

MANAGEMENT AND LETTING BUSINESSES

THE ACCOUNTANT'S ROLE



About McAdam Siemon

At McAdam Siemon our mission statement is simply one word: **trust**

Trust is the foundation on which our business operates.

For over 17 years, McAdam Siemon has been entrusted to handle the business advisory, taxation, accounting and financial goals for a wide range of clients.

We have been advising clients in the Management Rights Industry on all aspects of their business cycle, from the initial purchase to the day to day management of the business and the eventual sale.

Earning the long term trust of every client is critical to achieving the strategic goals of our firm.

We achieve our mission by:

- Working closely with our clients and listening carefully to their needs
- Going beyond the call to deliver exceptional results - tailored to our client's needs
- Always providing proactive, prompt and professional service



CONTENTS

1.0	OVERVIEW	2
2.0	THE PURCHASE	3
2.1	Financial Verification	3
2.1.1	General	3
2.1.2	Verification of Profit	4
2.1.3	Valuation	5
2.2	Finance	6
2.3	Business Structure	6
2.4	Business Registrations	9
2.5	Income Tax and Capital Gains Tax Considerations	9
3.0	TRUST FUNDS VERSUS MANAGERS INCOME	10
3.1	Trust Accounting	10
3.2	General Accounting	10
4.0	SUMMARY	11
x.x	APPENDIXES	12

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), to assisting in obtaining finance, 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

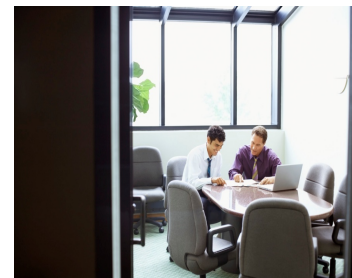
2.1.1 GENERAL

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

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 your 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 STRUCTURE

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 purchasers 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.



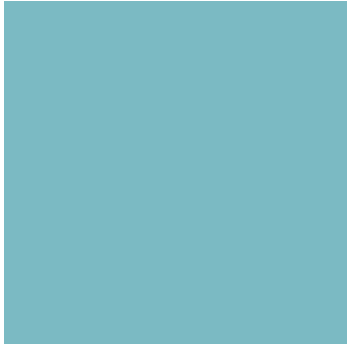
COMPANY

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 BUSINESS REGISTRATIONS

After discussing with your Accountant the best structure to suit, there are some fundamental registrations that need to take place before signing a contract:

- Ensuring an application for Letting Agent Licence has been made to the Office of Fair Trading.
- Ensuring registrations are made to the relevant statutory bodies including registration for Tax File Number, ABN, GST and Pay As You Go Withholding, Payroll Tax, Workers Compensation, Application for Business Name, Application to nominate a default Superannuation Fund.

For a more detailed checklist of Points to consider when purchasing a Management Rights Business see Appendix 3.

2.5 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 TRUST FUNDS VERSUS MANAGERS INCOME

3.1 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 6/1 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.

3.2 GENERAL ACCOUNTING

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 6/2 the typical flow of funds regarding the general bank account of the manager.



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 1

SAMPLE PROFIT & LOSS FOR THE YEAR ENDED 30 JUNE 2011

INCOME

\$

\$

Body Corporate Salary

Letting Commissions

Cleaning

Linen

PABX - calls

- hire

Credit Card Charges

Hire of Plant & Equipment

Repairs & Maintenance

DIRECT EXPENSES

Cleaning - wages

- materials

Linen - laundry

- replacement

Telephone

PABX lease

Credit Card Charges

OVERHEADS

Audit Fees

Accounting Fees

Bank Charges

Commissions

Computer Software

License Fees

Motor vehicle

Postage

Printing & Stationery

Telephone (office)

APPENDIX 2

CHOICE OF STRUCTURES

INCOME

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

- Lower Tax Rate (30%)
- 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



WORKSHEET - TO DO LIST - PRE CONTRACT STAGE

Task	Responsibility	Action Required Pre-Contract Stage	✓
Business Structure(s)	Your Accountant	Contact your Accountant to discuss and arrange appropriate business structure(s)	
ATO Registrations, TFN, ABN, GST, PAYGW	Your Accountant	Contact your Accountant to discuss and arrange application of these registrations	
Finance	Your Bank/Broker	Source a financier before signing the contract	
Resident Letting Agent licence	You	Contact Office of Fair Trading to apply	

ADVISORS CONTACT LIST	NAME	PHONE NUMBER OR EMAIL
BROKER		
BANK		
ACCOUNTANT		
SOLICITOR		

NOTES



APPENDIX 4



WORKSHEET - TO DO LIST - CONTRACT STAGE

Task	Responsibility	Action Required Pre-Settlement	✓
Financial Verification	Your Accountant	Contact your Accountant to conduct financial verification	
Legal Due Diligence	Your Lawyer	Contact your Lawyer to conduct legal due diligence	
Licence - Approval	You	Ensure successful application has been approved or is close to being finalised, delays are common	
Licence - Appoint Auditor	You	Appoint your Auditor, this is a condition of your licence	
Bank Accounts	Your Bank/Broker	Open general bank account and Trust bank account	
Merchant Facility	Your Bank/Broker	Arrange merchant facilities	
Insurance	You	Arrange for both Public Liability and Professional Indemnity Insurance, Workcover if relevant	
Insurance – Personal Risk	You	Discuss requirement for personal risk Insurance cover	
Insurance – Managers Unit	You	Arrange for contents Insurance and office contents insurance (if applicable)	
Computer – Hardware & Software	You	Assess suitability of computers to be transferred on settlement, upgrade if required	
Trust Account Software	You/Vendor	Organise transfer of licences	
Employment contracts	You/Solicitor	Consideration of employment contracts for staff	
Sub-contractors	You/Vendor	Compile a list of names, duties and contact details	
Memberships	You	Apply for memberships (e.g. ARAMA, REIQ etc.)	
Address	You	Notify banks, Insurance & utility providers of new address	
Departure Letter	You/Vendor	Include a departure letter to owners when sending out final statements	
Ongoing Tax Advice	You	Engage your tax advisor who will provide ongoing services such as tax planning & annual tax returns	
Action Required At Settlement			✓
Trust Account	You	Ensure deposits held in Trust Account are transferred upon settlement	
Cash Float	You	Establish a cash float the day of settlement	
Monthly Salary	You/Body Corp	Ensure Body Corporate is aware of hand-over date for remuneration payments	
Licensee details	You	Ensure licence details displayed are changed to reflect new management	
Booking Software Licence	You	Ensure booking software licence is transferred to your business.	
Stock on Hand	You	Complete stock take on day of settlement	
Signed employment contracts	You	Ensure staff sign employment contracts	
Business name	You/Vendor	Contact ASIC - Business name to be transferred on settlement	
Utilities – Electricity, Gas & Telephone	You	Transfer accounts to your name and arrange meter readings	
Email Address, Internet & Website	You	Transfer accounts and update details	
Creditors & Sub-contractors	You	Set up credit arrangements with all major suppliers	

Cont...



**McADAM
SIMON**
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ACCOUNTANTS AND BUSINESS ADVISORS

WORKSHEET - TO DO LIST - CONTRACT STAGE

		Action Required At Settlement (Cont...)	✓
Linen Supplier	You	Complete stock take of linen on hand	
Work In Progress	You/Vendor	Provide new owners with all details of any work in progress at day of settlement	
Unit Owner Payments	You	Check and update owner payment methods and account numbers	
Equipment	You	Complete registration transfer documents, purchaser check existence at settlement	
Brochures, Business Cards, etc.	You	Check stock levels, order business cards etc.	

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APPENDIX 5



WORKSHEET - TO DO LIST - OPERATIONAL STAGE

Task	Responsibility	Action Required Operational Stage	✓
Caretaking & Letting Agreements	You	Copy to be at hand for reference	
Occupational Health & Safety	You	Ensure OHS manual and register are up to date and understood	
Code of Conduct	You	Copy to be at hand for reference	
RTA – Bonds	You	Ensure bond balance records are up to date	
Tenant Payments	You	Provide all tenants with the new trust account details	
Welcome Letter	You	Send letter to owners and tenants introducing yourselves	
Remuneration Structure	Body Corp	Review caretaking & letting agreements re basis of remuneration reviews	
Register Superannuation Fund	You	If employing staff you will need to register a default superannuation fund for employees	
Tax Planning	Your Accountant	Contact Accountant to discuss requirements	
Thinking of Selling the Business?	You	Contact Accountant and Solicitor to discuss business 'Health Check', at least 12 months before listing	

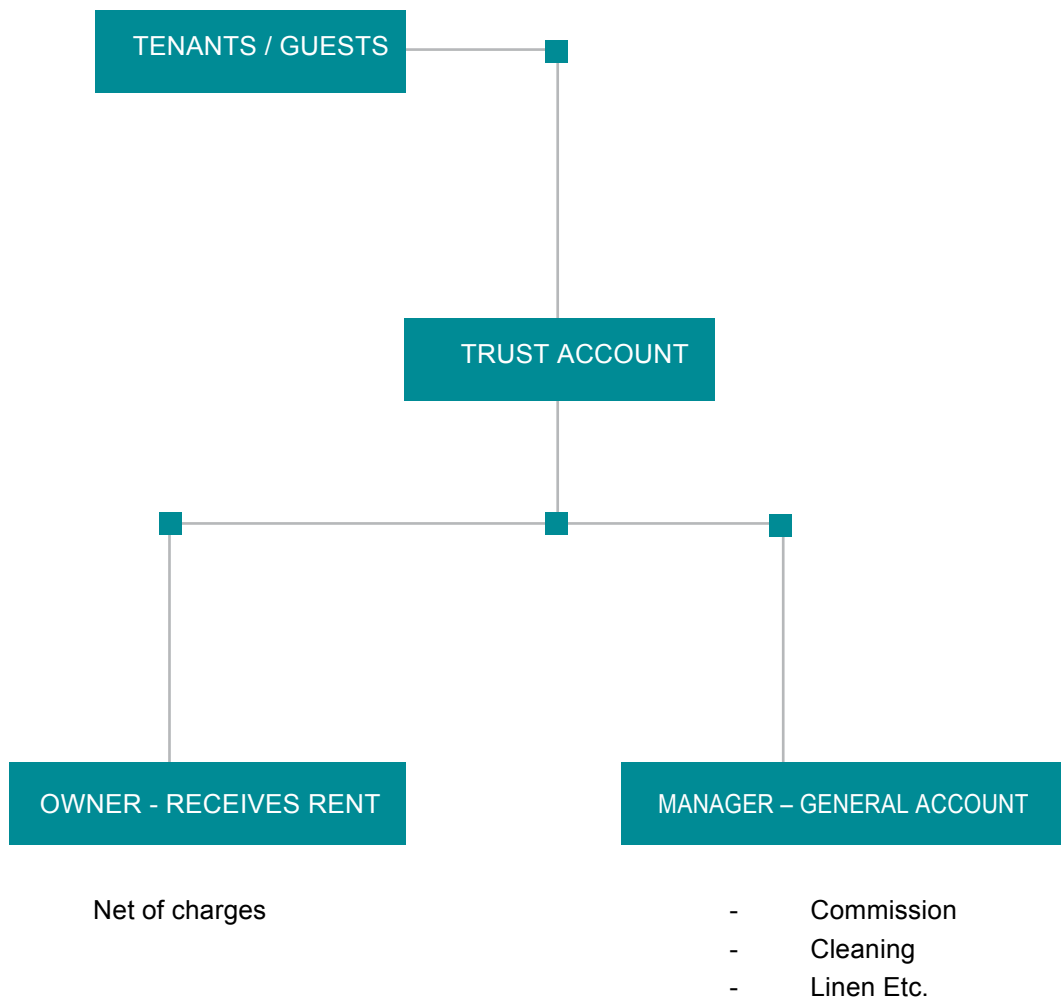
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APPENDIX 6/1

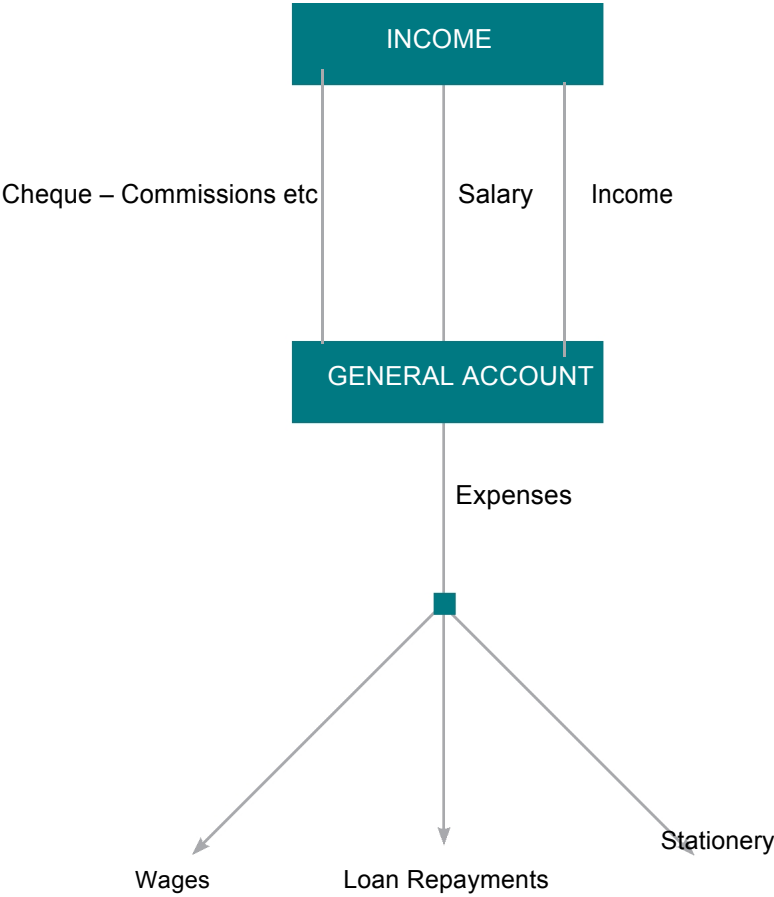
TRUST ACCOUNT

FLOW OF FUNDS



APPENDIX 6/2

GENERAL ACCOUNT FLOW OF FUNDS



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McAdam Siemon is a CPA Practice



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