MANAGEMENT & LETTING BUSINESSES

THE ACCOUNTANTS ROLE

Stephen Shirley
sps audit

Shop 7, Buderim Mall
86 Burnett Street
BUDERIM QLD 4556

Telephone: (07) 5456 2991
Mobile: 0400 6444 73
Fax: (07) 5456 1992
e-mail: stephen@spsaudit.com.au
Postal: P O Box 486, BUDERIM, 4556

MANAGEMENT & LETTING BUSINESSES - THE ACCOUNTANTS ROLE

CONTENTS

			Page No.
1.0	OVERVIEW		2
2.0	THE PURCHASE		3
	2.1	Verification	3
	2.1.1	General	3
	2.1.2	Verification of Profit	4
	2.1.3	Valuation	5
	2.2	Finance	7
	2.3	Business Structure	7
	2.4	Income Tax and Capital Gains Tax Considerations	10
3.0	YOU ARE NOW THE NEW MANAGER		11
	3.1	Getting Started	11
	3.2	Trust Accounting	11
	3.3	General Accounting	12
	3.4	Budgeting	13
4.0	SUMMARY		13

MANAGEMENT RIGHTS - THE ACCOUNTANTS ROLE

1.0 OVERVIEW

Over the last number of years, the Management & Letting industry has seen a rise in popularity and professionalism - from both the managers and external consultants' point of view.

To succeed, the managers are required to call on 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 in ensuring you are fully informed with respect to the current status of the market and the 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, letting authorities etc. Failure to do so may result in complications upon your subsequent sale with the ultimate value of your business being affected (and in some cases, you may find you have nothing at all to sell).

As is the case with your other advisors, we believe the Accountants role is an ongoing one. From performing a review of the business (ie. not only verifying the profitability of the business but getting an understanding of it at the same time), assisting in obtaining finance, to providing tax planning advice and formulating budgets, we believe our role is an on-going one which can ultimately add value to the business.

2.0 THE PURCHASE

2.1 Verification

2.1.1 *General*

Given that in most cases the value of the Management and Letting business is valued on the basis of its profitability, 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 that:

(i) Income is not overstated
(ii) Expenditure is not understated AND
(iii) There is a correct matching of income and expenditure

Once again, 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 owners and Body Corporates in relation to charges and work required. Accordingly, we believe the verification process is necessary in order to get an understanding of the business as it is presently managed, passing on potential problem areas/areas for improvement (some of which may require attention before settlement) identification of potential growth prospects to you as purchasers, and ensuring 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?

In order to be in a position to assess the accuracy of the vendors 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.

- The Review Process

The verification process involves a review of the trading statements for the period stipulated in the contract. It should be noted that an audit of the books of the vendor is not performed unless specifically requested.

The review process generally involves a detailed review of the Profit and Loss provided by the vendor with balances being checked to supporting documents where possible and for reasonableness based on industry standards. Information is also extracted from the vendors trust account which is required to be audited annually under the Property Agents & Motor Dealers Act.

Accordingly, the review 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.

- Should more than one financial years trading results be reviewed?

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

- Sample Profit & Loss Statements

Attached as Appendix 1 are sample Profit & 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) **AND**

(ii) The capitalisation rate applicable to those future maintainable profits.

In the context of Management & 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:

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 in relation to the purchase of Management and Letting businesses can also be a specialised task. With the changing focus of the industry and relevant legislative guidelines, the attitude of financiers has also been one of continual change.

Issues requiring consideration in relation to 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 your financier.

In purchasing the business, financiers will generally require a copy of the Verification Report (to establish profitability and get an understanding of the business) and in most 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 Verification process.

2.3 Business Structures

It is usual in these businesses for the managers unit to be owned by the individuals concerned (ie. for capital gains tax reasons). As far as the Management and Letting business is concerned a number of options are available.

Whilst the choice of an appropriate structure will vary depending on the purchasers circumstances the typical choice of structures are as follows:-

Sole Trader
Partnership
Company
Trust (Discretionary or Unit)

SOLE TRADER

A sole trader consists of one 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 readily understood and in its simplest terms would be where a husband and wife purchase a management rights business with the Income from the business typically being split equally between them. The partnership is not a separate legal entity with each partner having real and effective control over their respective share of the business and their share of net income derived.

DISCRETIONARY TRUST

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

A discretionary trust is created by way of a gift (typically of $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 at the discretion of the trustee.

The concept of a trust is somewhat more complex than the sole trader or partnership but in practice is a very popular structure, primarily due to the flexibility it offers in terms of distribution of different classes of income and capital to beneficiaries. It is important to note that 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 that 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 unitholders 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 as to dividends and participation in the proceeds of winding up. The beneficial interests of a shareholder does 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.

In relation to the specific advantages and disadvantages and other factors to consider we have set out at Appendix 2 to this report a summary of the advantages and disadvantages of each structure together with an analysis and comparison of the choices available which deals with what we believe to be the typical issues to be addressed in deciding which structure to use. It should be kept in mind that although tax considerations are important in selecting a structure, other commercial considerations should not be overlooked (e.g. asset protection, limitation of liability etc).

2.4 Income Tax and Capital Gains Tax Considerations

Non-tax factors influencing choice of structure may include:

- Limited/unlimited/joint and several liability of the owners
- Duties and potential liability of officers (e.g. directors) or other parties (e.g. trustees)
- Protecting assets outside of the business
- Formation Costs
- Registration and annual return requirements
- Continuing administrative costs
- Flexibility – based on current & future circumstances
- Stamp duty consequences
- Method of financing

Income Tax & Capital Gains Tax issues to consider include:

- Rates of tax;
- Consequences of transferring or redeeming an interest in the entity;
- Flexibility with income splitting;
- Loss of concessional CGT treatment (eg on disposal of active assets of a small business) upon making distributions;
- Availability of rollover relief under the CGT and capital allowances rules if assets are transferred;
- Ability to offset losses against profits of another entity, through consolidation;

The above comments are intentionally general and 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, you are satisfied as to the profitability of the business and the vendor's statements in relation thereto, there are a number of other issues requiring consideration prior to settlement which we take an active role in coordinating.

These issues may include:

- Ensuring Application for Resident Letting Agent licences have been made to the Office of Fair Trading.
- Ensuring registrations are made to the relevant statutory bodies including registration for Group Tax and Workers' Compensation.
- References for appropriate insurance cover.
- Apportionment of purchase price. As noted above, due to the continuing uncertainty in relation to goodwill issues and their impact on Management & Letting businesses, we believe it is important that due consideration be given to an apportionment 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 (ie. a separate asset for capital gains tax purposes). We suggest professional advice be sought in this regard.

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 (ie. holiday makers or permanent type tenants). The On-Site Manager is required to enter into a written contract with the unit owner - the contract setting out the terms and 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 Licence and in doing so operate a Trust Account for the receipt of all such money from tenants.

All monies received by way of 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 & Motor Dealers Act. Disbursements can only be made for expenses, commissions and other charges relevant to the transaction. We set in Appendix 3/1 the general flow of funds in relation to a Trust Account of Resident Unit Manager.

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

3.3 General Accounting

The manager generally uses a General Bank Account/Business Bank Account into which his 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, and so on.

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

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

3.4 Budgeting

Cashflow budgeting assists in 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 going to have a cash shortage allows you to plan for more finance or to delay expenses such as holidays or capital expenditure. Similarly, knowing when you were 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 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 & Letting industry has improved significantly over the last number of years. The popularity of the businesses continues to attract prospective managers with a diverse range of skills.

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 1

SAMPLE PROFIT & LOSS

FOR THE YEAR ENDED 30 JUNE 2005

INCOME		
Body Corporate Salary		
Letting Commissions		
Cleaning		
Linen		
PABX - calls - hire		
Credit Card Charges		
Hire of Plant & Equipment		
DIRECT EXPENSES		
Cleaning - wages		
- materials		
Linen - laundry		
- replacement		
Telephone		
PABX lease		
Credit Card Charges		
OVERHEADS		
Audit fees		
Accounting fees		
Bank Charges		
Commissions		
Computer Software		
Licence fees		
Motor vehicle		
Postage		
Printing & Stationery		
Telephone (office)		

SUMMARY

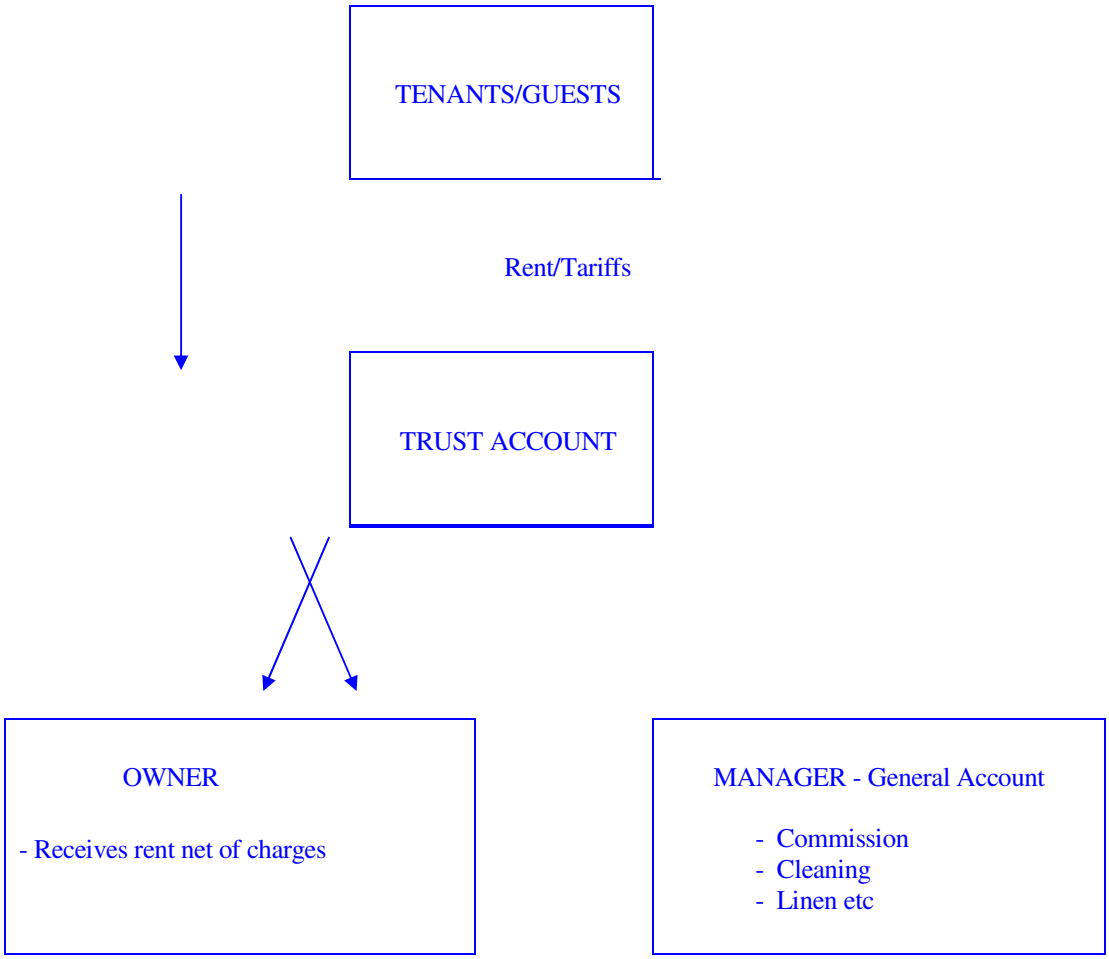
Appendix 2

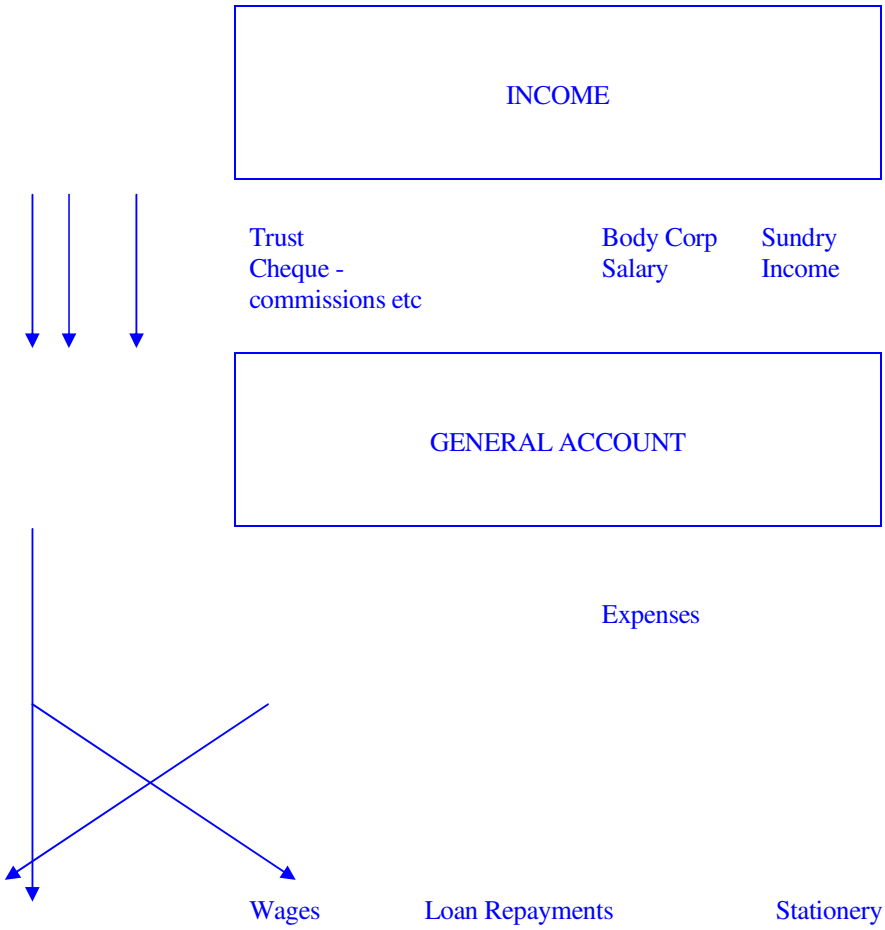
CHOICE OF STRUCTURES

	Advantages	Disadvantages
Sole Trader	• Simplicity • Cost of Structure • Control	• Inflexible Income Splitting • Income subject to progressive tax rates • Unlimited Liability • Limited Superannuation
Partnership	• Simplicity • Cost of Structure • Limited Income Splitting • Loss Sharing	• Unlimited Liability • Progressive Tax Rates Applicable • Limited superannuation - • Some Loss of Control
Company	• 30% Tax Rate • Limited liability (watch personal guarantees) • Provision of higher superannuation? • Provision of tax effective benefits (fringe benefits) • Income Splitting?	• Cost of Structure • Losses Trapped • CGT Implications including on Liquidation • Some Loss of Control
Discretionary Trust	• 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.	• 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