Small funds ... big issues

As the number of SMSFs continues to grow, who will be held accountable – advisers or trustees? BEN POWER reports on whether education is the answer.

The release of the Cooper Review's Phase Three report has triggered debate over the level of educational requirements for trustees overseeing Australia's Self-Managed Super Funds (SMSFs).

The Super System Review, chaired by former Deputy Chairman of ASIC, Jeremy Cooper, has raised the prospect of the enforcement of minimum financial and compliance knowledge standards for SMSF trustees in a bid to boost governance standards.

Such a move, which was raised in the Review's Phase Three: Structure Issues Paper released in December, has been questioned by SMSF industry players, who say a greater focus on education and training for SMSF professionals, such as accountants and tax agents, would generate better outcomes.

"Logistically it (trustee education) would be a nightmare to administer," said Shirley Schaefer, Partner, Audit and Assurance, Superannuation at BDO. "I obviously support that tax agents and accountants should be better qualified and there should be better training for that."

The Cooper Review, which is examining the governance, efficiency, structure and operation of Australia's superannuation system, is being touted as an opportunity to provide a strong platform for the SMSF sector's future.

"It's an opportunity to really shape the SMSF industry going forward," said Aaron Dunn, SMSF Specialist Adviser at Outlook Tax and Accounting Solutions.

"There's a need for a greater level of governance. There's a lot that needs to be debated and challenged.

"The profession is the one that really needs to stand up. Because if they don't and don't acknowledge the need to change as they need to, in some respect their hand will be forced regardless."

Earlier in December the Cooper Review released its Statistical Summary of SMSFs, which was designed to overcome a lack of comprehensive information on the sector which has 410,000 funds housing $332 billion of assets – just over 30 percent of all super assets.

While SMSF industry members concede there is a need to boost professional standards in the industry, they say the statistics show the SMSF funds and the broader industry are in good shape, with solid returns, falling costs, few problem funds, and no overweighting to overly risky assets.

"The statistics support what the SMSF sector's been saying for a while," Schaefer said, adding that many perceptions of the sector have previously been based on anecdotal evidence.

Submissions on the Cooper Review's reports close as this issue of *Superfunds* was distributed, with the release of preliminary recommendations due around April/May this year.

Dunn says education is one of the major issues generating industry talk.

"They (the Cooper Review) want to make sure that there's an increased awareness – of trustee obligations," he said. "There's a perception that the literacy level isn't where they want it to be."

The Phase Three report asked whether: "given the obligations of being a trustee and the minimal barriers to entry, should there be some minimum level of financial and compliance knowledge required?"

But most industry players reject that as an option. "While I think everyone in the industry would certainly agree that if trustees understood everything much better that would be a good thing, administering some form of mandatory education or mandatory skills would be very difficult," BDO's Schaefer said, noting that a person can be a director of a company without any training at all.

Dunn agrees that enforcing educational levels on trustees "isn't necessarily the way to do it".

"That won't work because it would be a disincentive to use SMSFs as a means of funding people's retirement," he said. "They (SMSF members) have already lost interest elsewhere. To have in force a level of mandatory education in my opinion wouldn't work. But that doesn't mean we (accountants and tax planners) shouldn't

have an obligation to be fully versed enough to play an educational role to our clients as a profession."

Dunn says that instead of compulsory trustee education there should be a further push to increase professional standards, either through a code of professional conduct requirements or legislated.

This view is backed up by Michael Hutton, a Tax and Super Partner at HLB Mann Judd.

"I think that if you train up the accountants and advisers that would have more impact than trying to train up the trustees," Hutton said.

"It's just because there are so many trustees with varying degrees of experience that it would be a fairly hard nut to crack. I think certainly the more on top of it accountants and advisors are, the better the advice that will flow through to the trustees."

The statistics released by the Cooper Review seem to support the case for the need to increase professional standards.

Some 60 percent of tax agents/ accountants have 10 or fewer SMSF clients. Furthermore, around 20 percent – or 3100 tax agents – have just one SMSF client.

"Over time from an education point of view, if the trusted adviser is the accountant, you need to be able to have a skill set to be able to pass on that knowledge," Dunn said.

"I presume there would be a lot of people in there doing things that are fundamentally wrong. Trustees are doing things wrong because no one is advising them; because those doing the returns don't know or understand the issues."

Dunn points to the improvement in auditor standards surrounding SMSFs as evidence that boosting professional standards can pay off.

In 2007 some 70 percent of auditors were auditing fewer than 5 funds, and 40 percent were auditing just one. As a result there was a push to improve standards.

CAs and CPAs have now got competency requirements, and the SMSF Professionals Association of Australia (SPAA) has introduced specialised auditor accreditation. That 70 percent of auditors doing less than 5 funds has now fallen to 51 percent in 2008.

"Changes in respect to that (higher professional standards) have started to push some people out of it (SMSF auditing)," Dunn said. "We're seeing a higher level of competence in the auditor side."

David Rolleston, a director of UBS Wealth Management Australia, says the Cooper Review's statistics are supportive of the industry. "I was very pleasantly unsurprised," he said.

He says there had been suggestions that many SMSFs have been doing the wrong thing and trying to rort the system.

"That isn't reflected in these figures," he said. He notes the number of SMSF funds made non-complying were 5 in 2007, 24 in 2008 and 99 in 2009, with the Cooper Review attributing the rise to an increased number of funds. "That's similar to APRA regulated funds," Rolleston adds.

The Cooper Review Phase Three report also asked whether there was another way of addressing the issue of low trustee financial literacy, "such as a mandated limitation on the products in which SMSFs, or some subset of SMSFs, are permitted to invest?"

It asks whether SMSF investments should be restricted to financial assets, such as listed equities and managed funds.

Basically they're saying that "if that lower level of educational literacy is par for the course, do we impose restrictions around how people can invest?" Dunn said. But he notes that any restrictions would severely curtail the appeal of SMSFs.

"The capacity to control has been, and will always be, the key driver for SMSFs," he said. "The ability for people to make choice in respect of how they invest and being able to control financial destiny themselves in essence is why people set up SMSFs."

BDO's Schaefer says the statistics highlight that the investment mix of SMSFs is not radical. "The investment mix for an SMSF actually doesn't look that different from that of an APRA fund," she said.

As at 30 June 2008, 32.4 percent of SMSF assets were in listed Australian shares and 26.4 percent in cash and term deposits. "That's where APRA funds are invested as well," she said.

The default investment strategies of APRA-regulated funds have average allocations to domestic equities of 29 percent and 26 percent to fixed interest.

One of the Phase Three report's main concerns is whether allowing super funds to use gearing has gone too far. The report asks whether instalment warrants over property, contracts for difference (CFDs), and other leveraged products should be accessible to SMSFs. But Dunn notes the statistics show that just 0.1 percent of SMSFs had a derivative or instalment warrant.

UBS's Rolleston also said just 0.1 percent are invested in artwork and collectibles and 3.3 percent in residential. He believes that leverage should be maintained, though there is always a risk the wrong people use it at the wrong time. The issue of education and knowledge levels of trustees has also triggered debate over the extent to which trustees receive advice.

Phase Three was also concerned about improving the access of SMSF members to quality information and advice, and how it could be delivered. It raised the prospect of requiring all SMSFs to have at least one key service provider licensed by ASIC.

Dunn notes the statistics suggest Trustees are getting more advice. Some 27 percent of SMSFs at 30 June 2008, which own 47 percent of all SMSF assets, are fully or partially in pension withdrawal phase. "That conversion to pension phase usually would have some level of advice attached to it because the law actually requires it."

He notes that while accountants are still the centrepiece of most SMSFs "the adviser is taking a more active role. SMSF is about strategy first and foremost. I think those licensed to be able to provide advice in that space, if they're doing it properly, are coming out quite well in a revenue point of view."

At the same time SMSFs have managed to outperform. The return on assets for the SMSF sector, according to the ATO, in the year to June 30 for 2006, 2007 and 2008 was 12.6 percent, 16.9 percent and -6.1 percent respectively – outperforming the 12.2 percent, 13.3 percent and -7.8 percent for APRA-regulated funds which have more than four members. The report does caution however, that the performance figures might not be directly comparable.

Craig Jameson, the managing director of SMSF specialist Super Concepts, says the statistics also show that one of SMSFs' comparative advantages are their relative cost- effectiveness.

The Statistical Summary said average operating expense ratio of the SMSF sector fell from 0.86 percent in 2006, to 0.77 percent in 2007 to 0.69 percent in 2008 – a fall of almost 20 percent. That's lower than the 1.2 percent for the whole of the superannuation industry, which includes SMSFs.

"There's a large proportion of trustees paying even less," Jameson said. "Prices quoted are well above what we charge."

THE ASFA VIEW

The real issue here is providing all SMSF trustees with the basic skills and knowledge to understand the rules and be in a position to query any advice that is received, says ASFA senior policy adviser, Tony Keir. Approximately 77 percent of SMSFs have more than one member.

ASFA believes that it is important that all trustees have enough knowledge to play an active role in the running of their fund, as such, ASFA has been a major provider of trustee education to the industry generally for a significant period.

ASFA is not advocating a process that makes SMSF trustees superannuation, taxation and investment experts. We understand that, given the depth and complexity of superannuation laws, any trustee education should be limited in scope to the SMSF trustee's basic obligations.

"Understanding your role and responsibility as an SMSF trustee can only be a healthy thing," Keir says. "Our experience over the years with phone calls made to the ASFA offices is that instances of SMSF trustees being poorly advised are, unfortunately, too common. Also, we have seen cases where there has been a death or a relationship break up (either personal or business) less dominant members of the SMSF have been disadvantaged."

ASFA believes that if the trustees understood their position at the point of establishment many issues could be avoided and different outcomes would have eventuated. "An example here is the lack of an external dispute resolution mechanism for SMSFs," Keir says.

At present disputes regarding SMSFs must go through the courts. "Resolving disputes through the courts is time-consuming and incredibly costly," Keir says.

"So too is trying to unravel investments such as the purchase of a trustee's parent's home to provide some cash flow for the parents to retire. These are real life occurences that have been reported to us.

"If these trustees understood what they were signing up for, would they have done so?"

ASFA supports the further training and skilling of advisers; this too is fundamentally a healthy thing.

"We know that mandating education standards is problematic," Keir says.

"At the very least though, a voluntary regime where education of SMSF trustees is actively encouraged, combined with improved training for advisers can only be a good thing."

IS THE TRUST MODEL APPROPRIATE FOR SMSFs?

The Cooper Review has questioned whether the trust model is appropriate for SMSFs and whether it still delivers the best outcomes. It suggested an alternative model would be fore SMSFs to be created by legislation rather than by private instrument.

"A SMSF could then be created simply by completing an approved form and paying a prescribed fee to the ATO (Australian Tax Office)," it said. Aaron Dunn, SMSF Specialist Adviser at Outlook Tax and Accounting Solutions said if reforms were to remove the need for a trustee "that would be a fabulous result". "If it could be done in a different environment, it's something that generally has merit," he said.

The report also commented on the size of funds. It asked what purpose is served by limiting SMSFs to four members. Some 90 percent of funds have only one or two members.

BDO's Shirley Schaefer said many industry players didn't understand the need to limit four members to a fund and believe it's an arbitrary number.

"What is an SMSF? It's a family super fund," she said. "Why is it (limited to) four? Mum and Dad and three kids can't all be in the same super fund. Perhaps there needs to be some changes." She said membership could be redefined and based on the relationship of members, not by number of members. But David Rolleston, a director of UBS Wealth Management Australia, said he was happy with the limit of four. "I just see it as a risk with more than four members who are all trustees ending up having disputes."

ARE SMSF MEMBERS GETTING YOUNGER?

The Cooper Review found that some 66 percent of members in new funds were aged under 55; against 46 percent for all SMSF members.

Some 81 percent of new fund members were aged between 35 and 64. "Member age for newly established funds is younger than the existing age demographic for all SMSFs," it noted.

Outlook Tax and Accounting Solutions' Aaron Dunn, said the statistics show "new establishment in 35 to 55 bracket was fairly high against what would be the average member age at the moment.

The driver is coming out of things like gearing in super. There's a general attraction for those sort of strategies for SMEs and property investors who have an interest in property."

Super Concepts' Craig Jameson agrees that SMSFs are attracting younger members. "That's clearly our experience as well," he said. "We think that the market's expanding. There's a number of issues that are converging to increase the number of people … for who it makes sense to have their own SMSF". "The market is moving down in age, which is increasing opportunity for this space."

Jameson noted a recent Rice Warner report that said SMSFs will start to diminish in relation to retail and industry, now baby boomers are heading towards retirement.

He said the report ignores other positive factors including rises in the size of members super balances, the increased desire for more control and investment flexibility, the desire for estate planning and the ability to gear into real property and other assets in their super funds.

The report "ignores all those things", he said, adding he is confident of the ongoing growth of SMSFs. "We think it's a good market." SF