RESPONSE TO DISCUSSION PAPER JULY 2018
"THREE YEARLY AUDIT CYCLE FOR SOME SELF-MANAGED SUPERANNUATION FUNDS"

Rex Walker **31 August 2018**

Release in July 2018 of the Discussion Paper *Three-yearly audit cycle for some self-managed superannuation funds* followed an announcement in the May 2018 Federal Budget in regard to the notion of offering relief to the SMSF sector. The Budget Papers provided no detail other than to make the announcement on the basis of reducing red tape and the compliance burden. Subsequent and various representations and discussions with government has been met with release of the discussion paper.

The SMSF environment

Any consideration of the compliance arrangements for SMSF's must be made with reference to their scale, risk characteristics and the environment in which they operate.

The self-managed basis of SMSF's poses a very high inherent risk. Recent statistics tell us that more than 580,000 SMSF's hold $712 billion in assets. Those funds will be operated by two to four trustees in an individual trustee structure, or one to four directors in a corporate trustee arrangement. The trustees are responsible to comply with considerable and complex superannuation, tax and trust legislation. Prior to their appointment, trustees are not required to satisfy any more than a fit and proper person test and to declare that they understand the essential tenets of Super Law. Most commonly, trustees rely in the first instance on advisors to operate the SMSF's in a compliant manner. Having regard to the highly adverse findings of the recent Royal Commission into Financial Services and ASIC Report 575 on Quality of Advice and Member Experience, it is evident that the inherent risk of SMSF's can be assessed as high.

SMSF's are distinguished from public offer and industry funds, as it is not trained staff, but the trustees who operate the bank account and deal with the acquisition and disposal of investments. Further, in my experience, the majority of SMSF's operate an "any trustee to sign" authorisation on the bank accounts. Due to their limited size, it is impractical to maintain an effective internal control environment. The most effective internal control available is the arrangement of multiple bank account signatories, which is a control that most SMSF's don't operate.

Financial and lifestyle influences and pressures arise at a point in time and past behaviours are not a predictor of future behaviour. Opportunity is a major risk associated with the concept. Human nature says that where self-serving gain is available, the greater the incidence of wrongful acts. Arguments that perpetrators will eventually be caught should be weighed against the expected rise of public exposure and ultimate confidence in the government as regulator and the SMSF sector.

Risks contemporarily exist in Australia from increasing fraudulent behaviour, scammers, spruikers, speculative high-risk investments, drug addiction, gambling, business financial stress and high levels of personal debt.

It follows that the total risk associated with SMSF's is at a level of exposure that, when operating under significant and complex regulatory requirements, warrants a commensurate level of scrutiny. Based on the foregoing, the three-year audit cycle is counterintuitive to these conditions and I maintain that an objective, competent and regular audit review is essential.

The underlying proposition of benefits

This submission examines the propositions made in the Discussion Paper and their basis. It is reasonable to expect that, because any initiative or change should meet a test of sensibility or need, be it economic, utility, disclosure and/or other imperatives.

Cost saving benefits in the Discussion Paper have been largely inferred, with no analysis or specific detail included as to how savings are the expected to accrue. Similarly, there is no articulation of the administrative tasks or any other benefit by reference to the SMSF audit process. On the basis that under the proposal, an SMSF must prepare annual accounts and lodge an Annual Return with the ATO, an examination of the tasks required of a trustee in relation to the annual audit finds that any benefits are minimal and it follows that the envisaged relief from "red tape for trustees" is negligible.

During the annual audit process, trustee involvement is generally limited to the signing of an engagement letter, representation letters and in some instances confirmation letters. When a fund is submitted for audit, dealings in relation to the supply of further explanations, documents are all but exclusively with the fund's appointed accountant. The most common reason that the trustee will become involved during an audit is when the accountant has not obtained the expected documentation. That is, their involvement is not by reason of the audit, but by the auditor identifying that necessary records were missing. In essence, there is little in the annual audit process that could reasonably be described as a compliance burden to the trustees.

The compliance burden derives from the regulatory requirements of the legislation and it has no connection with the timing of the annual audit. Under the proposal there will be no change in the obligation or the timing of the trustees' requirement to comply with the Superannuation, Taxation and other applicable legislation. Annual financial reporting and annual compliance tasks such as review of the fund's investment strategy and insurance needs, preparation and lodgement of the SMSF Annual Return, which incorporates the annual tax return, would continue the proposal as it does now under. Typically, trustees engage professionals in relation to preparing much of the administrative and taxation documentation and returns, including lodgement of the Annual Return. These constitute the compliance burden, not the audit of it. While Superannuation legislation does require an annual audit, the proposed change contemplates a time-shift of the requirement of an annual audit, which does not constitute relief from it.

This submission concludes that the assertion that the proposed measure will reduce the compliance burden is ill-founded in my opinion.

Commentary: Cutting red tape and the potential for cost savings

I express disappointment at reference to the audit of SMSF as being part of "red tape". This is irresponsible, disrespectful and it denigrates the important function that the audit function serves in the sector.

The Discussion Paper refers to a potential reduction in administrative costs and audit fees, but it does not indicate the basis for the reduction. Over many years of conducting audits of SMSF's, experience has demonstrated, almost without exception, that the audit of multiple years involves

more time than would have been involved, had the audits been completed year-by-year. This was largely due to the time involved in identifying and requesting documentation necessary to complete each audit. The supply of supporting detail in this manner results in a less efficient audit, because of a stop-start process. Errors requiring correction to the accounts have flow-on effects, which add to both the accounting/administrative cost and the audit cost.

The nature of certain supporting documentation can be of such importance to audit verification of compliance that when it cannot be produced, an Auditor Contravention Report is required. This can also be the case when for instance, a timely valuation has not been obtained.

Trust Deeds are prepared in a multitude of ways and I would expect that some are written in such a manner that some trustees would be faced with the need to amend the trust deed, should they be eligible and wish to opt in to the three-year audit arrangement.

In my experience, a three-year audit cycle will have the effect of increases in administrative and audit costs in many cases and I do not consider that savings in any amount would accrue.

I submit that the practical effect of introducing the three-year audit cycle would not realise any savings to trustees in relation to time and cost. However, the introduction of any model necessary to administer a three-year audit cycle will generate an inordinate amount of “red tape” and it will introduce new costs to the sector. Trustees, the ATO, advisors/accountants and auditors would variously become involved in a range of tasks not previously required. Logically, these costs will flow back to the SMSF’s and the new cost burden will be far less welcoming than the prospect of time-shifting audits.

Eligibility for Three-Year Audit Cycle

The paper contemplates a self-assessed basis to qualify for access to the three-year audit cycle. A range of possible key events are listed, which, having regard to their high risk of failing compliance, which would disqualify eligibility for the three-year audit cycle.

The task of self-assessment presents potential adverse impacts at various levels. In my experience, the ability of trustees, and in many cases appointed administrators, will not reliably correctly identify a key event. An opportunity to avoid audit scrutiny for a period might be a conduit for non-complying behaviour over a two or three-year period, such as early release of benefits and numerous other requirements, such as those cited below, in the list of key events.

Completing an assessment is a task not part of current processes and consequently it will introduce additional time and cost. This will involve the assessor communicating the qualifying status of a fund among the trustees, administrator, ATO and auditor, including amendments to the status. This would require maintenance of a register of qualifying funds, the eligible three-year period, any changes to that eligibility due to a key event, or due to failure to lodge an SAR on time.

Trustees will feel the financial impact of the assessment, via the new costs of the administrator and the auditor and an expected increase in the ATO Supervisory Levy.

Key Events

The idea that key events contribute to increased risk is supported; audit methodology is predicated on that. However, checklist approaches have limitations in their effectiveness and they cannot be a substitute for professional judgement. For example, an auditor might identify two or more lesser risk events that in combination constitute a significant risk.

In my opinion, the number of key events necessary to approach an acceptable identification of high risk events would reduce the number of qualifying SMSF's to such a low number as to render the proposal untenable.

The overriding concern that I have is that, as much as prima-facie risk factors might be used as a tool to reduce risk in qualifying SMSF's for the arrangement, it will not mitigate all risks. I contend that an absence of independent review for a prolonged period poses an unreasonable risk. I therefore disagree with the assertion that the proposal will, as stated, "maintain appropriate visibility of errors in financial statements and regulatory breaches"

I submit further key events and risks, which are not included in the paper's key events: -

- Valuation of investments

In particular, real property which commonly represents a material investment, the valuation of which is more readily manipulated.

Legislation requires that investments must be carried at market value at year-end. This is necessary to establish the correct year's levels of pension benefit levels; it affects Total Super Balance, which impacts on segregation eligibility, exempt pension income calculation methods and the ability of members to make non-concessional contributions.

- A charge placed over a fund asset

This is prohibited by Super Law and may not be identified unless an audit is conducted.

I cite an actual example in which an SMSF's trustees' bank registered a mortgage on the fund's real property when restructuring their personal affairs. This was unknown to the accountant and discovered by the auditor's title search. An Auditor Contravention Report was lodged with the ATO.

- Investment dealings not complying with the SMSF's investment strategy

Super Law requires that the trustees formulate and give effect to an investment strategy. This is a fundamental document that guides the investing activities, upon which the auditor specifically reports. The trustees are required to establish a strategy at fund commencement, then regularly review the strategy and the investing activities must comply with the adopted strategy. These requirements cannot be verified unless subject to audit. Most non-complying circumstances are considered reportable by an Auditor Contravention Report.

- Acquisition of an investment

In compliance with legislative requirements, a fund's investments must be held separately to other assets. This requires the asset to be held under a title which describes that the trustee/s holds it "in

trust for" (the SMSF). When investments are not kept separately, they are exposed to the risk of claimants on the trustee's personal and/or business assets.

- Meeting the definition of a Self-Managed Superannuation Fund

The annual audit involves verification that changes in the trusteeship do not result in discontinuation of concessional tax treatment and other abilities available to a complying superannuation fund. This can occur when a person becomes disqualified to act as a trustee, which might occur because of bankruptcy or having failed the fit and proper person test by reason of, for example, dishonest conduct.

The above is not an exhaustive list. These and many other items would be necessarily added to the list of "Key Events" to highlight high risk. They are provided as examples of the nature and impact of the numerous ways in which an SMSF might continue to operate in breach of requirements in the absence of timely audit review.

In my experience, key events, or higher risk factors, are not well understood other than by those suitably trained. Accountants primarily have compilation and taxation objectives and they conduct their work looking through a different lens than does an auditor, whose attention is largely on risk and compliance. This is relevant to who is most suited to risk assessing an SMSF and I suggest that self-assessment is inappropriate.

Effect on auditors and audit firms

Transitional arrangements are incorporated in the Discussion Paper, having regard to the envisaged changes to auditors' workflow. This is commended as an essential feature, otherwise the proposal would invoke widespread and major disruptive impact on SMSF auditors, to an extent that I could imagine to be so adverse as to compromise the audit profession's ability to service the SMSF industry.

In relation to how a staggered approach might be implemented, I would suggest dissecting the Tax File Numbers into three groups, possibly by reference to the last three numbers (ie. 000 – 333, 334 – 667 & 668 – 999), each group assigned to a year in the three-year cycle.

Implementation of the proposal would consume audit resources with workflow planning and additional resource management.

Conclusion

This paper contends that the benefits sought by the proposed measure would not be realised. To the contrary, despite a well-meaning intent, it would unnecessarily introduce administrative cost and complication. Those costs would impact trustees, administrators and the ATO. The proposed mechanisms designed to lower risk are considered insufficient, in consideration of the size of the SMSF sector and having regard to the high level of inherent risk. Although additional key risk events could be identified, I believe that the methodology would leave unacceptable residual risk.

The anticipated and inevitable increase in compliance problems will increase costs and degrade the integrity of the sector. Damaged public confidence would reflect poorly on the Government in administering the SMSF sector. The proposal is therefore not in the public interest, nor in the best interests of the trustees of SMSF's. In view of this analysis, I submit that the proposal should not proceed in any form.

I am available to discuss any matter in regard to this submission and the proposal under discussion.

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