

Technically Speaking: Impact of recent SMSF audit court cases

2018 saw two significant court cases where SMSF auditors were found liable for investment losses of an SMSF and were required to pay extensive damages to the SMSF trustee. These cases, [Cam & Bear Pty Ltd v McGoldrick \[2018\] NSWCA 110](#) (“Cam & Bear”), and [Ryan Wealth Holdings Pty Ltd v Baumgartner \[2018\] NSWSC 1502](#) (“Baumgartner”), should be understood by all SMSF professionals. The cases have a broader impact than just for SMSF auditors but affects advisers who act as an intermediary between trustees and auditors and those who arrange investments, especially unlisted ones, for trustees. In light of these cases, advisers across the sector are likely to need to provide auditors with more evidence of asset valuations going forward.

The cases highlight that any SMSF adviser not meeting their professional standards may expect future litigation from trustees who are looking to recoup losses from their investments.

The following analyses the key takeaways from these cases and how industry practices may change considering both decisions.

Breaking down Cam & Bear

The Facts

- The trustee of the SMSF was Cam & Bear Pty Ltd. Dr Bear and Ms Campbell were directors of the trustee for the SMSF.
- Mr McGoldrick was the auditor who audited the SMSF, including for the financial years ended 30 June 2003 to 2007.
- According to Dr Bear, from 1996 to 2008, he understood from his conversations with Mr Lewis, the custodian, and from the financial accounts that he received, that the fund’s assets consisted of cash amounts and shares.
- In fact, the cash amounts were actually lent on an unsecured basis to Mr Lewis’ company LSL holdings.
- Mr McGoldrick, queried the description in the financial accounts but Mr Lewis advised him the SMSF trustee was happy with the description.
- Mr McGoldrick signed and certified the audit reports without qualification each year. They stated that the financial statements fairly reflected the financial position of the fund.
- At no time did Mr McGoldrick communicate directly with the SMSF trustee, Dr Bear.
- Dr Bear went to withdraw cash from the SMSF to start a new medical practice, however, he was unable to since the contributions had been used for unsecured loans. Mr Lewis’ companies then went into voluntary administration.
- Cam & Bear Pty Ltd sued Mr McGoldrick for damages for negligence and misleading and deceptive conduct.

The Decision

- The court found that the failure to tell Dr Bear the loans might not be recoverable caused Dr Bear to continue to make contributions to the SMSF’s investment, which otherwise would not have been made.



- Mr McGoldrick should have sought and considered the financial statements for the LSL Holdings. In doing so, he would have found that LSL Holdings had a significant deficiency in assets. This would have resulted in further investigation or a qualification of the audit report.
- Importantly, the court found a competent auditor would have made these enquiries about the financial condition of LSL Holdings.
- The Court stated that Mr McGoldrick was a very experienced auditor who was engaged for the purpose of protecting the fund and its trustees against financial risks that included the risk of loans forming part of the SMSF's assets not being recoverable because of the poor financial position of the debtors. Mr McGoldrick was found to be clearly negligent in failing to make proper enquiries.
- The Court was not satisfied that Databank, the company which compiled the financial statements, was a concurrent wrongdoer. There was no evidence to establish the basis upon which it was engaged that negligence and/or misleading conduct occurred.
- The level of trust reposed in Mr Lewis prior to 2008, together with the conceded lack of understanding as to the difference between the description "Cash - LSL Holdings" and "Loans - LSL Holdings" lead to the conclusion that the misdescription in the financial statements was not the cause, nor a contributing factor, to the losses incurred. Rather, it seems, the losses were occasioned by an inappropriate level of trust in Mr Lewis, an inappropriate arms' length relationship between the Trustees and Mr Lewis, which trust was misplaced and/or abused.
- The Court apportioned 10 per cent of damages to Cam & Bear and 90 percent to Mr McGoldrick. The departure from the peer standard by Mr McGoldrick was most significant.

Breaking down Baumgartner

The Facts

- Baumgartner Partners undertook audits for the Ryan Holdings Retirement Fund in three successive financial years ending 2007 to 2009.
- In 2006, Ryan Wealth Holdings Pty Ltd (SMSF Trustee) entered into a series of investments by way of unsecured loans pursuant to a series of facility agreements. These were based on advice from the trustee's financial adviser who was also their accountant and a beneficiary of the investment money.
- Over the period of 2012 to 2014, several of the entities associated with the property ventures with respect to the loans and investments were placed into bankruptcy or liquidation.
- Ryan Wealth Holdings Pty Ltd believed that as a result of the failure of the auditor, irregularities went undetected for many years. These included a lack of interest receivable, distributions and financial statements. When irregularities were discovered, the opportunity to redeem many of the loans and investments of the SMSF, or to pursue recovery against those who advised on the loans as investments, had been lost.
- They believed if the auditor contacted them, or issued a qualified audit report, an alarm would have been raised to them as SMSF trustees.
- Baumgartner Partners believed that notwithstanding some fault of their audit, the trustee did not demonstrate causation or loss.



The Decision

- The Court was satisfied, on the balance of probabilities, that if a qualified audit report had been issued in 2008 or in subsequent years, the SMSF trustee would have 'called in' the loans and investments.
- Had Baumgartner Partners performed their role competently, the deficiencies in the financial accounts and operation of the SMSF would have been exposed.
- The Court also found that the auditor should have notified a breach of the investment strategy regulations as the fund was not adequately diversified and investments were not in line with providing for retirement, and certain covenants in the strategy.

SMSF Association Best Practice Case Takeaways

In both cases, the SMSF auditor was found to fall short of the required standard for their professional auditor duties.

Whilst trustees and their advisors are responsible for preparing the financial statements for their SMSF, it is crucially the fund's auditor who owes a duty of care to the trustee to ensure that the funds' investments are correctly stated in the financial reports.

ATO Update – Auditors may need to qualify more

In response to the cases, the Australian Taxation Office (ATO) released a [short statement](#) reinforcing the obligations imposed on auditors, notably that the requirement to value assets at market value was the most common contravention not identified or reported by auditors who were referred to ASIC. They stated,

“SMSF auditors need to obtain sufficient appropriate audit evidence from SMSF trustees to verify the value of a fund's investments. It is not the auditor's job to undertake a valuation but they should seek evidence that shows how the asset was valued, including the method used and the data relied upon.

If the auditor is unable to obtain sufficient verification that material assets are valued at market value, they should qualify the financial and compliance report sections of their SMSF Independent auditor's report stating they have been unable to obtain sufficient appropriate audit evidence to verify the asset values. They should also lodge an Auditor/actuary contravention report for the contravention and notify the trustees in a management letter.”

Unlisted investments

In many SMSF audits, it is difficult to confirm the value of unlisted investments such as private companies and the recoverability of unsecured loans. As highlighted by the cases, the decisions now serve as a warning that SMSF auditors need to obtain sufficient independent audit evidence, particularly regarding material balances, to meet their professional requirements and be comfortable in their audit opinion.



SMSF auditors will need to review their processes and ensure they are:

- Requesting and reviewing as much information as possible, such as the agreements, rights and obligations relating to the balance of unsecured loans.
- Requesting and reviewing the financial statements of entities connected with the unlisted investments or unsecured loans.
- Undertake enquiries regarding any 'red flags' noted in the audit of these investments.
- Request representations from relevant parties but not solely rely on these.

However, it is important to remember that SMSF auditors do not have the obligation to value SMSF assets. Their obligations also do not extend to the audit of any underlying investments but merely to obtain sufficient audit evidence.

Communication with trustees to alert them of any concerns is also an essential takeaway from these cases. This may be in the form of verbal communication throughout the audit but also via an emphasis of matter, management letter or the audit report. This may include needing to send trustees the audit report directly, not just to their accountant or administrator. It is particularly important, that trustees are aware of any limited ability that the auditor may have in accurately auditing the value of unlisted investments or the recoverability of unsecured loans.

This may lead to more qualifications of audit reports, as emphasized by the ATO or auditors being unable to express an opinion on certain assets.

Investment strategies

The audit of the SMSF investment strategy was also analysed, particularly in the Baumgartner case, as an area that SMSF auditors must refocus their attention.

An SMSF auditor must read the investment strategy and determine whether each investment by the SMSF is made in accordance with regard to the whole of the circumstances of the SMSF.

Typically, it is a document that does not attract much attention from SMSF trustees and in turn may not get a detailed audit by an auditor. However, the investment strategy is a significant document from a regulatory perspective that must be reviewed in detail.

In Baumgartner, the Court found that the auditor should have notified a breach of the investment strategy regulations as the fund was not adequately diversified and investments were not made in accordance with the whole circumstances of the SMSF and the strategy.

SMSF auditors therefore need to closely review the investment strategy and query concerns with the trustee and their accountant and follow up any effective resolution of any issues.

However, it is important to remember that an SMSF auditor need only review the strategy from a compliance point of view and not to determine its suitability or effectiveness for the trustee.



Trustee education and contact

SMSF auditors will also need to re-think the way they communicate with their clients, which is ultimately the SMSF trustee.

As indicated above, this may involve direct communication with the SMSF trustee rather than the trustee's accountant, adviser or administrator. It may also involve more communication throughout the audit process.

SMSF auditors also need to re-think the form of communication. Rather than relying on an audit report or management letter that may not reach the SMSF trustee effectively, auditors may need to speak with the trustees to inform them of concerns or the process. This is especially relevant where the trustee's accountant or adviser has dealt with the relevant asset in question as in *Cam & Bear*.

This involves educating trustees to be aware they may be receiving more detailed requests for information about their investments as auditors and advisers seek to ensure they are adequately providing quality professional services. SMSF trustees also need to be educated that a qualified audit report is not a cause for panic but a flag for trustees to look at the underlying cause of the qualifications and seek assistance on how to rectify them.

Another lesson from these court cases for SMSF trustees is the potential danger of having all advice services – accounting, auditing, administration and investment advice – with the same or even closely-related advisory firms. If trustees believe this is the most cost-effective and efficient solution, there is an even greater need for them to do due diligence to ensure their fund is compliant.

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