

KELLY + PARTNERS

CHARTERED ACCOUNTANTS

30th August 2018

Consumer Property Law Review
Policy and Legislation Branch
Consumer Affairs Victoria

By email: consumerpropertylawreview@justice.vic.gov.au

To whom it may concern,

Submission by Kelly + Partners Chartered Accountants Commentary & submission in relation to Owners Corporations Regulations 2018 Regulatory Impact Statement

Below will outline our major concerns and attach our original submission in relation to the current legislative review dated 15th December 2016 (refer Appendix B)

MAJOR FLAWS IN PROPOSED APPLICATION OF AUSTRALIAN ACCOUNTING STANDARDS TO PRESCRIBED OWNERS CORPORATIONS.

There are some major flaws in the logic applied to the proposed application of Australian Accounting Standards (AAS) to prescribed owners corporations in Victoria. We cannot stress enough how this will impose significant costs on the individual owners corporations and furthermore the desired outcomes of better governance across the sector will not be achieved due to the materially insignificant number of owners corporations (0.5%) that it will relate to.

We also note that in NSW the application of AAS under the trust account reporting pertaining to Outgoings Audits has lead to many participants under the regime effectively ignoring the provisions.

Below we outline our serious concerns about the applicability of AAS to prescribed Owners Corporations in Victoria and our view that the focus should be upon a more inclusive definition of Prescribed Buildings under the regulations because the current proposed approach will not achieve the desired outcomes of better governance more broadly across one of the most important growing sectors in the Victorian economy.

Finally, we must stress the fact that the assertion in the Regulatory Impact Statement that :

“Stakeholder feedback indicates that most financial statements for prescribed owner’s corporations are prepared by certified or chartered accountants. Therefore, they would be prepared in accordance with Australian accounting standards.28” ...in our experience is false.

Based on our extensive audit experience across the sector both in Victoria and nationally we find this not to be the case , rather these financials are often prepared by unqualified individuals employed by Owners Corporation managers with little or no knowledge of AAS . Please refer to Appendix A of this submission indicating all AAS that need to be considered . We note that although many do not apply a complete understanding of AAS is required to determine applicability.

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SUMMARY DISCUSSION POINTS REGARDING APPLICATION OF AAS TO BODIES CORPORATE REPORTING IN VICTORIA

- **Negative impacts resulting from applicability of AAS to Bodies Corporate**
Overall the intention that the regulation of prescribed owners corporations and OCS more generally should be tightened is certainly not disputed, however, the negative impacts resulting from the application of AAS to bodies corporate in Victoria cannot be overstated.
- **Limited knowledge and reduced understanding of presented financial reports**
The applicability of the AAS will actually reduce the understandability of the financials presented. Strata managers and employed accountants currently do not have the necessary knowledge to prepare AAS compliant financials. In addition to this the ability for body corporate owners of limited accounting knowledge will find the information potentially less understandable. This will have the potential effect of disenfranchising owners and potentially impede decision making.
- **Body corporate managers directly impacted**
The greatest impact will be on the strata managers and their accounts staff preparing financial reports. Strata managers will be unable to provide AAS compliant financials :
 1. Existing Software and associated compliance upgrades – significant investment would be incurred by the body corporate manager and these costs would be passed on to the consumer.
 2. Knowledge – Body Corporate managers are not trained in AAS reporting & lack sufficient understanding AAS reporting requirements. This is outside the scope of their expertise. Our observation of the accounting knowledge across the body corporate industry generally is that it is low.
 3. As a result Bodies Corporate will require external expert accountants to prepare financials for prescribed owners corporations and will have to absorb any associated costs.
- **AAS compliance potentially in conflict with industry standard practice and current legislation**

Some of the impacts resulting would be that all plans falling under the regime would be accruals; Capital items would be reported on the balance sheet contradicting the existing legislation pertaining to maintenance funds.

IT IS IMPORTANT TO NOTE THAT : the applicability of AAS would be necessarily retrospective creating the need to prepare prior period financials that were AAS compliant.

These items alone all pose potential severe complications for the strata manager and the owners. The applicability of AAS would be an imposition on the industry that would not achieve the desired outcome of improved governance and represent significant costs.

- **Logistical considerations, pricing & capacity issues**
There will be a deluge of accounting jobs to accounting firms in order to prepare AAS compliant reports – costing in the vicinity of \$5k each. The capacity for accounting practices (many of whom have had little or no experience within the Body Corporate sector) to cope with this rush for the AAS compliant financials is questionable and the presentation of those AAS compliant financials may not fit within the timeframe of the AGM. Additionally, the cost of an audit to provide any assurance under the AAS regime will also increase significantly for a prescribed owners corporation.

RESTRICTED COVERAGE OF ONLY 0.5% FALLING UNDER PRESCRIBED PROVISIONS DIMINISHES GOVERNANCE OF SECTOR AND PRODUCES INEQUITY

It is stated that the mandatory requirements to audit financial statements in Victoria affects 403 owners corporations (or 0.5 per cent of all owner's corporations). This is an abysmally small sample and suggests an overemphasis on the "visible" high rise apartment lot owner and the majority "invisible" rate paying lot owners (99.5%).

There is a potential equity issue here and the question should be asked: "Why do 100 lot owners in one building have more of a right to accurate, materially correct audited financial information than 100 lot owners comprising 10 x 10 lot buildings?". Presumably each individual lot investment should be regarded as equally important regardless of the building size they happen to reside in? This is where the sole focus on an extremely narrow band of 0.5% of the sample set fails to deliver better outcomes for the entire sector.

Furthermore, the current definition of Prescribed owners corporations includes a major flaw by excluding extraordinary levies and any other revenues derived from the owner's corporation other than annual fees. Accordingly, this definition can be manipulated to avoid the prescribed regulations.

Currently the definition of Prescribed owners corporations (formerly body corporate):

- have more than 100 lots (including storage lots, car parking lots, and accessory or ancillary lots), OR
- collect more than \$200,000 in annual fees in a financial year. This fee total includes fees collected:
 - from separate owner's corporations for storage lots, car parking lots and accessory lots
 - for general administration and maintenance and contributions to maintenance plans.

IMPORTANTLY NOTE: It does not include extraordinary fees as determined under section 24 of the Owners Corporations Act 2006. This is clearly problematic and opens a major flaw in the regulation whereby an Owners Corporation or Owners Corporation manager in anticipation of the \$200k annual fee threshold being reached can potentially resolve a "normal fee" to be an "extraordinary fee" to purposely avoid the prescribed regulations.

Additionally, **it does not include revenues from external 3rd parties** including rental or lease agreements for telecommunications towers, billboards etc.

For the existing prescribed OC definition to work effectively the monetary threshold of \$200,000 needs to include all revenues derived by the OC from all sources. This all inclusive approach will increase audit coverage and ensure that OC's striking large extraordinary fees or receiving significant revenues from 3rd parties are included in the regime, there is no substantive argument that would not support this approach.

AN ALTERNATE PRESCRIBED MONETARY THRESHOLD CALCULATION SEE NSW REG 21

An alternate approach to tighten the prescribed monetary threshold is provided by Regulation 21 of the Strata Schemes Management Act 2015 Regulations. As part of the general tightening of the governance of bodies corporate in Victoria there are some practical measures that could be implemented.

Currently the monetary threshold for a prescribed plan is \$200k of annual fees. Interestingly it excludes extraordinary fees.

Resultingly, the period in which a Body Corporate often makes its most significant capital investment is excluded from the prescribed regime. This is counter intuitive and may also provide scope for avoiding the mandatory audit provision by classifying fees as extraordinary.

We note that the recently revised NSW legislation has provided a more inclusive definition of the revenues and assets that would trigger the monetary threshold. See sec 95 of the Strata Schemes Management Act 2015 and the prescribed calculation of the threshold contained in Regulation 21

For the purposes of Section 95(4) of the NSW Act, the amount of the annual budget for determining mandatory audit is to be the sum of the following:

- Budgeted Levies (including special levies)
- PLUS Any Other Income (e.g. interest received, rental income, insurance receipts, legal settlements, disposals of common property)
- PLUS Opening Balance Cash held (including Cash at Bank and Investments)

IMPORTANTLY: under the NSW legislation and associated regulation we note the inclusion of Special Or Extraordinary income AND the opening cash and investment balances. This should be a best practice guideline adopted particularly since major trust account frauds have occurred in Victoria over the past 3 years totalling millions of lot owners funds. The current approach clearly isn't a deterrent.

The adoption of a similar basis for the monetary threshold would achieve the desired outcome of a tightening in governance and independent oversight across the Victorian sector.

CONCLUSION:

We believe that the impact of AAS on prescribed owners corporations has been made on several false assumptions including the notion that most prescribed OC's are already applying AAS to their financial reporting. We also note that by adopting AAS would include acknowledging the retrospective nature of the approach as it would require prior year comparative balances in financial statements to be recast so as to be presented in accordance with AAS.

The focus, we believe should be on redefining the definition of a Prescribed Owners Corporation particularly in relation to the monetary threshold component to ensure that extraordinary and other revenues are included in the calculation. This would assist in wider audit coverage and better governance across the sector.

Thank you for the opportunity to contribute to the Consumer Property Law Review process.

Yours faithfully,



Peter Dawkins
Senior Client Director



Joel Russell
Client Director

APPENDIX A

Summary of potentially applicable AASB Standards

AASB No.	Title	Notes	Issue Date	Operative Date
<u>1</u>	First-time Adoption of Australian Accounting Standards [For for-profit entities only]	Compiled <u>Extra</u>	Dec 2017	1 Jan 2018
<u>2</u>	Share-based Payment	Compiled <u>Extra</u>	Dec 2017	1 Jan 2018
<u>3</u>	Business Combinations	<u>Extra</u>	Aug 2015	1 Jan 2018
<u>4</u>	Insurance Contracts [For for-profit entities only]	Compiled <u>Extra</u>	Jul 2017	1 Jan 2018
<u>5</u>	Non-current Assets Held for Sale and Discontinued Operations	<u>Extra</u>	Aug 2015	1 Jan 2018
<u>6</u>	Exploration for and Evaluation of Mineral Resources	<u>Extra</u>	Aug 2015	1 Jan 2016
<u>7</u>	Financial Instruments: Disclosures	Compiled <u>Extra</u>	Dec 2017	1 Jan 2018
<u>8</u>	Operating Segments	Compiled <u>Extra</u>	Nov 2015	1 Jan 2016

AASB No.	Title	Notes	Issue Date	Operative Date
<u>9</u>	Financial Instruments	<u>Extra</u>	Dec 2014	1 Jan 2018
<u>10</u>	Consolidated Financial Statements	Compiled <u>Extra</u>	Dec 2017	1 Jan 2018
<u>11</u>	Joint Arrangements	<u>Extra</u>	Jul 2015	1 Jan 2016
<u>12</u>	Disclosure of Interests in Other Entities	Compiled <u>Extra</u>	Feb 2017	1 Jan 2017
<u>13</u>	Fair Value Measurement	<u>Extra</u>	Aug 2015	1 Jan 2018
<u>14</u>	Regulatory Deferral Accounts	<u>Extra</u>	Jun 2014	1 Jan 2016
<u>15</u>	Revenue from Contracts with Customers [For for-profit entities only]	Compiled <u>Extra</u>	Dec 2016	1 Jan 2018
<u>16</u>	Leases	<u>Extra</u>	Feb 2016	1 Jan 2019
<u>17</u>	Insurance Contracts	<u>Extra</u>	Jul 2017	1 Jan 2021
<u>101</u>	Presentation of Financial Statements [For for-profit entities only]	Compiled <u>Extra</u>	Dec 2017	1 Jan 2018

AASB No.	Title	Notes	Issue Date	Operative Date
<u>102</u>	Inventories	<u>Extra</u>	Jul 2015	1 Jan 2018
<u>107</u>	Statement of Cash Flows	Compiled <u>Extra</u>	Mar 2016	1 Jan 2017
<u>108</u>	Accounting Policies, Changes in Accounting Estimates and Errors	<u>Extra</u>	Aug 2015	1 Jan 2018
<u>110</u>	Events after the Reporting Period	Compiled <u>Extra</u>	Dec 2017	1 Jan 2018
<u>111</u>	Construction Contracts [superseded for for-profit entities by AASB 15 Revenue from Contracts with Customers for periods beginning on or after 1 January 2018]	Compiled <u>Extra</u>	Dec 2016	1 Jul 2015
<u>112</u>	Income Taxes	<u>Extra</u>	Aug 2015	1 Jan 2018
<u>116</u>	Property, Plant and Equipment	Compiled <u>Extra</u>	Oct 2015	1 Jan 2018
<u>117</u>	Leases [superseded by AASB 16 Leases for periods beginning on or after 1 January 2019]	<u>Extra</u>	Aug 2015	1 Jan 2016
<u>118</u>	Revenue [superseded for for-profit entities by AASB 15 Revenue from	Compiled	Dec 2016	1 Jan 2018

AASB No.	Title	Notes	Issue Date	Operative Date
	Contracts with Customers for periods beginning on or after 1 January 2018]			
<u>119</u>	Employee Benefits	<u>Extra</u>	Aug 2015	1 Jan 2016
<u>120</u>	Accounting for Government Grants and Disclosure of Government Assistance	<u>Extra</u>	Aug 2015	1 Jan 2018
<u>121</u>	The Effects of Changes in Foreign Exchange Rates	<u>Extra</u>	Aug 2015	1 Jan 2018
<u>123</u>	Borrowing Costs	<u>Extra</u>	Aug 2015	1 Jan 2018
<u>124</u>	Related Party Disclosures	<u>Extra</u>	Jul 2015	1 Jul 2016
<u>127</u>	Separate Financial Statements	<u>Extra</u>	Aug 2015	1 Jan 2016
<u>128</u>	Investments in Associates and Joint Ventures [For for-profit entities only]	Compiled <u>Extra</u>	Dec 2017	1 Jan 2018
<u>128</u>	Investments in Associates and Joint Ventures [For not-for-profit entities only]	Compiled <u>Extra</u>	Dec 2017	1 Jan 2018
<u>129</u>	Financial Reporting in Hyperinflationary Economies	<u>Extra</u>	Aug 2015	1 Jan 2016
<u>132</u>	Financial Instruments: Presentation	<u>Extra</u>	Aug 2015	1 Jan 2018

AASB No.	Title	Notes	Issue Date	Operative Date
<u>133</u>	Earnings per Share	Compiled <u>Extra</u>	Nov 2015	1 Jan 2018
<u>134</u>	Interim Financial Reporting [For for-profit entities only]	Compiled <u>Extra</u>	Dec 2017	1 Jan 2018
<u>136</u>	Impairment of Assets	<u>Extra</u>	Aug 2015	1 Jan 2018
<u>137</u>	Provisions, Contingent Liabilities and Contingent Assets		Aug 2015	1 Jan 2018
<u>138</u>	Intangible Assets	Compiled <u>Extra</u>	Oct 2015	1 Jan 2018
<u>139</u>	Financial Instruments: Recognition and Measurement	<u>Extra</u>	Aug 2015	1 Jan 2018
<u>140</u>	Investment Property [For for-profit entities only]	Compiled <u>Extra</u>	Feb 2017	1 Jan 2018
<u>141</u>	Agriculture	<u>Extra</u>	Aug 2015	1 Jan 2016
<u>1004</u>	Contributions	Compiled	Jan 2015	1 Jul 2015
<u>1023</u>	General Insurance Contracts [For for-profit entities only]	Compiled	Dec 2017	1 Jan 2018
<u>1031</u>	Materiality [superseded by AASB 108 for periods beginning on or after 1 July 2015]		Dec 2013	1 Jan 2014
<u>1038</u>	Life Insurance Contracts	Compiled	Dec 2013	1 Jan 2014
<u>1039</u>	Concise Financial Reports	Compiled	Jan 2015	1 Jul 2015
<u>1048</u>	Interpretation of Standards		Dec 2017	Ending 31 Dec 2017

AASB No.	Title	Notes	Issue Date	Operative Date
<u>1049</u>	Whole of Government and General Government Sector Financial Reporting	Compiled	Mar 2015	1 Jul 2016
<u>1050</u>	Administered Items	Compiled	Dec 2013	1 Jan 2014
<u>1051</u>	Land Under Roads	Compiled	Dec 2013	1 Jan 2014
<u>1052</u>	Disaggregated Disclosures	Compiled	Jun 2014	1 Jul 2014
<u>1053</u>	Application of Tiers of Australian Accounting Standards	Compiled	Jan 2015	1 Jul 2015
<u>1054</u>	Australian Additional Disclosures	Compiled	Jan 2015	1 Jul 2015
<u>1055</u>	Budgetary Reporting	Compiled	Dec 2013	1 Jul 2014
<u>1056</u>	Superannuation Entities		Jun 2014	1 Jul 2016
<u>1057</u>	Application of Australian Accounting Standards	Compiled	Nov 2015	1 Jan 2016
<u>1058</u>	Income of Not-for-Profit Entities		Dec 2016	1 Jan 2019
<u>1059</u>	Service Concession Arrangements: Grantors		Jul 2017	1 Jan 2019

15th December 2016

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Submission by Kelly + Partners

Options Paper 1: Options for reform of the Owners Corporations Act 2006

Question 37: Which option, and why, represents the most appropriate way to differentiate the level of regulation of owners corporations according to size?

In response to Question 37 of the Consumer Property Law Review we refer to page forty-four, particularly paragraph six of the issues paper, which states:

“These measures are designed to respond to the feedback that the current ‘lighter touch’ approach to the regulation of owners corporations with less than 100 lots or annual fees of \$200,000 is not working.”

Improved Governance

Kelly + Partners agree that the current ‘light touch’ approach needs to be reviewed. Broadening the application of mandatory independent audits (which previously only applied to Prescribed Owners Corporations) will result in a greater level of assurance and therefore, we believe, improve and increase the confidence in the financial reporting of owners corporations.

Victoria does not currently require formal licensing for owners corporation managers and has no mandated owners corporation trust account reporting requirements, both of which we understand are included in this legislative review. It is our opinion that implementing these measures and broadening the application of mandatory independent audits of owners corporations will improve the governance of this significant sector of the Victorian economy.

In considering the proposed tiered structure in Table 1 as it relates to independent audits we comment as follows:

1. Tier 1 - No further comment as we believe mandatory audits of owners corporations comprising more than 51 lots will significantly improve governance and assurance.
2. Tier 2 - in our opinion, an independent audit is preferable to an independent review.

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Australian Auditing Standard ASRE 2400 *Review of a Financial Report Performed by an Assurance Practitioner Who is Not the Auditor of the Entity* governs the conduct of review engagements. While the review process is primarily limited to enquiry and analytical procedures, which are generally less time-consuming than substantive audit procedures, the assurance practitioner is still required to obtain an understanding of the entity's accounting systems, accounting records and internal control as they relate to the preparation of the financial statements.

As a result, for smaller entities the time required for a review will be similar to an audit, but the level of assurance provided by a review report is significantly less than an audit report.

In our experience, independent reviews may be appropriate where

- the cost of an audit is significantly greater than an independent review; and
- the entity is structured in a manner that provides a level of confidence in the controls over the financial reporting process.

As there is unlikely to be a significant difference between the cost of an independent audit and an independent review for owners corporations comprising between 10 and 50 lots, we believe an independent audit is affordable and provides significantly greater assurance.

Alternatively, the adoption of a monetary threshold for mandatory audits of Tier 2 owners corporations could be considered. We recommend a more clearly defined monetary threshold of \$200,000 (which is the current monetary requirement for Prescribed Owners Corporations) be applied. Please refer to our commentary below.

3. Tier 3 - for owners corporations in this category we consider an independent audit should only be required where the monetary threshold is exceeded.

Monetary Threshold

In our opinion, the lot-based threshold should be supplemented by a monetary threshold for determining whether an independent audit of an owners corporation is required. The *Owners Corporation Act 2006* requires mandatory audits for Prescribed Owners Corporations only, being owners corporations which levy annual fees in excess of \$200,000 in a financial year or consisting of more than 100 lots.

We submit that the monetary threshold should remain at \$200,000, but should be defined as being the sum of

- total owners contributions (including special levies) raised for the year, regardless of whether or not they have been paid;
- any income of the owners corporation from any other source (this will include defect settlements, insurance receipts, income from common property such as from rentals including telecom towers etc); and
- any cash balances (deposits, bank and investment accounts) held by an owners corporation at the commencement of the year.

The above elements of the monetary threshold are similar to those contained in the recently released NSW legislation *Strata Schemes Management Act 2015* and *Strata Schemes Management Regulation 2016*, which we believe will significantly improve the governance and financial reporting of strata plans in NSW.

A monetary threshold will ensure that smaller owners corporations (as defined by lot size) will require an independent audit where significant monies are raised and cash held. Without such a monetary threshold a Tier 2 owners corporation could raise levies that match or exceed a Tier 1 owners corporation, yet be free from similar levels of scrutiny.

Inherent Risk In Low Regulatory Environment

While we acknowledge that issues relating to the regulation of owners corporation managers, including licencing and the management of money held in trust, are addressed in the issues paper, we believe that strengthening the mandatory independent audit requirements is an appropriate response to improving financial governance.

In summary, we submit that the mandatory audit provisions should include the following:

1. The proposed Tier system described by Table 1 of Option 14A of the Options Paper.
2. For Tier 2 owners corporations:
 - replace the proposed obligation for an independent review with an independent audit; or
 - apply the monetary threshold referred to above for determining the application of the mandatory audit requirements.
3. For Tier 3 owners corporations apply the monetary threshold referred to above for determining the application of the mandatory audit requirements.

Thank you for the opportunity to contribute to the Consumer Property Law Review process.

Yours faithfully,



Peter Dawkins

Senior Client Director



Joel Russell

Client Director