**25 July 2018**

**Division Head**
**Retirement Income Policy Division**
**The Treasury**
**PARKES ACT 2600**

**Dear Sir / Madam**

**SUBMISSION RE: THREE-YEARLY AUDIT CYCLE FOR SOME SELF-MANAGED SUPERANNUATION FUNDS**

This submission is made jointly by Elite Super Pty Ltd and Peak Super Audits Pty Ltd under our strategic alliance.

Elite Super and Peak Super Audits are specialist SMSF audit practices, which together present:

- More than a decade of expertise & experience in the SMSF audit sphere;
- National award-winning qualifications in SMSF audit;
- A well-recognised standard of best practice in the audit of SMSFs.

We welcome the opportunity to make this submission to Treasury regarding the discussion paper that has been released on the proposed three-yearly audit cycle for SMSFs. Our submission opens with an overview of the historical context in which the annual audit currently takes place. This overview is contained in Part A of the submission. Our responses to the specific matters raised for comment in the discussion paper follow in Part B.

Yours gratefully,


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## PART A

## HISTORICAL CONTEXT OF THE ANNUAL AUDIT:

We note that the Government's **object** in proposing a three-yearly audit for eligible SMSFs is to:

A. Reduce red tape;
B. Reduce compliance burden for SMSF trustees where suitable.

The Government has the following **expectations** in introducing this policy:

1. The maintenance of appropriate integrity and visibility of errors;
2. To potentially reduce administrative costs and auditor fees;
3. To create an incentive for SMSF trustees to lodge SARs in a timely manner.

The measure's premise is to reward those trustees who do the right thing.

However, we strongly believe that the three-yearly audit measure will not realise this objective.

Further, if implemented, we believe the government's expectations of this policy are not sustainable.

As professionals with experience both in the audit and administration of SMSFs, we believe that the three-yearly audit proposal is fundamentally flawed. This proposal contradicts the policy direction supported by Government, ASIC, and the ATO over the last five years, which has emphasised the need for independent oversight and exposed low-cost audits that fail the competency standards. The three-yearly audit proposal undermines the importance of independent review in the large and self-regulated superannuation sector. We quote from the Super System Review Final Report:

> *"Some SMSF trustee submissions recommended that [the audit's] 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."*

This opinion was delivered by the best independent minds in superannuation. They further state:

> *"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."*

The Super System Review was commissioned in May 2009. SMSF investment has since burgeoned by more than **220%** and now comprises approximately **one third** of Australian superannuation.[1]

[1] See links to Media articles in relation to these statistics:

The sector is managed by mum & dad trustees with limited education in compliance matters, who lead busy lives. Since the Super System Review, SMSF legislation has dramatically increased in complexity. Changes include market valuation requirements, contributions rules, and the transfer balance cap. Recent years have also seen major changes to the non-arm's-length income (NALI) provisions as these apply to SMSF borrowing. As auditors, we work continuously with fund administrators, assisting them in understanding and implementing the new rules. This real-time partnership will suffer if the annual audit relationship is discontinued.

An independent annual audit is the bulwark to compliance integrity in the SMSF sector. It is the vehicle by which the SMSF Regulator is able to regulate effectively. Notwithstanding the level of robust criteria that will apply to eligible funds, we feel that a three-yearly period of independent oversight presents an unquantifiable compliance risk. The Cooper Review's conclusion to retain the annual audit has intensified relevance today.

Within this historical context, we now comment on the specific matters raised in Treasury's discussion paper.

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https://www.eqfinancial.com.au/smsf-assets-up-70-since-2009;
https://www.superguide.com.au/smsfs/smsfs-lead-the-super-pack-again. SMSF total investment was recorded as $316.5 billion in 2009; SMSF total investment was last measured at $696.7 billion in June 2017.

## PART B

## RESPONSE TO CONSULTATION QUESTIONS:

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

***Possible efficiencies***

We believe that certain efficiencies may be gained through auditing three consecutive years at one point in time. These efficiencies relate to the process of acquainting oneself with the characteristics of an SMSF as relevant for the audit. Examples of such efficiencies include:

A. **Determining the investment mix & implications for the audit plan / audit process.** If the investment mix is consistent over the three-year period, efficiencies are generally gained in making a three-year assessment at a single point in time. However, if the investment mix changes from one year to the next, there is little efficiency in acquainting oneself with the fund once every three years, as each year will require separate consideration.

B. **Establishing the fund's ongoing compliance with SISA s 17A, which relates to the fund's status as an SMSF**. If the fund's composition of members & directors is unchanged, it is more efficient to assess the fund's SMSF status once every three years as opposed to conducting an annual check. However, there are many changeable factors that can influence the fund's status as an SMSF under s 17A – such as residency or trustee mental capacity. Where there is change in any such influencing factor, there is no efficiency in conducting the s 17A audit once every three years. Indeed, the risk of costly error increases.

C. **Considering the Trust Deed** for its accommodation of fund developments (such as the appointment of a trustee with power of attorney, the ability to pay certain pensions or accommodate certain investments). It is more efficient to check the deed for its accommodation of multiple events over the past three years as opposed to conducting this review every year. Again, however, the risk of costly error increases.

If such efficiencies can be secured without any detracting influence, audit fees for a three-yearly assessment may reduce slightly.

Even in the best-case scenarios, we believe that audit fee reductions will not be significant. This is because three separate periods must be audited.

Certain processes and basic checks are necessary, even for the most straightforward and compliant funds. Auditing three periods together will not reduce these requirements.[2]

[2] The only possible means of significant cost reduction we can foresee is offshoring the audit process, to be undertaken with reduced oversight by less skilled persons. See further comments on this issue in response to Consultation Question 6.

There is very little scope for economies of scale in a thoroughly conducted SMSF audit, which complies with the competency standards prescribed by ASIC.

***Historically, fees for multiple year audits do increase***

Our experience is that audits involving multiple years do *not* result in fee reductions. Fees are sometimes increased. There are several reasons for this:

1. **Missing documentation**

   The challenge of obtaining historical documentation is multiplied exponentially where the events in question took place several years ago. Sometimes this is due to poor record keeping by the trustees. Sometimes good record keepers do not realise the importance of obtaining or preserving certain records and cannot source these at a later date. Often, documentation required for the audit will not be necessary to prepare the annual return – so we do not expect that annual lodgement of SARs will necessarily improve this tendency. The process of tracking and retrieving information adds time and cost to the audit.

2. **Forgotten details**

   Our experience is that trustee recollections become hazy after a period of several years. In the absence of detailed minutes, the trustees are obliged to restructure events and transaction details from memory. This process usually involves multiple emails or telephone conversations with the auditor and accountants and adds cost to the audit and accounting fees.

3. **Issues go undetected**

   Even diligent trustees make mistakes. Where the offence is picked up quickly, the issue is often non-reportable and easily fixed. But many such issues can become major problems over three years. Retrospective rectification may be required for financial statements, tax returns, and transfer balance account reporting. This adds time and cost to the audit.

***Conclusion***

In conclusion, we predict that a three-year audit cycle will not create significant cost savings for the audit. Audit fees are unlikely to reduce and may increase, depending on complications that arise from a delayed audit.

**Consultation questions**

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

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

Treasury's discussion paper recommends that a fund's eligibility for the three-yearly audit be self-assessed by fund trustees, according to 'good recording keeping and compliance' criteria:

- Three consecutive years of clear audit reports;
- Timely submission of SMSF annual returns (SARs).

We consider these criteria separately.

**CONSULTATION Q 2: Definition of a Clear Audit Report**

The discussion paper suggests that a 'clear audit report' be defined as the absence of financial or compliance contraventions in an ACR.

From this proposal, we conclude that the Government considers that all matters not reported in an ACR:

- Do not require annual review;
  OR
- If relevant for annual review, will be identified and dealt with as appropriate, notwithstanding the absence of an independent audit.

We have several objections to this assumption.

**CONSULTATION Q 3: Definition of a Timely Submission of a SAR**

We recommend that the timely submission of SARs should relate to the fund's lodgement history over the past three years. It is unreasonable to assess timely submissions on the fund's whole lodgement history; it is also inaccurate to assess submission history on the basis on a single year. A three-year rolling history is consistent with other eligibility criteria and appears reasonable.

***Objection 1: Financial contraventions do not appear in ACRs***

Apart from the recognition of fund investments at market value, material misstatements relating to the financial report do not require an ACR. An SMSF may:

- materially misstate taxable income, expenses or revenue
- cease to be a going concern
- receive a qualified, adverse or disclaimed opinion in the Part A Financial Statement audit

Without the issue being flagged in an ACR. Such funds obviously should not qualify for the three-yearly audit. We believe that material financial contraventions should be taken into account in defining what is meant by a 'clear audit report'.

***Objection 2: Material compliance contraventions may not require an ACR***

It is important to note that auditors are only required to report a contravention where:

1. A fund is less than 15 months old at 30 June and the contravention exceeds $2,000;
2. A prior year contravention is repeated;
3. A prior year contravention is unrectified at the time of audit;
4. The contravention either exceeds $30,000 or 5% of fund total assets.

This leaves vast scope for material contraventions that are not necessarily reported via an ACR. Materiality is determined using professional judgment. It involves both quantitative and qualitative considerations. It must be established for each engagement when preparing the audit plan and adjusted as necessary throughout the audit. Where the auditor considers that a material compliance breach has occurred, they must qualify the Part B Compliance report.[3] Funds committing a material compliance breach should not be a candidate for the three-yearly audit. We believe that material compliance contraventions should be taken into account in defining what is meant by a 'clear audit report'.

***Objection 3: Non-material contraventions often reveal significant concerns***

SISA s 129 requires the auditor to report the contravention of any reportable section to the trustees, irrespective of materiality. One presumes that this is required to ensure that trustees are informed of their mistakes and have the opportunity to make corrections before they become material.

We estimate that 65% of our management letters contain actionable advice to the trustees. Bundling the audit service in a three-year cycle will mean that these compliance issues are not communicated in a timely way and are not corrected by the following year's audit. Auditors will find increased non-compliance in years 2, 3 (and probably 4). This will increase the cost of the audit and put trustees at greater risk of committing a material contravention that could endanger fund assets or attract ATO penalties.

It is important to note that many administrators and accountants are not SMSF specialists and are not able to raise compliance issues with the same efficacy as the auditor. Our experience shows that where a compliance matter is raised in the management letter to prevent a breach, accountants and administrators were frequently unaware of the matter and did not know it presented an issue. A three-year audit cycle will result in accountants and advisors having to "wear the auditor's hat" in identifying SIS issues and communicating these to the trustees to avoid a situation of unrectified offences that continue for multiple years and result in an ACR. Casting the administrator in this role raises both compliance integrity and cost issues, which are discussed in greater detail below.

Common issues that begin as non-material and may be resolved through an annual audit (but which typically balloon into nightmares over a longer period) are set out in in Appendix A.

[3] Depending on whether the statement is pervasive, it may be necessary to issue an adverse opinion on the Part B Compliance Audit.

***Objection 4: SMSF Trustees, Accountants & the ATO do not provide adequate oversight***

It is evident to us that reporting via an ACR is an inadequate means of defining appropriate application of the three-year audit cycle. We conclude that the Government's objective in this proposal to strike a balance in sharing the responsibility of annual oversight between three other parties:

1. Fund trustees
   (whom the discussion paper proposes will self-assess eligibility for a three-year audit);

2. The fund's accountant or financial adviser
   (who are often the same person or are employed by the same firm);

3. The Australian Taxation Office
   (which may 'become aware' of errors in applying the three-yearly cycle)

We have grave concerns in this attribution of annual oversight.

***Trustees***

SMSF trustees administer their own superannuation trust. This means there is a complete lack of independence at the trustee level of administration. For this reason, it has long been accepted that even honest, well-equipped trustees are incapable of providing any assurance as to internal control within an SMSF. Fund trustees must not be relied upon *in any measure* for the oversight of their fund.

***Accountants & Advisors***

Accountants are generally trusted and capable professionals, who act in the best interests of their SMSF clients and reduce the frequency of error through timely advice. In reducing the oversight responsibility of SMSF auditors, it is inevitable that accountants and advisors will be called upon increasingly in this role. However, as stated above, our experience shows that accountants and advisors are often 'general practitioners' in SMSF compliance. They often rely on a specialist annual audit as a safety check. This is supported the findings of ASIC Report 575 SMSFs: Improving the Quality of Advice and Member Experience, which revealed that:

- In 91% of files reviewed, the adviser did not demonstrate compliance with the requirement to provide appropriate advice;
- In 86% of files reviewed, the adviser did not demonstrate prioritisation of the client's interests.[4]

These statistics are extremely concerning. They speak to the need for independent review within a self-managed superannuation sector that accounts for **one third** of Australian superannuation.

Murray Wyatt is the chairman of Morrows, a financial services firm which conducts remedial work for SMSFs that have run into difficulty. He comments:

[4] See ASIC Report 575 at p 63. The full Report (issued at June 2018) can be found at: https://download.asic.gov.au/media/4779820/rep-575-published-28-june-2018.pdf.

> "If you've got that degree of non-compliance, you need to look at it more often, not less … [I]f there is an error that did occur in the first year, manifesting through to the third year, it usually compounds to become a much bigger problem."[5]

SMSF auditors are required to be independent. No such requirement exists for accountants or advisers. These professionals therefore cannot provide the same level of disinterested oversight in the SMSF sector and should not be relied upon in this manner.

***Australian Taxation Office (ATO)***

We note that the discussion paper states:

> 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.

It is not clear how the ATO will monitor appropriate application of the three-year audit cycle. We ask that further details be released as to how the ATO will monitor this and what additional cost (if any) will be involved.

***Conclusions***

In conclusion, we recommend that a 'clear audit report' be defined as an audit report that is free from the following:

1. Issues reported via an ACR
2. Material financial contraventions – Part A audit
3. Material compliance contraventions - Part B audit
4. A 'compliance note' outlining any SIS issues.

In relation to Point 4 above: We suggest that auditors be empowered to add a 'compliance note' in the management letter as part of their current reporting under SISA s 129. 'Compliance notes' would generally relate to non-material contraventions which the auditor is obligated to raise under s 129 and which the auditor feels are noteworthy to the fund's ongoing compliance integrity. If a matter is raised as a 'compliance note', the auditor will recommend to the trustees that an annual audit be conducted.

We propose that in the first instance a 'compliance note' will not impact the status of a 'clear audit report'. We also suggest that the trustee should be free to decline the recommendation of an annual audit. However, if the auditor (or any auditor engaged) raises another 'compliance note' in the next subsequent management letter, this second 'compliance note' will appear in the audit report and the fund will lose its 'clear audit report' status.

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[5] See comments at https://smsmagazine.com.au/news/2018/07/10/asic-report-at-odds-with-three-year-audit-cycle/.

**Consultation questions**

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?

Treasury's discussion paper recommends that, in addition to compliance with 'good record keeping and compliance' criteria, eligibility for a three-yearly audit cycle should only extend to those funds that do not have a 'key event'.

We do not believe a three-yearly check provides sufficient oversight for any fund with the following investments or activity. These circumstances present significant compliance risk and we believe should be included as 'key events':

| | |
|---|---|
| **Related party activity of any nature** | We believe that the annual audit requirement must apply to every year the fund holds this investment, as the potential for non-arms'-length dealing and failure of the sole purpose test is so significant.<br><br>For example:<br>From our experience, related party property dealings often result in financial assistance to members' businesses. Without an annual audit prompting trustees to put in place leases at market terms, the SMSF will continue to provide more extensive financial assistance to the members' business; for example: unpaid rents, leases at less than market rates, absence of lease agreements, etc. |
| **Joint ownership of an investment** | We believe the allocation of revenue, expenses & maintenance of joint bank accounts should be checked every year. |
| **A limited recourse borrowing arrangement**<br>**(any LRBA – but especially related party LRBAs)** | As above, we believe it is critical that the annual audit requirement is not limited to the year the borrowing is incurred, but must apply to every year the fund holds this borrowing, as the restrictions of SISA s 67A continue throughout this time.<br><br>We strongly believe that a related party LRBA with possible NALI implications must be audited annually due to the <u>**annual**</u> changes in the RBA interest rate and monitoring of the LVR, loan term etc (as required under PCG 2016/5). These are not "set and forget" requirements. Our experience has shown that the trustees and accountants are often not aware of these annual requirements, and our advice has assisted in keeping these loans out of NALI tax treatment. |

| | |
|---|---|
| **Acquisition or continued investment in bitcoin** | Special requirements apply to the audit of high risk investments of this nature; an annual engagement is necessary. |
| **Acquisition or continued investment in derivatives** | Special requirements apply to investments that introduce a charge over fund assets. There are many different categories of derivative investment, all with different consequences for the audit. An annual engagement is necessary. |
| **Acquisition or continued investment in collectible or personal use assets** | These investments may only be held under strict conditions in SISR reg 13.18AA. An annual engagement is necessary. |
| **Commencement of a pension** | We believe pension documentation and access considerations should be subject to independent, specialist audit in the year of commencement. |
| **Death** | The death of a member has many implications that require independent, specialist audit in the year of that event. |
| **In specie contributions and in specie lump sum payments** | In specie transfers raise issues such as:<br>1. market value assessments,<br>2. transfer of title,<br>3. CGT consequences, that require independent, specialist audit in the year of transfer. |
| **A corporate trustee that is also engaged in business activities or has previously been engaged in business activity** | It is critical to ensure that fund assets are held separately on trust for the SMSF and may not be accessed in satisfaction of business related liabilities; the safeguarding of fund assets in this position should be monitored every year. |
| **A change of trustee in the current year** | It is important that investment title is updated following a change of trustee, to ensure there is no confusion as to asset ownership. This separation of investment should be reviewed by independent audit in the year of change.<br>Our experience has shown that without prompting from the annual audit, many funds that change trustees fail to update asset titles. It may not be until the 3rd or 4th annual audit reminder that trustees finally take action and contact share registries, banks etc. A three-year audit cycle will see investment names remain under old trustees without constant annual audit reminder. |

| | |
|---|---|
| **Special circumstances in the composition of the fund's structure** | **Such special circumstances could include overseas travel by the trustees or the appointment of a trustee with enduring power of attorney. While these special circumstances exist, it will be necessary to monitor ongoing implications for SISA s 17A (SMSF definition) and SMSF's status as a resident fund.** |
| **IMPORTANT NOTE re NALI tax law changes from 1/7/18 – s295-550** | Please note:<br>We believe that any related party dealings, and investments entered into at less than market values with SMSFs should require an annual audit, especially considering the stricter Tax Act changes that target SMSFs for NALI where a scheme is entered into.<br><br>The intention of this new legislation is to prevent inflation of SMSF earnings through non-arm's length dealings and a three-year audit will not adequately locate any potential NALI issues. Considering NALI will apply to income and capital gains in such arrangements, we believe an annual audit is required. |

**Consultation questions**

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?

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

**CONSULTATION Q 5: Transition Arrangements**

We believe that a transitional approach to introducing the three-yearly audit will be necessary in view of the major seasonal swings an unstaggered approach of this cycle could present.

There are many SMSF audit firms in Australia (Elite Super and Peak Super Audits among them) that provide no services apart from these highly specialised engagements and the provision of compliance guidance to our client base. It is largely due to the high level of specialisation in such practices (across skills, knowledge and systems) that the cost of conducting the annual audit has materially reduced. However, these practices now face the following challenges:

These practices will be required to:

- Maintain practice overheads throughout any 'slow' seasonal troughs;
- Maintain appropriate levels of insurance;
- Maintain specialist teams and high-quality staff, in an industry that will be less able to support them than previously;
- Maintain the highly specialised skills base of their managing directors or partners, where these skills may only be sporadically required;
- Maintain and manage uneven workflow as audits are required each 3 years with an unidentifiable pattern (the events-based approach makes it impossible to accurately forecast audit workflow). Accountants' expectation of timely audits (often 2-3 week turnaround) will be impossible to achieve and could result in late lodgement penalties for SMSFs.

In view of these challenges, we feel some form of transition is necessary.

We are uncertain as to the best means of achieving this, as it appears to us that any attempt to 'split' the SMSF sector is going to be difficult to administer and will add another layer of complexity to the system. We suggest that the following would reward those trustees who are trying to do the right thing:

- FIRST eligible: Clean funds that have never had late lodgements or received an ACR;
- SECOND eligible: Funds with clean lodgement and compliance history for the last 5 years;
- THIRD eligible: Other eligible funds.

We are unsure if this would effectively stagger the sector. We do believe that this system will be challenging and costly to administer.

**CONSULTATION QUESTION 6: Other Issues**

- **COMPLEX ELIGIBILITY CRITERIA & DECREASED OVERSIGHT BY AUDITORS**

Policy developers need to consider that increased fees that may be charged by accountants if increased responsibility for annual oversight comes to rest with them. We have had a lot of communication from our accountant clients, saying that they do **not** want the responsibility of identifying compliance issues/breaches or communicating these matters to trustees. They inform us that this will add more work to an already over-loaded accountant / administrator, with significant TBAR reporting now on their plate. Our accountants advise that their fees will reflect this change.

If, as we predict, a three yearly audit cycle results in retrospective amendments to SMSF financials and SAR, this will also add substantially to the fund's accounting fees. We have received extensive professional feedback that an annual audit (which identifies changes to the financials / SAR on a timely basis) is preferred by accountants. Maintaining the status quo has been the preferred option from our clients.

- **COSTS IN RELATION TO DEED UPGRADES**

From our experience, arranging for trustees to update their trust deeds is a difficult process. Many trustees do not understand the need to upgrade and resist recommendations. We anticipate that a wide-scale upgrade of trust deeds will be required if the legislated annual audit changes to a three-yearly cycle. Many trustees will resent this extra cost to bundle their audits. This may result in:

**1.** Those resisting the cost of upgrade who are knowledgeable of their deed will continue with the annual audit;

**2.** Those resisting the cost of upgrade without an understanding of their deed may seek the triennial audit in breach of their deed.
This may cause misunderstandings and disputes, should it be incumbent on the auditor to point this out.

- **RISK OF POLICY FORCING EXIT OF SKILLS BASE FROM INDUSTRY & AUDIT MOVING OFFSHORE**

In order to manage extreme swings in the volume of audits from year to year, some firms with fewer staff may consider offshoring parts of the audit function to maintain efficient turnaround times (and avoidance of ATO late lodgement penalties). Exposing the security of Australian SMSF financial information to overseas audit providers is a risk that the pressures of industry should not bring to bear on SMSF trustees. The probable loss of industry skills and jobs overseas should also be a consideration of policy makers.

- **PRACTICAL DIFFICULTIES RE TRANSITION & TRACKING**

Policy developers need to consider how compliance status is to be tracked. Trustees will inevitably lose track of when their last audit took place and SMSFs could go years overdue without scrutiny. Without a penalty regime in this regard, there will be no incentive for SMSF trustees to keep up to date with their three yearly audit cycle. There is a risk that there will be confusion as to when an audit was last conducted – particularly upon the change of accountants. Such confusion may ensue, even if a penalty regime is adopted and administered.

We therefore feel it is important that auditors are able to track this status in the funds they audit. Possibly SMSF auditors could have access to the Tax Agent Portal (or a specialist SMSF auditors portal) allowing auditors to see when a fund has last been audited.
We do anticipate that additional cost will be incurred through the preparation and implementation of such a service by the ATO.

- **OTHER INDUSTRIES RELY ON THE SMSF AUDITORS ADVICE**

We note that other industries depend on the annual audit. We query what will happens if a fund requires financing from a bank and that institution requests the latest audited financial accounts. Such considerations may influence the financing decisions of trustees, with negative consequences.

As auditors, we often assist solicitors in settlements to ensure contracts are correct. We aid financial planners with compliance advice in their implementation of insurance and investments for trustees. SMSF auditors are the back office technical help desk of the general tax practitioner. We anticipate that the cost and efficiency of services across many industries will be negatively impacted by lack of an annual audit.

- **FREE SMSF ADVICE WILL CEASE**

In extension of the above point, we propose that a decision to introduce a three-yearly audit will reduce our involvement in the provision of free advice to accountants, lawyers, financial planners etc and that this will be at the detriment of the SMSF and Superannuation sector as a whole. If SMSF auditors are to be called on for compliance advice, this will be invoiced to the trustees (where in the past this was free). This will increase costs to the SMSF.

- **3 YEAR AUDIT CYCLE UNWANTED BY MAJORITY OF THE SMSF SECTOR**

From our discussions with professionals in the sector (and numerous trustees as well), we are receiving feedback that the proposal in its entirety is unduly complex, will not achieve looked-for cost reductions, and will cause significant disruption to the sector.

The overwhelming preference from industry participants of our acquaintance is that the measure be dropped. The annual audit was functioning well as an integrity measure before the 2018 budget. In the words of ATO Assistant Commissioner, Kasey McFarlane (our emphasis):

> *"The role of SMSF auditors and the annual independent audit that every SMSF is required to undergo are **cornerstones** of good governance and regulatory compliance within the sector.*
>
> *…Importantly, **it allows any irregularities to be identified at an early stage**, thus facilitating the timely resolution and rectification of the issues by trustees."*[6]

A policy move to engender the goodwill of amendment-weary SMSFs trustees on the presumption that this "may" create cost savings and reduce red tape is not worth the integrity risk and disruption this will bring to the sector.

Red tape and cost savings could be obtained in many areas with industry consultation.

- **OTHER WAYS TO SAVE SMSFs MONEY/REDUCE RED TAPE,** as previously proposed by members of the SMSF audit industry, in our preliminary submission on this measure:

1. Removing the need for certain minor contraventions to be reported 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 standard setters to design more relevant and efficient mandatory auditing standards applicable to self managed superannuation fund audits.
4. SMSFs are now required to use more complex methods for calculating tax exemptions. SMSFs now require an actuarial certificate when 100% in pension phase, under $1.6m cap and where the member has super in another fund. This is an extra cost for no benefit, as we already know the fund is 100% exempt. Also, if the fund is 100% in pension mode then moves to pension and accumulation interests, the fund will effectively require 3 sets of accounts[7]. This will require significant changes to SMSF administrators' systems & processes, and this cost will be passed onto trustees. We suggest reviewing this with the industry to establish an improved approach.
5. Currently SMSF are required to pay an annual ATO levy fee of $259, which equates to $155 million per year, as close to 600,000[8] SMSF exist as at 30 June 2017. Perhaps reducing this fee or eliminating it all together will help trustees increase their retirement savings.

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[6] Kasey McFarlane, 'What the ATO Expects of SMSF Auditors' Sept 2016; accessed 15th July 2018 at <https://www.smsfadviser.com/strategy/14736-what-the-ato-expects-of-smsf-auditors>

[7] Doug McBirnie, 'ATO interpretation increases red tape' June 2017; accessed 15th July 2018 at <https://www.smsfadviser.com/strategy/15595-ato-interpretation-increases-red-tape>

[8] ATO Population table – annual data; accessed 15th July 2018 at <https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/Statistics/Quarterly-reports/Self-managed-super-fund-quarterly-statistical-report---June-2017/?anchor=SMSFpopulationtableannualdata#SMSFpopulationtableannualdata>

# APPENDIX A

**Common examples of non-material contraventions, which can become major issues after three years.**

| | |
|---|---|
| **Ineligible contributions** | This may occur through the payment of fund expenses by a member who is ineligible to contribute. Bad habits can form over a three-year period, with costly results if the contributions must later be returned from the fund. |
| **Intermingling of SMSF funds** | This is a frequent breach, which may occur via shared bank accounts or inaccurate reimbursement of expenditure. |
| **Loans to members or relatives** | This is a frequent breach, often non-reportable in nature, which reveals concerns about the trustees' understanding of SMSF compliance and their diligence in fund management. |
| **Failure to identify non-arm's length income** | Major changes have been introduced to the non-arm's-length income (NALI) provisions as these apply to SMSF borrowing. As auditors, we find there is great confusion as to the application of these rules and the results on making a mistake can be devastating.<br><br>We have provided intensive guidance on this matter and take a proactive approach in assisting accountants and trustees to resolve the issue quickly before a major problem develops. |
| **Failure to identify a related party** | This breach frequently occurs though misunderstanding the concept of control, which differs between trust and company structures. Accountants typically do not understand these special rules. |
| **Mismanagement of a Reg 13.22C trust** | The special exemption status for Reg 13.22C trusts under the in-house asset rules is irreparably lost through small oversights, such as the non-payment of trust distributions or the trust's investment in another entity. Auditors assist in the ongoing management of these vehicles by monitoring anomalies and helping trustees resolve the issues as they arise.<br><br>For example, debtors and creditors that build up over 2-3 years become loans, and hence regulations 13.22C & D are breached (these trusts are unable to borrow or lend money). A loan asset or borrowing renders these trusts or companies an In House Asset, which usually requires the investment to be removed from the SMSF, sometimes at great inconvenience and loss. So a timely reminder to trustees through the annual audit is a necessity to keep these investments on track and complying. Accountants typically do not understand these special rules. |

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| **Shortfall of annual pension.** | SMSF auditors are empowered to evoke the Commissioner's powers of general administration to allow a pension to continue despite a shortfall if certain conditions are met and the shortfall is a first-time offence.<br><br>Once this one-off exemption is used, the trustees risk losing their pension and the fund's exempt income status if another shortfall should occur. If the audit is conducted on a three-yearly cycle, the following may result:<br>• Trustees lose the opportunity to respond to the auditor's first warning;<br>• If the pension fails retrospectively, there will be changes to the amount of exempt pension income. The tax provision and annual return will need to be amended retrospectively;<br>• The SMSF may incur a considerable tax debt. |
| **Actions that jeopardise the fund's status as an SMSF.** | Common examples are an improperly executed enduring power of attorney or a trustee's decision to travel overseas. SMSFs are given a 6-month period of grace in which such issues can be rectified without penalty. An annual audit has a much better chance of correcting the problem in a timely way. |
| **Mistakes relating to a Limited Recourse Borrowing Arrangement (LRBA).** | Strict rules apply to SMSF borrowing and these rules apply while ever the loan exists. Small actions (such as the improvement of a loan-financed property) can have devastating consequences. Auditors who see the warning signs often help to prevent costly mistakes. |
| **Considerations relating to the deed or investment strategy.** | The deed may require amendment to accommodate certain investments (such as bitcoin). Certain investments (such as derivatives) may require special consideration in the investment strategy or the preparation of a derivative risk statement. Trustees (and accountants) are generally unaware of these specialist matters until raised by the auditor. |

# APPENDIX B

## About Elite Super

***Elite Super is a specialist SMSF auditing firm with a team of highly skilled staff.***

*Katrina Fletcher is the managing director of Elite Super and has 22 years' experience in the SMSF and accounting professions. For the last 13 years, she has worked exclusively in the audit of SMSFs. For many years, Katrina has hosted SMSF technical events and is considered a leading authority in SMSF auditing best practice.*

*Katrina is a member of the Chartered Accountants Australia and New Zealand (CAANZ) and has SMSF professional advisory qualifications through the Strategist Group with an Advanced Diploma of Financial Services (Financial Planning). Katrina is a member of the SMSF Association and holds accreditations of both SMSF Specialist Auditor and SMSF Specialist Advisor.*

## About Peak Super Audits

***Peak Super Audits is a specialist SMSF auditing firm.***

*Naomi Kewley is the managing director at Peak Super Audits. She is a Tax Masters graduate from the University of NSW and is a member of the Chartered Accountants Australia and New Zealand (CAANZ). She is a member of the SMSF Association, holding duel accreditations of SMSF Specialist Auditor and SMSF Specialist Advisor.*

*Prior to joining the audit sphere several years ago, Naomi worked as an accountant on a one-to-one basis with SMSF trustees and their advisors. Naomi is an active contributor in the SMSF sphere. She writes and presents on SMSF matters and has published articles in several Australian Taxation journals.*

***Naomi received the SMSF Specialist Auditor Top Achiever Award 2017.***