

Three Year Audit Cycle for some SMSF's
Consultation paper feedback – Evolv Super



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super audits redefined

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Dear Sir/Madam,

We take this opportunity to provide a submission with respect to the July 2018 Discussion Paper – Three yearly audit cycle for some self-managed superannuation funds.

We acknowledge the Government's focus and commitment to reducing red tape and compliance burden for SMSF trustees where suitable, however it is Evolv's view that we do **NOT** believe that allowing SMSF's with a history of good record keeping the choice to move to a three-yearly audit cycle will benefit the trustees of SMSFs and will **NOT** maintain system oversight and integrity.

We make reference to the Super System Review: Final Report of 29 May 2009.
Paragraph 7.5.1 Timing of audits stated:

“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.”

As a result of both competency standards and independence requirements which have been mandated subsequent to this report, plus other industry forces, the following has occurred:

1. The number of approved SMSF auditors has **reduced** from an estimated 11,500 in 2007, to less than 6,000 in 2018. It is our view that this will continue to trend downwards, particularly with the increased auditor registration fee of \$1,927;
2. The average and median level of audit fees has **reduced** since 2008 which has, by itself, incentivised good record keeping and compliance;
3. The annual SAR lodgement fee is now \$259 which does not incentivise SMSFs.

As a result of the above, we question why the Government has chosen to revisit this recommendation without formal investigation and industry consultation prior to announcing the proposal. We note that SMSFs were excluded from the recent Draft Productivity Report, and we are not aware of ASIC's view on this proposal.

To support our view, we undertook a survey of key participants in the SMSF sector, specifically, trustees, accountants, SMSF administrators & auditors. We received a total of 583 individual responses representing approximately **44,500** SMSF's.

We will use this feedback together with our own observations to now address each of the consultation questions raised:

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

Audit involves the identification of risk and verification of information through sampling a population of transactions. The audit fee normally reflects any complications during the audit process. It is usually only in extremely limited circumstances that economies of scale in audit fees can be achieved by auditing consecutive years of SMSFs at once.

For reasons noted above and discussions with our audit colleagues and clients, it is our view that audit costs and (administration) fees will on average **increase** if this proposal is legislated.

Uncertainties:

1. For those SMSFs qualifying for a 3 yearly audit cycle, is a single audit report required covering all 3 financial years, or alternatively whether an audit report will still be required for each individual year?
2. Will there be repercussions of failing to appropriately self-assess eligibility for a 3 yearly audit cycle? Any monetary penalties will immediately negate any potential cost savings of having a 3 yearly audit cycle.

Certainties:

1. Where errors are identified by auditors requiring amendments to any 3 years of financial statements, the cascading adjustments required to each subsequent financial year will increase both audit costs and administration fees for multiple years, versus one year. Contravention fees for all audit years might also have been avoided.
2. Where changes occur to service providers (accountants, financial advisers or auditors) in the preceding years of the audit being conducted, increased fees will result.
3. Where trustees seek advice to assess their eligibility for the three year audit cycle, they will normally be charged for this service. Advisers will incorporate their liability of being responsible for any penalties in their fees.
4. Where adequate source documentation cannot be located for each audit year, fees will increase and may result in an increase in the lodgement of auditor contravention reports for breaches of Section 35C(2) of SISA.
5. The simple time value of money dictates that wages will increase in future years rather than decrease, and automation is not advanced enough to counter this.
6. Audit firms will struggle to maintain adequate levels of professional resourcing during alternate years where their SMSF clients are not required to be audited. This will

yield numerous consequences in addition to fee increases, including the possible reduction of SMSF individual auditors and consolidation of audit firms.

To further support our position that the measure will lead to increased costs at the audit and other service provider levels, our survey respondents provided the following:

| Role | Comment | Percentage |
|---------------------------------|---|------------|
| Trustee | I will rely on professional help to determine eligibility for a three-yearly audit cycle | 62% Yes |
| Trustee | If the auditor identified a material issue in year three which could have been rectified in year one resulting in three years of contravention report fees levied by the auditor rather than one year's contravention report fee, would you still support this measure? | 49% No |
| Accountant / SMSF administrator | Do you have any concerns in advising trustees of their eligibility for the three-year audit cycle? For example, with any penalties in undertaking this assessment? | 53% Yes |
| Accountant / SMSF administrator | Do you believe that the three-yearly audit cycle will increase the administrative costs that you charge your trustee clients? | 47% Yes |
| | Do you believe that the three yearly audit cycle will increase the audit fees by doing 3 years of work cumulatively versus having the fund audited each year? | 66% Yes |
| Auditor | Do you believe that the three-year audit cycle will increase administrative costs | 51% Yes |
| Auditor | Do you believe the three-year audit cycle will increase the audit fees by doing 3 years of work cumulatively versus having the fund audited each year? | 82% Yes |

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

Evolv's view is that an alternative definition of 'clear audit reports' should be adopted to extend to funds where there has been either a Part A or Part B audit qualification on the audit report and where an audit management letter has been issued to the trustees for minor breaches.

The issuing of an ACR and the qualification of an audit report do not necessarily occur together as different criteria are used by the auditor to assess the requirement for each. That is, there could be a lodgment of an ACR without a corresponding qualification of the audit report, alternatively there could be a qualification of the audit report without a corresponding lodgment of an ACR.

With respect to the audit qualification criteria, it would be expected that the overall risk profile of the client where there has been an audit qualification would be higher, in particular, where there has been a Part A qualification, the auditor has not been able to sign off on the

financial statements as being free of material error. Where there has been a Part B qualification, the auditor has not been able to sign off on the SIS compliance of the fund. As such, funds that have had a qualified audit report issued should not be eligible for the 3-year audit cycle for at least 3 years.

At present the ATO can identify where the auditor has made a Part B qualification of the audit report as this is notified to the ATO in the annual SAR and is therefore relatively straightforward to identify. In order to obtain the information for a Part A qualification, the SAR question could easily be amended to ask whether there has been any audit qualification.

In addition, it should be noted that the majority of instances of non-compliance by the SMSF would not be notified to the ATO via either an ACR or qualification, as the auditor may only be required to notify details of the breach directly to the trustees via a management letter, that is the breach may neither be material or fall within the requirements for notification in an auditor contravention report.

In addition, even though a trustee is issued with an auditor management letter, the trustee does not necessarily take action and rectify their compliance breach until the time that the next year's audit is being undertaken.

If the criteria for good compliance does not exclude those funds where an auditor management letter has been issued, a fund may qualify for the 3-year audit cycle. In this situation, it could be up to 4 years before any further action is taken to rectify the breach.

For the above reasons, Evolv's view is that any fund that has had a breach of the superannuation legislation, including those which have been reported to the trustees through a management letter should not qualify for the 3-year audit cycle.

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

Evolv's view is that an SMSF that has not submitted a late SAR in the last three years would meet the criteria of timely submission of a SAR.

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?

As part of our survey to practitioners in the SMSF sector, we posed the following question:

- Which of the following key events is likely to increase risks of non-compliance in SMSF's requiring an annual audit (please select any identified).

The percentage of respondents who agreed are listed below:

| Risk Area | Accountant / SMSF Administrator response | Auditor response |
|---|--|------------------|
| Commencement of a superannuation income stream for the first time | 65% | 83% |
| Death of a member | 57% | 79% |
| Add or remove a member and/or trustee | 47% | 81% |
| Receipt of non-arm's length income (NALI) | 60% | 86% |
| Commencement of a limited recourse borrowing arrangement | 60% | 92% |
| Maintenance of a limited recourse borrowing arrangement | 51% | 69% |
| Acquiring an asset from a related party | 72% | 91% |
| Investments, loans or leases with a related party | 78% | 97% |
| In-Specie lump sum payments to a member | 49% | 80% |

Other Key events identified by the survey respondents:

- Early release schemes
- Pension shortfall
- Privately held investments in companies and unit trusts
- Property investments
- Artwork
- Newly established funds
- Acquisition or disposal of an asset greater the 30% of total fund assets
- Errors in ECPI calculations
- Foreign shares

An audit of an SMSF requires the auditor to express an opinion on both the financial statements and compliance with SIS legislation. The auditor signs off on financial audit assertions and on SMSF compliance with the SIS Sections and Regulations listed in the audit report. Those assertions and SIS legislation are also captured in the key events listed above.

From the audit perspective the key events above can be summarised as follows:

Financial audit:

- Receipt of non-arm's length income (NALI)
- Pension shortfall
- Errors in ECPI calculations
- Foreign shares
- Segregated asset method

Compliance audit:

- Commencement of a superannuation income stream for the first time
- Death of a member
- Add or remove a member and/or trustee
- Commencement and maintenance of a limited recourse borrowing arrangement
- Acquiring an asset from a related party

- Investments, loans or leases with a related party; acquiring an asset from a related party
- Early release schemes
- Privately held investments in companies and unit trusts
- Property investments
- Artwork
- Newly established funds
- Acquisition or disposal of an asset greater than 30% of fund assets

Other instances when an annual financial audit should be required –

- To avoid financial abuse by advisers, the fund should be audited annually when the fund has been advised by a financial planner.
- To avoid elder abuse by other family members, the fund should be audited annually when trustees are approaching a significant age.
- When members or trustees are the subject of a marital / spousal separation

Whilst trustees are required to retain appropriate source documentation for any of the noted “key events”, the documentation requirements for the audit of the above investments tend to be more extensive, and sometimes difficult to obtain even when auditing each financial year.

To obtain this documentation 3 or more years after an event has occurred could prove to be almost impossible, and certainly time consuming for trustees, accountants, administrators and auditors.

Further we note the disparity between accountants / SMSF administrators and their auditor peers in relation to the responses identifying those key events which pose greater compliance risks and therefore should trigger an annual audit. If this measure is adopted, a significant education program will need to be undertaken to ensure practitioners fully understand the assessment for eligibility.

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?

Should a large number of funds be eligible for the measure, our view is that it will be critical that an appropriate system be put in place to manage the transition with respect to auditors’ workflow management and other business matters.

In terms of what metric should be used to stagger the introduction, given every audit practice is different with different net value clients, a randomly generated metric (for example based on ABN or TFN number) would hopefully produce an outcome that will ensure every audit practice can be fairly impacted by the new measures.

Further, it is our view that should only a small number of funds be eligible for the measure (e.g. 5-10%), then any additional criteria for implementation will only act to increase overall cost and red tape within the industry.

Our survey respondents suggested the following arrangements should be considered:

- Trustee education / course to ensure trustees can self-assess eligibility or allowing only SMSF trustees that meet professional education standards to be allowed to apply for a three-yearly audit cycle
- Value of the fund to be used in the phase-in metric
- Relaxation of the penalties for non-compliance for a period of time
- SMSF annual returns to become more detailed
- A rolling introduction of the measure
- Only allowing funds that are in accumulation phase to transition to a three-yearly audit cycle
- Trustee application to the ATO for the three-yearly audit cycle to be granted on a fund by fund basis
- Development of an annual questionnaire to determine eligibility
- Allowing lower value funds the ability to adopt the measure first
- ATO monitoring of eligibility and having that available to practitioners and trustees to view

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

In our view, the implementation of this measure will see another complex layer of legislation which will need to be implemented by the SMSF community as well as be monitored by the ATO for compliance with the same. This will increase the compliance burden and red tape with limited quantifiable foreseeable benefits resulting.

The role that the auditor plays and the value that they provide in the relationships which we develop with our accountants, administrator and financial planning clients should not be underestimated. Reducing the frequency of this interaction is not in the best interest of the industry and is likely to increase administration fees with the burden of proper oversight reverting to the accountants and administrators in the intervening years of audit.

The following provides factual evidence gathered by Evolv in our survey which is conclusive to arguing against the implementation of the proposal:

- 43% of trustees indicated that they would remain in an annual audit cycle even if it was determined that they would be eligible for the three-yearly audit cycle
- 78% of accountants / SMSF administrators indicated that they do not agree with the measure and will advise their trustee clients to remain in an annual audit cycle
- 95% of auditors do not agree with the proposed measure
- 80% of accountants / SMSF administrators believe that the three-yearly audit cycle will lead to trustee non-compliance
- 70% of accountants / SMSF administrators are concerned about audit firms' ability to adapt their resourcing to meet the requirements of the proposed measure
- 69% of auditors believe the measure will negatively impact their business workflow
- 85% of accountants / SMSF administrators do not believe the proposed measure is in the best interest of the integrity of the SMSF sector
- 82% of auditors believe the measure will adversely affect their ability to provide trustee education and guidance via a management letter
- 48% of auditors will review their decision to provide SMSF services should the measure be passed (SMSF auditor registrations and competency could decline).

The following should also be considered in policy development:

- All 22 sections and regulations which are reportable contraventions should be reviewed for their efficacy
- SIS legislation will need changes to allow for a breach in year 1 which is not audited and identified until after year 3 - what is the penalty in that case?
- The risk of conducting an SMSF audit has increased as a result of the recent decision in *Cam and Bear Pty Ltd v McGoldrick*
- Triennial audits may result in a higher number of TBAR reporting amendments (e.g. if the financial statements have been materially misstated but the misstatement would not have been picked by the auditor at least 3 years later). The maximum backlog may be up to 4 years.

If the overall aim is to reduce red tape and costs for trustees, other options should be evaluated and benchmarked against the perceived but unsubstantiated benefits in the proposal of changing to a three year audit cycle.

A well-functioning SMSF sector is a by-product of good regulation. Given the growing size of the SMSF sector which represents one-third of all superannuation in Australia, it seems prudent to have timely independent regulatory oversight to avoid problems from happening as they occur. Without this oversight we are fearful that the current low rate of contraventions may start to increase for the sake of a small reduction in costs (if any) which over time may lead to a loss of integrity in the SMSF sector.

We have other alternative suggestions which are relevant but outside the scope of this submission. We welcome the opportunity to discuss any of the above items in greater detail with you.

Yours sincerely

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