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HillsAudit

To

Division Head

Retirement Income Policy Division

The Treasury

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Dear Sirs,

RE: three yearly audit cycle – discussion paper – comments

as requested in the discussion paper released last July, please find my comments below.

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

Audit costs and fees for SMSF trustees that move to three yearly audit cycle are expected to remain the same or increase.

A – As the treasury made clear in a recent correspondence to the industry, a three-year audit cycle means the new proposed audit will need to cover 3 years of operations of the SMSF. There are no logical reasons to expect any decrease in the costs and fees for the audit as the amount of work needed to perform will simply be tripled compared with the current annual audit. The amount of documentation required to collect, the checks to run, the verification processes remain the same for each year, as the auditors still have to comply with auditing standards. Everything will just be tripled as it will become an audit of 3 financial years instead of one

B – in the case of undetected issues/breaches in year 1 or 2, the work of the auditor and the associated costs might more than likely increase due to the following:

- more documentation may be required,
- more time will be needed to determine the nature of possible issues and to suggest possible action to rectify them,
- more time required to liaise with the trustee and the accountant
- preparation of the qualified report, the management letter and lodgement of an ACR if the case.

Furthermore additional fees may be required for the additional work of the accountant as amendments to the financial reports of year 1, 2 and 3 may be necessary.

There are countless examples of how this may happen.
Typical issues are:

- the use of non complying criteria for the valuation of an asset. If the fund is paying (or going to pay) a pension it might cause a breach of the Transfer Balance Cap. If this issue were detected during the 3rd year of the new audit cycle, the trustee may then be required to review 3 financial years and will then incur all relevant consequences in terms of professional fees and possible penalties;

- assets not kept at an arm's length basis with consequent NALI – for example a loan to a related party (but also unrelated) at terms and conditions not at market rates;
- money withdrawn from the fund by members and paid back in the same financial year to provide financial assistance.

2 – Do you consider an alternative definition of "clear audit report" should be adopted? Why?

An alternative definition of "clear audit report" is an unqualified audit report that doesn't include any management letter to the trustee.

A management letter is released by the auditor to recommend changes in the administration of the fund. The auditor releases the letter not only in the case of reported breaches but also when some issues have been identified that, even if not reportable or not material at the time of the audit, if not rectified might lead to breaches and possible negative consequences for the fund. The letter may be referred to the financial or compliance audit. The absence of any management letter means that, from an auditor's perspective, the fund is administered correctly, complying with accounting principles and SIS/SISR.

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

The most appropriate definition of timely submission of the SAR is when a fund has never lodged a SAR late and never with a qualified report.

The reason being that the trustees show that they are fully aware of their obligations and provide the necessary documentation to the accountant and the auditor in a timely manner in order to lodge the SAR within the due date fully complying with the relevant SIS/SISR provisions. It must be pointed out that trustees have more than 10 months to collect all the information and documentation required for the preparation of the financial reports and perform the annual audit; a late lodgement is an indication of a lack of knowledge of trustees' obligations.

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 presents the most significant compliance risks?

The following may be considered key events:

payment of benefits (any kind)
borrowing from non financial institutions
lending to small entities (individuals, small proprietary companies)
a variation of more than 15% in the net asset value of the fund
assets not maintained at arm's length basis – NALI
investments, loans or leases with related parties
existence of a LRBA
conducting a business
changes of members/trustees
new auditor
release of a management letter in prior years

It should be pointed out that any "key event" would be detected only years later.
For example, if a fund is entitled to the 3 year audit cycle and in year 1 invests in a loan to a related party (assuming this as a key event), this will be detected only in year 3 by the auditor, which is actually year 3 + 1 if we consider the SAR lodgement time frame. The accountant might overlook it as it is not a requirement to fully check the investments of the fund. In regards to the trustees, it would be clearly unreasonable to expect them to possess the technical skills required to recognise a "key event" to request the audit of the fund.
The identification of the "key event" would then result pointless.

5 – Should arrangements be put in place to manage transition to three-yearly audit for some SMSFs? If so, what metric should be used to stagger the introduction of the measure?

According to the information provided in the discussion paper, the percentage of SMSFs entitled to the 3 year audit cycle would go from a maximum of 98.4% (if the entitlement depends only from the existence of an ACR), to a minimum of about 60% if other eligibility criteria (like timely lodgements) are to be considered.
In any case SMSF audit firms would see their workload considerably reduced for a number of years.
The most likely consequences will be:

– Staff management.

There will be a huge variation of workload between the first 2 years and the end of the audit cycle. For many audit firms it will be impossible to retain staff during the first 2 years as there will be an insufficient number of audits to perform. The problem will be reversed at the end of the 3 years cycle, resulting in a considerable workload but not enough staff to realistically be available any more. The uncertainty created by the 3 year cycle will make the management of personnel very difficult if not impossible, with the loss of many jobs and the impossibility for many firms to cope with the changes in the market. Junior SMSF auditors will be discouraged by the uncertainty and the discontinuity of work and will probably be encouraged to leave the sector for more secure job prospects.

– Loss of clients for small audit firms.

Part of the auditor job is to provide advice to accountants and trustees in relation to compliance matters. It is not realistic to expect a professional auditor to be available to provide the same level of service to clients that do not need an annual audit and who can change accountant and auditor during the 3 years cycle. Many professionals will be reluctant to provide advice especially if there is a likelihood they will lose that client. This will be detrimental to professional and client relationships.

– Loss of income.

It will be inevitable that audit firms will suffer a dramatic loss of income in the 3 years of the new audit cycle. The audit will be performed only in the 4th year when the fund is expected to lodge the 3rd year SAR. Realistically the loss of income will not be sustainable by the majority of small audit firms. The expectation that the loss of income in the first 3 years might be recovered does not seem to compensate the uncertainty created in the relationship with clients, the difficulties in creating and retaining capable staff and the problems in performing an audit of 3 financial years.

For the reason outlined above many professionals will be forced out of the industry as the loss of income and the difficulties that the new policy implies will make the SMSF auditing not profitable and therefore impossible for the majority of small audit firms.
A more gradual introduction of the policy will not avoid this inevitable outcome.
Would it be then reasonable and fair to consider a longer period of time before the introduction of the new measure, at least 5/6 years, to allow these professionals a reasonable time to exit the industry minimising as much as possible the consequences of the sudden loss of income.

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

A - According to the discussion paper, the proposed changes aim to:

1 – Reduce the compliance burden for trustees
2 – Potentially reduce the administration and audit costs
3 – Incentive a timely submission of the annual SAR

In relation to point 1:

Any reduction of the compliance burden for the trustees will only be apparent in the first 2 years of the cycle as an audit of all the 3 years is still required.
The compliance burden will be even heavier for the following reasons:

– a massive documentation is required to audit 3 years; trustees will find it more difficult than usual to collect and provide the necessary documentation to the auditor; the work of the auditor will be longer and

more complex as multiple years will have to be checked and more explanations will be required from the trustees.

- In the case of undetected issues in the first 2 unaudited years, the relevant compliance matters will be much more perceivable by trustees as actions will have to be taken to rectify the issues.
- Trustees and accountants will have to liaise with the regulator in order to minimise consequences, discuss possible penalties, lodge amended returns where necessary adding complexities that could have been avoided if detected earlier.

In relation to point 2

There is no logical reason why the administration costs should be reduced for trustees.
The administrators/accountants will have to do the same usual work and there is no reason why they should reduce their fees.

In regards to the audit fees, the audit of the three years is still required and, as mentioned previously, in order to comply with relevant audit standards and regulations, there are no reasons to assume that a reduction of audit fees can occur as the same amount of work is required for each year.

On the contrary, the complexity of a 3 financial year audit, with the possibility of undetected issues occurring in the first 2 years, will require more time, more attention, more documentation and realistically an increase in the audit fees. Furthermore, there may be the likelihood of additional accounting fees if any further work is required by the accountant to rectify undetected errors or breaches.

It should be also noted that the most probable disappearance of small audit firms caused by the introduction of the new policy might create a less competitive market as only the biggest and most financially capable organisations will remain operating in the sector. Hence if there will be less competition audit fees will probably rise in the years to come, causing exactly the opposite effect that the policy is trying to achieve.

In relation to point 3

The assumption that the annual audit is the cause, or one of the causes, of the SARs late lodgements seems irrational.

After the end of the financial year, trustees have more than 9 months to collect and provide the necessary documentation to the accountant for the preparation of the tax return and to allow the auditor to perform the annual audit. In the vast majority of the cases, the turnaround time for an audit is a few days, sometimes just hours if the work of the auditor is assisted by direct data feed or dedicated software.

B- integrity of the SMSF sector

The stakeholders of the super system in Australia, of which the **SMSF sector is about 30%**, are not only the trustees, the professionals and the other operators involved in the industry, **but Australians as a whole**. The SMSF sector is designed to allow individuals to create and manage their own retirement resources in order not to represent a burden for the Country. The annual audit exists to avoid and prevent abuse of the system and to maintain it's integrity.
Like in the listed companies sector, the annual audit provides protection to investors but it also contributes to maintain trust in the financial markets.

To allow trustees to self assess their entitlement to be exempt from the annual audit, even if temporarily, derives from the assumption that some trustees deserve it as they have been compliant for a certain period of time.
The proposed changes do not consider that those trustees have been compliant also *because* of the annual audit requirement and the work of auditors.
It is therefore not unreasonable to assume that without an annual audit it may be easier for trustees to find some way to misuse the fund's resources.

The possible misuses and abuses of a SMSF are endless.
Just to name a few:

- use the fund as a cash reserve, having the possibility to withdraw money and to repay it within the 2 years unaudited time frame
- manipulate the valuation of assets, typically unlisted unit trusts (related/unrelated) and properties in order to minimise the value of the pension accounts and relevant taxation
- lend fund money to a related party not at an arm's length basis

The possible objection that those breaches would be identified at the end of the 3 year cycle do not look convincing as the SMSF will be in any case perceived as an entity fully manipulable by trustees.

For example:

Fund X is entitled to the 3 years audit cycle starting from 01/07/2019.
In September 2019 the fund invests in a loan to a related party at an interest rate well below the market rate.

The 2019/2020 SAR will be lodged in 2021 unaudited
The 2020/2021 SAR will be lodged in 2022 unaudited
The 2021/2022 SAR will be lodged in 2023 audited
The breach that occurred in the 2019fy is identified in 2023fy.

The breach will be identified 4 years after it occurred.

Other important consequences would derive by unintentional errors of the trustee and his advisors.
It is important to mention the recurrent issue of assets not properly held in the name of the SMSF and as such exposed to the action of the creditors of the trustees.
If the asset is acquired in year 1 or 2, the issue might be overlooked till year 4 (the actual time of the audit) when it might be too late to rectify it, especially if trustees run a company and is exposed to business risks.

C – Added complexities to a sector already burdened by new legislation in the last years

Many phases to make the proposed changes operating show unresolved complexities

I – what entity or professional will be in charge and/or responsible to verify the trustees self assessments? Accountants and auditors will be the first to be asked for advice by the trustees; what is their role in this self assessment process? Will they be held responsible to report to the regulator if they become aware that trustees have made errors in their self assessment? What is their legal responsibility in case trustees request their advice?

II – A fund entitled to the 3 year audit cycle might lose this concession for many reasons.
Who then will decide and when the fund should be audited again in the ordinary annual way? The accountant might be aware that a “key event” occurred but well before the SAR is lodged. Will the accountant be responsible to report it? A late lodgement might be planned by the trustees to postpone the “official” identification of the “key event”. Will the ATO be the entity in charge of maintaining a register of funds entitled or not entitled to the 3 years audit cycle? would not this add costs to the management of the industry?

III – In the first 2 years of the cycle audit firms specialised in SMSF audit will lose at least 50% of their income (as a minimum) due to the introduction of the new time frame. The retention of skilled personnel will be impossible as the cost would be prohibitive. A large number of operators will be pushed out of the industry, including those in the process of becoming registered SMSF auditors. Audit firms will be forced to outsource the audit services to overseas companies with an inevitable decrease in the quality of the audit and to the detriment of the sector.

IIII – The vast majority of the 600,000 SMSFs are administered by non professional SMSF administrators, typically tax accountants. During the financial year auditors provide an invaluable compliance and technical advice to trustees and accountants in order to avoid issues, maintain the fund fully compliant or rectify breaches when necessary. Before any important operation (paying a benefit, complex investment schemes, etc.) auditors are usually requested to express an opinion whether there might be any issue in the planned operation. The professional fees for this advice are in the vast majority of the cases included in the audit fees requested for the annual audit and is part of a healthy professional relationship between accountant, auditor and trustees. It is therefore not realistic to believe that this relationship can be maintained if funds will not pay any fees for 3 years (considering the lodgements time frame). Many accountants and trustees will be deprived of essential advice. This will inevitably contribute to the detriment of the sector.

V – a recent NSW Appeal Court decision (Bear vs McGoldrik) found an auditor responsible for the losses suffered by a SMSF due to his lack of diligence in informing the trustees of the bad quality of the investment that caused the losses. The Court decision put an accent on the professional duties of the SMSF auditor and its essential role in the protection of the SMSF's assets. The proposed 3 years audit cycle appears to contradict the Courts' decision and the principles that inspired it.

Kind Regards

17/08/2018

The Director

Ivano Laureti