Financial Capacity Building & Professional Advisors

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Toni Chardon[a*], Brett Freudenberg[b] and Mark Brimble[c]

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1 ABSTRACT

In the context of legislative obligations under the *Corporations Act* 2001 ('best interests of the client') and the tax (financial) advisor requirements of the Tax Practitioners Board it is increasingly important for advisors to be acutely aware of their client's own understanding of any financial matters being advised. The exploration of the relationship of the professional advisor and their attitude towards capacity building their clients is therefore important and timely.This research and the initial findings presented in this paper extends the prior financial and tax literacy work of the authors (Chardon, Freudenberg, & Brimble, 2016; Freudenberg, Chardon, Brimble, & Belle Isle, 2017) and explores the role of advisors in financial (and tax) capacity building. Recent research by the authors (Freudenberg et al., 2017) indicates that tax literacy is higher for those operating small business. However, it is unclear whether this is directly linked to better relationships with professional advisors or indirectly through experience. The ability to improve financial literacy and the professional-client relationship has been explored in prior research, including the role and views of financial planners in combating financial literacy, frameworks for financial literacy education and different models of financial advice that are based on improving client engagement and financial literacy (Blue & Brimble, 2014; Hunt, Brimble, & Freudenberg, 2011). However this research is almost always in the context of financial planning and there less research that extends to accounting, tax and business advisors more broadly. Given the current regulatory framework around providing both financial and tax advice; and the likelihood this regulation will further increase, the research in this project is timely. The perceptions of advisors regarding financial capacity building of clients, knowledge of client's levels of financial literacy and means by which capacity building occurs will be important in the context of not only the National Financial Literacy strategy but also for regulators moving forward.

[a] Dr Toni Chardon, School of Law and Justice, University of Southern Queensland
[b,c] Dr Brett Freudenberg and Dr Mark Brimble, Griffith Business School, Griffith University
[*] Corresponding author, E-mail: toni.chardon@usq.edu.au, Tel.: +61 7 4631 5514

2 INTRODUCTION

The *Corporations Act* (Cth) 2001 requires providers of financial advice to act in the 'best interests of the client'. As will be detailed later, part of this requirement is that providers must identify the 'client's relevant circumstances'. Further, since 1 July 2017, providers of tax (financial) advice must be appropriately registered with the Tax Practitioners Board (TPB) and comply with requirements under the *Tax Agent Services Act* (Cth) 2009. This also includes a requirement to 'act lawfully in the best interests of your client'. From this, it is important for professional advisors (of all types) to be acutely aware of their client's own understanding of any financial matters being advised. This research project exploring the relationship of the professional advisor and their attitude towards capacity building their small business clients comes at an important time in this new regulatory regime. Prior research by the authors (Freudenberg et al., 2017) indicates that tax literacy is higher for those operating small business. However, this research measured levels of tax literacy of the small business owners and the drivers of these outcomes were not explored. The question arose as to whether this higher tax literacy was linked to better relationships with professional advisors or indirectly through experience. Financial literacy research and programs are about building capacity so that individuals can understand financial matters, seek appropriate information, ask relevant questions and be able to understand and apply the information they are provided (Widdowson & Hailwood, 2007). However, mismatches between self-assessed financial knowledge and actual understanding can be a deterrent to seeking out professional advice leading to undesirable financial outcomes (Lusardi & Mitchell, 2006). Added to this is the finding that advisors tend to overestimate the level of empowerment given to their clients (through increasing awareness, knowledge and skills) (Hunt et al., 2011). Academics and professionals researching in the financial planning context are acutely aware of the problems caused by lack of confidence in seeking out advice and the impact of the advisor-client relationship. Prior research has explored the role and views of financial planners in combating financial literacy, frameworks for financial literacy education and different models of financial advice that are based on improving client engagement and financial literacy (Blue & Brimble, 2014; Hunt et al., 2011). This research is almost always in the context of financial planning and there is little, if any, financial literacy research that extends to accounting, tax and business advisors more broadly. Given the changes to the regulatory framework mentioned earlier and the likelihood this regulation will further increase, this research is timely for regulators moving forward as well as in the context of the National Financial Literacy strategy. The research will specifically explore whether or not advisors seek to develop their clients' financial literacy and by what means, especially when they operate a small business. This paper will begin by providing some contextual information about the place of this research within the National Financial Literacy strategy, as well as some recent research reporting on the financial and tax literacy of small business owners. This will be followed by further detail on the regulatory requirements of professional advisors and how this links to understanding and improving the client's financial literacy. The fifth and sixth parts of this paper will present the research questions and methodology of the research project. The paper will conclude with some comments about the research moving forward and potential impacts of the project.

3 Financial and Tax Literacy

Financial literacy is defined in the 2014-17 Australian National Financial Literacy Strategy as "a combination of financial knowledge, skills, attitudes and behaviours necessary to make sound financial decisions, based on personal circumstances, to improve financial wellbeing" (Australian Securities and Investment Commission, 2014, p. 6). The strategy states that "the more knowledgeable consumers are in the way they interact with the financial services sector, the more effective and efficient that sector will become, creating savings (wealth) and ideally reducing the need for regulatory intervention" (Australian Securities and Investment Commission, 2014, p. 5 & 16). It is important to understand that building financial literacy of consumers is not just about basic money management and understanding and/or avoiding debt. It covers a range of attitudes and behaviours and spans a person's lifetime regardless of whether they have simple or sophisticated financial affairs or whether they are an individual or operating a business. This is reinforced in the recently launched 2018 National Financial Capability Strategy[1] which focuses on building capability through three core behaviours; managing money day-to-day, making informed money decisions and planning and saving for the future (Australian Securities and Investment Commission, 2018b). The research in this project therefore aims to explore the final step in that process of making informed decisions,

[1] Note that ASIC moved from the term Financial Literacy to Financial Capability when releasing the 2018 strategy. These terms are therefore often used interchangeably in Australian research.

that is; ‘know where to go for guidance and support’ and building confidence in talking about money and knowing what questions to ask. Much of the prior research in financial literacy to date has identified challenges people face in terms of their finances, explored the risks of poor financial decision making and developed strategies for overcoming these risks and avoiding further poor decisions. All previous National Strategies have included this component of ‘knowing when to seek advice’, however research so far has not necessarily explored what happens once that step is taken. Does their financial capability continue to develop through that relationship with their advisor, or are they simply shifting the responsibility of financial decision making to their trusted advisor?

In previous tax literacy research, it was found that tax literacy was lower than basic financial literacy for individual Australians (Chardon et al., 2016). Tax literacy appeared to be more closely related to increased engagement in the workforce than other demographic factors. This supported previous ideas that literacy would be lower for those financial concepts considered more complex such as taxation and superannuation. Later research extended this for small business owners specifically and found that the tax literacy of small business owners was higher than other individuals (Freudenberg et al., 2017). Further, it has been found that tax education has a positive effect on tax knowledge of SME owners and that in turn, this tax knowledge has a positive effect on tax justice (Mukhlis, Utomo, & Soesetio, 2015). It was further argued that poor knowledge about taxation can lead to distrust and negative attitudes towards taxation (Mukhlis et al., 2015). In a recent report it was found that 85% of small business owners use a tax professional and that of these the vast majority (95%) used an accountant (Australian Taxation Office, 2017). Given that small business owners have been found to have higher tax literacy, the question arises as to whether this higher tax literacy came from experiences in operating their business or more directly through the relationship with their advisor. Other research has suggested small business owners develop the financial literacy and skills for running their business through a whole range of means including prior knowledge, trial and error, electronic software as well as accountants when needed (Samkin, Pitu, & Low, 2014). For this reason, the research will be exploring financial capacity building of small business clients with professional advisors. Results from this research may provide additional evidence for the National Financial Literacy Strategy as to the importance and outcomes of seeking professional advice as well as for professional bodies in supporting their members.

4 THE ADVISOR/CLIENT RELATIONSHIP

As mentioned earlier, knowing when to seek advice, which questions to ask and how to interpret that advice are key aspects of financial capability and financial wellbeing. Research both in Australia and overseas often incorporates aspects which measure the extent to which persons seek appropriate advice from professionals and their confidence in communicating with their advisor. For example, a recent Australian report found that one in five Australians prefer not to talk about their finances with anyone, including finance professionals (Australian Securities and Investment Commission, 2018a). Though they were more likely to talk to a paid advisor when choosing an investment product. The ANZ Financial Resilience report measures 'willingness to seek advice' as a component of financial resilience and found that from 2015 – 2016 there had been an increase in persons who reported having sought advice from a professional (from 4.8% in 2015 to 7.8% in 2016) (Marjolin, Muir, Ramia, & Powell, 2017). Though a positive trend, the overall percentages remain worryingly low. The relationship between seeking professional advice and improved financial outcomes was highlighted in a recent financial wellbeing report which stated 'a number of participants had also sought professional financial advice. Some people report that this improved their financial knowledge and skills and as a result supported them to improve their financial decisions and behaviours" (Muir et al., 2017, p. 22). Further, many respondents in this report highlighted a sense of wariness in financial advice and the importance of trust in the person providing the advice (Muir et al., 2017).

The following section explores some findings in relation to the professional advisor relationship and small businesses in particular. A study by Cameron (1992) found that personal chemistry between the advisor and small business client was an important factor in whether the client might change accountants. Similarly, Duncan (1989) suggests there are a range of factors that may influence the nature of advice provided by tax practitioners (whether conservative or aggressive) including the nature of the client themselves and the client risk preference. Whereas other studies have suggested small business taxpayers engage tax practitioners for the primary reason of submitting accurate tax returns (therefore placing less importance on the relationship itself). For example, Tan (1999) found that small business clients who disagree with their advisors approach on a transaction are more likely to disengage that practitioner. In a study by Hite, Stock & Cloyd (1992), it was found that taxpayers required a level of certainty before being willing to claim a tax deduction that was ambiguous, again suggesting accuracy is most important. It has been argued that practitioner's approach (whether conservative or aggressive) depends on whether the transaction is ambiguous or not (Klepper, Mazur, & Nagin, 1991). In this regard advisors are balancing their professional ethical obligations to ensure accuracy of the tax return with their obligation to the client to get the best tax outcome where transactions may be ambiguous or arguable. Improvements in small business financial and tax literacy might therefore increase certainty for the small business owner and therefore might increase the likelihood of clients and advisors agreeing on the approach for particular transactions and thus improving trust and longevity of the relationship.

From this, it is seen that seeking professional advice is can be an important part in improving financial wellbeing, though it is not yet clear to what extent this professional advice impacts upon improved financial outcomes. It is also clear that the relationship between the small business client and the accountant/tax advisor is complex with sometimes competing purposes and dual obligations. The following section will explore the professional advisor's regulatory environment in more detail to highlight that understanding the client's financial context is important from this perspective as well.

4.1 Regulatory Requirements

The *Corporations Act* (Cth) 2001 requires a financial services licensee (and their representatives) as 'providers' of personal financial advice to a retail client to 'act in the best interests of the client'. Specifically, in demonstrating this, under section 961B *Corporations Act* (Cth) 2001 advisors must be able to prove they have done the following:

(a) identified the objectives, financial situation and needs of the client that were disclosed to the provider by the client through instructions;
(b) identified:
  (i) the subject matter of the advice that has been sought by the client (whether explicitly or implicitly); and
  (ii) the objectives, financial situation and needs of the client that would reasonably be considered as relevant to advice sought on that subject matter (the **client's relevant circumstances**);
(c) where it was reasonably apparent that information relating to the client's relevant circumstances was incomplete or inaccurate, made reasonable inquiries to obtain complete and accurate information;
(d) assessed whether the provider has the expertise required to provide the client advice on the subject matter sought and, if not, declined to provide the advice;

(e) if, in considering the subject matter of the advice sought, it would be reasonable to consider recommending a financial product:
    (i) conducted a reasonable investigation into the financial products that might achieve those of the objectives and meet those of the needs of the client that would reasonably be considered as relevant to advice on that subject matter; and
    (ii) assessed the information gathered in the investigation;
(f) based all judgements in advising the client on the client's relevant circumstances;
(g) taken any other step that, at the time the advice is provided, would reasonably be regarded as being in the best interests of the client, given the client's relevant circumstances .

Even prior to these requirements coming into effect on 1 July 2013, there has always been a duty to 'know the client' which places importance on the quality of the advisor – client relationship (Hunt et al., 2011). The Association of Financial Advisors (AFA) argues that 'Informed Client Consent' (one of the six Principles of Professionalism) must include educating clients and taking responsibility for improving their financial literacy (Fox, 2014).

From 1 July 2017, all Australian Financial Services licensees and their representatives are required to be registered with the Tax Practitioners Board (TPB) if they provide tax (financial) advice.[2] The *Tax Agent Services Act* (Cth) 2009 regulates these practitioners and provides obligations under a legislated Code of Professional Conduct. The code requires an advisor to 'act lawfully in the best interests of your client' (*Tax Agent Services Act* (Cth) 2009, section 30-10) and that this duty is similar to the duty between other professional services providers and their clients (Tax Practitioners Board, 2010). It is argued therefore that taking reasonable steps to ascertain the client's relevant circumstances similarly applies to registered tax agents governed by the Code of Professional Conduct. Certainly, as others have pointed out, understanding the client's likely financial literacy and taking steps to improve this and the relationship is key to meeting this obligation and in improving the overall wellbeing of the client.

5 Research Questions

Given the literature presented, the entire project aims to address the following research questions:

- To what extent do advisors value financial capacity building of their small business clients? (what are the inhibitors and enablers to this capacity building)

[2] Subject to certain transitional rules.

- What particular components of financial and tax literacy are relevant for small businesses?
- What specific methods do professional advisors use to improve the financial capability of their small business clients and to what extent have these been successful.
- Do attitudes toward financial capacity building of small business clients and methods to improve differ between types of professional advisors (i.e. Financial planners, tax agents, accountants, business advisors)?

The conference presentation accompanying this paper presented some initial findings in relation to the following specific questions and sub questions:

- To what extent do advisors value financial capacity building of their small business clients?
  i. Are advisors aware of the notion of financial capability and the National Financial Literacy Strategy?
  ii. Perceptions on the role of advisors in improving financial capability of small business clients.

- Whether advisors take active steps to ascertain the financial capability of specific small business clients.

- Whether advisors have taken active steps to improve the financial capability of small business clients.

6 METHODOLOGY

The research questions in this project are exploratory in nature. There is little to no prior research exploring advisors views on financial capability/capacity building therefore the research explores and unfamiliar problem (Krishnaswamy, 2010). For this reason, the research will take a qualitative approach in the form of 20-30 in-depth interviews with a range of professional advisors. Some triangulation will be achieved through a short online pre-interview survey. It is argued that even a second method of data collection can refine and strengthen conceptual links (Berg, 2017). Interviewees will be invited to participate in the research through email invitations sent to accounting firms in the researcher's local areas (Toowoomba and Brisbane). Snowball sampling will occur from the initial interviews conducted. The project has ethical approval in line with the National Statement on Ethical Conduct in Human Research (2015).[3]

[3] University of Southern Queensland Human Research Ethics Committee Approval - H18REA298

7 CONCLUSIONS AND GOING FORWARD

Given continuing media coverage of regulation around the provision of financial advice as well as the ongoing importance of supporting small business in the economy, the results of this project will be timely not only for regulators but also for the professional bodies and for the National Financial Literacy Research Strategy. It is hoped that data from this project will provide a new insight in financial capacity building of small businesses as it focuses on the advisor perspective. Interviews and data collection for this project are currently ongoing with finalisation of the full results by mid-2019. Initial findings from a small number of interviews were discussed in the conference presentation. Comments and questions regarding the project and details of any publications emerging from the project can be directed to the lead author in the first instance.

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