



Our ref: ICAEW Rep 167/12

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Dear Jennifer

UITF Information Sheet 92 *Residents' Management Companies Financial Statements*

ICAEW is pleased to respond to the request for comments on UITF Information Sheet 92 *Residents' Management Companies Financial Statements*.

We would like to thank the Accounting Council for the flexibility shown in allowing us sufficient time to obtain new information and to be able to put in a fuller response, which we hope that the Council will find of use. There is a significant amount of complexity surrounding the accounting obligations applicable to the typical RMC. Views vary as to the most effective way to discharge these. In the response attached we explore these issues in more detail and suggest a way forward for the UK GAAP company accounts of RMCs.

Please do get in touch should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW REPRESENTATION

UITF Information Sheet 92 *Residents' Management Companies Financial Statements*

Memorandum of comment submitted in November 2012 by ICAEW, in response to UITF Information Sheet 92 *Residents' Management Companies Financial Statements* published in May 2012.

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on Information Sheet 92 *Residents' Management Companies Financial Statements*, published by the UITF on 10 May 2012.

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council (FRC). We provide leadership and practical support to over 138,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.
3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.
4. The Financial Reporting Faculty is recognised internationally as a leading authority on financial reporting. The Faculty's Financial Reporting Committee is responsible for formulating ICAEW policy on financial reporting issues, and makes submissions to standard setters and other external bodies. The faculty also provides an extensive range of services to its members, providing practical assistance in dealing with common financial reporting problems.
5. This response reflects consultation with many ICAEW members with experience in this area and with the Service Charges Working Party of the ICAEW Business Law Committee. Business Law Committee includes representatives from public practice and the business community and is responsible for ICAEW policy on business law issues and related submissions to legislators, regulators and other external bodies.

ICAEW COMMENTS

Clarification of Residents' Management Company (RMC) accounting requirements is long overdue

6. We appreciate the efforts of the UITF in tackling this topic. There are large numbers of RMCs in the UK and the sector has been growing and evolving in recent years – not least through the emergence of 'right to manage' companies following the 2002 *Commonhold and Leasehold Reform Act*. As the number of RMCs has expanded and the law has evolved, questions have increasingly been asked about the appropriateness of the models typically used to discharge the RMC's accounting obligations. Clearer guidance has been called for, particularly by many in the sector exposed to the practical difficulties that can be caused where inappropriate accounting information is presented to lessees. In some cases, accounts have been rejected in tribunal hearings where they have, for example, not distinguished service charge disbursements from other expenditure incurred by the RMC.
7. The complexity here arises largely from the fact that RMCs have in effect a triple accounting obligation.
 - a) As companies, they are accountable to members and must prepare statutory accounts for them.
 - b) They are also likely to be accountable under their leases to lessees and therefore must provide information to these individuals about service charges paid and expended.
 - c) In addition, those paying service charges have a right under the Landlord and Tenant Act 1985 to demand a 'statement of charges' detailing certain information about service charges paid.

To address the issue of reporting for lessees, in 2011 a joint professional body working party, managed by staff of the ICAEW Business Law Committee, issued **TECH 3/11** to provide guidance on the preparation of 'service charge accounts' produced to address the accounting requirements of the lease. This working party had originally examined the RMC's company reporting obligations as well, but were unable to agree on the most appropriate treatment in these accounts, leading to the approach to the UITF.

8. There is a strong case for clear articulation of the principles underlying the RMC's statutory company accounts in the interests of RMC directors, members, creditors and leaseholders, and of the preparers of RMC financial information. Once the principles underpinning RMC statutory accounts have been clarified, ICAEW and other interested bodies can assess the need to provide further resources for these entities. These resources could help clarify how the lessee and Companies Act reporting requirements interact and how both can be discharged in the most efficient way.
9. It is important that any company accounting solution is not unnecessarily complex; lessees and RMC members (often but not always the same individuals) require clear financial information. In many cases, the affairs of RMCs are straightforward. Indeed, many RMCs are micro-entities. It would be highly unfortunate if the contribution accountants make to transparency and accountability in this sector was undermined by the imposition of financial reporting requirements that reduced the practical value of the information provided to users. It would certainly be most efficient if the base data prepared to satisfy the statutory company accounting requirements could be drawn upon in preparing accounting information for lessees.

Service charge accounts: the wider debate

10. We acknowledge that the scope of the Abstract is limited, quite appropriately, to a consideration of the relevant UK GAAP accounting issues and we explore these in some detail in the paragraphs that follow. Before we do so, it might help set the scene if we explain that we have from our extensive consultations identified a range of views on the most practical solution for those relying on RMC financial information. Opinions about how most efficiently to discharge the RMC's triple reporting obligations vary. This complexity is compounded by the fact that, while many RMCs are very small and the information needs of tenants relatively straightforward, other RMCs are much larger and look after multiple properties, as well as holding their own interests which, for example, may yield ground rents.
11. Leasehold industry specialists, with extensive experience of tribunal cases, favour the production of separate service charge accounts to ensure that the accounting requirements of the lease are complied with. They point to settled tribunal cases where, without separate service charge information, the accounts have proven inadequate when relied upon to support a proceeding. With these service charge accounts then available for leaseholders, they feel that the statutory accounts often convey less useful information.
12. Many accounting practitioners, by contrast, view the production of separate service charge accounts as unduly burdensome. The term 'RMC' covers a range of different entities, managing blocks of different sizes and compositions. Some own the freehold and collect ground rents and premiums on lease extensions, some may receive income from a variety of additional sources. But many RMCs are very small and their affairs straightforward, encompassing only the service charge transactions for a single property. From their regular contact with RMC accounts-users, these accountants suggest that a simple set of accounting information is adequate to meet the information needs of individuals who are both leaseholders and members of the company (and both sets of individuals are exactly the same) and at the same time discharge the statutory reporting obligations of the RMC. After all, the production of service charge accounts for lessees does not alter the legal requirement to prepare company accounts for the RMC. RMC statutory accounts have to be prepared and presented to members by law, and it is important, they argue, that those accounts contain information that is useful. Lessees, they point out, have in any case the right to demand a 'statement of charges' if

they require specific information about service charges paid. This statement should only contain items allowed under the lease.

RMCs are seeking greater certainty about the accounting treatment they should adopt

13. In reaching a consensus on this issue, the UITF essentially re-articulated the principles of Application Note G to FRS 5. We agree with this approach. The Application Note already establishes a clear precedent for the accounting treatment to be adopted by entities acting as agent or principal and it is therefore natural that the Abstract reflects this.
14. It is unfortunate however, that having identified the appropriate reference in UK GAAP, the Abstract is unable to specify with certainty which of the two treatments RMCs should adopt in practice. It is a rather cumbersome solution to require each individual RMC to assess the capacity in which it acts. Although the test is already established in UK GAAP, the Abstract would be most effective if it could indicate on which side of it RMCs are likely to fall.

A presumption that RMCs act as principal

15. ICAEW has obtained further legal advice suggesting that RMCs invariably act as principal in their transactions with suppliers of goods and services. It has already been established that service charge monies are invariably received, and held, on trust by the RMC. We have subsequently obtained further legal clarification in this area. Counsel concluded that, as trustee, the RMC acts to procure goods and services to discharge its obligations under the lease. Individual lessees have a contractual relationship with the RMC to receive services, and it is then up to the RMC how it provides these. There is generally no recourse from the lessee to the third party supplier; if the lessee is dissatisfied with the service, recourse would be to the RMC. In making its recommendations to the FRC, the Accounting Council will clearly wish to perform its own evaluation of this advice, but it appears that it may be possible to state with certainty in the Abstract that the RMC acts as principal. On this basis, we assume that the service charge transactions would always be required to be reported in the RMC's profit and loss account. From a practical perspective, the Accounting Council should be aware that this does perhaps mean, where separate service charge accounts are prepared, that transactions may be duplicated between the two documents; although in cases where the company and lease year-ends are consistent, the same data set might be used to populate both reports.

The need for transparency over the service charge cash balance

16. This advice may help the Accounting Council determine how service charge transactions ought to be treated, but it does not address the accounting for any service charge cash the RMC might hold at the year-end. The draft Abstract references here an earlier legal opinion received by ICAEW, with paragraph A12 explaining that the UITF gave 'careful consideration' to whether counsel's conclusions were appropriate. It is of course appropriate for counsel's opinion to have been considered carefully during the UITF's deliberations. But in our view, the Council should make its own determination as to whether, on the basis of all the evidence, the service charge cash is an asset of the RMC in accounting terms on a substance over form basis; the legal view on the trust status alone cannot in our view be definitive with reference to the accounting. This important point is discussed further below.
17. We have consulted widely with our members on this issue, and many feel that it is of paramount importance that there is transparency over any service charge cash held at the year-end. Lessees and other users have a high level of interest in these accounts, and one of their areas of focus is invariably the amount of unspent service charge contributions that the RMC holds. It does therefore seem desirable in principle for service charge monies to be clearly visible when users refer to the RMC balance sheet. Accounts showing the service charge transactions but not the residual cash balance relating to leaseholder monies are likely to be viewed by constituents as a poor compromise. Some may even consider such accounts to be misleading.

The Accounting Council should evaluate whose asset the service charge monies are

18. The Statement of Principles establishes criteria for assessing whether a particular resource is an asset. Preparers would look at whether an entity has both the right to deploy the resource and to enjoy the benefits of deployment. There seems no doubt that service charge cash passes the first leg of this test. But because the cash is held on trust, the ability of the RMC to benefit from it is strictly limited. Due to the importance of this question, we asked counsel to explore in more detail the legal facts and circumstances in this second area.
19. Although a number of factors were evaluated, counsel was unable to determine any material ways in which the RMC could benefit legally. It may be possible, contingent on certain other events occurring, for the RMC to obtain ownership of the cash in the future when all leases expire, but there is only a remote possibility of this crystallising. As the cash is held on trust, the RMC can only generally use it to disburse qualifying service charge expenses. When these expenses occur, the RMC, in any case, has a right to recover them from the lessee. Therefore legally, there would be some ambivalence over whether the RMC was in a different position by holding the cash directly as opposed to where it was still retained by lessees or had been collected, but was held by a managing agent. The RMC would not, in a legal sense, be in a more advantageous position simply because it had cash available in the trust fund.
20. However, at this point we suggest that the Council might consider whether it is the legal status of the cash balance that is the most salient factor in determining its accounting treatment. FRS 5 establishes the principle that the substance underlying an accounting transaction should take precedence over its legal form. The Council may wish to consider the implications of that principle in this case. In doing so, it is pertinent to consider, in substance, whose asset the cash is. The Council could explore this by evaluating each of the possible alternatives and the evidence in each case with a view to determining, if not an asset of the RMC, whose asset the cash would be. Through such a process the Council might decide that, despite the absence of legal ownership, in substance the funds are an asset of the RMC. Such a decision could be viewed as analogous to the position of finance leases – despite the lack of legal ownership these are recognised as assets (and liabilities) in the interests of good accounting practice. An analogy could also be drawn to ESOP trusts. Similar to the funds received by ESOPs, residential service charge monies are held in trust. UITF 38 *Accounting for ESOP Trusts* requires that ESOP monies are recognised as assets of the entity. Charities also recognise the cash they hold, regardless of any restrictions as to its use. However, while it might appear that there is a case for consistency here, it should also be noted that pension schemes do not recognise the assets they hold in trust. Given the diverging accounting treatments applying to situations where reporting entities hold assets on trust, we suggest that the Accounting Council should take an overall substance over form view for RMCs, which is possible given the legal position that apparently pertains in all RMC cases.
21. Whether or not the Council decides that the service charge cash should be recognised in the balance sheet, it is important that the cash is not simply omitted from the accounts altogether. Therefore, if the balance is not shown within assets, it might be appropriate to include it as a separate memorandum item below the balance sheet numbers. It might also be useful to present the balance on any service charge reserve separately here. If these presentational concerns are considered to be outside the Council's remit, they might be explored as part of extended RMC accounting guidance that could if necessary be developed by ICAEW and other interested bodies to complement the final Abstract (or equivalent Financial Reporting Council pronouncement).
22. We suggest that thought should also be given to the credit side of the entry. We believe that some entities may previously have included 'sinking fund' balances within reserves. Consideration should be given as to whether this is the most appropriate treatment and how any other service charge creditor should be presented.
23. If the conclusion were reached that service charge cash should be recognised in the RMC balance sheet, this leads to a further question about how it should be presented and whether

any additional disclosures should be made. We are advised that there are practical reasons why it is desirable for the service charge cash to be segregated from any other cash balances the RMC may hold. It appears to be important, for example, that the RMC has access to its own resources, within the company, as a buffer fund. The RMC can only use the service charge cash to pay for qualifying items under the lease. If expenditure was to occur that did not qualify, perhaps because it was not envisaged in the drafting of the lease or because it relates solely to the company, the company needs to have the ability to deal appropriately with this. If it is not adequately funded, there is a risk it could become insolvent. There may therefore be a need for either the FRC to extend the scope of the Abstract to address this presentational issue, or for the matter to be addressed through any future ICAEW guidance. Further narrative disclosures explaining the restrictions on trust cash are also likely to be desirable. Further thought may need to be given to how practically to approach the situation where all monies are held by a managing agent rather than the RMC itself.

The UITF was right to limit the scope of the Abstract to RMCs

24. We note that paragraph 5 of the Abstract limits its scope to RMCs (which should in fact be ‘Residents’ not ‘Residential’ Management Companies). We agree with this focus and strongly suggest that in issuing the final Abstract the FRC should explicitly retain this limitation. Although there are other entities that are ‘landlords’ of residential leasehold property, for example companies that own large numbers of residential freeholds, we do not believe there is any compelling case for extending the scope of the Abstract. Social Housing providers who apply the Registered Social Landlord SORP 2010 are already required to recognise service charge transactions. For other entities, the accounting treatment for agents and principals is clearly set out in Application Note G and we are not aware of non-RMC landlords having any particular difficulties in interpreting this aspect of UK GAAP. The Abstract deals with a practical application issue for a particular class of entity. If similar application issues exist elsewhere, these should be considered as a separate exercise.
25. Nevertheless, the Council does need to consider the implications were non-RMC landlords to feel it necessary to extrapolate the principles set-out in the Abstract to their own circumstances. For landlords with multiple freeholds currently applying agent accounting, the costs of complying with the Abstract could be significant. Service charge information may not otherwise be consolidated and therefore this new requirement could necessitate an extensive additional exercise. Lease year-end dates may differ and might not be consistent with that of the landlord. In finalising their recommendations for the FRC the Council might like to consider consulting with some major landlords to understand any concerns that they may have.

Publication of the Abstract may need to be accompanied by further sector guidance

26. If revised as suggested above, the Abstract will clarify the contents of the statutory accounts that RMCs are required to prepare under the Companies Act. However, this is not the only applicable reporting obligation, as discussed above. These reporting obligations are outside the scope of the Accounting Council's exercise, but in making its final recommendations to the FRC the Accounting Council should be aware that there is likely to be a demand from constituents for guidance to assist RMCs in discharging their reporting obligations more holistically. **ICAEW TECH 3/11** provides guidance for the preparation of residential service charge accounts, but explicitly excludes consideration of the Companies Act reporting requirements of the RMC. And although the Abstract will be useful in establishing the principles underlying these accounts, there are likely to be other questions pertaining to the statutory accounts that it does not address. These questions might also include how any cash balance that mixes RMC and trust monies should be segregated in the accounts; this will depend on how far the FRC is prepared to go in the guidance it gives. Therefore, once the conclusions of the FRC have been published, industry guidance addressing these considerations may need to be provided. It will be important to ensure that any such guidance is published on a timely basis.

Practical benefits from segregating service charge transactions and cash

27. One crucial area that the Abstract does not currently address is the extent to which any service charge transactions or balances recognised in the accounts should be segregated from any transactions or balances the RMC may enter into entirely on its own account, i.e. outside any lease arrangements. It is important to note that some RMCs have other sources of income; for example from ground rent, lease renewals, mobile phone aeriels, parking fees, and rents. The monies received from such income will not be subject to trust and would therefore be the property of the RMC. If the service charge cash is recognised in the balance sheet, it would appear sensible to segregate out in the accounts this service charge cash, held on trust, from other funds of the RMC to which the trust does not apply. It may also be appropriate to segregate the related income and expenditure. This is an important issue for RMC accounts, but may be one better tackled through sector guidance rather than within the Abstract.

An effective date of 31 December 2012 is too early

28. The draft Abstract proposes an effective date of 31 December 2012. We are conscious following our extensive investigations over the past few months that it may take some time both to finalise the Abstract and to devise any new guidance to accompany it. It is essential that adequate time is available to ensure that the effects of the new literature can be properly evaluated and that preparers have adequate time to plan for implementation. The practical effects of the change may only be apparent to preparers once further guidance is available. We thus strongly suggest that an effective date of accounting periods *beginning* on or after 1 January 2013 be considered. Application should be prospective, but importantly early adoption should be permitted.

29. If you have any questions regarding the comments above, please do not hesitate to contact Nigel Sleigh-Johnson (Nigel.Sleigh-Johnson@icaew.com) or myself. We would be happy to meet with you to discuss the issues raised.

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