

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

## Comments on Consultation Paper

1. I appreciate the opportunity to comment on the 2018-19 Budget proposal to change the annual audit requirement to a three-yearly requirement from 1 July 2019 for SMSFs with a history of good record-keeping and compliance.
2. I declare my interest in the proposal as trustee of a SMSF that has had an exemplary record of good record-keeping and compliance since its inception in 2007.

## Purpose of the proposed change

3. The ostensible objective of the proposal is to-

“to incentivise good record-keeping and compliance by SMSFs whilst maintaining system oversight and integrity.”

This objective is situated in the context of the Government’s desire to reduce the “compliance burden for SMSF trustees where suitable”.

4. In order to achieve that objective, there must be a positive behavioural change resulting from the reform as proposed. It is therefore informative to consider what behavioural drivers are exhibited in the present system and whether or not the proposal is likely to affect trustee behaviour to a material degree.

## First principles

5. The SMSF system confers certain tax advantages to promote the saving of money to fund the retirement of individual SMSF members. The function of the regulatory system is ensure those tax advantages are not abused.
6. SMSF members are assured of the tax benefits of their SMSF savings only if the regulator is satisfied, on an annual basis, that the statutory prerequisites to those benefits have been fulfilled, i.e. that the relevant law has been complied with.
7. The present regulatory system concerning SMSFs consists of 3 actors – the ATO as Regulator, the registered auditor and the trustee. It is informative to consider the roles these actors play in the SMSF system.
8. The independent audit concept originates from separation of ownership and management of capital. In the corporate context, the accounts of a public

company are independently audited in order to satisfy shareholders that mismanagement is not occurring. In the collective investment vehicle context, the audit requirement protects the savings of investors from mismanagement.

9. In the SMSF context, the trustee is the member. There is identity of interests. A priori, there is little if any value to SMSF members in the performance of an independent audit.
10. The Consultation Paper refers to the statutory obligation of trustees to have their SMSFs audited. The SMSF audit requirement merely replicates the audit requirement that applies to retail and industry superannuation funds as collective retirement savings vehicles.
11. It follows that the benefit of the audit in the SMSF context flows primarily to the Regulator. The SMSF audit is essentially an outsourcing of the regulatory function.
12. As the SMSF audit is a prerequisite to annual return reporting and hence the confirmation of compliant status by the Regulator, it operates as the principal compliance assurance mechanism.
13. For compliant SMSFs, the Regulator's compliance verification function is no more than rubber-stamping the compliance assessment by the auditor. However, compliant SMSFs must also pay a SMSF Supervisory Levy for that privilege.
14. The foregoing demonstrates that the audit function is an essential component to a SMSF system where members require confirmation of the tax advantaged status of their SMSF. It represents a significant compliance cost, as does the SMSF Supervisory Levy. As a supplement to audit fees, the SMSF Supervisory Levy operates as a double compliance cost to SMSF members.
15. The SMSF Supervisory Levy is imposed to cover the entire cost of the Regulator's administration of SMSFs, including the pursuit of non-compliant SMSFs. This is confirmed by paragraph 1.30 of Explanatory Memorandum to the *Superannuation Legislation Amendment (Reform of Self Managed Superannuation Funds Supervisory Levy Arrangements) Bill 2013* extracted below.

The money collected from the SMSF supervisory levy covers the costs incurred by the ATO (for example, annual compliance activities to ensure trustees comply with rules on contributions, benefit payments and superannuation investments) in regulating this rapidly growing and diverse SMSF sector. The SMSF supervisory levy does not currently fully recover the ATO's costs of regulating the sector. These amendments ensure that the ATO's costs of regulating the SMSF sector are fully recovered.
16. For grossly non-compliant SMSFs, there is no incentive to have an audit. The aberrant trustee/member knows that they are non-compliant. An audit would merely confirm what they already know. This may in part explain the poor lodgement history of such SMSFs. The pursuit of non-lodgers by the Regulator does not appear to be a high priority. Such action also entails high administrative cost relative to the cost/benefit application of the Regulator's limited resources.
17. As a system design element the independent audit does not assure overall SMSF compliance. It effectively operates as a hurdle to annual return lodgement, and in instances of deliberate non-compliance it is totally irrelevant.
18. While increasing administrative costs on the Regulator to pursue non-complaint SMSFs may be used to justify increasing the Supervisory Levy, it would produce the perverse outcome that compliant SMSFs would effectively be funding the

costs of countering non-compliance arising from administrative and structural inefficiencies.

## **A three-yearly audit cycle**

19. The Consultation Paper makes the following assertions as justification for the proposed change.

“Allowing SMSFs with a history of good record keeping the choice to move to a three-yearly audit cycle will have benefits for SMSF trustees, including:

- a reduction in the compliance burden on SMSF trustees while maintaining appropriate visibility of errors in financial statements and regulatory breaches;
- a potential reduction in administrative costs and auditor fees for SMSF trustees due to less frequent audits. Annual fees for SMSF auditors range from less than \$500 to over \$2,000. For 2016, the average auditor fee was \$694 and the median was \$550; and
- an incentive for SMSF trustees to submit SARs in a timelier manner.”

20. The Consultation Paper does not however, provide any evidence, reasoning or proposed legislative direction, such as an audit fee cap or freeze, to support those assertions.

21. What the assertions do illustrate is a complete misunderstanding of the audit task.

- **The compliance burden on the trustee**

22. Firstly, the compliance burden on the SMSF trustee derives from the record-keeping obligations that accrue on a continual basis as SMSF transactions are undertaken. The proposal has no effect whatsoever on that burden.

- **Administrative costs and auditor fees for SMSF trustees**

23. It is taken as given under the proposal that the audit requirement would not be limited from its present scope. In other words, all 3 years would need to be audited in each cycle.

24. So far as the SMSF trustee expends effort in engaging the auditor with the SMSFs records, the benefit of less frequent trips to the auditor’s office is outweighed by the need to transport almost 3 times the volume of records.

- **The incentive to submit annual returns in a timelier manner**

25. If the requirement for an audit report in 2 of 3 years is obviated there will be an incentive to submit annual returns earlier for those SMSFs that anticipate a refund in those years, but not if tax payable is assessed.

## **Likely behavioural outcomes**

26. Other than facilitating access to earlier franking credit offset refunds in 2 out of 3 years, the proposal will have no behavioural effect on lodgements.

27. The proposal offers no prospect of a material reduction in compliance costs for trustees.

## **Conclusion**

28. The proposal is highly unlikely to achieve its intended objectives. It would not be inaccurate to describe the proposal as a Clayton's reform.
29. If the Government desires to proceed with a proposal that provides a simpler and visibly tangible benefit to compliant SMSFs it would be better advised to consider removing the double-dip compliance benefit to the Regulator that occurs with imposition of the Supervisory Levy in addition to the outsourcing of compliance verification function to the independent auditor.

## **Consultation Questions**

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

30. When questioned about the proposal, my auditor's first impression was that total audit fees would not be reduced.
31. It is not apparent how the audit task could be reduced given that the scope of the audit would remain unchanged.

## **Eligibility criteria**

32. As the proposal affects the design of the SMSF system to a relatively minor degree, the proportionality principle dictates that eligibility criteria should be as simple as possible.
33. If simple criteria cannot be devised for the proposal as announced, consideration should seriously be given to developing an alternative that can be simply administered.

## **Good record keeping and compliance**

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

34. It is not apparent how the application of the criterion as proposed would promote either compliance or lodgement to any material degree.
35. If the existence of an audit contravention report is to be used as the basis for disqualifying eligibility to a lodgement concession, then it should only be the existence of an ACR in relation to the relevant reporting period that should be taken into account.
36. If the trustee hasn't learned from their past error or omission then they should remain ineligible. If they have learned from their mistake, and have no ACR in the current reporting period, then why should they be disqualified in the current and subsequent reporting periods?

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

37. It may appear trite to observe that submission of an annual report in accordance with lodgement timeframes is essential to effective administration.
38. To provide an incentive to lodgement, eligibility to a concession should be linked directly to the relevant reporting period. To do otherwise increases complexity and diminishes the behavioural impact.
39. For instance, apart from any other qualifying criteria, an exemption or waiver of the Supervisory Levy should apply if the relevant annual return is lodge on time. An exemption or waiver would not apply if the return is lodged late - no exceptions.

### **Key events**

40. The need to consider key events, as covered in the Consultation Paper, illustrates the complicating consequences of a poorly conceived reform proposal.
41. Given the relatively insignificant potential benefits of the proposal, the complexity inherent in determining eligibility to the lodgement concession as proposed does not appear justifiable.

Consultation Question 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?

42. As suggested above, eligibility for a minor lodgement concession should be defined simply. The need to consider key events would introduce a disproportionate degree of complexity.

### **Transitional arrangements**

43. The need to consider transitional arrangements, as covered in the Consultation Paper, illustrates the complicating consequences of a poorly conceived reform proposal.

Consultation Question 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?

44. As suggested above, eligibility for a minor lodgement concession should be defined simply. The need to consider transitional arrangements would introduce a disproportionate degree of complexity.

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

45. Question 6 appears to be raised with a view to eliciting considerations in relation to the proposal not otherwise covered in the Consultation Paper. It should, however, be raised in the broader context of the compelling policy consideration of providing long-term stability to the retirement savings system. To ignore this factor constitutes a fraud on individuals saving for their retirement.
46. The Simpler Super reforms introduced by the Howard/Costello Government represent the high point of redesign of the retirement savings system.

47. Since then, we have witnessed a succession of poorly conceived SMSF reform proposals emanating from both LPA and ALP, announced and enacted, that have affected and will continue to adversely affect their prospects in marginal electorates.
48. The administrative difficulties and, ultimately, costs to SMSF members arising from the FASS amendments are evident from ongoing commentary by expert practitioners on topical websites.
49. The present proposal does not exhibit any features that would justify it as a desirable reform in accordance with generally accepted law design principles.
50. Consideration ought to be given to developing the far simpler and more effective alternative suggested above.

Wil Duda  
B.Ec.[Monash], LI.B.[ANU], M.Tax.[UNSW]