will relate to administration, failure to document the investment policy, report keeping and in-house assets - one of the largest risk areas for SMSFs.

Trustees will be more susceptible to breaches under a three-year audit because they will not have the technical experience to operate their fund compliantly within the complex SIS framework.

Therefore, the risks regarding the trustee's potential to beach the SIS rules is exacerbated, and the integrity of the system will be compromised.

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?

We strongly recommend that arrangements should be put in place to stagger the transition to three-yearly audits for eligible SMSFs.

5.1 Implications of a Non-Staggered Introduction

Allowing all eligible SMSFs to commence a three-yearly audit cycle at once would result in highly fluctuating workloads from year to year, which in turn would have a number of significant adverse impacts on the SMSF industry:

5.1.1 Risk to Quality & Increased Costs

To handle highly seasonal workloads, auditors will be driven to employ staff on a seasonal or contract basis, possibly every three years. This will result in staff with less experience, increasing the risk of quality issues and increasing costs as additional time will be required for training and quality review for work.

5.1.2 Increased Late Lodgement

Highly seasonal workloads will require auditors to reduce staff in low years then increase resources in the year all eligible SMSFs require a triennial audit. The challenges of achieving this on-demand may lead to pressures on lodgement timeframes resulting in higher levels of non-compliance and lower rates of Clear Compliance History.

5.1.3 Shortage of Skilled Auditing Resources

As detailed above in section 1.2, auditing standards require that all years are independently audited, regardless of whether the audit is conducted annually or three-yearly. The savings in audit time are therefore expected to be minimal, implying a massive increase in resource requirements during peak years over and above current industry levels. In our experience, recruiting skilled audit staff is already challenging, and it is unlikely that sufficient resources would exist in Australia to meet the peak demand introduced by non-staggered three-yearly audits. This will also create upward pressure on auditing wages if demand exceeds supply, which in turn will create upward pressure on costs to Trustees.

5.1.4 Increased Offshoring

To manage the resourcing pressures discussed in 5.1.3, it is likely there will be an increase in audit firms using outsourced/offshore resourcing. While we are not against the use of offshore firms or staff, we believe this is not in line with Government policy to retain and promote jobs within Australia. It may also compromise the security of members' confidential financial information.

5.1.5 SMSF auditors leaving the industry.

In 2015-16[6], there were 5,814 SMSF auditors with 68% of them auditing fifty (50) funds or less. These auditors will struggle to remain in a system that will see revenue stretched out over a three-year period, leaving a relatively small number of auditors to service a growing pool of superannuation funds.

5.2 Staggered Introduction

The metric used to stagger the introduction of the measure should be simple and easy to administer to minimise any disruption or administrative burden to the SMSF industry.

We recommend using the last digit of the SMSF's ABN and staggering the first year of eligibility based on that digit, e.g.

- ABN Ending in 0,1,2 – FY2020
- ABN ending in 3,4,5 – FY2021
- ABN ending in 6,7,8,9 – FY2022

[6] ATO, Self-Managed Super Funds: A Statistical Overview 2015-16

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

Previous Reviews

There have been previous reviews which have examined reductions in costs, compliance burdens and red tape.

Super System Review

The Super System Review completed in 2010 specifically addressed the timing of audits, including potential cost savings. Their conclusions are cited in full below as they categorically rejected the removal of the annual audit.

> ***7.5.1 Timing of audits***
>
> *The Panel believes that the annual audit provides a high level of assurance to members, regulators, government and the community more generally. Without this assurance, it would be unlikely the current 'control' features enjoyed by trustees could be retained.*
>
> *Some SMSF trustee submissions recommended the removal of the audit requirement or for its frequency to be reduced. These submissions often cited cost and the belief that the audit was unnecessary. The Panel strongly rejects these views, noting that the extent of tax concessions for SMSFs justifies the public interest in independent assurance about the existence and value of fund assets, and funds' compliance with legislated requirements.*
>
> *On the other hand, other submissions indicated that having less frequent audits would result in increased compliance costs and potentially a greater number of contraventions throughout the sector. The Panel agrees with these views and it also believes the annual audit acts to engage trustees with their superannuation.*
>
> *Given the growing size of the SMSF sector and the importance of the audit role, the Panel believes that the current frequency of annual audits is appropriate and should not be reduced.*

Reducing Regulation and Red Tape – Government Deregulation

In February 2014, the Superannuation Industry Relationship Network met with attendees from Industry and Government including the ATO, Treasury, APRA and ASIC.

The focus of the meeting was around the Government's commitment to *'Reducing the Compliance regulation and red tape burden for individuals, businesses and community organisations'*. Timing of audits was neither tabled or proposed as a consideration for reducing red tape.