



# An Auditor's Guide to Instalment Warrants

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An Auditor must review any loan instalment warrant arrangement within a Self Managed Superannuation Fund (SMSF) in accordance with section 67 of the Superannuation Industry (Supervision) Act (SIS Act).

Any SMSF that invests in Assets held via an instalment warrant arrangement must be considered not only in terms of compliance with section 67 of the SIS Act, but also in the context of duties imposed on Auditors of SMSFs.

What follows is an overview of Auditor's responsibilities in respect to SMSF Loans and the need to understand such responsibilities.

## Audit Overview

Every SMSF is required to be audited, and as part of the ongoing compliance with respect to SMSFs, the ATO is targeting Auditors to ensure that standards are met and contraventions are reported.

Furthermore in response to the need for standard auditing practices for SMSFs, the Auditing and Assurance Board (Auditor's Board) has released Guidance Statement GS 009, which outlines the auditing requirements for SMSFs.

Both the ATO and the Auditor's Board promote the independence of the Auditor.

In order to maintain independence an audit should be declined if:

- The financial statements are also prepared by the Auditor; or
- The trustee has a relationship with the Auditor; or
- The firm provides investment advice and their income is linked to SMSF performance; or
- The administrator is putting pressure on or intimidating the Auditor to complete the audit without due consideration.

An SMSF Loan by its structure is governed by the SIS Act and hence would need to be included within an SMSF Audit.

## Trust deed considerations

A Trustee of an SMSF contemplating instalment warrant borrowing must first ensure their trust deed requirements of the SMSF are met. Many SMSF deeds limit borrowing to temporary borrowing as previously permitted under the SIS Act. Medium to long term instalment warrant debt is not a temporary borrowing, and so in this instance the SMSF deed would need to be updated prior to any debt agreement being structured within the SMSF.

## Sole Purpose Test

The Auditor must consider the impact of instalment warrant arrangements on the SMSF's Trustee in satisfaction of the sole purpose test. Instalment



warrant arrangements may be negatively geared. Trustees of the SMSF should document how a negatively geared investment satisfies the sole purpose test.

### **Investment Strategy**

The Auditor must also review the investment strategy to ensure it contains the minimum legislative requirements of risk, return, liquidity and diversification. Typically an SMSF's investing in instalment warrant arrangements could have limited diversification. This should be adequately documented within the strategy. Further, where this type of debt arrangement is negatively geared the SMSF's investment strategy should document why negative returns are considered appropriate in light of the SMSF's overall strategy to provide for the interest of members.

### **Acquisition of Permitted Assets**

The Auditor must ensure the Asset being acquired is a permitted acquisition. The SMSF is prohibited generally from acquiring an Asset from a related party (unless exempted under section 66 of the SIS Act in respect to Business Property or Listed Shares). The exemptions under section 66 of the SIS Act also apply to the acquisition of an Asset using an instalment warrant arrangement. So, notwithstanding the SMSF is not acquiring the Asset, as the Asset is held by the custodian, the Asset must be a permitted acquisition under the SIS Act.

Furthermore the requirements of section 67(4A) of the SIS Act are that the borrowing must be used to acquire an Asset, and as a result the Auditor must distinguish between costs that are capitalised and the actual Asset being acquired. That is to say, Auditors should also

ensure interest on the debt is not capitalised onto the loan account. It can be capitalised onto the cost of the Asset, but should not be added to the debt the SMSF has with the financier.

### **Custodian Arrangement**

The Auditor should ensure the ownership structure is appropriate and complies with section 67(4A). That is the Asset should not be owned directly by the SMSF. Rather it should be owned by a custodian, or a trustee, who holds the Asset in trust for the Trustee of the SMSF.

The Custodian / Bare Trust Trustee should be a different legal entity to the Trustee of the SMSF to ensure the structure of the SMSF and the Trustee are separate.

If the Auditor is going to review the custodian documentation, then evidence should be obtained to confirm the Asset is held in trust for the trustee, and that the SMSF has a beneficial interest in the Asset.

### **Limited Recourse Loan**

The Auditor must review whether the loan structure is limited in recourse. The financier can only access the Asset being acquired under the Finance arrangement. This limitation in recourse has been implemented to safeguard other Assets of the SMSF, and to ensure that the financier has no ability to claim on the other Assets of an SMSF.

### **Guarantees Sought by Members**

Many Financiers are obtaining guarantees from the Members of the SMSF. The Auditor should consider whether the proposed guarantor understands the implications of executing a guarantee. The ATO issued a Tax Payer Alert on this particular



matter. Any party looking to provide a guarantee to the financier should review their personal risks. The provision of a guarantee also allows the provider to seek compensation from the party it has been provided to in the event the bank demands payment from the guarantor. The impact of this common law right, is the members providing the guarantee can take action against the SMSF for any losses they might incur as a result of providing that guarantee.

It may therefore difficult to argue that the provision of a guarantee is a limited recourse loan, as there is recourse, potentially, on the Assets of the SMSF. To ensure the structure complies with section 67(4A) of the SIS Act members are asked to execute a guarantee disclaimer, which removes their right to take action against the Assets of the SMSF for any losses they might incur personally.

#### **Loan Documentation**

The Auditor must ensure the documentation has been correctly completed, and the relevant party is noted on various documents. The loan documentation should note the SMSF, not the custodian of the Asset.

It is recommended that the Auditor request a representation letter from the Solicitor providing the loan and trust documentation to the SMSF, to ensure there is legal representation that the structure complies with the SIS requirements.

#### **Cash Flow Considerations - Generally**

Auditors have to assess whether a SMSF is in an unsatisfactory financial position, may also have to determine whether the going concern assumption is

appropriate each financial year. Where a SMSF has geared heavily, and has a limited ability to repay the debt, the Auditor may need to determine if this constitutes an unsatisfactory financial position, and whether the SMSF in question is a going concern.

#### **Cash Flow - and Contributions to the SMSF**

Where debt was planned to be repaid using contributions alone, consideration should be given to the ability of the members to contribute at these levels, especially given the government's reduction in contribution limits for all members.

#### **Cash Flow - and Payment of Insurance Premiums**

The Auditor may also wish to consider whether income protection insurance and life insurance are adequate or appropriate as a contingency plan to ensure the debt obligations can be met in the event of the death of a member or the loss of employment by a Member of the SMSF.

#### **Accounting for the Warrant**

There are two methods to account for the instalment warrants including:

The market value method values the warrant at the closing trading price (in the case of listed warrants). No liability is reported for the balance owing on the warrant.

Under the Asset/Liability method the value of the full Asset is reported, as if the SMSF held the Asset directly. The liability booked equates to the outstanding amount of the warrant payable plus interest and borrowing costs at year end.

The ATO state that the Asset / liability method should be used for tax reporting purposes.



There should be no accounting entries for the Custodian, and all income and expense items pertaining to the Asset being acquired are accounted for in the records of the SMSF.

### **Conclusion**

The issues raised in respect to an Auditor's responsibilities are critical in respect to any adviser who seeks to work with

SMSF Trustees. Crucial to such understanding would involve specialised training to ensure all compliance and audit responsibilities are met.

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**For Further information please visit [www.ili.com.au](http://www.ili.com.au) or contact:**  
Melinda Wood - ili Enquiries (02) 9251 3611 [enquiries@ili.com.au](mailto:enquiries@ili.com.au)