



MANAGEMENT AND LETTING BUSINESSES

THE ACCOUNTANT'S ROLE



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1.0 OVERVIEW

OVER THE LAST FEW YEARS, THE MANAGEMENT AND LETTING INDUSTRY HAS SEEN A RISE IN BOTH POPULARITY AND PROFESSIONALISM – FROM BOTH THE MANAGER'S AND EXTERNAL CONSULTANT'S POINT OF VIEW.

To succeed, managers are required to utilise and continually refine marketing, administration and communication skills. Like any business, this can be achieved by ensuring you are surrounded by the right people to provide the right advice on a timely basis.

In purchasing, the appointment of a specialist agent is critical to ensure you are fully informed regarding the current status of the market and changing market conditions. Similarly, prior to accepting an unconditional contract, it is of prime importance to ensure your solicitor reviews not only the contract but the management and letting agreements and letting authorities etc. Failure to do so may result in complications upon your subsequent sale. The ultimate value of your business may also be affected, and in some cases you may find you have nothing at all to sell.

Similar to the roles of your other advisors, we believe the accountant's role is an ongoing one. From performing a due diligence review of the business

(i.e. verifying the profitability of the business and gaining an understanding of it in unison), assisting in obtaining finance, to providing tax planning advice and formulating budgets, we believe our role is an ongoing one which ultimately adds value to a business.



2.0 THE PURCHASE

2.1 FINANCIAL VERIFICATION

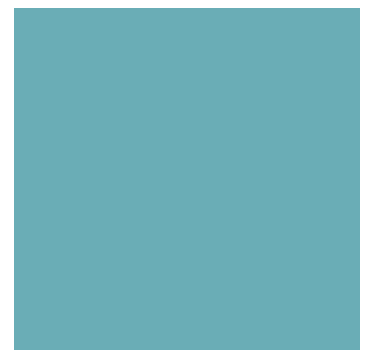
2.1.1 GENERAL

In most cases, the value of the Management and Letting business is based on its profitability, and there is generally a clause in the contract of purchase which gives the purchaser and his accountant the right to inspect the records of the vendor. This ensures the purchaser has adequate opportunity to check the following:

- (i) Income is not overstated
- (ii) Expenditure is not underestimated; and
- (iii) There is a correct matching of income and expenditure

The vendor will generally provide a profit and loss statement for the relevant period, which provides a basis for the verification process.

As is the case with all businesses, each Management and Letting business we review is different. The businesses will generally have different administrative and marketing practices, and varying arrangements with the owners and Body Corporate regarding charges and work required. Accordingly, we believe a financial verification process is necessary to gain an understanding of the business as it is presently managed and to ensure the vendor's profit is reasonably stated.



2.1.2 VERIFICATION OF PROFIT

WHAT IS NET PROFIT?

Net profit is defined in the REIQ standard conditions of sale as follows:

‘For the purpose of this clause net operating profit shall be calculated by deducting from the gross income of the Business for the relevant period the actual expenses of operating the Business for that period (in particular excluding depreciation, borrowing expenses, interest on borrowings and any payment for labour related to work which would normally be performed by a two person resident management team)’...

WHAT RECORDS SHOULD BE MADE AVAILABLE?

To be in a position to assess the accuracy of the vendor’s net profit, the vendor should generally make available all general and trust accounting records. The position of the purchaser is strengthened if this is set out in the contract.

SHOULD MORE THAN ONE FINANCIAL YEAR’S TRADING RESULTS BE REVIEWED?

We would generally encourage as much information as possible to be obtained from the vendor. If trading figures from prior year/s are available, these can be used to assess the reasonableness of the current year profitability. However, in most cases it is not necessary to verify previous period trading results.

THE REVIEW PROCESS

The verification process involves a review of the trading statements for the period stipulated in the contract. An audit of the vendor’s books is not performed unless specifically requested.

The review process generally involves a detailed review of profit and loss, provided by the vendor with balances being checked against supporting documents where possible and for reasonableness based on industry standards. Information is also extracted from the vendor’s trust account, which is required to be audited annually under the Auctioneers and Agents Act.

Accordingly, the reviews process does not incorporate checking every single item and is not a warranty that the profit of the vendor is exact, rather that the profit is reasonably correct and there are no material errors or omissions.

SAMPLE PROFIT AND LOSS STATEMENTS

Attached as Appendix 1 are sample profit and loss statements. Purchasers (and their agents) should encourage vendors (and their accountant) to present the information in this format, as failure to do so may unnecessarily complicate matters and result in greater cost to the purchaser.

2.1.3 VALUATION ISSUES

Management and Letting Businesses have typically been valued on the basis of capitalisation of future maintainable earnings. In applying this valuation methodology, two factors need to be considered:

- (i) Future maintainable profits of the business (part of the verification process);
- (ii) The capitalisation rate applicable to those future maintainable profits

In the context of the Management and Letting Businesses, the capitalisation rate is generally expressed as a price earnings rate or multiple. The higher the multiple, the lower the perceived risk associated with deriving future profits of the business.

In comparing different businesses and their corresponding values, consideration should be given to the following factors:



CONTRIBUTING FACTORS

1. Security of Tenure
 - length of agreements
 - exclusive use areas
 - office on title
 - body corporate history
2. Location and age of complex
3. Future growth prospects
4. Ease of management
 - maintenance requirements
 - physical layout of building
 - management systems in place (Manager's handbook)
5. Technology
 - use of technology in making business run more efficiently
6. Other Matters
 - sinking fund
 - size of complex
 - staff requirements
7. Impact of legislative change (e.g. Managed Investment Act).



2.2 FINANCE

Obtaining finance for the purchase of a Management and Letting business is a specialised task. With the changing focus of the industry and relevant legislative guidelines, the attitude of financiers has been one of recurrent change.

Issues requiring consideration regarding finance include:

- Ensuring you get finance
- Structuring your finance package to achieve maximum tax advantage and minimum impact on initial cash flow
- Establishing a sound ongoing relationship with you financier

In purchasing the business, financiers will generally require a copy of the Financial Verification Report (to establish profitability and get an understanding of the business) and in some cases a projection of trading Income and Expenditure for the forthcoming twelve month period. This information can generally be provided as an extension of the financial verification process.

2.3 BUSINESS STRUCTURES

It is common practice in these businesses for the manager's unit to be owned by the individuals concerned (i.e. for capital gains tax reasons). Regarding the Management and letting business, a number of options are available.

Whilst the choice of an appropriate structure will vary depending on the purchaser's circumstances the typical choice of structures are as follows:

Sole Trader
Partnership
Company
Trust (Discretionary or Unit)

BUSINESS STRUCTURES

SOLE TRADER

A sole trader consists of an individual owning the Management Rights Business and accordingly any income generated would be included in the assessable income of that individual.

PARTNERSHIP

The concept of a partnership is commonplace and, in its simplest terms, would be where (for example) a husband and wife purchase a Management Rights Business with the income for the business typically being split equally between them. The partnership is not a separate legal entity, as each partner has real and effective control over their respective share of the business and their share of the net income derived.

DISCRETIONARY TRUST

A trust of income or property may be described as a fiduciary obligation imposed on a person (i.e. the trustee) to hold income or property for the benefit of persons listed in the trust deed (i.e. the beneficiaries).

A discretionary trust is created by way of a gift (typically \$10) by the settlor of the trust. The trustee of the trust is empowered by the Trust Deed to invest funds for the benefit of the beneficiaries of the trust. The income and capital of the trust is distributed to the beneficiaries of the trust and with the discretion of the trustee.

The concept of a trust is somewhat more complex than the situation with a sole trader or partnership, but in practice is a very popular structure, primarily due to the flexibility it offers regarding distribution of different classes of income and capital to beneficiaries. Importantly, whilst the legal title to the business purchased by a discretionary trust is held by the trustee (either a corporate trustee or as individuals) it is the beneficiaries of the trust who have the legal rights to any income or capital distributions.

UNIT TRUST

The structure of a unit trust is similar to that of a discretionary trust, generally governed by a corporate trustee. The trust is created by the issue of units to unit holders, and the trustee is usually required to distribute the capital and income in accordance with unit holdings. This structure has a significant disadvantage in that it restricts the distribution of possible future tax-exempt capital gains.



COMPANY

A company is incorporated under the Corporations Law and subject to the duties and obligations imposed by that law.

Shares in a company may have differential interests regarding dividends and participation in the proceeds of winding up. The beneficial interests of a shareholder do not extend beyond his/her shareholding. The company is a distinct separate legal entity and, whilst the shareholder has real and effective control over his/her shares and the income generated by those shares, ownership of the management and letting business rests with the company in its capacity as a legal entity and a taxpayer in its own right.

Regarding the specific advantages, disadvantages and other key factors for consideration set out in Appendix 2 of this report, we have included a summary of the advantages and disadvantages of each structure, together with an analysis and comparison of the choices available regarding what we believe to be the typical issues to be addressed when deciding which structure to use. It should be kept in mind that although tax considerations are important in selecting a structure, other commercial considerations such as asset protection and limitation of liability should be primary factors in business structuring.





2.4 INCOME TAX AND CAPITAL GAINS TAX CONSIDERATIONS

The following tax issues may impact on a decision regarding the appropriate structure in which to conduct your business:

- Assets held for longer than 12 months will be entitled to 50% deduction in the capital gain
- Capital gains derived on disposal of 'active assets' will also be eligible for a further 50% reduction for a small business entity
- The existing capital gains tax rollover provisions and superannuation concession available for small business entities

The above points are intentionally general. If you are considering establishing a structure, we strongly suggest that you seek professional advice to ensure that an appropriate structure is selected to suit your particular circumstances.

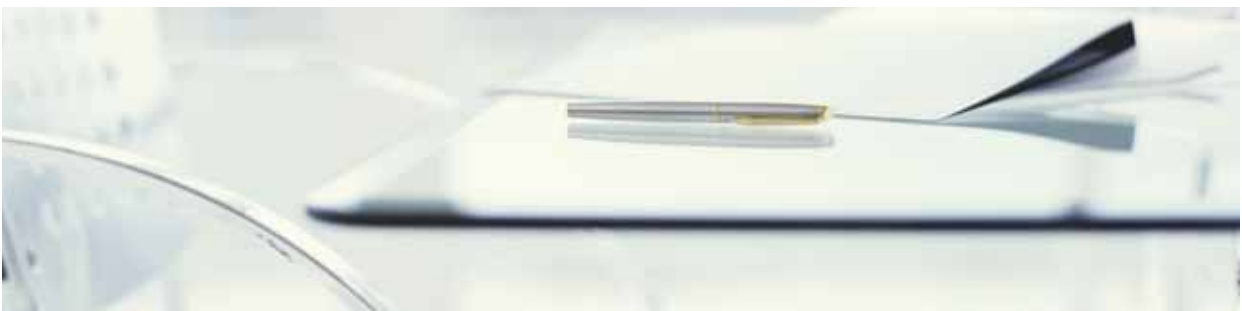
3.0 YOU ARE NOW THE NEW MANAGER – ONGOING ROLE

3.1 GETTING STARTED

Once you have received confirmation that the Management and Letting agreements are in order, and you are satisfied regarding the profitability of the business and the vendor's statements in relation thereto, there are several other issues requiring consideration prior to settlement which we take an active role in coordinating.

These issues may include:

- Ensuring an application for Restricted Real Estate license has been made to the Office of Fair Trading
- Ensuring registrations are made to the relevant statutory bodies including registration for ABN, GST, PAYG Withholding and Workers' Compensation.
- References for appropriate insurance cover
- Appointment of purchase price. As noted above, due to the continuing uncertainty with goodwill issues and their impact on Management and Letting Businesses, we believe it is important that due consideration be given to an appointment of the purchase price in the contract of purchase between the relevant assets being purchased. This may include goodwill, plant and equipment and management rights (i.e. a separate asset for capital gains tax purposes). We suggest professional advice be sought.



3.2 TRUST ACCOUNTING

The owner of a Management and Letting Business in a building complex acts as an intermediary between the owners of units within the complex and the tenants (i.e. holiday makers or permanent/semi-permanent tenants). The On-Site Manager is required to enter into a written contract with the unit owner, with the contract outlining the terms, conditions and applicable charges in relation to the arrangement.

Given that the On-Site Manager is acting as an intermediary, consumer protection is afforded to the unit owners by requiring the On-Site Manager to obtain a Restricted Real Estate License and in doing so, operate a trust account for the receipt of all such money from tenants.

All monies received from letting out a unit are trust monies and a receipt must be banked into the Trust Account forthwith and retained there, until disbursed as required under the Property Agents and Motor Dealers Act 2000. Disbursements can only be made for expenses, commissions and other charges relevant to the transaction. Refer to Appendix 3 regarding the general flow of funds regarding a Trust Account of Resident Unit Manager.

The Trust Account must be reconciled on a monthly basis and funds dispersed to the unit owners and manager on a monthly basis. Under the provisions of the Property Agents and Motor Dealers Act 2000, the trust account is required to be audited on an annual basis.

3.3 GENERAL ACCOUNT

The manager uses a general bank account/business bank account into which his/her monies received from the Trust Account are banked, and out of which expenses in relation to the ongoing management of the business are paid.

All business expenses are paid from the general account, including payments to cleaners, linen hire, telephone charges, loan repayments, wages etc.

The general account of the owner is not required by law to be audited. We would strongly suggest however, that any payments be clearly separated from the general account of the manager.

We set out on Appendix 3/2 the typical flow of funds regarding the general bank account of the manager.



3.4 BUDGETING

Cash-flow budgeting assists with your business planning and helps you achieve goals. Whilst in a Management and Letting Business, you generally do not have the same problems recovering money as with a lot of other small businesses, a cash flow budget helps you plan. Knowing when you are likely to have a cash flow shortage allows you to plan for more finance or to delay expenses such as holidays or capital expenditure. Similarly, knowing when you are going to have a cash surplus allows you to make your cash work for you.

The preparation of a clear and precise budget can also assist you in comparing income and expenditure on a monthly basis to both the prior year and current year to date. If significant variances occur, action can be immediately taken to counteract any adverse trends.



4.0 SUMMARY

The professionalism of the Management and Letting industry has improved significantly over the last number of years, and the increasing popularity of these businesses continues to demand a diverse range of skills from prospective managers.

These skills can be supplemented by your professional consultants. In many cases, the role of your consultants should not end on completion of the purchase; rather it should end on the completion of the sale.

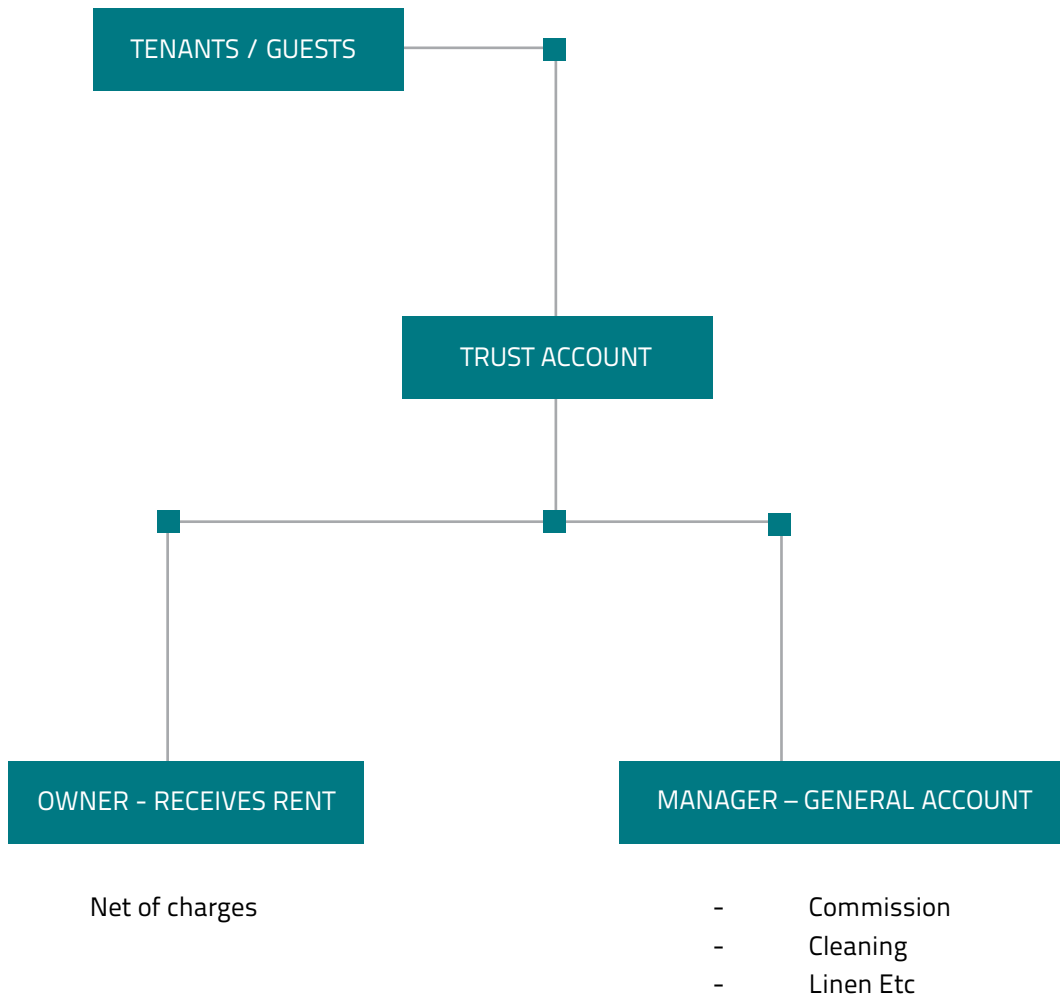
APPENDIX 2

CHOICE OF STRUCTURES

INCOME	Advantages	Disadvantages
Sole Trader	<ul style="list-style-type: none"> ▪ Simplicity ▪ Cost of Structure ▪ Control 	<ul style="list-style-type: none"> ▪ Inflexible Income Splitting ▪ Income subject to progressive tax rates ▪ Unlimited Liability ▪ Limited Superannuation
Partnership	<ul style="list-style-type: none"> ▪ Simplicity ▪ Cost of Structure ▪ Limited Income Splitting ▪ Loss Sharing 	<ul style="list-style-type: none"> ▪ Unlimited Liability ▪ Progressive Tax Rates Applicable ▪ Limited superannuation – Some Loss of Control
Company	<ul style="list-style-type: none"> ▪ Lower Tax Rate (30%) ▪ Limited liability (watch personal guarantees) ▪ Provision of higher superannuation? ▪ Provision of tax effective benefits (fringe benefits) ▪ Income Splitting? 	<ul style="list-style-type: none"> ▪ Cost of Structure ▪ Losses Trapped ▪ CGT Implications including on Liquidation ▪ Some Loss of Control
Discretionary Trust	<ul style="list-style-type: none"> ▪ Limited liability (with corporate trustee) (watch personal guarantees) ▪ Flexibility in income distribution ▪ Provision of higher superannuation? ▪ Provision of tax effective benefits. ▪ No loss of goodwill CGT exemption. 	<ul style="list-style-type: none"> ▪ Cost of Structure ▪ Losses Trapped ▪ Comprehension of Concept ▪ Some Loss of Control ▪ Proposed Tax Reform

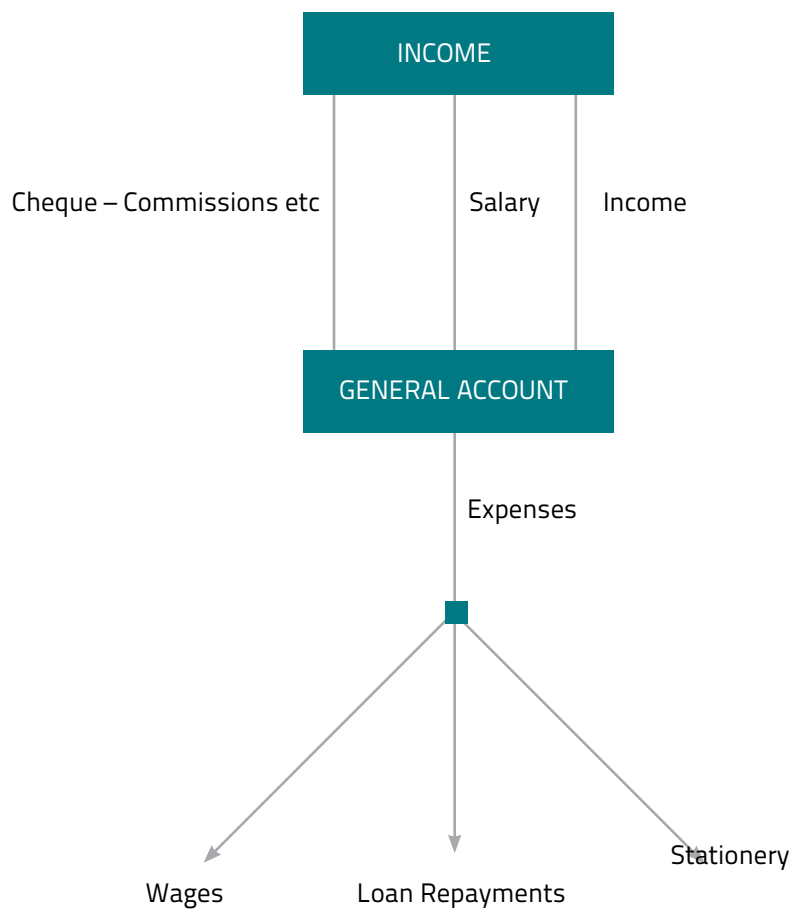
APPENDIX 3/1

TRUST ACCOUNT FLOW OF FUNDS



APPENDIX 3/2

GENERAL ACCOUNT FLOW OF FUNDS



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