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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

I provide this submission in relation to the above proposal and the discussion paper issued by Treasury in July 2018.

I have operated a specialist SMSF audit practice since 2007. However, I have been involved in many aspects of the superannuation industry since 1993 when I started working at the Insurance and Superannuation Commission. Since then, I have worked for banks, investment managers and public-sector superannuation funds. However, in 2007 I set up my own practice and have been auditing SMSFs exclusively for the past 11 or so years. In that time I have contributed to the superannuation industry in that I co-wrote *GS 009 Auditing Self-Managed Superannuation Funds* for the Auditing and Assurance Standards Board. I feel with my balance of policy, practical and long term experience, I have the requisite knowledge to comment on the proposed measure.

With respect to the policy proposal and the consultation question, I feel that others will have made long submissions on the potential mechanics of the introduction of the three-year audit cycle. Having had the opportunity to contribute to a number of submissions, I do not feel that I can add much weight to the mechanics of the potential introduction and how it would work. My submission will be directed to the last consultation question around what else should Treasury and the Government consider with respect to this proposed measure.

Yours faithfully

Lewis Walker CA

Background

The discussion paper seeks responses to the proposal on the measure announced in the 2018-19 Budget to change the annual audit requirement to a three-yearly requirement from 1 July 2019 for SMSFs with a history of good record-keeping and compliance.

The discussion paper states:

"The objective of the measure is to incentivise good record-keeping and compliance by SMSFs whilst maintaining system oversight and integrity.

Under this measure, audits conducted for SMSFs on a three-yearly audit cycle will cover all of the three preceding years, maintaining integrity within the SMSF sector. SMSFs that do not meet the eligibility criteria will not be eligible for a three-yearly audit cycle and will continue to be annually audited."

The paper contains six questions on which Treausry are seeking feedback.

These are:

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

The final question is:

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

I consider that many other practitioners will have done quantitative studies and surveys on the pros and cons of the proposal and these are very valid and valuable but they are focussing on the mechanics which should be considered but it is the fact that the proposal should be dismissed as folly and dangerous to the integrity of the SMSF sector and hence if the proposal was to be rejected the preceding questions should be ignored. However, if the proposal was to succeed, then those questions would be relevant and those who have done much quantitative study would have more valid input.

Other issues to consider

1. **The annual audit underpins the SMSF sector's integrity and protects the broader superannuation sector from incorrectly contributed amounts**

The stated policy objective, as espoused in the discussion paper is:

"The objective of the measure is to incentivise good record-keeping and compliance by SMSFs whilst maintaining system oversight and integrity."

The ATO have stated that in their view that:

"approved SMSF auditors have a critical role in helping to maintain the health and integrity of the SMSF sector through the annual audit of each SMSF."

I believe that the annual audit of the financial statements and compliance for every SMSF is the cornerstone of maintaining the SMSF sector's integrity.

SMSF auditors act as gatekeepers for the superannuation sector checking the integrity of the money going into the system and the appropriateness of any money exiting the system. They also check that money rolling over to an APRA fund or exiting the superannuation system is legitimate superannuation money. Importantly, they also ensure that the SMSF assets are appropriately managed whilst in the SMSF. Removing the gatekeeper for long periods will undermine the integrity of the system, potentially allowing inappropriate money in and letting money out too early. This would, in my view, undermine the integrity of the whole superannuation system.

2. **The total cost of the proposal, incorporating all the factors such as tax, audit fees, accounting fees, financial planning fees and administration fees should be taken into consideration when considering this proposal**

The cost of the proposal needs to take into consideration all costs, not just the cost of the audit. It is short-sighted not to view this proposal in its entirety when looking at costs in terms of time and money. Hence, prior to changing any legislation, consideration would need to be given to the impost upon the accountant or administrator putting together the interim Year 1 and year 2 accounts. Their time would increase as additional checks would be required to ensure that the fund was complying. Likewise, administrators would have the same issue. Financial planners would need to do some preliminary checking prior to recommending any strategy to ensure that the fund was complying and able to undertake the strategy. The notion of taxation is discussed in the next section as it is so important.

3. **Errors affecting the taxation impost upon the fund**

The Three year audit cycle poses many risks to Trustees, some of which could undo any of the proposed benefits.

With respect to tax, the Exempt Current Pension Income (ECPI) deduction is a major deduction for any fund in pension mode. If a fund member were to short-pay a pension in year 1, the pension would be deemed to have stopped in year one and any payments in year 2 and 3 would be lump-sum payments. Thus the fund would lose its ECPI deduction for all years. This would cause the accounts to be recast for years 1 and 2, the SAR would need to be re-lodged for both years. Further, the auditor would need to review the accounts again before issuing an audit opinion on years 1 and 2. However, most important is that the Trustees would be thrown from a refund position to a position where they would have to repay tax to the ATO and this would probably be in the multiple of thousands for most funds.

With respect to costs, the potential for errors and the effect and quantum of these are errors are so significantly large as to dwarf any potential benefit. This is best illustrated by example:

- In Year one, a 65 year old member at the beginning of the year with $1m in shares with $60,000 of dividends and imputation credits of $25,000 only takes $40,000 rather than the required pension drawdown of $50,000.
- The reason for the shortfall was that the member turned 65 in the previous year and didn't realise that the minimum pension drawdown percentage had gone up to 5%. However, this goes unnoticed due to either ignorance of the law or the poor advice.
- The $10,000 short-fall is bigger than 1/12th of the minimum pension so the Trustee can't take advantage of the Commissioner's General Power of administration powers and self-assess that the fund has met the minimum. Consequently, the pension would cease from the beginning of the year and the fund would lose the exempt current pension income (ECPI) deduction.
- In Year two, having realised their mistake they think they are making another pension payment of $60,000 – the $50,000 and the $10,000 catch-up, thinking they have satisfied the minimum

pension amount, they lodge the return, collecting a refund of another $25,000 of imputation credits.
- In Year 3, they make another $50,000 pension payment, expecting a refund of another $25,000.
- When the auditor goes back and discovers the short payment in Year 1, the news is that in light of the ceased pension, the pension is deemed to have ceased and the fund will lose its ECPI deduction for years 1, 2 and 3..
- In light of losing the ECPI deduction, the accounts need to be redone for two years. The Self-Managed Superannuation Fund Annual Return would need to be re-lodged with correct figures and the Trustee would be required to pay back $50,000 to the ATO along with any interest penalties. Further, the fund would have lost another $25,000 refund of imputation credits.

The result is very unhappy Trustees with a debt to the ATO of $50,000 and accountants or administrators who are in danger of losing their client. The auditor would also be in the bad books for just doing his/her job.

However, this would be a good outcome for the Treasury as the extra $75,000 is a bonus or a $150,000 turnaround.

Overall, the proposal appears to be looking at the short term benefit of not paying $400 to $600 on a plain vanilla audit in order to save a notional bit of time and a notional couple of hundred dollars overall. The consequences of the proposal should consider all the costs of not having any regular oversight, be that accounting, financial planning, investment management and taxation as well as audit cost. Of all the costs considered, getting taxation wrong could be a hundred-fold bigger than scrimping on an annual audit fee of $500 and this point seems to be ignored.

Trustee will make mistakes and they will be costly if they are missed in Year one or even in Year Two.

The annual audit would pick up this pension shortfall, thereby ensuring that Trustees weren't disadvantaged in at least Years 2 and 3. However, if no audit was performed they would be seriously disadvantaged when it came to the audit at the end of the 3 year cycle.

4. The audit underpins Trustees confidence in the sector

The annual financial and compliance audit is critical to maintaining the integrity of the system as it underpins Trustees confidence in the system and asserts, to the extent an audit can, that the member's assets are there, the income was as stated in the accounts and that the fund members and trustees have conducted the fund in a complying manner and; importantly although not formally required, that the taxation calculation is correct.

Trustees on the whole, are getting older and as they get older, they need more protection from their own errors and require more hand holding to continue to invest in their SMSF. Trustees take comfort from the fact that another, independent set of eyes are looking out for their interests and the cost of an annual audit is not so prohibitively expensive to give comfort.

5. The annual audit protects the taxation concessions provided to superannuation funds

Superannuation benefits are constructed from two sources contributions and earnings. Balances are enhanced by special taxation treatment whilst in accumulation that contrive to grow the balance and then in drawdown mode, the balance under $1.6million is treated with a bonus zero taxation rate. The special taxation treatment is a major contributor to the overall balance and to the retirement incomes policy of endeavouring to have more people self-finance their retirement and reduce their reliance on a part or full aged pension entitlement. In providing this special taxation treatment, the Government and public give up considerable taxation revenue which could be spent

on other things. This concession is a huge Budget measure and needs constant oversight to ensure that it is not being abused.

Removing the annual audit can lead to those valuable taxation concessions being abused by unethical or ill-informed trustees using the funds in their SMSF for early release of benefits or providing loans to related parties, provision of financial assistance et. In itself these actions unjustifiably discriminate against the bulk of Australians who behave well in their own SMSF or industry fund or retail fund. Removing the annual oversight, simply provides unscrupulous trustees the opportunity to abuse the system for a period between audits at the expense of the Australian public.

6. Costs of Deed Upgrade

A good number of Trust deeds require annual audits. If the proposal was to be implemented the deeds would need to be updated to reflect this change and this would be expensive and time consuming.

7. The onus for compliance will move to the accountant or financial planner

Registered SMSF auditors have accumulated great experience in SMSFs, in superannuation law and are adept at finding things out – good or bad about a fund. Registered SMSF auditors provide a vast resource to the accountants and financial planners who rely on them for high level advice and guidance and to keep Trustee in check.

SMSF auditors acts as a key reference points for accountants and advisers. This is particularly so when the Trustee is embarking on a transaction that the accountant is uncomfortable about, perhaps because they are unfamiliar or too conservative, and the accountant does not want to have a hard conversation with the potential to lose an over-ambitious client. Accountants call on auditors to be the "bad cop" with the expression being "I'll see if I can get it by the auditor" being a common phrase in client meetings. Auditors are either the first or second line of defence against wanton and ill-advised strategies and misbehaviour by SMSF trustees. They get in early to address potential compliance issues before they are even an issue.

ASIC registered auditors are required by law to be independent by virtue of compulsorily having to follow APES 110 *Code of Ethics for Professional Accountants* (which is the standard on Integrity and objectivity as issued by the Accounting Professional Ethics & Ethical Standard Board). Accountants and financial planners are not so hamstrung by their ethical obligations and may bend the rules to retain or even attract other clients. Auditors are bound to be independent, the same cannot be said for the accountants and financial planners. It is to those people that compliance falls to in the interim period if the proposal were to succeed.

8. Remove the need for actuarial certificates

If Treasury was looking to remove red tape, it could easily do this by approving Class Super and BGL 360's software algorithm that provides an estimate of the ECPI percentage, thus removing the need for actuarial certificates for these funds and providing incentives for trustees and accountants to move to more sophisticated software.

If Actuarial certificates were removed, that would be a significant saving of around $30m a year. This figure is is based on say, 300,000 fund in pension mode, multiplied by a notional $100 per actuarial certificate.

Most of the larger Actuarial Certificate services are automated and the Actuarial Certificate appears to be automatically generated at the push of a button.

9. Measures to increase compliance with "Notice of Intent to Deduct"

The ATO have noted and it was in the Budget papers that some unscrupulous individuals are utilising a reporting loophole to avoid paying tax on concessional contributions. Thes "Noite of Intent to Claim" is a well abused loophole which the Budget papers cost nearly $500 million a year. It would not be difficult for the ATO to modify the auditor's responsibility to ensure that the s290-170 noticies under the Tax Act are signed and the correct amount in the correct box on the SAR. Thus ensuring that the any deduction attributable to the concessional contribution is at least taxed in the fund. Currently auditors are not required to check this but do so as a check of the SAR to ensure that the Tax position of the fund is not incorrectly stated.

10. Risk of permanent loss of skills and Australian jobs via off-shoring the audit function

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.

If the proposal were to get up, a good number of auditors would leave the industry as they could not survive for a two to three year period with no work. The loss of that intellectual capital would be devastating to the Australian economy and the retirement income sector. The loss of the "bad cops" would mean that accountants would be less likely to resist the overtures of ambitious clients, thus undermining the sector's integrity.

Conclusion

In conclusion, with an ageing base of SMSF members and trustees, the potential for errors increases every year. Fundamentally, the annual audit assists with keeping Trustees on the straight and narrow, picking up errors in a timely manner so that they may be rectified and helps protect their retirement nest-eggs. Removing this annual health check for funds is short-sighted and ultimately of little to no benefit to Trustees and will ultimately, potentially, cost them significantly more than what they could possible save whilst at the same time reducing the integrity of the sector, potentially irreparably.