Speaking Up for One Million Australians with SMSFs

31 August 2018

Division Head
Retirement Income Policy Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email to: superannuation@treasury.gov.au

Dear Sir/Madam

SISFA is pleased to make a submission with respect to the July 2018 Discussion paper - Three yearly audit cycle for some self-managed superannuation funds.

SISFA is the Self-managed Independent Superannuation Funds Association. It was established in 1998 as Australia's original self managed superannuation fund (SMSF) advocacy association, and since then has grown to be the national voice for SMSFs in the superannuation policy debate. SISFA provides an important link between fund trustees, the superannuation industry, authorities and the community though its regular liaison on matters such as policy, proposed legislation and rulings impacting on SMSFs.

Whilst we applaud the Governments objective to reduce red tape and compliance burden in the industry, we believe a move to triennial audits may only marginally reduce costs, whilst creating other issues including increasing the administration burden on fund trustees and compromising the integrity of the system.

With the billions of dollars in the SMSF sector, the annual audit function plays a critical role in ensuring on-going compliance with superannuation law at a relatively low cost.

As such, SISFA's view is that the move to triennial audits should not proceed.

However, should the policy proceed, SISFA's view is that the eligibility for the 3-year audit cycle should be further extended beyond that which has currently been proposed to maintain the integrity of the system.

We would like to address each of the consultation questions raised:

1. How are audit costs and fees expected to change for SMSF trustee that move to 3-yearly audit cycles?

It is currently unclear for those SMSF's qualifying for a 3-yearly audit cycle as to whether the auditor would only have to issue one set of audit documents, including audit report covering all 3 financial years, or alternatively whether an audit report will still be required for each individual year. Either way, it is SISFA's view that the issue of the audit report is only a small portion of the work required by the auditor and issuing one audit report covering all three years as opposed to issuing 3 audit reports for each year will only marginally reduce audit costs.

We believe there may be minor cost reductions for some SMSF's with simple investments such as funds with cash, listed securities and term deposits as a result of economies of scale, however, the extent of the reduction, if at all, would be dependent upon:

- All source documentation for each year being readily available
- No material errors in any of the financial year reports
- No change in service provider during the course of the 3 years
- No compliance issues being identified
- One set of audit reporting at the end of year 3 as opposed to reporting for each individual year.

We believe it is more likely that moving to a 3-yearly audit cycle would actually increase the costs of the annual audit, for the following reasons:

- Three years is a long time for an audit to not be undertaken. There would be an expectation that the auditor's assessment of the underlying risk profile of the client will increase as a result. The auditor will therefore need to introduce additional measures and tests to mitigate the increased risk of the audit.

- Source documentation may not be readily available for each financial year; in particular, there may be gaps in documentation provided which could be difficult, time consuming and costly to obtain. For example, trying to obtain property valuations, limited recourse borrowing documentation or financial statements for an unlisted company or trust investment held by the fund several years later could prove to be difficult. Furthermore, for the trustee to recall and explain a transaction to the auditor several years later could be problematic.

- There would be an expectation that over time the cost of auditing naturally increases as a result of, for example, increases in labour costs and CPI adjustments. Under a 3-yearly audit cycle, the audit is being conducted for each of the preceding 3 financial years at the higher year 3 rates.

- Any change in service provider during the course of the 3 years would present its own challenges in the ability to undertake an audit at reasonable costs. For example, the auditor may be engaged to conduct the audit for the 3 years, however, the financial accounts for year 1 and year 2 may have been undertaken by one accountant and year 3 by another accountant. It is possible that all 3 years of accounts were conducted by 3 different accountants. In this instance, the auditor would need to liaise with at least 2 accountants to undertake the audit, with an expectation of additional accounting costs being incurred for the retrieval of documentation from an accountant who is no longer acting for that client. Alternatively, there may be a situation where the 3-year audit is not conducted by the same auditor which would negate any cost savings as a result of economies of scale. It is possible that a newly engaged accountant could request copies of the prior accountants working papers, this would still not necessarily be a solution as:

- There is no legal requirement for an accountant/administrator to provide that information.
- As an audit had not been undertaken, there may be gaps in the documentation gathered that may be required for audit purposes.
- There may be transactions that are not self-explanatory requiring further work to understand the transaction.

- Because an audit is still required for each financial year, depending on the complexity of the audit and the nature of investments held, there may not be any economies of scale achieved.

  In particular, it must be noted that an audit is required to be conducted in line with Australian Auditing Standards, which imposes certain documentation and other requirements for each financial year audit.

- We would expect that any errors in the financial report identified by the auditor, would result in additional costs, in particular, should an error occur in year 1, the financial accounts would need to be adjusted for year 1 with corresponding adjustments expected to flow through to years 2 and 3. It is also probable that the SAR would need to be amended and re-lodged, alternatively an auditor qualification may result where the accounts are materially misstated, again increasing the overall costs of conducting the audit. This is coupled with the increase in accounting time to amend financial reports and prepare and lodge amended SAR's.

- Any compliance breach may not be identified in a timely manner which could then result in a failure to rectify same in a timely manner, resulting in audit complications for several years rather than just one. An increase in audit time would therefore be inevitable because an ACR would most likely be required in years 2, 3 and 4.

- It is currently unclear as to the repercussions of failing to appropriately self-assess eligibility for a 3-yearly audit cycle. Any monetary penalties will immediately negate any potential cost savings of having a 3-yearly audit cycle. It is also probable that trustees would seek professional advice to ascertain their eligibility thus increasing overall costs.

<u>Eligibility criteria – Good record keeping and compliance</u>

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?

SISFA's view is that an alternative definition of 'clear audit reports' should be adopted to extend to funds where there has been either a Part A or Part B audit qualification on the audit report and where an audit management letter has been issued to the trustees for minor breaches.

The issuing of an ACR and qualification of an audit report do not necessarily occur together as different criteria are used by the auditor to assess the requirement for each. That is there could be a lodgment of an ACR without a corresponding qualification of the audit report, alternatively there could be a qualification of the audit report without a corresponding lodgment of an ACR.

With respect to the audit qualification criteria, it would be expected that the overall risk profile of the client where there has been an audit qualification would be higher, particularly where there has been a Part A qualification and the auditor has not been able to sign off on the financial statements as being free of material error. Where there has been a Part B qualification, the auditor has not been able to sign off on the SIS compliance of the fund. As such, funds that have had a qualified audit report issued should not be eligible for the 3-year audit cycle for at least 3 years.

At present the ATO can identify where the auditor has made a part B qualification of the audit report as this is notified to the ATO in the annual SAR and is therefore relatively straightforward to identify. In order to obtain the information for a part A qualification, the SAR question could be amended to ask whether there has been any audit qualification.

In addition, it should be noted that the majority of instances of non-compliance by the SMSF would not be notified to the ATO via either an ACR or qualification, as the auditor may only be required to notify details of the breach directly to the trustees via a management letter, that is the breach may neither be material or fall within the requirements for notification in an auditor contravention report.

For example, a fund with a balance of $1 million could have a one-off breach to the value of $29,000 but this would not necessarily result in an audit qualification or an auditor contravention report. The auditor's role in this example is to inform and educate the trustees of their error in order to reduce the chance of future breaches of the legislation.

In addition, even though a trustee is issued with an auditor management letter, the trustee does not necessarily take action and rectify their compliance breach until the time that the next year's audit is being undertaken.

If the criteria for good compliance does not exclude those funds where an auditor management letter has been issued, in the above example, the fund would qualify for the 3-year audit cycle. In this situation, it could be up to 4 years before any further action is taken to rectify the identified breach.

For the above reasons, SISFA's view is that any fund that has had a breach of the superannuation legislation, including those which have been reported to the trustees through a management letter should not qualify for the 3-year audit cycle for at least 3 years.

In order to easily identify funds where a management letter has been issued, the SAR could be amended to include an additional question as to whether an audit management letter has been issued on minor compliance matters.

SISFA's view is that a SMSF that has not submitted a late SAR in the last three years definition of timely submission is appropriate.

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?

SISFA's view is that where the SMSF has one or more of the following investments, it should be precluded from qualifying for the 3-year audit cycle:

- Property (Commercial and residential)
- In-house assets
- Unlisted investments (companies and trusts)
- Loans
- Collectables
- Limited recourse borrowing arrangement

There are a number of reasons for this view, including:

- The above-listed investments tend to have more complicated valuation criteria, including valuation requirements for related party acquisition and disposals, as well as year-end reporting. Due to the associated complexities, the likelihood of incorrect valuations is higher. The resulting impact of incorrect valuations could include:
    - In-house asset values being manipulated to ensure any in-house asset acquisitions and investments fit within the allowable limits.
    - Keeping asset values low to enable:
        - The ability of members to continue to contribute into super and not exceed contribution caps.
        - To gain access to a higher rate of ECPI, for example by ensuring member balances remain below the $1.6 million transfer balance cap, resulting in lower tax being paid.
        - To gain access to the concessional contributions catch-up for members with a Total Superannuation Balance of less than $500,000.
        - To reduce the required minimum pension payment resulting in higher pension balances being maintained in a concessional tax environment.
        - To gain access to asset segregation as opposed to the requirement to use the proportionate method for members with pension balances greater than $1.6 million.

- Keeping asset values high to enable:
  - A higher rate of pension paid for a transition to retirement pensioner above the allowable 10% limit.

- Whilst trustees are required to retain appropriate source documentation, the documentation requirements for the audit of the above investments tend to be more extensive, and sometimes difficult to obtain even when auditing each financial year. To obtain this documentation 3 or more years later could prove to be almost impossible, and certainly time consuming. For example, trying to obtain property valuations, limited recourse borrowing documentation or financial statements for an unlisted company or trust several years later could prove to be difficult. Furthermore, for the trustee to recall and explain a transaction to the auditor several years later could also prove difficult.

- A SMSF investment in an unlisted unrelated trust may not be an in-house asset, but could become an In-House Asset (IHA) through a change in structure. For example, in year 1 the ownership structure of the trust may mean it is an unrelated trust and therefore not an IHA. In year 2, the ownership structure may change to the extent that the SMSF is a majority owner and therefore become a related entity and therefore an IHA. At this point in time, the trustees would have a year to rectify the situation if required to ensure the SMSF does not breach the IHA provisions.

  The auditor would often be the person to identify this issue, report the matter to the ATO and communicate it in their section 129 notice in order that the trustee can rectify within the required timeframe. Had an audit not been undertaken in the year in which the ownership changed, it is possible that the impact of the change in structure is not identified, resulting in a rectification not being made for several years and therefore an IHA and compliance issue being maintained by the fund.

- There are often related party transactions involved with these types of investments, including:
  a. In-house assets
  b. Regulation 13.22 related party non-geared investment structures
  c. Related party limited recourse borrowing arrangements
  d. Leases of business real property to a related party

  Should an audit of these investments not be required to be undertaken each financial year, in extenuating circumstances, the motivation of trustees to undertake transactions in contravention of the law and/or on terms other than arm's length increases. For example, if a related party business is struggling, the possibility of rent not being paid on a related party commercial property or for the terms of an in-house asset loan to not be arm's length increases.

Whilst we appreciate non-arm's length transactions can occur at any time, the requirement to not have them audited each year could extend the length of time of non-compliance where breaches are not being identified, notified and corrected within a timely manner.

In addition, there are tax consequences for the trustee if they permit non-arm's length LRBA arrangements – which would have been minimised or avoided with timely audit intervention and guidance.

SISFA's view is that where the SMSF has one or more of the following transactions, it should also be precluded from qualifying for the 3-year audit cycle:

- Commencement of a pension
- Commutation of a pension
- Death of a member
- The addition or removal of a member
- Rollover of a benefit
- Payment of a lump sum
- Family law split of superannuation benefits
- Wind up of superannuation fund

There are a number of reasons for this view, including:

- Many of these transactions require the satisfaction of a condition of release in order to access benefits. If the required condition of release has not been audited or is audited several years later, it may be difficult to prove that condition of release was satisfied at the relevant time. For example, if a person retires the ability to obtain appropriate confirmation from the employer may diminish if obtaining several years after the fact.

- The value for each of these transactions must be calculated at the time of the event. Failure to correctly value, for example the commencement of a pension could result in breaches of the transfer balance cap going undetected, higher proportion of values allocated to pension balances resulting in higher ECPI claims or incorrect pension payments being made.

- Where an error has been made with, for example, the starting value of a pension, trying to correct a number of years later would be time consuming and problematic.

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

SISFA's view is that should a large number of funds be eligible for the measure, it will be critical that an appropriate system be put in place to manage the transition with respect to auditors' workflow management and other business matters.

In terms of what metric should be used to stagger the introduction, given every audit practice is different with different net value clients and so on, a randomly generated metric (for example based on ABN or TFN) would hopefully produce an outcome that will ensure every audit practice can be fairly impacted by the new measures.

SISFA's view is that should only a small number of funds (i.e. 5-10%) be eligible for the measure, then any additional criteria for implementation will only act to increase overall cost and red tape within the industry.

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

The implementation of this policy objective will see another complex layer of legislation which will need to be understood and implemented by the SMSF community as well as be monitored by a team in the ATO for compliance with same. This in itself will increase compliance burden and red tape with little to no foreseeable benefits resulting.

The auditor plays a critical role in educating the trustees to help avoid any future compliance issues. For example, if a fund invests in a regulation 13.22C related unit trust, the auditor may remind the trustees of their responsibilities of what the unit trust can and can't do to avoid any potential breaches.

Furthermore, it should not be underestimated the role of the auditor to be used as the 'fall guy' to obtain information from trustees. Trustee's may be more blasé about providing information to their accountant if they know they are not being audited until several years later.

Due to the practical difficulties of auditing 3 years at once, we could see an increase in audit qualifications (particularly around insufficient audit evidence and potentially disclaimers of opinion) which would detract from the overall integrity of the sector and the inherent value of the audit.

SISFA believes there are alternative avenues available to achieve the Government's commitment to reducing red tape and compliance burden.

Recent changes to actuarial certificate requirements for the 2018 financial year are creating large amounts of additional compliance burden and cost for accountants, actuaries, trustees and auditors. In particular, the need to obtain an actuarial certificate for a fund which would otherwise be 100% in pension phase but only required due to a members total superannuation balance exceeding $1.6 million due to moneys invested outside of the SMSF for example in a retail or industry fund, to simply state the obvious outcome that the SMSF ECPI percentage is in fact 100% is a classic example.

The increased burden on the SMSF industry with respect to the new TBAR reporting arrangements is also causing large amounts of additional compliance burden and cost, particularly for those that fall in the quarterly reporting regime. Duplications of TBAR reporting are already presenting themselves again causing additional compliance burden and cost. These reporting obligations should simply form part of the annual SAR with an annual reporting obligation.

In conclusion, SISFA reiterates its appreciation and support of the extended consultation period and is pleased to have been involved in and made a contribution to the process.

We look forward to our continued involvement.

Yours faithfully

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