Chapter 8

Self-managed superannuation funds

8.1 This chapter has two main parts. The first provides a brief overview of self-managed superannuation funds (SMSFs) including reasons for their rapid growth. This is followed by sections that address the administration, regulation and viability of SMSFs, including:

- the minimum threshold to make SMSFs viable;
- whether the current maximum number of four members of SMSFs has intergenerational utility;
- concerns over whether the Australian Tax Office (ATO) is the body most suitable to administer and regulate SMSFs; and
- whether the current Australian Financial Services (AFS) licence exemption allowing accountants to advise on the structure of SMSFs is appropriate.

Self managed super funds

8.2 Self-managed superannuation funds have become an increasingly significant part of the Australian superannuation landscape over the last five years. The Reserve Bank of Australia in its Financial Stability Review report stated that:

> By fund type, industry and self-managed funds have recorded the strongest growth in assets under management over recent years. These funds, together, account for nearly 40 per cent of industry assets, compared to around 23 per cent five years ago ... At the same time, there has been a decline in the share of total superannuation assets held in public sector and corporate funds.[1]

8.3 The number of new SMSFs reached its highest point in 2003-04, when about 3000 funds were established per month, with the figure now resting at about 1800 per month. According to the Self-Managed Super Fund Professionals' Association of Australia (SPAA), the five-year average indicates that the number of funds opening per month has actually decreased over that time, although the average balance of the funds has grown.[2]

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1 Investment and Financial Services Association, *Submission 60*, p. 23.

2 Mrs Andrea Slattery, Chief Executive Officer, SPAA, *Committee Hansard*, Sydney, 24 October 2006, p. 4.

A snapshot of the sector

8.4 Self-managed superannuation funds have become an increasingly popular way for people to hold retirement savings. Recent evidence shows that the number of SMSFs and the value of funds under their management have been increasing rapidly, with no end in sight. According to Australian Prudential Regulatory Authority (APRA) statistics issued on 28 June 2007 (for the Quarter ended March 2007) there were 337,902 SMSFs regulated by the ATO that satisfied the definition of a SMSF under section 17A of the SIS Act. The SMSF sector now accounts for 99.81 per cent of total number of superannuation funds and represents 23.3 per cent of total superannuation savings.[3]

8.5 According to the Commissioner of Taxation, Mr Michael D'Ascenzo, the SMSF market is currently growing at a rate of approximately 1800 a month and there is no sign of this rate falling.[4] APRA estimates that the number of SMSFs will grow to 344,841 as at 30 June 2007, which is a 78.31 per cent increase over the eight years from 1 July 1999. This rate of growth is clearly shown in Table 1 and Figure 1.

Table 1: Growth in SMSFs[5]

	Jun-07	Jun-06	Jun-05	Jun-04	Jun-03	Jun-02	Jun-01	Jun-00	Jun-99
SMSF's	344,841*	319,805	299,696	289,132	262,175	235,626	219,064	212,538	193,396
Increase (#)	25,036	20,109	10,564	26,957	26,549	16,562	6,526	19,142	
Increase (%)	7.83%	6.71%	3.65%	10.28%	11.27%	7.56%	3.07%	9.90%	
Average Increase (#)		18,931							
Largest Increase (#)		26,957 (2003/04)							
Smallest Increase (#)		6,526 (200/01)							

8.6 In terms of asset holdings, SMSFs outrank both public sector and industry and corporate funds. Table 2 shows how SMSFs compare with other major fund types.

8.7 Figures from the ATO also show:

- the top five asset classes for SMSF investments are cash and term deposits (30 per cent), listed shares (21 per cent), public trusts (10 per cent), other trusts (6 per cent) and real property (5 per cent); and

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3 APRA figures included in SPAA, updated statistics, July 2007.

4 *Self managed super funds – the Tax Office Perspective*, Speech by Michael D'Ascenzo, Commissioner of Taxation, National SPAA Conference, 1 March 2006.

5 APRA figures included in SPAA, *Submission 70a*, p. 4.

- the average member account balance rose from $184,490 in June 2000 to $342,500 as at 30 June 2006 (which compares with approximately $52,000 per member for public sector funds).[6]

Figure 1[7]

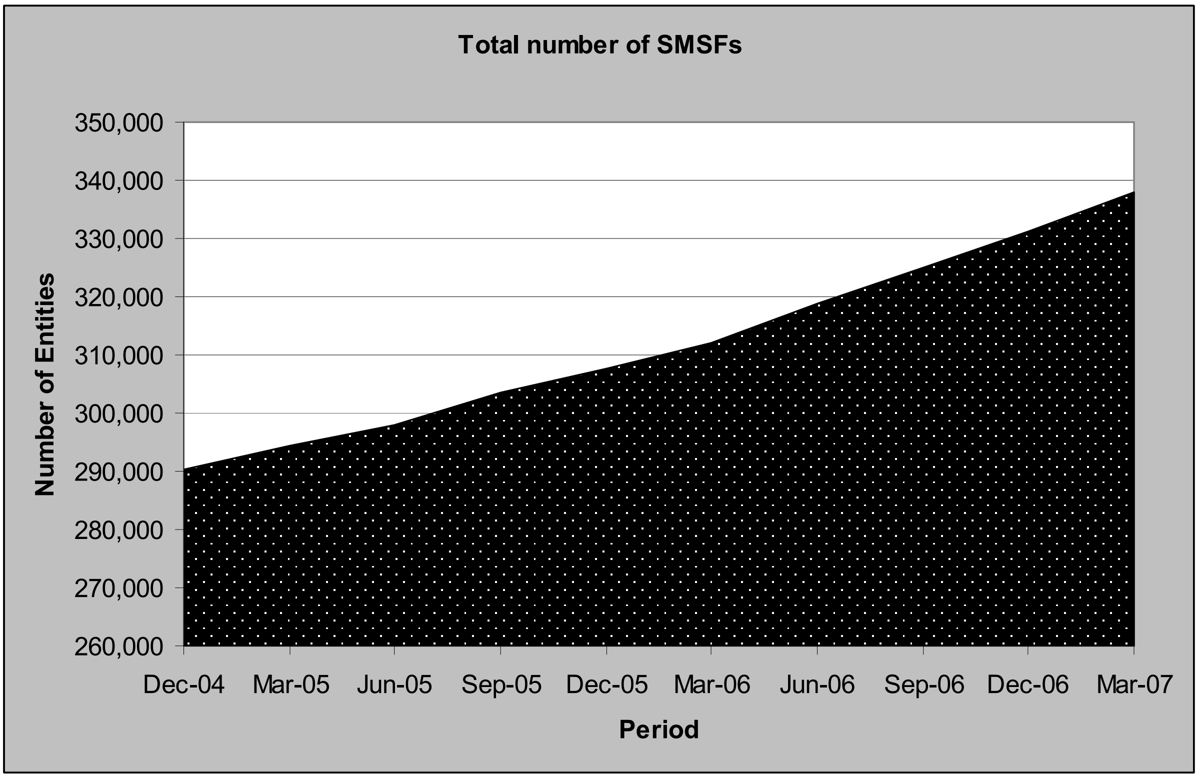

Table 2: Asset holdings of different funds[8]

Fund Type	Assets as at 31 March 2007		Entities as at 31 March 2007	
	$ billion	% Total	Number	% Total
Corporate	69.4	6.11	335	0.09
Industry	182.7	17.33	75	0.02
Public Sector	165.8	15.73	41	0.02
Retail	343.9	32.63	173	0.01
SMSF	245.6	23.30	337,902	99.81
Total	**1053.8**	**100**	**338,526**	**100**

6 APRA figures included in SPAA, updated statistics, July 2007, p. 4.

7 SPAA, updated statistics, July 2007, p. 5.

8 APRA figures included in SPAA, updated statistics, July 2007, p. 3.

Reasons for growth

8.8 Term of reference number 7 refers specifically to the reasons for growth in the number of SMSFs over the past decade. The committee notes that much of the evidence on this issue is anecdotal and speculative. A number of submitters and witnesses provided similar reasons as to why SMSFs have grown to the extent they have in recent years. First and foremost, there is general agreement within the industry that SMSFs have grown in popularity because they provide members with flexibility to control their own investments, with expectations of earning higher returns, and diversify their assets within the superannuation fund.[9] As noted by the submission from SuperRatings:

> … many Australians believe that they are able to manage assets better than traditional fund managers, which assisted in the term DIY Funds being phrased. This is no different to the managed fund area where investors are split between using traditional fund managers and investing directly in the equity markets themselves, often via web-based brokers. Not surprisingly, anecdotal evidence indicates that most SMSF money is invested either directly in the Australian equity market or held in cash.[10]

8.9 This view was also confirmed at a hearing by SPAA:

> We find that … by having control over those superannuation fund assets, people are able to make decisions about their future and they are able to invest, and time those investments, to their advantage so that, if they think that a particular investment in the market is suitable to purchase or to sell, then they can do that based on their judgement and advice they may give. The flexibility certainly comes out of that timing aspect of the particular investment. When you think about the many people who have self-managed superannuation funds, those being self-employed people or some executives, they like to control their own destiny a lot more than employees…[11]

8.10 The popularity of SMSFs is also attributed to the absence of fees charged by professionally managed superannuation funds, the ability to invest in assets not otherwise available in a regulated fund and advice from accountants and financial planners. Research conducted by CPA Australia on the SMSF market identified the main reason for the establishment of an SMSF as: '…control followed by flexibility, tax advantages and a good way of planning towards retirement'.[12]

8.11 While the committee accepts that SMSFs have become an attractive option for the reasons outlined above, dissatisfaction with larger fund performance, including the

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9 Treasury, *Submission 55*, p. 16.

10 SuperRatings, *Submission 49*, p. 7.

11 Mr Graeme Colley, SPAA, *Committee Hansard*, Sydney, 24 October 2006, p. 5.

12 CPA Australia, *Self Managed Super Funds*, A Financial Advisory Services Research Report, October 2004, p. 2.

cost burden of over-regulation and the lack of transparency regarding fees, either real or perceived, should not be underestimated as factors driving people into SMSFs.[13] A research report commissioned by the Investment and Financial Services Australia (IFSA) found that 36 per cent of respondents cited poor performance from existing funds as a reason for setting up a SMSF. The report found that:

> …clients disillusioned with returns were more likely to feel that their existing super fund was not performing well, regardless of whether this reflected underperformance or simply a drop in equity markets. As a result of this reassessment, many felt they were being charged too much by their existing super provider and opted to establish a SMSF instead.[14]

8.12 Experts within the SMSF industry have speculated that four out of five new SMSF funds will be established by newcomers to superannuation to take advantage of new 'simplified superannuation' laws that allow contributions of up to $1 million of after tax funds to be made in to retirement savings accounts. However, the committee notes that the ATO has warned people of the dangers involved in setting up an SMSF as a result of the new rules simplifying the taxation arrangements for superannuation. The ATO has encouraged anyone considering setting up a SMSF to ensure they are familiar with the rules governing SMSFs and the obligations of trustees.[15]

Committee view

8.13 The committee notes the rapid growth in the number of SMSFs over the last decade. While the committee does not have any serious concerns about the growth of the SMSF sector, it believes there are a number of potential disadvantages and risks associated with SMSFs that should not be overlooked. Specifically, there is some evidence that the significant and expanding portion of superannuation assets held in SMSFs is not protected by the industry's broader safeguards. In brief:

- SMSF's are only cost-effective for investors with significant assets. ASIC have indicated a minimum maturity figure of $250,000;
- trustees are generally inexperienced in making investment decisions and are time-poor. This may result in poor returns and funds becoming non-compliant;
- SMSFs cannot use the Superannuation Complaints Tribunal and members are not eligible for compensation for losses arising from fraud; and

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13 Association of Independent Retirees, *Submission 19*, p. 7.

14 *SMSF Trends*, Investment Trends/IFSA Self Managed Super Funds (SMSF) Report, February 2006, p. 11.

15 John Wasiliev, 'ATO warns on super fund risks', *Australian Financial Review*, 12 February 2007, pp. 1 and 56.

- trustees of SMSFs could be personally liable for members' losses.[16]

8.14 The committee notes that the statistics published by APRA on SMSFs is limited when compared with the detailed data available on other sectors in the superannuation industry. The committee believes it would be useful if the ATO (which regulates SMSFs) were to compile a representative sample of data that would enable a more useful comparison across the industry.

Regulatory and compliance arrangements

8.15 A self-managed superannuation fund is a fund in which:

- the trust deed meets the requirements of the *Superannuation Industry (Supervision) Act 1993* (SIS Act);
- there are no more than four members;
- all the members are trustees of that fund;
- no member of the fund is an employee of another member of the fund, unless they are related, and
- no trustee of the fund receives any remuneration for their services as trustee.[17]

8.16 Because all the members of SMSFs are trustees, the fund is not subject to the full range of prudential regulation and supervision. Trustees of these funds are not subject to the fit and proper requirements and other obligations imposed on trustees of APRA supervised superannuation funds. However, trustees of SMSFs still have to meet a number of obligations. These include:

- lodging an annual income tax return and superannuation fund annual return;
- lodging superannuation member contributions statements;
- reporting payments of member benefits;
- appointing an approved auditor to complete the annual audit;
- maintaining records for up to 10 years, and
- complying with investment restrictions.

8.17 Some of the key restrictions under the SIS Act applying to SMSFs include:

- meeting the sole purpose test;
- the requirement to formulate and enact an investment strategy;
- not accessing members' money without meeting a specific condition of release;

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16 Tom Valentine, 'Regulation of DIY Superannuation Funds", *The Australian Economic Review*, vol.37, no.2, 2004, pp. 216-17.

17 Leslie Neilson, *Superannuation ready reckoner: taxation and preservation rules for 2004-05-revised February 2005*, Research Brief no.10 2004-05, Parliamentary Library, pp. 18-19.

- not providing loans or financial assistance to members or relatives; and
- not borrowing money to invest.[18]

8.18 The 2006 Budget included provision for improvement in the regulation of SMSFs by increasing funding to the ATO for compliance activities, streamlining reporting requirements and other measures. It also increased the supervisory levy for these funds to $150 to place them on a similar cost recovery basis as other superannuation funds.

8.19 Before examining more commonly raised themes, the committee notes two matters which attracted limited comment, but are worth discussing nonetheless. The first of these is the difficulties faced by those running and contributing to a SMSF while living overseas for extended periods of time. Trustees residing overseas for periods in excess of two years risk having their fund deemed non-complying, on the basis that the active member test for an Australian superannuation fund requires a resident active member's accumulated benefit to be greater than 50 per cent of the total accumulated benefit for all active members. The provisions, as they stand, are overly restrictive.

8.20 It was submitted by Cavendish Superannuation that the active member test is unnecessary, because its objectives are met by other applicable laws. These include provisions which require the 'central management and control' of a super fund to take place in Australia, and which impose caps on contributions. The committee was also reminded that in order to claim a self supported contribution deduction, other Australian-sourced income would need to be declared within the Australian tax system.[19]

Recommendation 26

8.21 The committee recommends that the active member test be removed from the definition of an Australian Superannuation Fund.

8.22 The second issue of concern is the inability of a member to draw a pension from their fund in any form other than cash, whereas 'in specie' payments are available when drawing a lump sum. In practice, a member may wish to draw securities such as shares, in lieu of cash, depending of their circumstances. It was submitted that differentiating between lump sums and pensions is unnecessary because members are entitled to take lump sums as often as they took their pension, should they so desire, rendering the rule illogical. The committee sees merit in this argument, and notes the

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18 Leslie Neilson, *Superannuation ready reckoner: taxation and preservation rules for 2004-05-revised February 2005*, Research Brief no.10 2004-05, Parliamentary Library, pp. 18-19.

19 Cavendish Superannuation, additional information, pp. 1-2. Central management and control test, s contained in S.295-95 of the *Income Tax Assessment Act 1997*.

submission from Cavendish Superannuation that the tax payable on the drawings would not change.[20]

Recommendation 27

8.23 The committee recommends that fund members be able to draw superannuation pensions 'in specie', in line with existing provisions for lump sum payments.

Possibility of minimum threshold for viability

8.24 The committee received evidence that some investors are establishing SMSFs in spite of having insufficient retirement savings to make this vehicle a cost effective option. There was also anecdotal evidence that poor advice was being given by accountants and financial advisors resulting in people with modest investment capital viewing SMSFs as a viable option. Commissions payable to financial advisers and accountant fees for ongoing fund management were seen as likely factors behind such advice being given.[21] Management fees are not inconsiderable, especially in the context of a fund with modest holdings. As IFSA explained to the committee:

> I am happy to send the committee a copy of one of our surveys that indicates that the average total amount spent in fees in running a self-managed super fund is $3,500, and that is a lot of money. Once you put that as a percentage of $100,000 or $200,000, that is a very high management expense ratio. So we think it has to be around $200,000 to $250,000.[22]

8.25 At the committee's hearing in Canberra, officers from the ATO submitted that, as at June 2006, the average total asset per SMSF was about $653,000, and that the ATO 'often regarded' $200,000 as being the minimum level of viability for SMSFs. The ATO also reported that, as of 2005-06, about 34 per cent of SMSFs carried balances of less than $200,000. The Self Managed Super Fund Professionals' Association of Australia told the committee that there had been a significant reduction in the number of SMSFs with balances of less than $100,000 over recent years.[23]

8.26 The wisdom or otherwise of imposing a minimum balance on the operation of SMSFs was the subject of considerable discussion throughout the inquiry. Some witnesses were in favour of a statutory limit. Others, while mindful of the need for sufficient returns to overcome the cost of management, saw no need to regulate a viability threshold. CPA Australia submitted that:

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20 Cavendish Superannuation, additional information, p. 2.

21 See, for example, Industry Funds Forum, *Submission 73*, p. 35.

22 Mr Richard Gilbert, Chief Executive Officer, IFSA, *Committee Hansard*, Sydney, 24 October 2006, p. 97.

23 Mrs Andrea Slattery, Chief Executive Officer, SPAA, *Committee Hansard*, Sydney, 24 October 2006, p. 4.

> In our publications we agree with the $200,000 limit only insofar as it is a reasonable dollar amount—that, if you were to look at a self-managed fund purely on a cost basis compared to, say, a retail fund, you would probably have to invest that sort of money to start getting ahead cost wise … [T]he issue really about establishing a self-managed fund is not so much how much money you have but it is the purpose you are establishing it for. People need to have a strict purpose for it. If you are just doing it for cost or because you think you can do better than a fund manager, you really need to think long and hard about what your alternatives are instead of just jumping into it … [F]unds may be established for business, in conjunction with your small business, when there is the exemption for holding assets, for holding business real property et cetera. Funds can legitimately operate quite effectively for amounts less than $200,000, and for good reason, for good purposes, so we certainly would not want to see any sort of statutory limit. I do not think it would work, and we certainly would not want to see it. I see that number just as a guide for the average person who has the barbecue discussion on the weekend about self-managed funds being the latest fad and thinks he can just go out and get one. I certainly do not think there should be a line as to when and where you can get one.[24]

8.27 Other witnesses supported the concept of a minimum balance requirement, but not necessarily at a threshold of $200,000. Professional Associations Superannuation Limited suggested the figure of $100,000 as a possible starting point:

> We have suggested that except for where there is a financial planner who has come up with a plan and suggested that the establishment of such a fund makes sense for an individual. The costs of a self-managed fund are very significant and many people establish them for the wrong reasons. What we are trying to do is encourage the consumer to not make that decision unless they have very strong advice otherwise … [O]ur submission says either $100,000 or a financial planner’s assertion that it is appropriate in that individual’s case. We would not put a timeframe. It is a categorical limit of $100,000 or $200,000—whatever you choose to have—with an out that says that if there is appropriate advice then they have the ability to set them up. It is very hard somehow to know what is particularly relevant to an individual.[25]

8.28 The need for flexibility in thresholds was also emphasised in evidence by SPAA, which submitted that generational change in the approach taken to investment and superannuation accounted for some of the popularity in SMSFs. It argued that a $200,000 threshold may unduly hamper sound investment strategies on the part of younger investors:

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24 Mr Michael Davison, Superannuation Policy Adviser, CPA Australia, *Committee Hansard*, 25 October 2006, Melbourne, p. 50.

25 Mr Kevin Beasley, Chief Executive Officer, Professional Associations Superannuation Limited, *Committee Hansard*, 6 March 2007, Melbourne, p. 9.

> As an association whose constituents are mainly practitioners, we find that there is a knowledge attribution to self-managed superannuation funds which is found in younger professionals in the business community who are restricted by the amount that they can contribute to a self-managed superannuation fund through salary sacrifice arrangements, super guarantee et cetera. They have a better grasp of the array of investment product available to them that they can control through a self-managed superannuation fund which makes that central control and management of the fund more suitable to them for achieving their retirement objectives in relation to the accumulation of wealth through superannuation, but particularly through a self-managed superannuation fund. So the level of contributions will increase quite dramatically, but also the performance that they are targeting is a higher performance for a longer preservation period. They are inclined to want to set up these funds, albeit that there may be a higher cost as a percentage of operating the fund in the earlier years than in the latter years, in order to get the traction that they need to get these funds up and running.[26]

Committee View

8.29 The committee sees problems with the imposition of a statutory viability limit, particularly in light of its likely effect on younger investors. The committee is also mindful of the fact that, because of infinitely variable investment performance, no single threshold amount could sensibly be applied to all funds. Rather, the committee views the highly individualised advice provided by accountants and financial advisers as the appropriate safeguard for investors seeking to establish an SMSF without viable seed funding. The committee, therefore, makes no recommendation in regard to minimum thresholds.

Limiting owner numbers

8.30 At present, legislation restricts to four the number of individuals who can own and manage a SMSF. Each owner is automatically a trustee. The committee heard some evidence that this limit should be increased in response to the prevalence of family businesses and funds that operate over two or more generations. The limitation also restricts operators of small businesses with multiple owners who seek to invest together. Evidence received from the Association of Independent Retirees (AIR) called for the limit to be raised to nine or ten parties:

> We have an SMSF, and there is a concern about who is going to deal with that when we die. If the executor also has superannuation in that fund, as a trustee member, then you have confidence that the process is going to continue through. Then you get to the next stage of how many of your sons or daughters want to be in that fund. We happen to have three. We happen to have a fight with them whenever one of them wants to be nominated

26 Mr David Ruddiman, Director and Chair of Regulatory Committee, *Committee Hansard*, 24 October 2006, Sydney, p. 12.

> without the other two being involved. Because the other two also have superannuation and they want to be in the fund, we really need five members to make that work effectively. So it is not an arbitrary thing; it is a family related thing that we suggest. Many other people are in that position.[27]

8.31 SPAA echoed this position:

> You have children, whose parents now under choice are able to select the fund they will be members of, who are wanting to join their parents' fund and have their employer contribute to that fund. There is a view currently in practice that the parents are now having to decide which of the children is to be excluded from that process.[28]

8.32 It was argued that allowing more than four members to be owners and trustees of an SMSF could create other problems. The primary drawback is that the management of the fund would become too complex. This was acknowledged as a possibility even by those in favour of raising the limit.[29] Representatives from Treasury argued that the requirement that all members be trustees was intended to ensure that SMSFs are genuinely self-managed and of a sufficiently small size, and that all members are involved in decision-making and able to protect their individual interests. In a larger fund, the decision making-process is considerably more difficult and generally involves one or more members forgoing representation.[30]

8.33 A cap on the numbers of trustees at state level was also raised as a constraint to any increase at the federal level.[31] Representatives of AIR argued that corporate trustees were potentially very helpful in such situations:

> We believe there should be a lot more done by the various regulatory bodies to encourage people to consider corporate trustees. You will find in the publicity that they are not mentioned at all. Furthermore, you get very bad advice from lawyers who say, 'Don't do it,' but 35 per cent of people do it very effectively. There is no education about the best type of trustee structure an SMSF should adopt. You still run into problems in that if one member of the [fund] dies then you have to restructure the whole thing, which is complicated in a trust situation but much simpler in a corporate

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27 Dr Barry Ritchie, National Chairman, Retirees Income Group, AIR, *Committee Hansard*, 20 November 2006, Canberra, p. 110. See also Mr Graeme Colley, Director, SPAA, *Committee Hansard*, 24 October 2006, Sydney, p. 7.

28 Mr David Ruddiman, Director and Chair of Regulatory Committee, SPAA, *Committee Hansard*, 24 October 2006, Sydney, p. 14.

29 Mr Graeme Colley, Director, SPAA, *Committee Hansard*, 24 October 2006, Sydney, p. 7.

30 Ms Erica Lejins, Senior Adviser, Superannuation and Retirement Savings Division, Treasury, *Committee Hansard*, 20 November 2006, Canberra, p. 37.

31 Ms Erica Lejins, Senior Adviser, Superannuation and Retirment Savings Division, Treasury, *Committee Hansard*, 20 November 2006, Canberra, p. 37.

> trustee situation. You also have to reduce the costs of the regulation of that so that duplicate costing is not involved.[32]

8.34 Doubts were expressed by some witnesses about the seriousness of the problem. The ATO submitted that the majority of funds have only two members.[33] This of itself indicates that there is little risk in raising the limit for the minority of SMSFs that need to do so.

Committee view

8.35 The committee is persuaded by the arguments put by the AIR, SPAA and others in relation to trustee limits. The problem which exists now, on whatever scale, has particular effect for funds seeking to operate across multiple generations, as well as for co-owners of small businesses seeking to invest together. The effect of this restriction is likely only to worsen in the future, and should be addressed sooner rather than later.

Recommendation 28

8.36 The committee recommends that the ATO consider raising the maximum number of trustees for any one SMSF from four to ten, in line with current and future demand.

Recommendation 29

8.37 The committee recommends that a simple and clear alert warning should be provided to all trustees of an SMSF on their duties and responsibilities, the recommended ASIC minimum maturity figure and the absence of part 23 compensation in the event of theft and fraud.

The appropriateness of the ATO as regulator of SMSFs

8.38 The ATO has regulated SMSFs since October 1999. This involves ensuring that the primary purpose of SMSFs is to generate a retirement benefit for members and that funds are managed in line with the rules and regulations of the relevant legislation. It also involves reviewing the work of approved auditors, ensuring that trustees meet their own taxation obligations and have an investment strategy in place.

8.39 The ATO reported that, as of November 2006, approximately 290 staff were assigned to work on SMSFs. Primary tasks included the provision of information, education and advice to help trustees understand their obligations; auditing funds at high risk of not complying; checking member contribution statements to check that all contributions are reported correctly; reviewing high-risk regulatory issues; and

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32 Dr James Ritchie, National Chairman, Retirees Income Research Group, AIR, *Committee Hansard*, 20 November 2006, Canberra, p. 111.

33 Mr Stuart Forsyth, Assistant Commissioner, Superannuation, ATO, *Committee Hansard*, 20 November 2006, Canberra, p. 39.

following up auditor contravention reports. The key risks for self-managed funds were identified as including trustees not fully understanding their obligations, unauthorised early access or personal use of fund assets, breaches of in-house asset rules, acquisition of assets from related parties and failure to lodge complete and accurate returns.[34] Critically, as regulator, the ATO has no view about the wisdom of the investment strategies adopted by funds, and therefore does not give financial advice to investors.

Administration fees

8.40 The administration fee for SMSFs is set to increase by almost three-fold.[35] Representatives of the ATO explained that most of the additional revenue will feed into work on compliance, and that over two years the staff involved in compliance would increase from approximately 150 to 500. This will bring about an increase in percentage of SMSFs audited from 1.2 per cent to about three per cent.[36]

8.41 The way in which the ATO conducts its compliance activities was the subject of some discussion, much of which centred on achieving the best balance between compliance on the one hand, and reasonable administration fees on the other. The AIR discussed this at length:

> I guess it goes back to this issue: what is the most cost-effective way of having compliance regulation on the industry? The tax office process is one that relates to the tax office auditing a certain number of high-risk funds and auditors auditing every fund, but that process is not efficient because the relationship is between the trustee and their accountant—78 per cent of all trustees use accountants to prepare their accounts ... [T]he client relationship is between the trustee and the accountant. The tax office approach is to the auditor. The auditor then has to check information from the trustee. That is checked through the accountant to the trustee. It can only be done, and is done, by getting signed statements from trustees that they have not entered into any loan arrangements, that they have conformed to the act, that the trustees are eligible. They are all signed statements from that auditor to the accountant to the trustee and back from the trustee to the accountant to the auditor.
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> That is a complex process which does not really achieve anything. The tax office said today that they were concerned that auditors were good at auditing the accounts but not at the compliance requirements, and that is the reason for it. If the focus is on accountants, and the accountants are properly trained and educated and meet the regulatory requirements, the trustees and

34 Ms Raelene Vivian, Deputy Commissioner, Superannuation, ATO, *Committee Hansard*, 20 November 2006, Canberra, p. 33.

35 Ms Raelene Vivian, Deputy Commissioner, Superannuation, ATO, *Committee Hansard*, 20 November 2006, Canberra, p. 35.

36 Ms Raelene Vivian, Deputy Commissioner, Superannuation, ATO, *Committee Hansard*, 20 November 2006, Canberra, p. 33.

> the accountants will achieve the same thing. We have said to the ATO that the design of their regulatory forms and checklists should be consistent for the trustee and the accountant. If that happens, and if they demonstrate that they conform, the need for auditing those funds is not such a requirement.[37]

8.42 Pointing to the fact that most SMSF trustees use accountants to run the fund, AIR suggested that the imposition of regular audits, even where the risk of non-compliance is very low, is an overly cautious approach. It highlighted the very low incidence of major breaches in compliance and proposed an alternative strategy involving auditing accountant-run SMSFs in their first three years of operation, after which regular auditing would be triggered only by non-compliance. Where an accountant is not used, auditing would occur annually. AIR explained how this alternative strategy would work:

> If [non-compliance] was the focus, there would not be the need to audit every fund every time. We need to recognise that the cost of that regulation is now very high. It is approaching $250 million. The cost of the audit fee and the cost of the $150 tax fee now comes close to $250 million. That is a very high cost on funds that have a relatively small $300,000 type trust which has a very simple structure in general. That is why we say it is wrong and that the audit process should be changed to reflect that.[38]

8.43 It also argued for a greater reliance on safeguards offered by accountants. It submitted that many accountants have received training from auditors on the kind of information needed to conduct audits, and that accountants are often the nexus between the ATO and the SMSF. Many aspects of compliance cannot be independently and readily checked by an auditor. These aspects are dealt with by requiring trustees to sign declarations that they meet the requirements of the legislation. Auditors require accountants to have these declarations completed by trustees. There is no reason why the accountant cannot be required to obtain these declarations in the first place without placing the onus on the auditor to obtain them through the accountant. Because of the greater knowledge that an accountant has of the affairs of an SMSF, it is far more likely that an accountant can identify improper use of funds than can an auditor.[39]

Committee view

8.44 The committee accepts the proposition that greater reliance should be placed on accountants as the key interface between members and the regulatory and compliance system. In view of the current and future growth of SMSFs it is important to ensure that the right balance is struck to minimise the regulatory burden of

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37 Dr James Ritchie, National Chairman, Retirees Income Research Group, AIR, *Committee Hansard*, Canberra, 20 November 2006, p. 111.

38 Dr James Ritchie, National Chairman, Retirees Income Research Group, AIR, *Committee Hansard*, Canberra, 20 November 2006, p. 111.

39 AIR, *Submission 19*, p. 8.

administration while also maintaining financial and legal integrity. The committee considers that, in large part, the proposal made by AIR strikes the appropriate balance.

Recommendation 30

8.45 The committee recommends 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.

Australian Financial Services Licence: accountants' exemption

Background[40]

8.46 The government has significantly reformed the consumer protection and disclosure framework overseen by ASIC since the regulator was established in 1998. In particular, the government introduced the *Financial Services Reform Act 2001*, which amended the Corporations Act to provide for a single licensing regime for financial sales, advice and dealings in respect of financial products. Under the act, any person wishing to carry on a financial services business in Australia must hold an AFS, or be the representative of an AFS licensee.

8.47 An AFS imposes a number of obligations on the licensee with respect to standards of behaviour and training. These obligations include a duty to comply with financial services laws, an obligation to have in place adequate arrangements for managing conflicts of interest and, if the relevant financial services are to be provided to consumers in a retail capacity, an obligation to allow access to an approved dispute resolution system.

8.48 On 1 December 2005, the government also introduced a series of refinements to financial services laws to improve the clarity and amount of information that consumers receive when obtaining advice about financial products. These include amendments to allow for the provision of a 'short-form' product disclosure statement that, in the case of superannuation and superannuation-like products, must include enhanced fee disclosure information. Also included are amendments dealing with the circumstances in which a Statement of Advice (SoA) must be provided in the case of an ongoing adviser-client relationship and reduced verbal disclosure requirements for advisers.

8.49 Many individuals depend on their accountants for advice and assistance with their entire business, taxation and financial affairs. Some individuals also seek the advice of financial planners. Research suggests that two main reasons cited by SMSF

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40 Comprehensive background to the AFS, and in particular the accountants' exemption, can be found in this committee's report, *Corporations Amendment Regulation 7.1.29A, 7.1.35A and 7.1.40(h)*, June 2004.

trustees for establishing their SMSF was advice from their accountant or financial planner.

8.50 Treasury notes that some specific activities, which by their nature do not constitute, or should not be treated as, financial services, are not subject to financial services licensing. This includes advice in relation to the structure and operation of SMSFs.

8.51 Recognised accountants that hold appropriate qualifications are able to provide advice to their clients on a decision to acquire or dispose of an interest in an SMSF without the need to be licensed under financial services regulation. This exemption, or 'carve out' as it is widely referred to, recognises that the establishment of an SMSF often forms part of an overall business strategy, which would include other advice not covered by financial services regulation, such as business structuring and taxation advice. The exemption does not cover the provision of advice on an SMSF's investment strategy. The fact is that the profession itself recognises the decision. A large number of accountants are licensed because they want or need to go beyond simply advising on structures.

Appropriateness of exemption

8.52 Witnesses conveyed widely different views on the accountants' exemption. The Financial Planning Association of Australia (FPA) called for a level playing field on the provision of advice, on the basis that all professionals seeking to offer advice in the field should be suitably licensed. To do otherwise would encourage confusion among consumers about the nature of the advice being provided:

> You might ask whether a self-managed super fund is appropriate for you versus, let us say, a managed investment or some other structure, and an accountant can certainly help you look at structures, but then you might say, ‘What investment strategy should I actually undertake? Should I put my money in a growth strategy or cash or whatever?’ That is where we are saying that, if you are going to provide advice that extends down the full spectrum of helping you with your end goals, then you should be licensed. It does require clarification, and we believe that providing advice is something that you should be licensed to do and that you should not stop and start the process.[41]

8.53 The Investment and Financial Services Association (IFSA) agreed, claiming that the regulatory arrangements that preceded the exemption for accountants were sufficient to deal with the problem they faced.[42] IFSA told the committee that the absence of an external dispute resolution process was an important factor when

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41 Ms Jo-Anne Bloch, Chief Executive Officer, FPA, *Committee Hansard*, 24 October 2006, Sydney, p. 42. See also Mr Michael Murphy, Past President, Association of Financial Advisers, *Committee Hansard*, 20 November 2006, Canberra, p. 91; Mr Steve Tucker, Chief Executive Officer, MLC, *Committee Hansard*, 7 March 2007, Sydney, p. 74.

42 IFSA, *Submission* 60, p. 24.

considering the future of the exemption, as it had significant ramifications for consumers caught up in a dispute.[43]

8.54 SPAA argued that the complexity of SMSFs required those advising on them to achieve accreditation at a higher level than is currently set by ASIC (PS146) and the Financial Services Education Agency of Australia. They consider that any lowering of standards, including the continued exemption of unlicensed accountants, would be unsatisfactory.[44]

8.55 The exemption was also said to complicate the job of accountants, who found the legislative boundary difficult to negotiate. Usually, accountants had the added complication of their client not recognising that a 'line' exists:

> [The] accountants' exemption is actually very difficult to adhere to in practice, and for anyone merely to advise on the structure of a self-managed superannuation fund without getting into the advice space is difficult, as shown by the outcomes in the ASIC shadow shopping report; the majority of accountants who were surveyed actually were acting without appropriate licence authorisation. So we believe the exemption really needs to be rethought.[45]

8.56 CPA Australia examined the same issue from a different perspective, expressing frustration with the exemption as it stands. It explained that:

> Accountants are limited. If a client comes in, they can ask to have a self-managed fund established. The adviser, if he is unlicensed, has no scope to suggest that that is not the most appropriate path and maybe they should consider another type of fund … ASIC has reached a conclusion that you cannot possibly advise on going into a particular type of fund or structure of fund, unless you have considered the fund that they might already be in; whether or not they are actually switching money from that fund. Essentially, the exemption as it stands, of being able to advise on self-managed funds, does not really work at all. ASIC is expecting accountants to consider the other options and yet they are hamstrung to do so.[46]

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43 Mr Richard Gilbert, Chief Executive Officer, IFSA, *Committee Hansard*, Sydney, 24 October 2006, p. 97.

44 SPAA, *Submission* 70, p. 6.

45 Mr John Anning, Manager, Policy and Government Relations, FPA, *Committee Hansard*, 24 October 2006, Sydney, p. 42. See also Mr Hugh Elvy, Manager, Financial Planning and Superannuation, Institute of Chartered Accountants in Australia, *Committee Hansard*, 7 March 2007, Sydney, p. 25.

46 Mr Michael Davison, Superannuation Policy Adviser, CPA Australia, *Committee Hansard*, Sydney, 25 October 2006, p. 38.

8.57 It called for the extension of the exemption to cover superannuation structures other than SMSFs, so that suitable superannuation options, other than SMSFs, could be suggested to a client.[47]

Committee view

8.58 The committee notes that the discussion of the accountants' exemption during the inquiry echoed much of the evidence received by the committee during its 2004 inquiry into the Corporations Amendment Regulation 7.1.29A, 7.1.35A and 7.1.40(h).[48] The committee believes that arguments then presented by the peak accounting bodies for an extension of the exemption to include general structural advice on *all* superannuation funds, remain valid. The committee is not inclined to change its view that the current situation which enables accountants to provide general structural advice on SMSFs but not other superannuation structures disadvantages consumers who will go back and forth from accountants to licensees searching for various 'pieces of the puzzle'.

8.59 The committee believes that arguments presented by CPA Australia for an extension of the exemption are consistent with the recommendation of this committee in relation to regulation 7.1.29A:

> The committee recommends that subregulation 7.1.29A(1) be amended to read: 'Subparagraph 7.1.29(5)(c)(ii) does not apply to a recommendation by a recognised accountant in relation to a superannuation fund structure.[49]

8.60 The committee's recommendation in effect was that accountants should be able to provide advice on the structure of superannuation funds, rather than being limited to advising on SMSFs, without being licensed as financial advisers. In making this recommendation, the committee emphasised that the exemption should be strictly limited to advice on the actual structure of superannuation funds, a view that is unchanged. The committee stated in its report that the exemption:

> …must not touch on past or future investment performances of funds, or on specific superannuation funds or products nor about a person's investment strategy in a fund. When providing information, the accountant can only speak in generic terms about the various superannuation structures or the form that funds take—SMSF, industry funds, retail and corporate funds—and definitely not about specific funds.[50]

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47 Mr Michael Davison, Superannuation Policy Adviser, CPA Australia, *Committee Hansard*, Sydney, 25 October 2006, p. 42.

48 Parliamentary Joint Committee on Corporations and Financial Services, *Corporations Amendment Regulation 7.1.29A, 7.1.35A and 7.1.40(h)*, June 2004.

49 Parliamentary Joint Committee on Corporations and Financial Services, *Corporations Amendment Regulation 7.1.29A, 7.1.35A and 7.1.40(h)*, June 2004, p. 23.

50 Parliamentary Joint Committee on Corporations and Financial Services, *Corporations Amendment Regulation 7.1.29A, 7.1.35A and 7.1.40(h)*, June 2004, p. 23.

Recommendation 31

8.61 The committee recommends that the accountants' exemption be broadened in keeping with its previous recommendation 1 to amend subregulation 7.1.29A. This would enable accountants to advise clients on the structure of any superannuation fund, rather than being limited to advising on the structure of self-managed funds only.

Senator Grant Chapman
Chairman