31 August 2018

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

Via email: superannuation@treasury.gov.au

Dear Rob

Three-yearly audit cycle for SMSFs – discussion paper

Chartered Accountants Australia and New Zealand (Chartered Accountants ANZ) and CPA Australia welcome the opportunity to provide comments on the abovementioned discussion paper.

Chartered Accountants ANZ and CPA Australia represent over 200,000 professional accountants in Australia. Our members work in diverse roles across public practice, commerce, industry, government and academia throughout Australia and internationally. Specifically, over 90 per cent of registered self-managed superannuation funds (SMSF) auditors are Chartered Accountants or CPAs.

Chartered Accountants ANZ and CPA Australia and their respective members have serious concerns regarding the potential impact of the proposed measure to introduce a three-year audit cycle for SMSFs. We do not believe it will meet the stated policy intent to reduce red tape and compliance costs for SMSF trustees. We question the benefit of this measure and the proposed cost savings when considered against the risks to the integrity off the SMSF segment.

Introductory Comments

The SMSF sector is the largest segment of Australia's $2.6 trillion retirement savings system. The latest statistics published by the Australian Prudential Regulation Authority estimates that in March 2018 there were just under 596,000 SMSFs with $712 billion in assets, or 27 per cent of total superannuation assets, catering for approximately 1.12 million Australians.

The Australian regulatory settings that permit these types of retirement funds are almost unique around the world in that families and/or close associates can run their own retirement savings plan without using the services of professional financial services organisations. The vast majority of SMSFs are two member funds run by spouses.

Over many years the Australian Taxation Office has publicly said on the whole SMSFs are both well run and in particular, most SMSF trustees are prudent and appear to invest their money sensibly. These statements are supported by the fact that the ATO report very few SMSFs as non-compliant each year, disqualify only a small number of SMSF trustees from holding that position and impose few administration penalties on trustees. The annual rate of SMSFs with contraventions reported by auditors or actuaries is only 1.6 per cent of all SMSFs.

The strict regulatory controls – and financial penalties – available to the ATO are a strong deterrent to non-compliance for the majority of SMSF trustees. This is especially the case given the ATO can impose penalties that represent up to 45 per cent of a fund's assets.

However, there will always be a small portion of trustees who deliberately breach the superannuation legislation. In addition, some trustees will inadvertently make mistakes even if in the ordinary course of events they diligently strive to comply with the law.

The SMSF annual audit regime serves two purposes - it reduces the risk of deliberate non-compliance but also enables early identification of inadvertent non-compliance which can enable rectification in a timely manner.

A history of amending the annual audit requirement

In 2007, the Parliamentary Joint Committee on Corporations and Financial Services (PJCCFS)[1], was persuaded that annual audits for SMSFs was an "overly cautious approach". The PJCCFS stated that:

> *it is important to ensure that the right balance is struck to minimise the regulatory burden of administration while also maintaining financial and legal integrity" and recommended that "SMSFs run by qualified accountants be audited annually for three years from their commencement and, subject to no irregularities, thereafter every five years. SMSFs found to be non-compliant are to be audited annually for three further years.*

With due respect to the former PJCCFS and this recommendation, we consider that it was made without an adequate analysis or understanding of the role, functions and duties of auditors.

The government of the day did not respond to this report but asked the Cooper Review to consider this matter. The Cooper Review[2] Panel concluded in 2010[3]:

> *The Panel believes that the annual audit provides a high level of assurance to members, regulators, government and the community more generally. Without this assurance, it would be unlikely the current 'control' features enjoyed by trustees could be retained.*
>
> *Some SMSF trustee submissions recommended the removal of the audit requirement or for its 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.*
>
> *On the other hand, other submissions indicated that having less frequent audits would result in increased compliance costs and potentially a greater number of contraventions throughout the sector. The Panel agrees with these views and it also believes the annual audit acts to engage trustees with their superannuation.*
>
> *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****. (emphasis added.)*

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[1] Inquiry into the structure and operation of the superannuation industry
[2] Review Into The Governance, Efficiency, Structure and Operation of Australia's Superannuation System
[3] Self-Managed Super Solutions: Phase Three Preliminary Report

Subsequent to these inquiries there have been no substantial environmental changes that would warrant a move away from annual SMSF audits. We also examined the 2018-19 pre-budget submissions[4] and could not find any request for changes to annual SMSF audits, including from organisations that had previously advocated changes to this policy setting.

Key Impacts of a three-yearly audit cycle for SMSFs

We foresee three key impacts on the SMSF sector:

1. Cost of the audit could rise rather than fall
2. Contraventions may increase and become more significant
3. Administrative problems with managing eligibility

As a result, we expect that the policy intent of a meaningful reduction in the compliance burden is unlikely to be achieved.

We explain below the reasoning for this view below along with a number of potential unintended consequences of this proposal.

Under the proposals, to ensure a sound basis to form their audit opinion, SMSF auditors will still have to audit the SMSF's financial statements and compliance for each of the three years within the period. Consequently, the potential relief offered by this measure is only the timing of those audits not their scope. Some SMSF audits for the most simple funds, such as those with managed investments and little activity, may be able to find some economies in auditing a triennium. However, these are likely to be a minority of funds which already enjoy relatively low audit fees with potential for only a minimal reduction in fees. For most funds, gathering evidence from external parties in particular, which is necessary for example to establish the existence and valuation of investments, stretching back over three years is likely to be a more time consuming and costly exercise, than if it was done on an annual basis. As a result, the measure may be at best a potential cost deferral but may in many cases lead to higher audit fees.

Material errors in the financial statements or contraventions identified during the audit may have existed for up to three years under this proposal, rather than being restricted to one year. This delay in detection may result in greater administration, costs, and penalties because the scale and impact of the error or non-compliance often multiplies over time. Greater work effort is likely in order to identify their full impact and navigate a more complex and onerous rectification process than if errors or non-compliance had been identified in a timely manner. Small contraventions identified in year one, for example unpaid rent from a related party, will not be reportable if they are under the Auditor Contravention Report (ACR) reporting thresholds, of greater than $30,000 or 5 per cent of the fund's total assets. The contravention could be rectified following identification by the auditor. However, in the absence of an audit the contravention may remain unrectified in years two or three and increase significantly in scale over that time, making it reportable but more importantly, difficult to rectify.

[4] https://consult.treasury.gov.au/budget-policy-division/2018-19-pre-budget-submissions/consultation/published_select_respondent?sort=excerpt&order=ascending&_b_index=180

Anecdotally, many of our SMSF auditor members have consistently advised that between 30 and 40 per cent of SMSF funds they audit have small contraventions that may be identified to clients via the management letter and rectified before they become reportable. If these contraventions were left unidentified, the current low contravention rate of 1.6 per cent would significantly increase unless the ATO adjusted the ACR reporting thresholds and the negative impact of the contraventions would escalate.

After the first three-year cycle, the ACR contravention rate is likely to increase due to the delay in detection, which combined with the high-bar eligibility criteria proposed, is likely to result in only a very small proportion of the SMSF population being eligible for the three-yearly audit cycle. We do not anticipate that this measure will be effective in reducing the compliance burden due to a combination of the limitations on eligible SMSFs, potential for an increase in non-compliant funds and the doubtfulness of costs savings in the audit accruing.

The proposed “key events” which trigger an annual audit when the SMSF is in a three-year audit cycle, could create unintended consequences and increase the compliance burden. Certain key events, such as the death of a member, could occur unexpectedly or the trustee may overlook that certain events have occurred which trigger an audit. If the key event occurs at or close to year end or the trustee doesn’t realise the audit has been triggered, they may find it difficult to engage an auditor to conduct a timely audit and it may create unreasonable pressures on auditors to conduct additional audits which they had not planned for in foreshortened timeframes. Time pressures have a negative impact on audit quality. If a trustee does not realise that an audit has been triggered until the time they submit their SAR and so fails to obtain an audit, this will create additional administration for the ATO and a contravention for the trustee. This unpredictability will make it difficult for auditors to plan for SMSF audits and to ensure they have sufficient resources to meet client needs.

We are also concerned with the potential impact on the integrity of the SMSF segment. The Australian Taxation Office has effectively outsourced a large part of the annual regulatory monitoring of SMSFs to the SMSF auditors. An annual independent audit ensures significant contraventions are identified, reported and rectified in a timely manner, providing an incentive for trustees to operate within the law and a safety net for those inadvertently contravening the requirements. Conversely, a longer audit period provides greater opportunity for potential abuse of the system and for greater illicit gain. A three-year audit period would result in any contraventions, inadvertent or otherwise, being more costly and time-consuming for trustees to rectify, and may expose trustees to more severe regulatory penalties.

A three-year cycle may also diminish the value of the ACRs to the ATO. If auditors were only identifying and reporting contraventions when they are engaged every three years the timeliness of the ACRs would clearly be lost. It would also result in many more rectified contraventions being reported for little regulatory value. The flow on effect to the ATO’s compliance program will be less reliable data when it is based on the SMSF Annual Returns (SARs) that will be unaudited for two out of every three years.

In a similar vein, Registered Tax Agents have shared their concerns regarding the risks associated with lodging SARs based on unaudited financial statements. Feedback from SMSF administration firms, tax agents and auditors indicate that many of them will encourage clients to continue having their SMSFs audited annually to provide greater confidence in their annual financial statements and identify and rectify errors and contraventions in a timely manner, which will minimise additional expense. Members have also advised that many of their clients intend to continue with annual audits for the same reasons.

Chartered Accountants ANZ and CPA Australia also hold concerns regarding the potential risk to auditor independence if auditors are pressured to turn a blind eye and not report contraventions in order for a SMSF to obtain a clean bill of health in order to become or to remain eligible for the three-year audit cycle, if it is seen as beneficial.

The eligibility criteria and key events proposed in the discussion paper may limit the uptake of three-yearly audits and so minimise the potential impact on SMSF auditors' workflow. However, if there is a large take-up of the three-year audit cycle there is a real risk the variable workloads and flow-on effect on revenue will make it difficult for audit firms to manage staffing levels and may see many auditors exit the sector, resulting in future supply shortages and upward pressures on audit fees.

In addition, regular engagement with an SMSF auditor provides benefits beyond the compliance and financial checks for trustees. Auditors identify minor contravention issues before they become significant, provide preventative advice and play an educational role. The annual audit cycle provides a regular check on financial advice provided to SMSF trustees by reducing the risk of inappropriate strategies resulting in SMSFs contravening superannuation law.

Our responses to the specific questions asked in the discussion paper are contained in the attachment to this letter.

If you have any questions regarding this submission, please do not hesitate to contact Michael Davison (CPA Australia) at michael.davison@cpaaustralia.com.au or Tony Negline (Chartered Accountants ANZ) at tony.negline@charteredaccountants.com.au.

Yours sincerely

Craig Laughton
Executive General Manager
Policy, Advocacy & Public Practice
CPA Australia

Simon Grant FCA
Group Executive - Advocacy, Professional Standing & International Development
Chartered Accountants Australia & New Zealand

Attachment: Chartered Accountants ANZ and CPA Australia's responses to the consultation questions

1. How are audit costs and fees expected to change for SMSFs that move to three-yearly audit cycles?

Anecdotal feedback from members suggests the proposed measure is unlikely to reduce costs for the majority of SMSFs. Auditing of an SMSF involves the examination of balances at each year end and transactions throughout the period to determine if they have been accurately recorded in a fund's financial statements as well as assessing whether the SMSF has been compliant with a myriad of requirements in the superannuation legislation throughout the period.

A large number of our respective members told us unequivocally that the process to complete both the financial and compliance audits for a 36-month period of time will be more expensive than three 12 monthly audits because it will be more difficult to obtain the evidence for the single, longer time period. Documentation and explanations will not be so readily available, particularly from external sources, going back three years or further, depending on the timing of the audit work. Material errors or contraventions identified during the audit may have existed for up to three or more years and may result in greater administration and cost for the auditor to advise on rectifying the matter than if they had been identified in a timely manner. At best, the measure may be a potential cost deferral and, as we note above, may actually lead to higher audit fees.

Feedback from SMSF administration firms, tax agents and auditors suggest many of them will encourage clients to continue having their SMSFs audited annually to identify and rectify mistakes and contraventions in a timely manner, to minimise additional expense and ensure confidence in their annual financial statements. Members have also advised that many of their clients intend to continue with annual audits for the same reasons.

Many of our members have advised that they will be required/obliged to perform their own "unofficial" financial and super law compliance audit before submitting a fund's annual return during a three-year audit cycle. The additional time required to perform these functions will be charged to clients.

It is our expectation that some eligible SMSF trustees will elect to initially use the three-year audit cycle believing they will save time and money. However, after moving through one three-year audit process we expect many of them will elect to voluntarily revert to annual audits if they have not benefited from any cost or time savings.

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

It is proposed that "a SMSF with a history of three consecutive years of 'clear audit reports' [would] be defined as a SMSF without any financial or compliance contraventions issued in an ACR in the previous three years".

CA ANZ and CPA Australia agree this is a straightforward approach, which is workable if a new requirement is introduced to require the ACR to be provided to the trustee. The shortcoming of the proposed approach is that trustees are required to self-assess their eligibility for a three-year audit, however auditors are not required to provide the trustee with ACRs which they submit to the ATO. Consequently, the trustee may not be aware that an ACR has been lodged and so their SMSF is not eligible.

In addition, it is important to appreciate that not all contraventions identified are reported via the ACR. Feedback from members suggests as many as 30 or 40 per cent of funds have minor contraventions that fall below the ACR reporting thresholds, but these contraventions would still be relevant to meeting the requirement for a good compliance record.

To ensure funds with a good compliance record are appropriately identified, we suggest the definition of 'clear audit report' should also include no qualified audit reports being issued to the trustee in the preceding three years, along with no ACRs being issued.

However, we also have major concerns with the reliance on ACRs. The ATO is a compliance regulator, whose function is to ensure that SMSFS comply with the superannuation laws. A key part in the ATO's compliance approach is the external surveillance of the sector provided by ACRs. The ATO uses this important data to determine if it needs to conduct its own examination of a super fund.

The clear impression we have gained from the ATO is that the majority of the ATO's compliance activities are likely to be initiated via ACRs. Given the important function these reports play in ensuring the integrity of the SMSF sector, we find it unusual that the government would institute a policy that would see the ATO potentially receive less timely ACRs.

Chartered Accountants ANZ and CPA Australia are also concerned about the threat to auditor independence if ACR lodgement is a key criterion for funds to be eligible for a three-yearly audit. We hold this concern because fund administrators and trustees will have an incentive, if they perceive cost savings are possible, to dissuade an auditor from lodging a contravention report for lineball contravention issues being reported to the ATO.

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

If the definition of 'clear audit reports' is not having an ACR lodged or audit report qualified in the preceding three years, for consistency purposes timely submission should be defined by a SMSF not having submitted a late SMSF Annual Return (SAR) in the last three years.

Provisions would have to be made to recognise situations where a SMSF trustee or tax agent may have successfully sought a lodgement extension from the ATO. Similarly, lodgement extensions would have to be provided where the last-minute lodgement of a SAR is rejected due to the requirement of an annual audit being identified close to lodgement deadline.

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?

In addition to the examples proposed in the discussion paper, we believe the following situations also represent significant compliance risks that should be considered key events:

- Any large percentage change in asset size
- Any large withdrawal, e.g. on retirement
- Any pension that is not an account-based pension
- Any situation where SMSF trustees are not fund members, for example, appointment of an enduring power of attorney, alternate director, guardian or parent acting for a minor
- Investments, loans or leases with or in a related party – this would include a LRBA because the asset is held in a related holding trust
- Overseas investments including shares and real estate
- Divorce or separation of spousal members until the Family Court finalises separation and the financial settlement in relation to the SMSF has been completed
- Early release – such as permanent or temporary disability/ disablement, compassionate grounds or financial hardship
- The payment of any life insurance claim to the fund
- The use of any reserve or suspense account
- Winding-up of a SMSF

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?

If the measure is proceeded with then yes, arrangements will be required to manage the transition to minimise the impact on SMSF auditors' workflows. Any transitional arrangements should be determined following careful analysis of ATO data to ensure fund eligibility is distributed over each year of a three-year cycle.

As an example, those with the longest period of time that they have submitted SARs on time and not had a compliance breach of their fund should be the first to offered triennial audits. At any one time, no more than one third of eligible funds should be offered triennial audits. In the first year of operation of triennial audits, funds who have lodged their SARs on time and had no compliance issues may be eligible. In the following year, it may be funds who have lodged on time for between five and eight years and not had compliance issues for that period of time may be eligible, and in the last year all remaining eligible funds would be eligible.

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

Notwithstanding our belief that this proposed measure will not meet its stated policy intent, the following issues should also be taken into account if it were to proceed:

- How do registered SMSF auditors maintain their currency to be registered if they are auditing a smaller number of SMSFs each year or only once every three years? ASIC may need to reconsider its registration requirements or there may be a reduction in the auditor population resulting in supply shortages and fee increases.

- Similarly, the three-year audit cycle introduces variable workloads and revenue for auditors, so some may exit the sector, the net result may be future supply shortages and upward pressures on audit fees. In addition, because of variable or potentially unpredictable workflow, coupled with significantly higher ASIC registration fees being introduced with the ASIC industry funding model, fewer auditors may be attracted to the sector which may lead to similar outcomes.

- The Cooper Review considered the Parliamentary Joint Committee recommendations and rejected them. What has changed in the meantime to warrant a shift to three-yearly audits, especially as no individual or organisation requested this amendment in their 2018 pre-budget submissions?

- A three-year cycle may diminish the value of the ACRs to the ATO. If auditors were only identifying and reporting contraventions when they are engaged every three years the timeliness of the ACRs would be lost. It would also result in many more rectified contraventions being reported for little regulatory value. There may also be a flow on effect on the ATO's compliance program when it is based on data from the SMSF Annual Returns (SARs) that will be unaudited for two out of every three years.

- Many SMSF trust deeds require annual audits to be performed. Utilising the availability of a three-yearly audit cycle would require the additional expense for trustees to amend their trust deeds.