Response to Treasury Discussion Paper

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

1 Summary

As an SMSF trustee, I am concerned about the proposal to introduce three-year audits for some SMSFs, primarily for the following reasons:

- None of the three benefits claimed for the proposal (reduction of compliance burden, reduction in audit cost, and rewarding the timely submission of SARs) withstands examination.
- Audit management will become more complex for the trustee, increasing the risk of inadvertent rule breaches.

I would not opt for a three year audit of my SMSF if this proposal becomes law.

2 Introduction

My wife and I have an SMSF under a corporate trustee structure. The fund was started in 2003 and has been totally in pension mode for several years. The SMSF and some investments outside superannuation will be our only sources of income for the rest of our lives, and this does tend to focus the mind.

Each year, we provide the fund's financial and share-trading data to our accountant who prepares the tax return etc, sends us a draft for checking and then forwards everything to the auditor. Following satisfactory audit (we have never had a problem), the SAR is then forwarded to the ATO without further intervention by us.

Given the complexity and instability of superannuation rules, we feel the multiple checkpoints in this process provide good protection against unintentional infringements which could see us in trouble with the ATO – a potentially costly and stressful outcome we are very keen to avoid. They can also help protect us against unwittingly increasing our investment risks.

The proposal to introduce an optional three year audit cycle for some SMSFs (which would include our fund) is therefore of considerable concern to us. We see heightened risk with no material compensatory benefit. Given the choice, we would not opt for three-yearly audits.

Below I provide more detailed comments in response to the specific Consultation Questions raised in the Discussion Paper

On 26 July, I had the opportunity to participate in a Treasury round-table discussion about this proposal, which I appreciated very much. I was there to present a trustee's view point, not that of any organisation, and I made some of the following comments at that meeting.

3 Consultation questions

3.1 How are audit costs and fees expected to change for SMSF trustees that move to three-year cycles?

This is a critical question, there being no point going ahead with the proposal if costs are to rise, so I would like to discuss it in detail with reference to each of the three benefits claimed and the two concerns mentioned on Page 3 of the Discussion Paper.

3.1.1 Benefit 1: "A reduction in the compliance burden …"

I cannot see the basis for this claim, given the following comments from other parts of the discussion paper:

- "It is proposed that eligibility … will be based on self-assessment" (Page 4)
- "If the ATO becomes aware that a SMSF trustee has incorrectly assessed their eligibility for a three-yearly audit cycle, … the ATO will notify the trustee that an audit is required and consider further action if necessary" (Page 4)
- " .. a number of events can represent a material change to the situation of the fund and may increase the risk of a breach …" (Page 5)
- "If a key event falls in a year when an SMSF is not otherwise to be audited, the SMSF will be required to obtain an audit … required to cover all financial years since the SMSF's last audit" (Page 5)
- Eight "possible key events" are listed on Page 5, with a request for suggestions.

It is crystal clear that moving some SMSFs to a three-year audit cycle will create a more complex compliance landscape.

This must increase the risk of inadvertent breaches. Trustees who opt for three-yearly audits will have to become aware of a greater number of rules, and be vigilant that they do not inadvertently fail to report a key event.

Both these aspects of three-year audits increase the compliance burden, rather than decreasing it.

In addition, the appalling instability of superannuation legislation suggests there is a very high likelihood that, if three-year audits are introduced, the list of key events will change and be extended over time – further exacerbating compliance worry and risk.

It is unlikely that the trustee or accountant will be spared any administrative effort by moving to a three-year audit cycle, because exactly the same set of transactions will eventually have to be presented for audit as with annual audits.

The second part of the first claimed benefit "… while maintaining appropriate visibility of errors in financial statements and regulatory breaches" just does not make sense. How can visibility be maintained if a transaction is not audited for two or three years?

3.1.2 Benefit 2: "A potential reduction in administrative costs due to less frequent audits…"

It is very hard to see where significant savings could come from:

- Auditing 3 years' data at once requires examining exactly the same set of transactions as for three one-year audits. The fact that the audit frequency has changed just means that SMSFs will receive one bill instead of three, but the total cost over three years must be at least as high.
- Audit fees are themselves not a major cost for most SMSFs. Even if some cost saving were to be achieved, its magnitude could only be trivial.
- There are some obvious ways in which audit costs must increase under this proposal:
    - Both accountants and auditors will find it more difficult to manage a mixture of clients on 1-year, 2-year and 3-year audits, rather than having everyone on a 1-

year cycle. This must push costs up for all clients, not just those who opt for three-year audits.

- Resolving errors, or even simple ambiguities, in data which is 2 or 3 years old will be more difficult, and therefore more costly, than when all data is no more than a year old and issues are still top-of-mind.

3.1.3 Benefit 3: "An incentive for SMSF trustees to submit SARs in a timelier manner"

The only benefit offered is the unsubstantiated hope that some cost savings will result, but even if that turns out to be true the savings will be small.

Such a nebulous offer is most unlikely to influence the trustee who has already indicated a disdain for fulfilling obligations on time and an indifference to potential penalties.

Late submission is really an administrative issue for the ATO, and it is something the ATO must face with every function it supervises. Complicating the audit cycle for SMSFs is not the way to deal with it.

3.1.4 Concern 1: "… increased non-compliance …"

Certainly the risk of inadvertent non-compliance is increased as discussed above.

The risk of deliberate non-compliance may also increase, because a more complex operating environment creates opportunities.

3.1.5 Concern 2: "… alter the workflow of the SMSF audit industry … lead[ing] to a reduction in the number of businesses specialising in SMSF audits"

That certainly seems likely, and if it occurs the reduced competitive forces will probably push audit costs up further across the market.

3.1.6 Mitigation: "… concerns will be mitigated by appropriate eligibility criteria and, if necessary, transitional arrangements"

I doubt that either eligibility criteria or transitional arrangements will address concerns about cost increases and complexity.

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

Clear audits and timeliness are proposed as the criteria by which SMSFs would qualify for a three-year audit cycle.

There is an implied assumption here that SMSFs with a history of clear audit reports and timely submissions are more likely than not to continue that behaviour. Intuitively that seems likely, until one considers the very high number (40%) of SMSFs that the ATO says reported late in a three year period. The assumption ought to be tested, and I assume that ATO has the data to do so.

If one were approaching this problem for the first time, without preconceptions, one might expect that the simplicity of an SMSF's structure and its transaction history would be a far better predictor of whether or not it routinely submits on time and receives clear audits.

However, simple SMSFs are cheaper to audit, reducing the potential (if any) for cost savings.

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

I think it is consistent with the spirit of this proposal to require "timely submission" to mean three consecutive years without a late submission.

3.4 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 risk?

I don't have a view on what should constitute key events, as I think that requires a professional opinion, but the following principles are critical from a trustee's point of view:

- The list of key events should be confined to items which, if not audited promptly, may cause serious problems later.
- Procedures should be put in place to ensure that the list of key events is kept as stable as possible, and is not allowed to grow unnecessarily.
- If trustees are to be responsible for self-assessment of their eligibility for 3-year audits, then it is essential that
  - key events do not include events which are outside the trustee's control
  - key events do not include events of which the trustee may be unaware
  - key events are easily understood by trustees
  - it is easy for trustees to keep up to date with the list of key events

3.5 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 to the measure?

Although I do not support the proposal, if it does become law then the method of introduction of the process should be a business decision for accountants and auditors.

Trying to impose some system (like odd and even number plates in a fuel shortage?) seems likely to make a complex issue even more so.

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

The superannuation regulatory environment is excessively complicated and has become severely unstable: grandfathering has been virtually abandoned and frequent changes have become the order of the day, in an area that is supposed to guide investment and income provision on a generational timescale. Such instability is not in the national interest.

In this environment the only way to avoid serious unintended consequences of proposed changes is to engage in a thorough process of socialization before they are introduced. To that end, discussion papers such as the present one are very valuable, and I appreciate having had the opportunity to contribute.

The rider I would add to that, though, is that it would have been far better - from both a political and a process point of view - to have had this public discussion before the Budget announcement, rather than after it.