

# SMSF Working Group

## Issues paper on Auditor Independence

April 2011

### PROPOSED REFORM

The Super System Review recommended, in conjunction with its recommendation on SMSF auditor registration, that the Australian Securities and Investments Commission (ASIC) should develop approved auditor independence standards that SMSF auditors must meet as part of their ongoing registration requirements. The Government announced that it agrees with the recommendation to implement independence standards for SMSF approved auditors and would consider existing auditor independence standards that could be imposed, developing new standards if necessary.

SMSFs are subject to a reduced level of regulation in comparison to APRA-regulated funds on the basis that members are in a position to protect their own interests. However, given the substantial tax concessions provided to superannuation savings, the Government is necessarily concerned to ensure that SMSF trustees comply with their obligations.

SMSF trustees are required to appoint an approved auditor to audit the operations of the fund for each year or part of the year the fund is in existence. The auditor is required to assess the fund's overall compliance with the law and the fund's financial statements.

Auditors play a crucial role in the regulation of the SMSF sector. The Government relies on the SMSF annual audit to assess trustee compliance with the law and ensure that the integrity of the superannuation system is maintained. The annual audit provides assurance to the Government and the general public that SMSFs are being managed appropriately. In particular, Auditor Contravention Reports provided to the Australian Taxation Office (ATO) identify and report contraventions of the superannuation legislation.

It is vital that annual audits are accurate and reliable. Auditor independence issues reduce the confidence that the Government can place in the audit and undermine the compliance-based regulation of the sector.

Some SMSF auditors are subject to independence requirements through their professional association, however there are currently no legal requirements under the superannuation legislation regarding auditor independence.

## ISSUES

The Super System Review recommended full audit independence for SMSF auditors. Full audit independence requires that both the auditor and auditing firm cannot provide non-audit services to the SMSF. The auditor and auditing firm also cannot provide advice or services to the individual member/trustees or their family business.

The Review's rationale for recommending full audit independence requirements for SMSF auditors was that the SMSF model and its regulatory framework are unique both within Australia and internationally. It argued that the central role of the compliance audit, as opposed to the financial audit, makes the Government a stakeholder along with the individual SMSF trustees and requires a higher standard of independence.

Non-audit services are generally regarded as any engagement in which an audit firm provides professional services to an audit client other than those relating to the audit of financial statements. The preparation of accounting records and financial statements is one such non-audit service. Other examples of non-audit services are valuation services, IT services, management advice and legal services.

### ***Existing Independence Standards***

In Australia, auditor independence standards are set out in the *Corporations Act 2001* (Corporations Act). These independence requirements apply to auditors of any financial reports prepared under the Corporations Act, such as Company Auditors. There is a general requirement under the Corporations Act that the auditor should not perform an audit if they are not capable of exercising objective and impartial judgment in relation to the conduct of the audit or a reasonable person, with full knowledge of all of the relevant facts and circumstances, would conclude that the auditor is not capable of exercising such judgment.

The Corporations Act also contains specific auditor independence requirements. These requirements only address financial, business and employment relationships with entities being audited and do not address non-audit services. However, members and employees of an auditor, and audit firm or audit company who provide non-audit services exceeding 10 hours during the period the audit relates and in the preceding 12 months are subject to many of these specific requirements.

The Corporations Act, through the auditing standards, also requires that auditors comply with the Accounting Professional and Ethical Standards (APES) Board's auditor independence standards as set out in 'APES 110 – Code of Ethics for Professional Accountants'. APES 110 requires that auditors be independent in mind and in appearance. APES 110 generally does not prohibit an auditing firm from providing non-audit services to an audit client. Instead, it would be expected that where non-audit services have been provided to the audit client by the audit firm, appropriate safeguards are put in place to ensure independence is not compromised.

However, different requirements apply in relation to audit clients that are Public Interest Entities (PIEs) than those that are not PIEs. PIEs are all listed entities or any entity defined by regulation or legislation to be a PIE. For PIEs, accounting and bookkeeping services of a mechanical nature can only be provided by members and employees of a firm who are not members of the audit team if the services related to matters immaterial to the financial statements. This is in contrast to entities that are not PIEs, for whom accounting and bookkeeping services can be provided to audit clients in emergency situations.

Members of the Institute of Chartered Accountants in Australia, CPA Australia and the National Institute of Accountants are required to comply with APES 110 as part of their professional

membership. The Joint Accounting Bodies' 'Independence Guide: Interpretations in a Co-Regulatory Environment' advises members that where the SMSF's accounts have been prepared by another partner in the firm, an appropriate safeguard exists if there is separation of both the roles and responsibility for the preparation of the SMSF financial statements and the roles and responsibility for the audit between different staff and partners.

In many other jurisdictions, except the United States, professional bodies have adopted the International Federation of Accountants' (IFAC) International Ethical Code. In relation to the matters outlined above, the APES 110 is identical to the International Ethical Code.

The United States has the most wide-ranging prohibition on the provision of non-audit services. The Sarbanes-Oxley Act 2002 (SOX) prohibits eight specific categories of non-audit services, including accounting and bookkeeping services, and requires that any other non-audit services must be preapproved by the audit client's audit committee. SOX applies to listed entities.

The European Commission is examining possible changes to reinforce its prohibition on non-audit services by audit firms, though a green paper issued in October 2010, 'Audit Policy: Lessons from the Crisis'. Article 22 of the European Commission's Directive on Statutory Audit (2006/43/EC) currently says that audit services should not be provided in cases where 'an objective, reasonable and informed third party would conclude that the statutory auditor's or audit firm's independence is compromised.' This rule is relevant to the provision of non-audit services.

### ***SMSF Audit Independence***

As outlined above, no jurisdiction prohibits auditing firms from providing all categories of non-audit services to an audit client. However, the provision of accounting and bookkeeping services by an audit firm are generally not permitted or are subject to significant restrictions. Even where they are permitted, such services are restricted to non-public interest entities and services must be of a routine or mechanical nature.

There is reason to argue that the independence of an auditor is undermined when they audit accounting records and financial statements prepared by someone else in their firm. Even with safeguards, the auditor is likely to be concerned about the potential for the firm to lose income or for the firm's reputation to be damaged. Therefore, a reasonable person may conclude that the auditor would not be able to exercise objective and impartial judgment in these circumstances.

An audit constitutes the principal external check on the integrity of financial statements. It serves to improve the credibility of the financial report and to provide users of the financial report with greater confidence. As users of the financial report, it is in the trustee's interest that a high standard of independence be applied. An independent audit can assist with the management of the fund by identifying errors that could have financial and regulatory consequences.

The SMSF audit has the added role of providing assurance that the trustees have not acted illegally and have used the superannuation taxation concessions for the purpose that they are intended. Given the significant taxation concessions provided to SMSFs and that SMSF trustees have direct control over the management of their own superannuation savings, the Government and the general public have an interest in the reliability and independence of the audit. Therefore, it could be argued that the public interest in the operation of SMSFs is similar to the public interest in PIEs and that audit independence requirements applying to SMSF auditors should be similar to those applying to auditors of PIEs under APES 110.

In 2009-10, the ATO's compliance activity involving high-risk auditors identified that 17% of these auditors had inappropriate or no safeguards in place for ensuring auditor independence. Although this figure is not reflective of the entire SMSF auditor population, it does demonstrate that audit

independence is a significant issue in the SMSF sector and that requiring safeguards where the audit firm has provided non-audit services does not guarantee audit independence.

In Australia and internationally, there is increasing recognition of the importance of auditor independence. A number of jurisdictions are moving towards tightening restrictions on firms providing non-audit services to audit clients.

Audit independence can never be fully guaranteed, however it could be argued that full audit independence provides the greatest assurance against bias, error or unethical behaviour. Given the role of the SMSF annual audit in the regulation of the sector and its importance in maintaining the integrity of the SMSF model, it may be reasonable to prohibit audit firms from providing some or all non-audit services to audit clients.

### Questions

Taking into consideration the different models for auditor independence standards in Australia and internationally, what auditor independence standards would provide sufficient assurance of the independence of an SMSF audit?

If audit firms are not prohibited from providing non-audit services to audit clients, should there be restrictions on certain non-audit services, such as accounting and bookkeeping?

Should SMSF auditors be subject to any specific independence requirements other than in relation to non-audit services, for example the auditor cannot be a member of the SMSF?