REPORT OF THE FINANCIAL REPORTING PANEL – OAKS HOTELS & RESORTS LIMITED

Executive Summary

Having formed the opinion that the financial report of Oaks Hotels & Resorts Limited ('Oaks') for the year ended 30 June 2009 ('the financial report') did not comply with the financial reporting requirements of paragraphs 93 to 97 of Accounting Standard AASB 138 *Intangible Assets* ('the relevant reporting requirements'), the Australian Securities and Investments Commission ('ASIC') referred the financial report to the Financial Reporting Panel under Subdivision B of Division 9 of Part 2M.3 of the *Corporations Act 2001* ('the Act').

The Panel has considered the financial report and the submissions and other information provided by ASIC and Oaks ('the parties'), and has determined that the financial report complies with the relevant reporting requirements.

Reasons for Determination

Background

The principal activities of the entities comprising the Oaks group (referred to in this report collectively as 'Oaks') during the year ended 30 June 2009 consisted of the management of strata titled apartment accommodation. There were no significant changes in the nature of the activities during the period.

The dispute between ASIC and Oaks concerns the accounting treatment of an asset described in Note 15 to the financial statements of Oaks for the year ended 30 June 2009 as Management Letting Rights.

Note 15 states:

> Management letting rights (MLRs) allow the Group to derive revenue from letting apartments in hotels and resorts. MLRs are amortised on a straight line basis over the useful life of the buildings to which they attach, which has been assessed to be not in excess (sic) of 40 years. The remaining useful life of the MLRs is approximately 36.5 years.

Further details of the accounting policy applied by Oaks in relation to the MLRs are contained in Note 1(n) to the financial statements which states:

> Management letting rights ('MLRs') allow the Group to derive its core revenue. MLRs are recognised at cost less any accumulated amortisation and any accumulated impairment losses. The cost of the rights is amortised over the life of the building with which it is associated on the basis that the useful life of the rights will equate to the period over which the building will be used for its current purpose. The directors have assessed that the buildings over which the Group has management letting rights have a finite useful life of not less than forty (40) years. The expense is taken to the income statements through the depreciation and amortisation line item.

MLRs are not revalued in the accounts as they are not traded in an active market. The amortisation period and amortisation method are reviewed at each balance date.

Note 15 to the financial statements shows the carrying amount of the Management Letting Rights at 30 June 2009 as $90,690,000 and Note 3 discloses management letting rights amortisation expense for the year ended 30 June 2009 of $3,218,000.

Following the lodgement of the financial report with ASIC, ASIC and Oaks entered into correspondence and discussions in relation to the compliance of the financial report with AASB 138.

During the course of this correspondence Oaks provided ASIC with a schedule listing the current agreements that Oaks had in place with the owners corporations or bodies corporate of the various properties where Oaks carries on its business.

These agreements are described by various terms but they are referred to by ASIC, and for convenience will be referred to in this report, as 'letting agreements'.

Although they vary in their terms, in general they provide for:

(a) the right and obligation for Oaks to manage the common property of the relevant building; and
(b) the exclusive right for Oaks to conduct the business of letting and managing units in the building on behalf of those unit owners who choose to employ Oaks to do so.

In addition many, if not all, of the letting agreements include clauses that prevent a licensed real estate agent that is not a party to the letting agreement from conducting the business of letting apartments from the property's common property or the property's lots.

These agreements are for initial terms of from three to fifteen years with, in most cases, one or more options of renewal for periods of from three to five years.

In no case does the total of the initial term and the options for renewal exceed thirty years.

Both parties agree that the Management Letting Rights are intangible assets with a finite useful life and should be accounted for in accordance with paragraphs 93 to 97 of AASB 138. Both parties also agree that paragraph 97 of AASB 138 requires that the depreciable amount of an intangible asset with a finite useful life must be amortised over its useful life.

For the purposes of the present dispute paragraph 6(a) of AASB 138 defines the useful life of an intangible asset as:

> the period over which an asset is *expected to be available for use* by an entity.

The principal dispute between the parties concerns the useful life of the MLRs for the purpose of paragraph 97.

ASIC relies, in particular, on paragraphs 94, 95 and 96 of AASB 138.

Paragraph 94 states in part that:

> The useful life of an intangible asset that arises from contractual or other legal rights shall not exceed the period of the contractual or other legal rights, but may be shorter depending on the period over which the entity expects to use the asset. If the contractual or other legal rights are conveyed for a limited term that can be renewed, the useful life of the intangible asset shall include the renewal period(s) only if there is evidence to support the renewal without significant cost.

Paragraph 96 states:

> Existence of the following factors, among others, indicates that an entity would be able to renew the contractual or other legal rights without significant cost:
>
> (a) there is evidence, possibly based on experience, that the contractual or other legal rights will be renewed. If renewal is contingent upon the consent of a third party, this includes evidence that the third party will give its consent;
>
> (b) there is evidence that any conditions necessary to obtain renewal will be satisfied; and
>
> (c) the cost to the entity of renewal is not significant when compared with the future economic benefits expected to flow to the entity from renewal.
>
> If the cost of renewal is significant when compared with the future economic benefits expected to flow to the entity from renewal, the 'renewal' cost represents, in substance, the cost to acquire a new intangible asset at the renewal date.

ASIC's View

ASIC's view is that the useful life of Oaks' Management Letting Rights is limited to the term of the individual letting agreements and that the amount paid to enter into each agreement should be amortised over the term of the relevant agreement.

ASIC considers that it is implicit in paragraph 94 of AASB 138 that renewal periods are periods by which an existing contract can be extended, as contemplated by the terms of the existing contract. It is the options to extend the contracts contained in the existing contracts that ASIC considers to be the "renewal periods" for the purposes of paragraph 94 of AASB 138.

ASIC does not dispute that Oaks may, if certain conditions are met, include the renewal periods of the letting agreements in determining the useful life of the MLRs.

However, as ASIC points out, even if all of the renewal periods under each letting agreement are included in determining the useful life of each Management Letting Right, the maximum useful lives of the rights do not exceed 30 years, which is less than the useful life of "not less than forty (40) years" attributed by Oaks to the Management Letting Rights.

ASIC further argues that even if the alternative view is correct, and "renewal periods" in paragraph 94 of AASB 138 include the period for which a new contract may be entered into, then there is insufficient evidence for the condition in paragraph 96(a) of AASB to be met.

In support of this view ASIC argues that none of the initial letting agreements that Oaks has entered into have yet run their full term, and while there have been limited examples of existing letting agreements being either extended or cancelled and replaced by a new agreement prior to their expiration, these examples are small in number and are not sufficient evidence that Oaks will be able to enter into new contracts as a matter of course once its existing contracts have expired.

Oaks did not accept ASIC's view and accordingly ASIC referred the financial report to the Financial Reporting Panel ('the Referral').

Procedure

The Panel received written submissions from both ASIC and Oaks with supporting evidence for their views. Both parties also appeared at a hearing before the Panel to discuss their written submissions, to provide additional evidence and to answer questions from the Panel.

In forming its conclusions, the Panel has taken account of all the evidence provided during this process and considered the requirements of the relevant Australian Accounting Standards.

Oaks' View

Oaks disagrees with ASIC's view that "renewal periods" for the purposes of paragraph 94 of AASB 138 are periods by which an existing contract can be extended, as contemplated by the terms of the existing contract and contends that a "renewal" of a contract includes a new or replacement contract and not merely the exercise of an existing option under an existing contract.

In support of this view Oaks makes a number of points.

Market Practice

Oaks argues that it is the practice in the market for letting agreements to be renewed or extended without the requirement for any substantial costs or the payment of a new fee.

It points out that in Queensland a body corporate is specifically prohibited from charging a fee for the extension of a letting agreement or the entry into a new letting agreement.

Accounting Practice

Oaks and the company's auditors cited the accounts of Mantra Group Pty Ltd, S8 Limited and Stella Resorts as examples of companies which have adopted a similar policy to Oaks in accounting for MLRs.

Oaks provided the Panel with a copy of the financial report of BreakFree Limited and its controlled entities for the year ended 30 June 2005 and of Mantra Group Pty Ltd (formerly named Stella Leisure Resort Holdings Pty Ltd) for the year ended 30 June 2009.

Oaks claims that the BreakFree accounts were the accounts reviewed by Oaks and its advisers in the formulation of Oaks' accounting policy prior to its listing in 2006.

The Panel notes that BreakFree Limited (now named Samarad Pty Ltd) was acquired by MFS Limited in May 2005, was delisted on 20 May 2005 and is now a wholly owned subsidiary of Mantra Group Pty Ltd.

S8 Limited was acquired by MFS Limited in 2006 and was delisted on 21 January 2007.

MFS Limited (now named Octaviar Limited) was delisted on 31 August 2009.

In response to a request by the Panel, neither party was able to identify any currently listed entity, apart from Oaks, which operates a similar business model to Oaks which might guidance to industry practice in accounting for MLRs.

The Panel also notes ASIC's contention that in determining appropriate accounting policies, AASB 101 *Accounting Policies, Changes in Accounting Estimates and Errors* only allows accepted industry practices to be considered to the extent that they do not conflict with the requirements of Australian Accounting Standards and that in ASIC's view, there is no need to consider industry practices because the requirements of AASB 138 prescribe the relevant requirements.

In these circumstances, the Panel was unable to obtain any guidance from industry practice in evaluating Oaks' accounting treatment of MLRs.

Key Real Estate

Oaks argues that it protects its MLRs by the acquisition of what it refers to as key real estate. This may include:

- Lots in a building dedicated as office or reception areas;
- Lots to which are attached by-laws conferring special rights or privileges on the owner or occupier of the lot; and
- Adjacent land from which it would be possible to conduct a letting business.

In a letter to ASIC dated 26 February 2010 Oaks said that in entering into letting agreements with bodies corporate to be the exclusive letting agent, it ensured that it generally protected its exclusive legal rights by also purchasing the freehold associated with the relevant reception and office areas. However it did not point out

at that stage that there were often attached to the lots it purchased by-laws which conferred special rights or privileges on the owner or occupier of those lots.

By-Laws

Oaks points out that a significant element of the legal rights comprising the MLRs are the rights conferred by by-laws to use particular lots, or in some cases defined areas of the common property, as offices or reception areas.

Some of the by-laws also confer on the owner or occupier of a specific lot the exclusive right to carry on the business of a letting agent from that lot and prohibit the owners corporation or body corporate from permitting a business of a similar nature to be conducted from any other lot or the common property.

In addition in some cases the by-laws grant to the owner of the relevant lot building naming rights and the right to erect signs on the common property.

Oaks contends that the by-laws are often the most relevant instrument in analysing the viability of a business and measuring its capacity to continue to operate on an ongoing basis. Indeed during the course of the proceedings Mr Myers of Small Myers Hughes, a firm of lawyers who specialise in the area of management letting rights, who had acted for Oaks in a number of the relevant transactions and who gave expert evidence on behalf of Oaks, commented that "By-laws are the key" (as compared to the letting agreements) in protecting the value of the MLRs.

The Panel notes that although there was a brief mention of the relevance of by-laws in a letter from Oaks to ASIC dated 29 July 2010, it was not until Oaks' first submission to the Panel on 26 August 2010 that comprehensive details of the by-laws and body corporate rules applicable to Oaks' properties were provided to the Panel or, apparently, to ASIC.

The Panel also notes that, in general, by-laws attached to a particular lot can only be amended or repealed with the consent of the owner of that lot so that they endure for the life of the building.

Market Value of MLRs

Oaks argues that the market value of the existing MLRs is significantly in excess of their book value. ASIC argues, and the Panel agrees, that the market value of the letting rights is not relevant to the requirement to amortise the cost of the letting rights over their useful life. As ASIC points out, amortisation is not a method of valuing an asset, but rather of allocating the cost of the asset as an expense over the period during which the asset is available for use by the entity.

Valuation Practice

Oaks also notes that, consistent with market practice, the price paid for MLRs (and the approach taken by independent valuers in valuing MLRs) is not based on the contractual life but implicitly factors in the expectation of contracts being renewed unless there is a dispute with the relevant body corporate that is likely to result in non-renewal.

In support of this argument Oaks provided a copy of a recent valuation by CB Richard Ellis of one of Oaks' properties. The Panel notes that the management rights business was valued on the basis of 4.25 times the estimated net maintainable profit. While a number of factors were taken into account in selecting the appropriate earnings multiple, the valuation made no specific reference to the unexpired term of the existing letting agreements.

Real Estate Licence

Oaks points out that Oaks Hotels & Resorts Limited (and where appropriate its controlled entities) are licensed Real Estate Agents in each of the states in which it operates. It says that as a licensed Real Estate Agent it is legally able to conduct the business of letting apartments in a building like any other Real Estate Agent, regardless of whether or not it has exclusive rights granted to it under a letting agreement with the relevant body corporate.

The Panel notes that whilst the holding of a real estate agent's licence is an important component of the legal rights constituting the MLRs, it does not of itself put Oaks in a stronger position than any other potential operator who also holds a real estate agent's licence.

Auditors' Opinion

The Panel notes that the Auditors' Report on Oaks' financial report for the year ended 30 June 2009 is unqualified and that Oaks' auditors have provided a letter to Oaks, which Oaks has included in its written submissions to the Panel, in which the auditors say that on the basis of the factors referred to in their letter, taken as a whole, the amortisation of the management letting rights for a period longer than the contract term and contracted option periods is not inappropriate.

They go on to say that based on the above factors, the management letting rights are clearly long term in nature. The primary limitation of the period over which the economic benefits from the management letting rights are expected to be enjoyed is the life of the building. Consistent with this fact pattern, the company has used a period of 40 years or less, as the case may be, as a proxy for the life of the building and amortised the rights over that period, which again in these circumstances, they say, is not inappropriate.

Whilst the opinion of the company's auditors is in no way conclusive of the dispute between Oaks and ASIC, it is a factor which the Panel has taken into account.

The Panel's View

ASIC's arguments have tended to focus on the contractual rights created by the letting agreements and to treat the other matters raised by Oaks as pertaining to the ability of Oaks to renew those agreements.

In focussing on the contractual rights, ASIC also sought to argue that "renewal" in the context of paragraphs 94 and 96 of AASB 138 referred to the exercise of an option contained in an existing contract.

This may be explained in part by the fact that although there was a brief reference in a letter from Oaks to ASIC dated 29 July 2010 to the relevance of the by-laws, it was not until after the Referral had been lodged with the Panel that comprehensive details of the by-laws were provided by Oaks to the Panel and ASIC.

However during the course of the proceedings it became clear to the Panel that the intangible asset described in Oaks' financial report as Management Lettings Rights was not limited to the contractual rights conferred by the letting agreements but in fact comprised a congeries of both contractual and other legal rights.

On this view, the possibility of renewing or extending the terms of the letting agreements is only one factor to be taken into account in determining the useful life of the Management Letting Rights.

This view is supported by the fact that paragraphs 94 and 96 of AASB 138 refer to both contractual rights and other legal rights.

The other major factor which the Panel has taken into account is the practice of "topping up" letting agreements.

Both in his oral evidence and in a subsequent written submission Mr Myers confirmed that it is a common occurrence for building managers to seek to "top up" the terms of letting agreements over and above any option for renewal contained in the relevant agreement.

In explanation of this practice he says that the relevant Queensland legislation prohibits the total unexpired term of a letting agreement (including options) from exceeding 25 years from the date of the body corporate meeting approving the additional option.

He says that in practice his firm prepares a Deed of Variation that adds a further option. In the event that a client wishes to top up for more than five years, a Deed of Authorisation is generally entered into, which effectively creates a new letting authorisation on substantially the same terms as the previous agreement and starts the whole 25 year term anew.

He says that generally financiers require borrowers to make an application to the relevant body corporate to top up the term of their agreements when a particular proportion of the term has elapsed.

Mr Myers' position is supported by letters from two other firms of solicitors who he says handle more than 50% of the total of all management rights transactions in Queensland and New South Wales.

One of these submissions was from John Mahoney of Mahoney Lawyers, who says that he has practised in property law for some 30 years and has specialised in management rights for the last 20 years. He says that he has represented the management rights industry in negotiations with the Queensland and Federal Governments since 1994. He explains the industry practice of top-ups as follows:

"The renewability or topping up of management rights agreements are one of the main reasons why management rights have the value attributed to them. Whilst management rights agreements might be for an initial term of 10 years, 15 years, 25 years or some other period, there is an inevitable expectation that the agreements will not end but will be topped up or that new agreements will be entered into at some stage during the term of, and to replace, the existing agreements.

Typically, as specifically contemplated by the legislation, a manager will, well before the end of a the term of an existing agreement, add a further option to the agreement or secure new, longer term agreements to replace the existing agreements. All that is required to do either of those is a simple majority of those owners who vote at the relevant general meeting. This process is quite distinct to simply exercising existing options.

Renewing existing agreements, or topping up existing agreements as it is commonly referred to, is a very common practice. It is also quite common to have new longer term agreements entered into to replace existing agreements. It is extremely rare for a Body Corporate to vote against either of these processes particularly where a majority or many of the owners are investor owners who depend upon the manager to let out their units to derive the rental income. From my experience, in these types of buildings, there would be less than 1% of buildings where a Body Corporate might vote against such a proposal."

Having regard to the implementation guidance contained in AASB 138 in respect of the determination of the useful life of intangibles, that both legal and economic factors need to be considered, and having regard to the advice that top-ups of letting agreements beyond their legal term (inclusive of options for renewal) are commonplace in practice, the Panel is of the view that Oaks has taken the necessary steps to ensure that its letting agreements will be renewed. The term of the individual letting agreements is therefore not limited to the legal term and renewal options specified in the agreement but includes the top ups which Oaks is able to procure by virtue of the freehold it owns, the special rights and privileges contained in the by-laws attached to some of the lots it owns and the relationship it has established with the investors in respect of the management of the building and the management and letting of their units.

Accordingly, the Panel believes that there is sufficient evidence that renewal as required in Paragraph 96(a) will occur and that Oaks' practice of amortising MLRs over the life of the associated buildings is consistent with the requirements of AASB 138.